

the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Phlx. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-Phlx-2008-35 and should be submitted on or before June 12, 2008.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>24</sup>

**Florence E. Harmon,**  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33-8918; 34-57819; File No. 265-24]

### Subcommittee Reports of the SEC Advisory Committee on Improvements to Financial Reporting

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Request for comments.

**SUMMARY:** The Advisory Committee is publishing four subcommittee reports that were presented to the Advisory Committee at its May 2, 2008 open meeting and is soliciting public comment on those subcommittee reports. The subcommittee reports contain the subcommittees' updates of their work through the May 2, 2008 open meeting and contain preliminary hypotheses and other material that will be considered by the full Committee in developing recommendations for the Committee's final report.

**DATES:** Comments should be received on or before June 23, 2008.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/other.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number 265-24 on the subject line.

#### Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Federal Advisory Committee Management Officer, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File No. 265-24. This file number should be included on the subject line if e-mail is used. To help us process and review your comment more efficiently, please use only one method. The Commission will post all comments on its Web site (<http://www.sec.gov/about/offices/oca/acifr.shtml>). Comments also will be available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

#### FOR FURTHER INFORMATION CONTACT:

Questions about this release should be referred to James L. Kroeker, Deputy Chief Accountant, or Shelly C. Luisi, Senior Associate Chief Accountant, at (202) 551-5300, Office of the Chief Accountant, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-6561.

**SUPPLEMENTARY INFORMATION:** At the request of the SEC Advisory Committee on Improvements to Financial Reporting, the Commission is publishing this release soliciting public comment on the subcommittees' reports. The full text of these subcommittee reports are attached as Exhibits A-D and also may be found on the Committee's Web page at <http://www.sec.gov/about/offices/oca/acifr.shtml>. The subcommittee reports contain the subcommittees' updates of their work through the May 2, 2008 open meeting of the full Committee and contain preliminary hypotheses and other material that may be deliberated by the full Committee in considering recommendations for the Committee's final report. As such, the Committee would like to request public input on the material in these subcommittee reports. The subcommittee reports have been prepared by the individual subcommittees and do not necessarily reflect either the views of the Committee or other members of the Committee, or the views or regulatory agenda of the Commission or its staff.

All interested parties are invited to comment on the enclosed subcommittee reports. Comments on the reports are

most helpful if they (1) Indicate the specific exhibit and paragraph to which the comments relate, (2) contain a clear rationale, and (3) include any alternative(s) the Committee should consider.

**Authority:** In accordance with Section 10(a) of the Federal Advisory Committee Act, 5 U.S.C. App. 1, § 10(a), James L. Kroeker, Designated Federal Officer of the Committee, has approved publication of this release at the request of the Committee. The solicitation of comments is being made solely by the Committee and not by the Commission. The Commission is merely providing its facilities to assist the Committee in soliciting public comment from the widest possible audience.

Dated: May 15, 2008.

**Nancy M. Morris,**  
Committee Management Officer.

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

#### Exhibit A

### SEC Advisory Committee on Improvements to Financial Reporting Substantive Complexity Subcommittee Update

#### May 2, 2008 Full Committee Meeting

#### I. Introduction

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

<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.

<sup>24</sup> 17 CFR 200.30-3(a)(12).

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 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 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.

<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.

#### 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.

### 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

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

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

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.

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 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

<sup>6</sup> Refer to appendix A 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

<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.

a mere 1% difference in the results of the quantitative tests leads to very different accounting.

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-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 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

<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.

<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.

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.

<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).

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 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 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, 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>

<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

<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.

○ 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 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 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 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

business activities—income taxes and discontinued operations.

<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.

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 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>

#### RECONCILIATION OF THE STATEMENTS OF INCOME AND CASH FLOWS

	Cash flow statement	Non-cash items affecting income				Income statement (A+B+C+D+E)	
		Cash flows not affecting income	Accruals and systematic allocations	Recurring valuation changes	Other valuation changes		
	A	B	C	D	E	F	
Operating:							
Cash received from sales.	2,700,000	.....	75,000	.....	.....	2,775,000	Sales.
	0	.....	(9,000)	.....	.....	(9,000)	Depreciation expense.
	0	.....	.....	.....	(15,000)	(15,000)	Impairment expense.
	0	.....	.....	(7,500)	.....	(7,500)	Forward contract adj.
Investing:							
Capital expenditures	(500,000)	500,000	.....	.....	.....	0	
Sale of available for sale securities.	5,000	(4,900)	.....	350	.....	450	Realized gain on sale.
Financing:							
Interest paid .....	(125,000)	.....	(100,000)	.....	.....	(225,000)	Interest expense.

Subcommittee I preliminarily believes that the correlation of rows and columns in this schedule will help users assess different elements of financial performance, e.g., sales is comprised primarily of cash receipts, but also end of period accruals. Recognizing 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

<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.

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



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.

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.

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 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

<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.

<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>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.



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.

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.

## Appendix A

### 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 scoping 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 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.

### 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

<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.”

<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.

derecognition of pension and other post-retirement benefit obligations via settlement, curtailment, or negative plan amendment.

- Different models for determining whether an arrangement is a liability or equity.

## Exhibit B

### SEC Advisory Committee on Improvements to Financial Reporting Standards-Setting Subcommittee Update

May 2, 2008 Full Committee Meeting

#### I. Introduction

The SEC's Advisory Committee on Improvements to Financial Reporting (the Committee) issued a Progress Report (the Progress Report) on February 14, 2008. In chapter 2 of the Progress Report, the Committee discussed its work to date on the standards-setting process, namely its:

- Developed proposals related to increased investor participation, FAF and FASB governance, standards-setting process improvements and interpretive implementation guidance;
- Conceptual approaches regarding clarifying the SEC's role in standards-setting, design of standards and the FASB's priorities; and
- Future considerations related to international governance.

Since the issuance of the Progress Report, the standards-setting subcommittee (Subcommittee II) has deliberated each of these areas further, particularly its conceptual approaches and future considerations and is in the process of refining them accordingly. This report presents a summary of Subcommittee II's latest thinking and serves as an update to the Committee. The Committee is also hosting panel discussions on May 2, 2008, in Rosemont, IL. Subcommittee II will re-deliberate each of these topics based on testimony received, guidance to be provided by the Committee and comment letters received thus far by the Committee. The Committee will deliberate any new proposals and proposed revisions to existing developed proposals in July 2008.

#### II. Current Status and Further Work

##### *International Considerations*

The Committee deferred deliberation of international considerations until 2008. Subcommittee II acknowledges that the SEC has already received significant input associated with its (1) removal of the U.S. GAAP reconciliation for foreign private issuers reporting under IFRS as promulgated by the IASB and (2) concept release on the

possibility of allowing domestic issuers to report under IFRS as promulgated by the IASB. Subcommittee II also observes that debates regarding both the end state of international convergence (that is, a single set of high quality global accounting standards) and the best way to accomplish that objective in the U.S. (that is, the transition) are underway among standards-setters, their governance bodies, the international regulatory community and others. After discussion with the SEC staff and in light of these ongoing deliberations, which include SEC staff consideration of comments received in response to the concept release, input from roundtables, and the staff's work on developing a roadmap for consideration by the Commission at the request of Chairman Cox, Subcommittee II does not intend to advance detailed proposals at this time.

Although an analysis of how the international standards-setting processes could be improved was not in the Committee's mandate, Subcommittee II believes that many of the Committee's developed proposals and conceptual approaches may be equally applicable in international standards-setting. Subcommittee II also noted that an important U.S. convergence question has not been openly debated in the public forum—how the SEC will fulfill its regulatory responsibility without creating a U.S. jurisdictional variant of IFRS.

Although not intending to recommend detailed proposals, Subcommittee II is deliberating whether the Committee should consider:

- Expressing high-level support for moving to a single set of high quality accounting standards in the U.S.,
- supporting the SEC's efforts to develop an international convergence roadmap, and
- encouraging all participants in the financial reporting community to increase coordination to foster consistency in global interpretations and avoid jurisdictional variants of IFRS.

The final determination of whether Subcommittee II's deliberations will result in a developed proposal will not be known until later in 2008.

##### *FASB Dialogue*

Since the Committee issued its Progress Report, Subcommittee II has engaged representatives of the FASB in a dialogue regarding the Committee's developed proposals and conceptual approaches. As a result of this dialogue, as well as the public comments received on the Progress Report, Subcommittee II is currently deliberating potential modifications to the Committee's

proposal for Committee deliberation as its final recommendations.

A number of tentative modifications are being contemplated, which are summarized as follows:

- International—The Committee's proposals assume that U.S. GAAP will continue to be in use for a number of years. However, convergence matters significantly drive priorities in standards-setting. Subcommittee II plans to propose clarifying the Committee's proposals that will be impacted by the ultimate path chosen by the SEC regarding international convergence.

- Governance—Subcommittee II plans to propose updating the Committee's proposals for recent changes made by the FAF, including emphasizing which proposals have yet to be fully addressed. Specifically, Subcommittee II is deliberating whether the FAF resolutions regarding increased investor representation on the FAF and FASB will meet the objective underlying the Committee's developed proposal. Subcommittee II would also like to emphasize the importance of the FAF establishing clear performance metrics related to the efficiency and effectiveness of standards-setting and may propose withdrawing the statement that academic representation should not be mandated on the FASB.

- Investors—Subcommittee II plans to propose integrating the discussion of investor pre-reviews into developed proposal 2.1 and propose clarifying that although investor involvement in standards-setting has been improved recently, more formalized, structured involvement utilizing existing advisory groups would be warranted, particularly before a document is issued for exposure. In addition, Subcommittee II plans to propose clarifying the Committee's view about the "significance" of investor involvement to further promote balanced standards-setting.

- Agenda—Subcommittee II plans to propose clarifying that the proposed Agenda Advisory Group was intended to be comprised of key decision makers from the SEC, FASB, PCAOB and other constituent groups that would meet on a real-time basis to address immediate needs in the financial reporting system at large. Such a Financial Reporting Working Group would not solely advise the FASB on its agenda. Involvement of other constituents could be effectuated by leveraging members or executive committees from existing FASB advisory groups. This may require the FAF and FASB to reevaluate the composition and responsibilities of other FASB advisory groups and agenda

committees, as well as what input is requested of them and when, to improve the efficiency and effectiveness of standards-setting.

- **Field Work**—Subcommittee II plans to propose clarifying that the intent of the proposals on cost-benefit analyses and field work were that these processes would benefit from additional consistency across major projects and transparency of the process followed and conclusions reached.

- **Periodic Reviews**—Subcommittee II plans to propose clarifying that the Committee's proposals regarding periodic reviews of new and existing standards were intended to formalize existing standards-setting processes for major projects. Subcommittee II may also propose dispensing with a bright line time requirement, due to the inconsistency of this approach with other Committee proposals and the need for the standards-setter and its advisory groups to evaluate the facts and circumstances surrounding each major project.

#### *Clarifying SEC Role in Interpreting GAAP*

Subcommittee II understands that the SEC staff is already in the process of instituting internal processes that may address many, if not all, of the points in the Committee's conceptual approach 2.A regarding SEC interpretations of GAAP. Subcommittee II is in the process of formulating a developed proposal that considers such improvements, which will be presented to the Committee for consideration in July 2008.

#### *Standards-Setting Priorities*

Conceptual approach 3.C recommends revisiting standards-setting priorities. However, Subcommittee II acknowledges that convergence matters significantly drive priorities in standards-setting and that the convergence paths being considered by the SEC will directly impact certain of the Committee's proposals and U.S. standards-setting priorities. As such, conceptual approach 2.C may not lead to a proposal being presented to the Committee, as this reprioritization is likely already being considered by those involved in the international convergence dialogue and could be addressed with assistance from the proposed Financial Reporting Working Group. However, Subcommittee II is deliberating the feasibility of a phase II codification project, subject to its path-dependency on international convergence matters, within the Committee's discussion of the FASB's current codification project and

proposed periodic reviews of existing standards. The Committee will deliberate this topic in July 2008.

#### *Design of Standards*

Subcommittee II has drafted a preliminary hypothesis related to the design of accounting standards based on conceptual approach 2.B from the Progress Report for the Committee's consideration, as follows:

*Preliminary Hypothesis:* The SEC should encourage the FASB to continue to improve the way accounting standards are written by using clearly-stated objectives, outcomes and principles that faithfully represent the economics of transactions and are responsive to investors' needs for clarity, transparency and comparability.

*Design of Standards:* As noted in the Progress Report, some participants in the U.S. financial reporting community believe that certain accounting standards do not clearly articulate the objectives, outcomes and principles upon which they are based, because they are sometimes obscured by dense language, detailed rules, examples and illustrative guidance. This can create uncertainty in the application of GAAP. Further, the proliferation of detailed rules fosters accounting-motivated structured transactions, as rules cannot cover all outcomes. As discussed in chapter 1 of the Progress Report, standards that have scope exceptions, safe harbors, cliffs, thresholds and bright lines are vulnerable to manipulation by those seeking to avoid accounting for the substance of transactions using structured transactions that are designed to achieve a particular accounting result. This ultimately hurts investors, because it reduces comparability and the usefulness of the resulting financial information. Therefore, a move toward the use of more objectives, outcomes and principles in accounting standards may ultimately improve the quality of the financial reporting upon which investors rely.

The Committee recognized in the Progress Report that the question of how to design accounting standards going forward is a critical aspect of the standards-setting process and is at the center of a decade-long principles-based versus rules-based accounting standards debate. There has been much discussion in the marketplace on this topic and there are differing views. The SEC has been a frequent participant in the debate and has long been supportive of objectives-oriented standards.<sup>29</sup> Rather

<sup>29</sup> For example, the SEC issued *Policy Statement: Reaffirming the Status of the FASB as a Designated*

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.<sup>30</sup> 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

*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.

<sup>30</sup> CEOs of the World's Six Largest Audit Networks, *A Proposed Framework for Establishing Principles-Based Accounting Standards*, Global Public Policy Symposium (January 2008).

economics of a transaction while promoting clarity, transparency and comparability for investors, it would be reasonable to provide prescriptive guidance in addition to objectives or principles.

#### **Exhibit C**

#### **SEC Advisory Committee on Improvements to Financial Reporting Audit Process and Compliance Subcommittee Update**

**May 2, 2008 Full Committee Meeting**

#### **I. Introduction**

The SEC's Advisory Committee on Improvements to Financial Reporting (Committee) issued a progress report (Progress Report) on February 14, 2008.<sup>31</sup> In chapter 3 of the Progress Report, the Committee discussed its work-to-date in the area of audit process and compliance, namely, its developed proposals related to providing guidance with respect to the materiality and correction of errors; and judgments related to accounting matters.

Since the issuance of the Progress Report, the audit process and compliance subcommittee (Subcommittee III) has received a considerable amount of public comment regarding the developed proposals included in the Progress Report. This public input includes feedback obtained during the panel discussions regarding the developed proposals in Chapter 3 of the Progress Report held during the Committee's March 13 open meeting, feedback obtained when certain members of the subcommittee met with the PCAOB Standing Advisory Group (SAG) on February 27, 2008, feedback obtained when the subcommittee met with market participants at our subcommittee meetings and the numerous comment letters received by the Committee. Based on this considerable public feedback, Subcommittee III believes that there are several areas related to the Committee's original developed proposals that warrant clarification by the Committee as well as some additional items that need to be considered by the Committee. This report represents Subcommittee III's latest thinking related to the developed proposals in Chapter 3 of the Progress Report and reflects the subcommittee's proposed clarifications for the Committee's consideration related to the original developed proposals. Subject to further public comment and Committee input, Subcommittee III will recommend these

revised developed proposals to the Committee for its consideration in developing the final report, which is expected to be issued in July 2008.

#### **II. Financial Restatements**

In the Progress Report, the Committee issued three developed proposals (developed proposals 3.1, 3.2 and 3.3) related to financial restatements. These developed proposals have been the subject of public debate and the subject of many comment letters received by the Committee. Subcommittee III believes that one cause of the debate surrounding these developed proposals relates to a lack of clarity regarding the developed proposals.

First, the developed proposals were not intended to recommend elimination of the guidance currently contained in SAB Topic 1M. Instead, the developed proposals were intended to enhance the guidance in SAB Topic 1M. As stated in the summary of SAB 99, which was codified in SAB Topic 1M, "This staff accounting bulletin expresses the views of the staff that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold." Subcommittee III believes that the guidance in SAB Topic 1M is appropriate and accomplishes what it was intended to do, which is to address situations where errors were not being evaluated for materiality simply due to the relatively small size of the error. As the SEC staff noted in SAB 99, this concept was not consistent with the total mix standard established by the Supreme Court. SAB Topic 1M was not written to address all situations one must consider when determining if an error is material, yet in practice, SAB Topic 1M is often cited as the guidance to use in all materiality decisions. Because SAB Topic 1M primarily addresses one issue, which was to correct the misperception in practice at the time that small errors need not be evaluated for materiality solely based on their size, Subcommittee III believes that this has resulted in less consideration to the total mix of information in the evaluation of whether an error is material or not. Since this is not consistent with the standard established by the Supreme Court or as we understand it the intent of SAB Topic 1M, Subcommittee III believes that additional guidance is needed to supplement the guidance contained in SAB Topic 1M.

Second, there have been some additional studies of restatements that have been published since the issuance of the Progress Report. The most significant study is the study commissioned by the U.S. Treasury entitled "The Changing Nature and Consequences of Public Company Financial Restatements 1997–2006", conducted by Professor Susan Scholz of the University of Kansas. Subcommittee III believes that the results of this study are not inconsistent with the developed proposals in the Committee's Progress Report.

Third, Subcommittee III believes clarifications are needed related to the use of the term "current" investor in the Progress Report. Some have concluded that this term only refers to investors who currently own securities of a company. Subcommittee III did not intend the Committee's developed proposal to convey such a narrow definition of current investor, so there are proposed edits to the developed proposal to reflect that the correction of an error should be based on the needs of all investors making current investment decisions.

Fourth, there were several public comments related to the use of the term "sliding scale" in the developed proposals in the Progress Report. Many of these comments were concerned that this term was confusing and did not help explain the principles in the developed proposal. Subcommittee III does not believe that the use of this term is critical to the principles articulated in the developed proposals in the Progress Report. Therefore Subcommittee III proposes to remove the use of this term in the developed proposals.

Finally, because Subcommittee III believes that issues related to the dark period, most notably the potential high cost to investors during the dark period, are very important, a new developed proposal is being recommended by the subcommittee to highlight the importance of this issue. This new developed proposal contains substantially the same wording that was included in the Progress Report, but has been moved to give more prominence to this important issue.

#### **III. Judgment**

Similar to the reaction to the Committee's developed proposals related to restatements in the Progress Report (Developed Proposals 3.1, 3.2 and 3.3), there has been much public comment related to the Committee's developed proposal 3.4 in the Progress Report related to professional judgment. Subcommittee III believes that the comments it has received during this

<sup>31</sup> Refer to Progress Report at <http://www.sec.gov/rules/other/2008/33-8896.pdf>.

process have been very helpful to its continuing deliberations on this matter. Based on the comments received, Subcommittee III believes that some changes are necessary to the developed proposal 3.4 in the Progress Report to allow the developed proposal to meet the goals established in that Progress Report without the risks that the subcommittee has been concerned about from the beginning, such as the risk that the developed proposal devolve into a checklist-based approach to making judgments and the risk that the proposed framework could be used as a shield to protect unreasonable judgments.

The primary change that Subcommittee III believes should be made is to refocus the developed proposal away from a recommendation for a framework. While Subcommittee III believes that there is great merit in the idea of a framework, the term "framework" can imply a mechanistic process. Making and evaluating judgments can involve a process, but the notion of a process is dangerous because it implies that an outcome can be achieved. Indeed, no matter how robust a process one uses to make judgments, there can be no guarantee that the outcome will be reasonable. Instead, Subcommittee III believes that a preferable way to accomplish the goals set forth in the Progress Report would be to have the SEC formally articulate in a statement of policy how the SEC evaluates judgments, including the factors that it uses as part of its evaluation. Therefore, Subcommittee III believes the developed proposal should be changed to formally propose such a statement of policy to be issued.

Some commenters have stated that developed proposal 3.4 in the Progress Report advocates a safe harbor be established for the exercise of professional judgment. Subcommittee III did not intend to advocate any particular way for the implementation of developed proposal 3.4. Instead, this decision was left to the SEC. With the change in focus outlined above, Subcommittee III believes that a statement of policy would be the preferred way to implement the revised proposal and therefore, there should be no reference to a safe harbor in the revised Chapter 3.

Subcommittee III also proposes to remove the use of the term professional when referring to judgment. Subcommittee III believes that there could be a misunderstanding that the term "professional" implies that one must have a professional certification in order to make or evaluate a professional judgment. While Subcommittee III

believes that such professional certifications are important, it did not intend to suggest such a requirement for the application or evaluation of accounting judgments.

## Appendix A

Subcommittee III has included as Appendix A to this update a revised version of Chapter 3 from the Progress Report that reflects the proposed edits for the Committee's consideration.

## Chapter 3: Audit Process and Compliance

### I. Introduction

We have concentrated our efforts to date regarding audit process and compliance on the subjects of financial restatements, including the potential benefits from providing guidance with respect to the materiality<sup>32</sup> and correction of errors; and judgments related to accounting matters: Specifically, whether guidance on the evaluation of judgments would enhance the quality of judgments and the willingness of others to respect judgments made.

### II. Financial Restatements

#### II.A. Background

##### Likely Causes of Restatements

The number of financial restatements<sup>33</sup> in the U.S. financial markets has been increasing significantly over recent years, reaching approximately 1,600 companies in 2006.<sup>34</sup> Restatements generally occur because errors that are determined to be material are found in a financial statement previously provided to the public. Therefore, the increase in restatements appears to be due to an increase in the identification of errors that were determined to be material.

The increase in restatements has been attributed to various causes. These include more rigorous interpretations of

accounting and reporting standards by preparers, outside auditors, the SEC, and the PCAOB; the considerable amount of work done by companies to prepare for and improve internal controls in applying the provisions of section 404 of the Sarbanes-Oxley Act; and the existence of control weaknesses that companies failed to identify or remediate. Some have also asserted that the increase in restatements is the result of an overly broad application of the concept of materiality and misinterpretations of the existing guidance regarding materiality in SAB 99, *Materiality* (as codified in SAB Topic 1M). SAB Topic 1M was written to primarily address a specific issue, when seemingly small errors could be material due to qualitative factors, however, the guidance in SAB Topic 1M is often utilized in all materiality decisions. As a result of this overly broad application of SAB Topic 1M, errors may have been deemed to be material when an investor<sup>35</sup> may not consider them to be important.

It is essential that companies, auditors, and regulators strive to reduce the frequency and magnitude of errors in financial reporting. When material errors occur, however, companies should restate their financial statements to correct errors that are important to current investors. Investors need accurate and comparable data, and restatement is the only means to achieve those goals when previously filed financial statements contain material errors. Efforts to improve company controls and audit quality in recent years should reduce errors, and there is evidence this is currently occurring.<sup>36</sup> We believe that public companies should focus on reducing errors in financial statements. At the same time, we believe that some of our developed proposals in the areas of substantive complexity, as discussed in chapter 1, and the standards-setting process, as discussed in chapter 2, will also be helpful in reducing some of the frequency of errors in financial statements.

While reducing errors is the primary goal, it is also important to reduce the number of restatements that do not provide important information to investors making current investment decisions. Restatements can be costly for companies and auditors, may reduce confidence in reporting, and may create

<sup>32</sup> A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

<sup>33</sup> For the purposes of this chapter, a restatement is the process of revising previously issued financial statements to reflect the correction of a material error in those financial statements. An amendment is the process of filing a document with revised financial statements with the SEC to replace a previously filed document. A restatement could occur without an amendment, such as when prior periods are revised in a current filing with the SEC.

<sup>34</sup> U.S. Government Accountability Office (GAO) study, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates* (March 2007), and Audit Analytics study, *2006 Financial Restatements A Six Year Comparison* (February 2007).

<sup>35</sup> We use the term investor to include all people using financial statements to make investment decisions.

<sup>36</sup> A Glass Lewis & Co. report, *The Tide is Turning* (January 15, 2008), shows that restatements in companies subject to section 404 of the Sarbanes-Oxley Act have declined for two consecutive years.

confusion that reduces the efficiency of investor analysis. This portion of this chapter describes our proposals regarding: (1) Additional guidance on the concept and application regarding materiality, and (2) the process for and disclosure of the correction of errors.

#### Our Research

We have considered several publicly-available studies<sup>37</sup> on restatements. The restatement studies we have reviewed all indicate that the total number of restatements has increased in recent years. The studies also indicate that there are many different types of errors that result in the need for restatements. Market reaction to restatements may be one indicator as to whether restatements contain information considered by investors to be material. Based on these studies, it appears to us that there may be restatements that investors may not consider important. We draw this conclusion in part based upon the lack of a statistically significant market reaction, particularly as it relates to certain types of restatements such as reclassifications and restatements affecting non-core expenses.<sup>38</sup> While there are limitations<sup>39</sup> to using market reaction as a proxy for materiality, other

trends in these studies are not inconsistent with our conclusion—the trend toward restatements involving correction of smaller amounts, including amounts in the cash flow statement, and the trend toward restatements in cases where there is no evidence of fraud or intentional wrongdoing.<sup>40</sup> Also, while there is recent evidence<sup>41</sup> that the number of restatements has declined in 2007, we note that the total number of restatements is still significant. We, therefore, believe supplementing existing guidance on determining whether an error is material and providing additional guidance on when a restatement is necessary for certain types of errors, would be beneficial in reducing the frequency of restatements that do not provide important information to investors making current investment decisions.

We have also considered input from equity and credit analysts and others about investors' views on materiality and how restatements are viewed in the marketplace. Feedback we have received included:

- Bright lines are not really useful in making materiality judgments. Both qualitative and quantitative factors should be considered in determining if an error is material.
- Companies often provide the market with little financial data during the time between a restatement announcement and the final resolution of the restatement. Limited information seriously undermines the quality of investor analysis, and sometimes triggers potential loan default conditions or potential delisting of the company's stock.
- The disclosure provided in connection with restatements is not consistently adequate to allow an investor to evaluate the likelihood of errors in the future. Notably, disclosures often do not provide enough information about the nature and impact of the error, and the resulting actions the company is taking.
- Interim periods should be viewed as more than just a component of an annual financial statement for purposes of making materiality judgments.

#### II.B. Developed Proposals

Based on our work to date, we believe that, in addressing a financial statement error, it is helpful to consider two sequential questions: (1) Was the error

in the financial statement material to those financial statements when originally filed? and (2) How should a material error in previously issued financial statements be corrected? We believe that framing the principles necessary to evaluate these questions would be helpful. We also believe that in many circumstances investors could benefit from improvements in the nature and timeliness of disclosure in the period between identifying an error and filing restated financial statements.

With this context, we have developed the following proposals regarding the assessment of the materiality of errors to financial statements and the correction of financial statements for errors.<sup>42</sup>

*Developed Proposal 3.1:* The FASB or the SEC, as appropriate, should supplement existing guidance to reinforce the following concepts:

- Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor.
- Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor.

Just as qualitative factors may lead to a conclusion that a small error is material, qualitative factors also may lead to a conclusion that a large error is not material.

The FASB or the SEC, as appropriate, should also conduct both education sessions internally and outreach efforts to financial statement preparers and auditors to raise awareness of these issues and to promote more consistent application of the concept of materiality.

The Supreme Court has established that “a fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available.” We believe that those who judge the materiality of a financial statement error should make the decision based upon the interests, and the viewpoint, of a reasonable investor and based upon how that error impacts the total mix of information available to a reasonable investor. One must “step into the shoes” of a reasonable investor when making these judgments. We believe that too many

<sup>37</sup> Studies considered include the study commissioned by the Department of the Treasury, *The Changing Nature and Consequences of Public Company Financial Restatements 1997–2006*, by Professor Susan Scholz, *An Analysis of the Underlying Causes of Restatements* by Professors Marlene Plumlee and Teri Yohn, GAO study, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates* (March 2007); Glass Lewis & Co. study, *The Errors of Their Ways* (February 2007); and two Audit Analytics studies, *2006 Financial Restatements A Six Year Comparison* (February 2007) and *Financial Restatements and Market Reactions* (October 2007). We have also considered findings from the PCAOB's Office of Research and Analysis's (ORA) working paper, *Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era* (October 18, 2007), understanding that ORA's findings are still preliminary in nature as the study is still going through a peer review process.

<sup>38</sup> Professor Scholz's study defines restatements related to non-core expenses as “Any restatement including correction of expense (or income) items that arise from accounting for non-operation or non-recurring activities”. This definition includes restatements related to debt and equity instruments, derivatives, gain or loss recognition, inter-company investments, contingency and commitments, fixed and intangible asset valuation or impairment and income taxes.

<sup>39</sup> Examples of the limitations in using market reaction as a proxy for materiality include (1) The difficulty of measuring market reaction because of the length of time between when the market becomes aware of a potential restatement and the ultimate resolution of the matter, (2) the impact on the market price of factors other than the restatement, and (3) the disclosure at the time of the restatement of other information, such as an earnings release, that may have an offsetting positive market reaction.

<sup>40</sup> These trends are addressed in Professor Scholz's study.

<sup>41</sup> Glass Lewis & Co. report, *The Tide is Turning* (January 15, 2008) indicates that approximately 1 out of every 11 public companies had a restatement during 2007.

<sup>42</sup> We have developed principles that we believe will be helpful in addressing financial statement errors. In developing these principles, we have not determined if the principles are inconsistent with existing GAAP, such as SFAS No. 154, *Accounting Changes and Error Corrections*, or APB Opinion No. 28, *Interim Financial Reporting*. To the extent that the implementation of our proposals would require a change to GAAP, the SEC should work with the FASB to revise GAAP.

materiality judgments are being made in practice without full consideration of how a reasonable investor would evaluate the error. When looking at how an error impacts the total mix of information, one must consider all of the qualitative factors that would impact the evaluation of the error. This is why bright lines or purely quantitative methods are not appropriate in determining the materiality of an error to annual financial statements.

We believe that the current materiality guidance in SAB Topic 1M is appropriate in making most materiality judgments. We believe that, in current practice, however, this materiality guidance is being interpreted generally as being one-directional, that is, as providing that qualitative considerations can result in a small error being considered material, but that a large error is material without regard to qualitative factors. This one-directional interpretation is not consistent with the standard established by the Supreme Court, which requires an assessment of the total mix of information available to the investor making an investment decision. We believe that, in general, qualitative factors not only can increase, but also can decrease, the importance of an error to the reasonable investor, although we acknowledge that there will probably be more times when qualitative considerations will result in a small error being considered material than they will result in a large error being considered not to be material.<sup>43</sup>

Therefore, we recommend that the existing materiality guidance be enhanced to clarify that the total mix of information available to investors should be the main focus of a materiality judgment and that qualitative factors are relevant in analyzing the materiality of both large and small errors. We view this recommendation as a modest clarification of the existing guidance to conform practice to the standard established by the Supreme Court and not a wholesale revision to the concepts and principles embedded in existing SEC staff guidance in SAB Topic 1M.

The following are examples of some of the qualitative factors that could result in a conclusion that a large error is not material. (Note that this is not an exhaustive list of factors, nor should this list be considered a "checklist"

whereby the presence of any one of these items would make an error not material. Companies and their auditors should continue to look at the totality of all factors when making a materiality judgment):

- The error impacts metrics that do not drive investor conclusions or are not important to investor models.
- The error is a one-time item and does not alter investors' perceptions of key trends affecting the company.
- The error does not impact a business segment or other portion of the registrant's business that investors regard as driving valuation or risks.

Finally, we recommend that the enhanced guidance suggest some factors that are relevant to the analysis of errors in the cash flow statement and the balance sheet. We note that the existing guidance suggests factors that are relevant primarily to the analysis of the materiality of an error in the income statement.

Internal education and external outreach efforts can be instrumental in increasing the awareness of these concepts and ensuring more consistent application of materiality. Many of the issues with materiality in practice are caused by misunderstandings by preparers, auditors and regulators. Elimination of these misunderstandings would be a significant step toward reducing restatements that do not provide useful information to investors.

*Developed Proposal 3.2:* The FASB or the SEC, as appropriate, should issue guidance on how to correct an error consistent with the principles outlined below:

- All errors, other than clearly insignificant errors, should be promptly corrected no later than in the financial statements of the period in which the error is discovered. All material errors should be disclosed when they are corrected.
- Prior period financial statements should only be restated for errors that are material to those prior periods.
- The determination of how to correct a material error should be based on the needs of current investors. For example, a material error that has no relevance to a current investment decision would not require amendment of the annual financial statements in which the error occurred, but would need to be promptly corrected and disclosed in the current period.
- There may be no need for the filing of amendments to previously filed annual or interim reports to reflect restated financial statement, if the next annual or interim period report is being filed in the near future and that report

will contain all of the relevant information.

- Restatements of interim periods do not necessarily need to result in a restatement of an annual period.

- Corrections of large errors should always be disclosed, even if the error was determined not to be material.

We believe that all errors, excluding clearly insignificant errors, should be corrected no later than in the financial statements of the annual or interim period in which the error is discovered. The correction of errors, even errors that are not material, should not be deferred to future periods. Rather, companies should be required to correct all errors promptly and make appropriate disclosures about the correction, particularly when the errors are material, and should not have the option to defer recognition of errors until future financial statements. Notwithstanding the foregoing, immaterial errors discovered shortly before the issuance of the financial statements may not need to be corrected until the next annual or interim period being reported upon when earlier correction is impracticable.<sup>44</sup>

The current guidance that is detailed in SAB 108 (as codified in SAB Topic 1N) may result in the restatement of prior annual periods for immaterial errors occurring in those periods because the cumulative effect of these prior period errors would be material to the current annual period, if the prior period errors were corrected in the current annual period. By correcting small errors when they are identified, a company will eliminate the possibility that the continuation of the error over a period of time will result in the total amount of the error becoming material to a company's financial statements and requiring correction at that time. Newly discovered errors that had occurred over a period of time when they were not material, however, would still trigger the need for correction. In the process of reflecting these immaterial corrections to prior annual periods, some believe that the prior annual period financial statements should indicate that they have been restated.

<sup>44</sup> We understand that sometimes there may be immaterial differences between a preparer's estimate of an amount and the independent auditor's estimate of an amount that exist when financial statements are issued. These differences might or might not be errors, and may require additional work to determine the nature and actual amount of the error. This additional work is not necessary for the preparer or the auditor to agree to release the financial statements. Due care should be taken in developing any guidance in this area to provide an exception for these legitimate differences of opinion, and to ensure that any requirement to correct all "errors" would not result in unnecessary work for preparers or auditors.

<sup>43</sup> Some have argued that, under such guidance, a very large error that affects meaningful financial statement metrics could be deemed immaterial by virtue of qualitative factors. The Committee believes that when one focuses on the total mix of information, the probability of this situation occurring is remote.



There is diversity in practice on this issue, and clarification is needed from the SEC on the intent of SAB Topic 1N. We believe that prior annual period financial statements should not be restated for errors that are immaterial to the prior annual period. Instead of the approach specified in Topic 1N, we believe that, where errors are not material to the prior annual periods in which they occurred but would be material if corrected in the current annual period, the error could be corrected in the current annual period<sup>45</sup> with appropriate disclosure at the time the current annual period financial statements are filed with the SEC.

We believe that the determination of how errors should be corrected should be based on the needs of investors making current investment decisions. This determination should take into account the facts and circumstances of each error. For example, a prior period error that was material to that prior period but that does not affect the annual financial statements or financial information included within a company's most recent filing with the SEC may not need to be corrected through an amendment to prior period filings if the financial statements that contain the error are determined to be irrelevant to investors making current investment decisions. Such errors would be corrected in the period in which they are discovered with appropriate disclosure about the error and the periods impacted. This approach provides investors making current investment decisions with more timely financial reports and avoids the costs to investors of delaying prompt disclosure of current financial information in order for a company to correct multiple prior filings.

For material errors that are discovered within a very short time period prior to a company's next regularly scheduled reporting date, it may be appropriate in certain instances to report the restatement in the next filing with appropriate disclosure of the error and its impact on prior periods, instead of amending previous filings with the SEC. This option should be further studied with regard to the possibility of abuse and, if appropriate, should be included

in the overall guidance on how to correct errors.

Assuming that there is an error in an interim period within an annual period for which financial statements have previously been filed with the SEC, the following guidance should be utilized:

- If the error is not material to either the previously issued interim period or to the previously issued annual period, the previously issued financial statements should not be restated.
- If the prior period error is determined to be material only to the previously issued interim period, but not the previously issued annual period, then only the previously issued interim period should be restated (i.e., the annual period that is already filed should not be restated and the Form 10-K should not be amended). However, there should be appropriate disclosure in the company's next Form 10-K to explain the discrepancy in the results for the interim periods during the previous annual period on an aggregate basis and the reported results for that annual period.

We believe that investors should be informed about all large errors when they are corrected. Even if a large error is determined to be not material because of qualitative factors, there should be appropriate disclosure about the error in the period in which the error is corrected.

We believe that the issuance by the FASB or the SEC, as appropriate, of guidance on how to correct and disclose errors in previously issued financial statements will provide to investors higher quality and more timely information (e.g., less delay occasioned by the need for restatement of prior period financial statements for errors that are not material and for errors that have no relevance to investors making current investment decisions) and reduce the burdens on companies related to the preparation of amended reports. Since our proposal would require prompt correction and full disclosure about all material errors, all large errors that are considered to be not material as well as many other types of errors, it would enhance transparency of accounting errors and help to eliminate the phenomenon of so-called "stealth restatements"—when an error impacts past financial statements without disclosure of such error in current financial filings.

*Developed Proposal 3.3:* The FASB or the SEC, as appropriate, should issue guidance on disclosure during the period in which the restatement is being prepared, about the need for a restatement and about the restatement itself, to improve the adequacy of this

disclosure based on the needs of investors:

Typically, the restatement process involves three primary reporting stages:

1. The initial notification to the SEC and investors that there is a material error and that the financial statements previously filed with the SEC can no longer be relied upon;

2. The "dark period" or the period between the initial notification to the SEC and the time restated financial statements are filed with the SEC; and

3. The filing of restated financial statements with the SEC.

We believe that a major effect on investors due to restatements is the lack of information when companies are silent during stage 2, or the "dark period." This silence creates significant uncertainty regarding the size and nature of the effects on the company of the issues leading to the restatement. This uncertainty often results in decreases in the company's stock price. In addition, delays in filing restated financial statements may create default conditions in loan covenants; these delays may adversely affect the company's liquidity. We understand that, in the current legal environment, companies are often unwilling to provide disclosure of uncertain information. However, we believe that when companies are going through the restatement process, they should be encouraged to continue to provide any reasonably reliable financial information that they can, accompanied by appropriate explanations of ways in which the information could be affected by the restatement. Consequently, regulators should evaluate the company's disclosures during the "dark period," taking into account the difficulties of generating reasonably reliable information before a restatement is completed.

We believe that the current disclosure surrounding a restatement is often not adequate to allow investors to evaluate the company's operations and the likelihood that such errors could occur in the future. Specifically, we believe that all companies that have a restatement should be required to disclose information related to: (1) The nature of the error, (2) the impact of the error, and (3) management's response to the error, to the extent known, during all three stages of the restatement process. Some suggestions of disclosures that would be made by companies include the following:

Nature of error:

- Description of the error;
- Periods affected and under review;

<sup>45</sup> We are focused on the principle that prior periods should not be restated for errors that are not material to those periods. Correction in the current period of errors that are not material to prior periods could be accomplished through an adjustment to equity or to current period income (which might potentially require an amendment to GAAP). We believe that there are merits in both approaches and that the FASB and the SEC, as appropriate, should carefully weigh both approaches before determining the actual approach to utilize.

- Material items in each of the financial statements subject to the error and pending restatement;
  - For each financial statement line item, the amount of the error or range of potential error;
  - Identity of business units/locations/segments/subsidiaries affected.
- Impact of error:
- Updated analysis on trends affecting the business if the error impacted key trends;
  - Loan covenant violations, ability to pay dividends, and other effects on liquidity or access to capital resources;
  - Other areas, such as loss of material customers or suppliers.

#### Management Response

- Nature of the control weakness that led to the restatement and corrective actions, if any, taken by the company to prevent the error from occurring in the future;
- Actions taken in response to covenant violations, loss of access to capital markets, loss of customers, and other consequences of the restatement.

If there are material developments related to the restatement, companies should update this disclosure on a periodic basis during the restatement process, particularly when quarterly or annual reports are required to be filed, and provide full and complete disclosure within the filing with the SEC that includes the restated financial statements.

*Developed Proposal 3.4:* The FASB or the SEC, as appropriate, should develop and issue guidance on applying materiality to errors identified in prior interim periods and how to correct these errors. This guidance should reflect the following principles:

- Materiality in interim period financial statements must be assessed based on the perspective of the reasonable investor.
- When there is a material error in an interim period, the guidance on how to correct that error should be consistent with the principles outlined in developed proposal 3.2.

Based on prior restatement studies, approximately one-third of all restatements involved only interim periods. Authoritative accounting guidance on assessing materiality with respect to interim periods is currently limited to paragraph 29 of APB Opinion No. 28, *Interim Financial Reporting*.<sup>46</sup>

<sup>46</sup> Paragraph 29 of APB Opinion No. 28, *Interim Financial Reporting*, states the following:

In determining materiality for the purpose of reporting the cumulative effect of an accounting change or correction of an error, amounts should be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings.

Differences in interpretation of this paragraph have resulted in variations in practice that have increased the complexity of financial reporting. This increased complexity impacts preparers and auditors, who struggle with determining how to evaluate the materiality of an error to an interim period, and also impacts investors, who can be confused by the inconsistency between how companies evaluate and report errors. We believe that guidance as to how to evaluate errors related to interim periods would be beneficial to preparers, auditors and investors.

We have observed that a large part of the dialogue about interim materiality has focused on whether an interim period should be viewed as a discrete period or an integral part of an annual period. Consistent with the view expressed at the outset of this section, we believe that the interim materiality dialogue could be greatly simplified if that dialogue were refocused to address two sequential questions: (1) What principles should be considered in determining the materiality of an error in interim period financial statements? and (2) How should errors in previously issued interim financial statements be corrected? We believe that additional guidance on these questions, which are extensions of the basic principles outlined in developed proposals 3.1 and 3.2 above, would provide useful guidance in assessing and correcting interim period errors. We believe that while these principles would assist in developing guidance related to interim periods, additional work should also be performed to fully develop robust guidance regarding errors identified in interim periods.

We believe that the determination of whether an interim period error is material should be made based on the perspective of a reasonable investor, not whether an interim period is a discrete period, an integral part of an annual period, or some combination of both. An interim period is part of a larger mix of information available to a reasonable investor. As one example, a reasonable investor would use interim financial statements to assess the sustainability of a company's operations and cash flows. In this example, if an error in interim financial statements did not impact the sustainability of a company's operations and cash flows, the interim period error may very well not be material given the total mix of information available. Similarly, just as a large error in annual

Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.

financial statements does not determine by itself whether an error is material, the size of an error in interim financial statements should also not be necessarily determinative as to whether an error in interim financial statements is material.

We believe that applying the principles set forth above would reduce restatements by providing a company the ability to correct in the current period immaterial errors in previously issued financial statements and as a practical matter obviate the need to debate whether the interim period is a discrete period, an integral part of an annual period, or some combination of both.

We also note that these principles will provide a mechanism, other than restatement, to correct through the current period a particular error that has often been at the center of the interim materiality debate—a newly discovered error that has accumulated over one or more annual or interim periods, but was not material to any of those prior periods.

### III. Judgment

#### III.A. Background

##### Overview

Judgment is not new to the areas of accounting, auditing, or securities regulation—the criteria for making and evaluating judgment have been a topic of discussion for many years. The recent increased focus on judgment, however, comes from several different developments, including changes in the regulation of auditors and a focus on more “principles-based” standards—for example, FASB standards on fair value and IASB standards. Investors will benefit from more emphasis on “principles-based” standards, since “rules-based” standards (as discussed in chapters 1 and 2) may provide a method, such as through exceptions and bright-line tests, to avoid the accounting objectives underlying the standards. If properly implemented, “principles-based” standards should improve the information provided to investors while reducing the investor's concern about “financial engineering” by companies using the “rules” to avoid accounting for the substance of a transaction. While preparers appear supportive of a move to less prescriptive guidance, they have expressed concern regarding the perception that current practice by regulators in evaluating judgments does not provide an environment in which such judgments may be generally respected. This, in turn, can lead to repeated calls for more rules, so that the

standards can be comfortably implemented.

Many regulators also appear to encourage a system in which preparers can use their judgment to determine the most appropriate accounting and disclosure for a particular transaction. Regulators assert that they do respect judgments, but may also express concerns that some companies may attempt to inappropriately defend certain errors as “reasonable judgments.” Identifying standard processes for making judgments and criteria for evaluating those judgments, after the fact, may provide an environment that promotes the use of judgment and encourages consistent evaluation practices among regulators.

#### Goals of Potential Guidance on Judgments

The following are several issues that any potential guidance related to judgments may help address:

a. Investors’ lack of confidence in the use of judgment—Guidance on judgments may provide investors with greater comfort that there is an acceptable rigor that companies follow in exercising reasonable judgment.

b. Preparers’ concern regarding whether reasonable judgments are respected—In the current environment, preparers may be afraid to exercise judgment for fear of having their judgments overruled, after the fact by regulators.

c. Lack of agreement in principle on the criteria for evaluating judgments—The criteria for evaluating reasonable judgments, including the appropriate role of hindsight in the evaluation, may not be clearly defined and thus may lead to increased uncertainty.

d. Concern over increased use of “principles-based” standards—Companies may be less comfortable with their ability to implement more “principles-based” standards if they are concerned about how reasonable judgments are reached and how they will be assessed.

#### Categories of Judgments That Are Made in Preparing Financial Statements

There are many categories of accounting and auditing judgments that are made in preparing financial statements, and any guidance should encompass all of these categories, if practicable. Some of the categories of accounting judgment are as follows:

##### 1. Selection of accounting standard.

In many cases, the selection of the appropriate accounting standard under GAAP is not a highly complex judgment (e.g., leases would be accounted for using lease accounting standards and

pensions would be accounted for using pension accounting standards). However, there are cases in which the selection of the appropriate accounting standard can be highly complex.

For example, the standards on accounting for derivatives contain a definition of a derivative and provide scope exceptions that limit the applicability of the standard to certain types of derivatives. To evaluate how to account for a contract that has at least some characteristics of a derivative, one would first have to determine if the contract met the definition of a derivative in the accounting standard and then determine if the contract would meet any of the scope exceptions that limited the applicability of the standard. Depending on the nature and terms of the contract, this could be a complex judgment to make, and one on which experienced accounting professionals can have legitimate differing, yet acceptable, opinions.

##### 2. Implementation of an accounting standard.

After the correct accounting standard is identified, there are judgments to be made during its implementation.

Examples of implementation judgments include determining if a hedge is effective, if a lease is an operating or a capital lease, and what inputs and methodology should be utilized in a fair value calculation. Implementation judgments can be assisted by implementation guidance issued by standards-setters, regulators, and other bodies; however, this guidance could increase the complexity of selecting the correct accounting standard, as demonstrated by the guidance issued on accounting for derivatives.

Further, many accounting standards use wording such as “substantially all” or “generally.” The use of such qualifying language can increase the amount of judgment required to implement an accounting standard. In addition, some standards may have potentially conflicting statements.

##### 3. Lack of applicable accounting standards.

There are some transactions that may not readily fit into a particular accounting standard. Dealing with these “gray” areas of GAAP is typically highly complex and requires a great deal of judgment and accounting expertise. In particular, many of these judgments use analogies from existing standards that require a careful consideration of the facts and circumstances involved in the judgment.

##### 4. Financial Statement Presentation.

The appropriate method to present, classify and disclose the accounting for

a transaction in a financial statement can be highly subjective and can require a great deal of judgment.

##### 5. Estimating the actual amount to record.

Even when there is little debate as to which accounting standard to apply to a transaction, there can be significant judgments that need to be made in estimating the actual amount to record.

For example, opinions on the appropriate standard to account for loan losses or to measure impairments of assets typically do not differ. However, the assumptions and methodology used by management to actually determine the allowance for loan losses or to determine an impairment of an asset can be a highly judgmental area.

##### 6. Evaluating the sufficiency of evidence.

Not only must one make a judgment about how to account for a transaction, the sufficiency of the evidence used to support the conclusion must be evaluated. In practice, this is typically one of the most subjective and difficult judgments to make.

Examples include determining if there is sufficient evidence to estimate sales returns or to support the collectability of a loan.

#### Levels of Judgment

There are many levels of judgment that occur related to accounting matters. Preparers must make initial judgments about uncertain accounting issues; the preparer’s judgment may then be evaluated or challenged by auditors, investors, regulators, legal claimants, and even others, such as the media. Therefore, in developing potential guidance, differences in role and perspective between those who make a judgment and those who evaluate a judgment should be carefully considered. Guidance should not make those who evaluate a judgment re-perform the judgment according to the guidance. Instead, guidance should provide clarity to those who would make a judgment on factors that those who would evaluate the judgment would consider while making that evaluation.

#### Hindsight

The use of hindsight to evaluate a judgment where the relevant facts were not available at the time of the initial release of the financial statements (including interim financial statements) is not appropriate. Determining at what point the relevant facts were known to management, or should have been

known,<sup>47</sup> can be difficult, particularly for regulators who are often evaluating these circumstances after substantial time has passed. Therefore, the use of hindsight should only be used based on the facts reasonably available at the time the annual or interim financial statements were issued.

#### Form of Potential Guidance

We believe that there are many different ways that potential guidance on judgment could be provided. To be successful, however, we believe that guidance on judgment should not eliminate debate, nor be inflexible or mechanical in application. Rather, the guidance should encourage preparers to organize their analysis and focus preparers and others on areas to be addressed; thereby improving the quality of the judgment and likelihood that regulators will accept the judgment. Any guidance issued should be designed to stimulate a rigorous, thoughtful and deliberate process rather than a checklist-based approach for making and evaluating judgments.

One potential way to accomplish the goals we set forth earlier as well as to guard against the potential that such guidance would develop into a checklist-based approach is for the SEC to formally state its approach to evaluating judgments. As discussed earlier in this report, one of the major concerns surrounding the use of judgment is the possibility of a regulator “second guessing” the reasonableness of a judgment after the fact. We believe that a primary cause of this concern is a lack of clarity and transparency into the process the SEC uses to evaluate the reasonableness of judgments. The SEC has articulated its policies in the past with success. Examples of previous articulations of policy by the SEC include the “Seaboard” report (October 23, 2001) relating to the impact of a company’s cooperation on a potential SEC enforcement case and the SEC’s framework for assessing the appropriateness of corporate penalties (January 4, 2006). We believe that a statement of policy could implement the goals we have articulated and therefore recommend that the SEC and the PCAOB issue statements of policy describing how they evaluate the reasonableness of accounting and auditing judgments.

#### The Nature and Limitations of GAAP

Some have suggested that potential judgment guidance for the selection and

implementation of GAAP be a requirement to reflect the economic substance of a transaction or be a standard of selecting the “high road” in accounting for a transaction. We agree that qualitative standards for GAAP such as these would be desirable and we encourage regulators and standards-setters to move financial reporting in this direction. However, such standards are not always present in financial reporting today and we cannot recommend the articulation of such standards in an SEC statement of policy without anticipating a fundamental long-term revision of GAAP—a change that would be beyond our purview and one that would not be doable in the near- or intermediate-term.

For example, there is general agreement that accounting should follow the substance and not just the form of a transaction or event. Many believe that this fundamental principle should be extended to require that all GAAP judgments should reflect economic substance. However, reasonable people disagree on what economic substance actually is, and many would conclude that significant parts of current GAAP do not require and do not purport to measure economic substance (e.g., accounting for leases, pensions, certain financial instruments and internally developed intangible assets are often cited as examples of items reported in accordance with GAAP that would not meet many reasonable definitions of economic substance).

Similarly, some would like financial reporting to be based on the “high road”—a requirement to use the most preferable principle in all instances. Unfortunately, today a preparer is free to select from a variety of acceptable methods allowed by GAAP (e.g., costing inventory, measuring depreciation, and electing to apply hedge accounting are just some of the many varied methods allowed by GAAP) without any qualitative standard required in the selection process. In fact, a preferable method is required to be followed only when a change in accounting principle is made, and a less preferable alternative is fully acceptable absent such a change.

We believe that adopting a requirement that accounting judgments reflect economic substance or the “high road” would require a revolutionary change not achievable in the foreseeable future. Our suggestion that the SEC issue a statement of policy relating to its evaluation of judgments could and we believe would enhance adherence to GAAP, but it cannot be expected to correct inherent weaknesses in the standards to which it would be applied.

#### III.B. Developed Proposals

We have developed the following proposal:

*Developed Proposal 3.5:* The SEC should issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it considers when making this evaluation. The PCAOB should also adopt a similar approach with respect to auditing judgments.

The statement of policy applicable to accounting-related judgments should address the choice and application of accounting principles, as well as estimates and evidence related to the application of an accounting principle. We believe that a statement of policy that is consistent with the principles outlined in this developed proposal to cover judgments made by auditors based on the application of PCAOB auditing standards would be very beneficial to auditors. Therefore, we propose that the PCAOB develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards. The PCAOB statement of policy should acknowledge that the PCAOB would look to the SEC’s statement of policy to the extent the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor’s compliance with PCAOB auditing standards.

We believe that it would be useful if the SEC also set forth in the statement of policy factors that it looks to when evaluating the reasonableness of preparers’ accounting judgments.

#### The Concept of Judgment in Accounting Matters

Judgment, with respect to accounting matters, should be exercised by a person or persons who have the appropriate level of knowledge, experience, and objectivity and form an opinion based on the relevant facts and circumstances within the context provided by applicable accounting standards. Judgments could differ between knowledgeable, experienced, and objective persons. Such differences between reasonable judgments do not, in themselves, suggest that one judgment is wrong and the other is correct. Therefore, those who evaluate judgments should evaluate the reasonableness of the judgment, and should not base their evaluation on whether the judgment is different from the opinion that would have been reached by the evaluator.

<sup>47</sup> We believe that those making a judgment should be expected to exercise due care in gathering all of the relevant facts prior to making the judgment.

We have listed below various factors that we believe preparers should consider when making accounting judgments. The SEC may want to take these factors into account in developing its statement of policy. We also believe that a suggestion by the SEC that preparers should carefully consider these factors when making accounting judgments would be beneficial in not only increasing the quality of judgments, but also in making sure that the SEC and preparers will be able to more efficiently resolve potential differences during the SEC's review of preparer's filings. The mere consideration by a preparer of these factors in a SEC statement of policy would not prevent a regulator from asking appropriate questions about the accounting judgments made by the preparer or asking companies to correct unreasonable judgments, however. In fact, there is no guarantee that the preparer's consideration of the SEC's suggested factors articulated in a statement of policy would result in a reasonable judgment being reached. Rather, the statement of policy should be designed to encourage preparers to organize their analysis and focus preparers and others on areas that would be the focus of the SEC's review, thereby improving the quality of the judgment and likelihood that regulators will accept the judgment. We encourage the SEC to seek to accept a range of alternative reasonable judgments when preparers make good faith attempts to reach a reasonable judgment. A preparer's failure to follow the SEC's suggested factors in its statement of policy, however, would not imply that the judgment is unreasonable.

We would expect that, in the evaluation of judgments made using the factors that are cited below, the focus would be on significant matters requiring judgment that could have a material effect on the financial statements taken as a whole. We recognize that the facts and circumstances of each judgment may indicate that certain factors are more important than others. These factors would have a greater influence in an evaluation of the reasonableness of a judgment made by a preparer.

#### Factors to Consider When Evaluating the Reasonableness of a Judgment

While we believe that the SEC should articulate the factors that it uses when evaluating the reasonableness of a judgment, we believe that the statement of policy would be even more useful to preparers if the SEC also made suggestions for ways in which accounting judgments could be made.

We believe that accounting judgments should be based on a critical and reasoned evaluation made in good faith and in a rigorous, thoughtful and deliberate manner. We believe that preparers should have appropriate controls in place to ensure adequate consideration of all relevant factors. Factors applicable to the making of an accounting judgment include the following:

1. The preparer's analysis of the transaction, including the substance and business purpose of the transaction;
2. The material facts reasonably available at the time that the financial statements are issued;
3. The preparer's review and analysis of relevant literature, including the relevant underlying principles;
4. The preparer's analysis of alternative views or estimates, including pros and cons for reasonable alternatives;
5. The preparer's rationale for the choice selected, including reasons for the alternative or estimate selected and linkage of the rationale to investors' information needs and the judgments of competent external parties;
6. Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated;
7. The level of input from people with an appropriate level of professional expertise;<sup>48</sup>
8. The preparer's consideration of known diversity in practice regarding the alternatives or estimates;<sup>49</sup>
9. The preparer's consistency of application of alternatives or estimates to similar transactions;
10. The appropriateness and reliability of the assumptions and data used;
11. The adequacy of the amount of time and effort spent to consider the judgment.

When considering these factors, it would be expected that the amount of documentation, disclosure, input from professional experts, and level of effort in making a judgment would vary based on the complexity, nature (routine versus non-routine) and materiality of a transaction or issue requiring judgment.

Material issues or transactions should be disclosed appropriately. We note that existing disclosure requirements should be sufficient to generate<sup>50</sup> transparent

disclosure that enables an investor to understand the transaction and assumptions that were critical to the judgment. The SEC has provided in the past, and should continue to consider providing, additional guidance on existing disclosure requirements to encourage more transparent disclosure. In addition, when evaluating the reasonableness of a judgment, regulators should take into account the disclosure relevant to the judgment.

**Documentation**—The alternatives considered and the conclusions reached should be documented contemporaneously. The lack of contemporaneous documentation may not mean that a judgment was incorrect, but would complicate an explanation of the nature and propriety of a judgment made at the time of the release of the financial statements.

#### Exhibit D

#### SEC Advisory Committee on Improvements to Financial Reporting Delivering Financial Information Subcommittee Update

May 2, 2008 Full Committee Meeting

#### I. Introduction

The SEC's Advisory Committee on Improvements to Financial Reporting (Committee) issued a progress report (Progress Report) on February 14, 2008.<sup>51</sup> In chapter 4 of the Progress Report, the Committee discussed its work-to-date in the area of delivering financial information including its developed proposals relating to XBRL tagging of financial information and improved use of corporate Web sites and its future considerations relating to disclosure of key performance indicators, improved quarterly press release disclosures and timing, and the inclusion of executive summaries in public company periodic reports.

Since the issuance of the Progress Report, the delivering financial information subcommittee (Subcommittee IV) has deliberated further the areas of improved use of

estimates in the Commissions Release No. 33-8350 "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, the Commissions Release No. 33-8040 "Cautionary Advice Regarding Disclosure About Critical Accounting Policies" and Accounting Principles Board Opinion No. 22 "Disclosure of Accounting Policies". We also encourage the SEC to continue to remind preparers of ways to improve the transparency of disclosure, such as through statements like the Sample Letter sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements) issued by the Division of Corporation Finance in March 2008.

<sup>51</sup> Refer to Progress Report at <http://www.sec.gov/rules/other/2008/33-8896.pdf>.

<sup>48</sup> In many cases, input from professional experts would include consultation with a preparer's independent auditors or other competent external parties, such as valuation specialists, actuaries or counsel.

<sup>49</sup> If there is not diversity in practice, it would be significantly harder to select a different alternative.

<sup>50</sup> Existing disclosure requirements would include the guidance on critical accounting

corporate Web sites, disclosure of key performance indicators, improved quarterly press release disclosures and timing and inclusion of executive summaries. This report represents Subcommittee IV's latest thinking, including its consideration of input received through comment letters and received orally at the March 14, 2008 Committee meeting in San Francisco and subsequent Subcommittee meeting with industry participants. Subject to further public comment, Subcommittee IV will recommend the following preliminary hypotheses to the full Committee for its consideration in developing the final report, which it expects to issue in July 2008.

## II. XBRL

In the Progress Report, the Committee issued a developed proposal regarding XBRL (developed proposal 4.1). Refer to the Progress Report for additional discussion of this developed proposal. At the Committee meeting on March 14, 2008 held in San Francisco, the Committee received oral and written input from market participants regarding the XBRL developed proposal. The Subcommittee understands the SEC has scheduled an open meeting on May 14, 2008 to consider whether to propose amendments to provide for corporate financial statement information to be filed with the SEC in interactive data format, and a near- and long-term schedule therefore. Subcommittee IV proposes no revisions at this time to the developed proposal.

## III. Use of Corporate Web Sites

In the Progress Report, the Committee issued a developed proposal regarding the use of corporate Web sites and the development of uniform best practices regarding corporate Web site use by industry participants (developed proposal 4.2). Refer to the Progress Report for additional discussion of this developed proposal. The Committee heard additional input from industry participants, including newswire services, reporting companies, investors, and securities lawyers regarding the developed proposal as part of the comments received on the Progress Report. The Subcommittee heard from companies and investors about the value of corporate Web site disclosures as an additional, though not exclusive, means of providing information to the market in a timely manner available to all persons. Subcommittee IV proposes no significant revisions at this time to the developed proposals regarding corporate Web sites and industry developed best practice guidelines.

## IV. Disclosures of KPIs and Other Metrics To Enhance Business Reporting

### *Preliminary Hypothesis 1*

The SEC should encourage private sector initiatives targeted at best practice development of company use of Key Performance Indicators (KPIs) in their business reports. The SEC should encourage private sector dialogue, involving preparers, investors, and other interested industry participants, such as consortia that have long supported KPI-like concepts, to generate understandable, consistent, relevant and comparable KPIs on an industry-specific and relevant activity basis. The SEC also should encourage companies to provide, explain, and consistently disclose period-to-period company-specific KPIs. The SEC should consider reiterating and expanding its interpretive guidance regarding disclosures of KPIs in MD&A and other company disclosures.

The Committee should further acknowledge the useful work of those consortia that endeavor to go beyond the limited scope of the Committee's recommendation to provide an overall structure which provides a linking of financial and KPI indicators into a seamless whole.

### Background

As the Committee noted in the Progress Report, enhanced business reporting and key performance indicators (KPIs) are disclosures about the aspects of a company's business that provide significant insight into the sources of its value. The Enhanced Business Reporting Consortium,<sup>52</sup> has stated that the value drivers for a business "can be measured numerically through KPIs or may be qualitative factors such as business opportunities, risks, strategies and plans—all of which permit assessment of the quality, sustainability and variability of its cash flows and earnings." KPIs include supplemental non-GAAP financial reporting disclosures that proponents have stated can improve disclosures by public companies. Such KPIs also may include non-financial measures. KPIs are leading indicators of financial results and intangible assets that are not necessarily encompassed on a company's balance sheet and can

provide more transparency and understanding about the company to investors. Proponents of the use of KPIs note that they are important because they inform judgments about a company's future cash flows—and form the basis for a company's stock price. Managers and boards of directors of companies use KPIs to monitor performance of companies and of management. Market participants and the SEC have identified KPIs as important supplements to GAAP-defined financial measures.

The Committee understands that investment professionals concur that investors are very interested in non-financial information as a way to better understand the businesses they invest in. They recognize that financial reports provide an accounting of past events and a current view of the financial condition of the company. The financials are viewed as an end-of-process result delivered as a combination of market conditions and company business strategies, processes and execution. The financials are, by their nature, not necessarily forward-looking indicators. Of interest to many investors from a business reporting standpoint is information regarding the fundamental drivers of the business and metrics used to give evidence as to how the business is being managed in the environment it finds itself in. Financial reporting captures some aspects of this but not all and, in fact, financial statements are not currently designed to provide a broader picture of the company and its operations.

From a corporate preparer standpoint, management uses KPIs as key metrics with which to direct the company as part of the strategic planning process both in terms of goal setting and as a way to provide analysis and feedback. In that regard the degree to which companies are comfortable sharing these metrics with shareholders, communication would be greatly enhanced. By its very nature such communication would increase the fundamental transparency of the business. Numerous prior studies have shown that greater transparency on the part of corporations reduces the company's cost of capital and no doubt improves market efficiency.

Recognizing this, the SEC encourages extensive discussion of the condition of the business in the MD&A. The SEC, in its 2003 MD&A Interpretive Release, stated "[o]ne of the principal objectives of MD&A is to give readers a view of the company through the eyes of management by providing both a short- and long-term analysis of the business. To do this, companies should 'identify

<sup>52</sup> The Enhanced Business Reporting Consortium was founded by the AICPA, Grant Thornton LLP, Microsoft Corporation, and PricewaterhouseCoopers in 2005 upon the recommendation of the AICPA Special Committee on Enhanced Business Reporting. The EBRC is an independent, market-driven non-profit collaboration focused on improving the quality, integrity and transparency of information used for decision-making in a cost-effective, time efficient manner.

and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company.’” In this regard, the SEC noted the importance of disclosures of key performance measures—“when preparing MD&A, companies should consider whether disclosure of all key variables and other factors that management uses to manage the business would be material to investors, and therefore required. These key variables and other factors may be non-financial, and companies should consider whether that non-financial information should be disclosed.” The SEC went on to state that “[i]ndustry-specific measures can also be important for analysis, although common standards for the measures also are important. Some industries commonly use non-financial data, such as industry metrics and value drivers. Where a company discloses such information, and there is no commonly accepted method of calculating a particular non-financial metric, it should provide an explanation of its calculation to promote comparability across companies within the industry. Finally, companies may use non-financial performance measures that are company-specific.”<sup>53</sup>

This discussion is intended to give information about the business in a way that is consistent with the manner in which the business is run.

#### Discussion

The Subcommittee’s hypothesis extends beyond a narrow definition of financial reporting to business reporting more generally. The Subcommittee has been evaluating whether public companies should increase their voluntary disclosure of financial and non-financial performance measures or indicators, such as KPIs. The Subcommittee has examined the current practices of public companies and notes that many companies are already disclosing some company-specific KPIs in their periodic reports filed with the SEC or in other public statements, but these company-specific measures may not necessarily be consistently reported by companies from period-to-period, are not necessarily well-defined, and may not be commonly used by other companies in the same industry so that they lend themselves to comparisons between and among companies. Therefore, as part of its review of KPI disclosure, the Subcommittee has

evaluated the kinds of KPIs that should be made available, in what format, and whether they should be consistently defined over time. The Subcommittee has found that various groups, within and outside industries, are working on developing industry-specific and activity-specific KPIs in order to improve comparability of companies on an industry basis.

In developing its preliminary hypothesis on KPIs and other possible metrics to enhance business reporting, the Subcommittee consulted with industry members and others who have been working on this subject. As a result of these discussions and its evaluation of other materials, the Subcommittee preliminarily believes that further exploration of the use of KPIs and other metrics by public companies would be constructive.

Accordingly, for KPI reporting to be most effective and improve user understanding, the Subcommittee is considering that the full Committee recommend that companies should consider the following to improve KPI disclosures.<sup>54</sup>

- *Understandability*—The Subcommittee believes that a given KPI term, such as “same store sales,” would be most useful in evaluating the relevant industry or activity if it had a standard agreed definition in the industry. For that reason, as part of its preliminary hypothesis, the Subcommittee notes that the SEC should explore ways to encourage private initiatives in various industries for the development of standard KPI definitions. It is presumed that there would be some terms that would be macro in nature that companies from all industries would make use of and thus would be activity-based, but it is assumed that many KPI terms would be industry-specific. Once a term has been defined by industry, the SEC and other global regulators should work with industry to support the use of such term in periodic and other company reports, with such modified or additional disclosures as the SEC and other global regulators deem necessary or appropriate. Companies should be encouraged to use such industry-defined terms and to disclose any differences in their use of terms from any industry-defined and accepted definition. Companies would still have

the freedom to use whatever terms they wished in describing their businesses but would be expected to make clear any differences between their definitions and those that have been industry defined.

- *Consistency*—Whether or not a company uses an industry-defined term for its KPI disclosures, the KPI that is used should be reported consistently from period-to-period. Any changes in the definition of a KPI should be disclosed, along with the reasons for the change. KPIs should be reported not just for the current period but for prior periods as well so that investors can assess the company’s development from period-to-period or year-to-year.

- *Relevancy*—KPI that are disclosed should be important to an understanding and tracking of the business or business segments for which they are used and should align with how reporting companies run their business.

- *Presentability*—When companies disclose KPIs in their reports and other releases, they should make clear to ordinary investors that the information is intended to provide information about the business of the company that is separate from and supplemental to the financial statements. This could either be done in a separate KPI section in MD&A or in subsections of parts of the MD&A, such as the general business discussion or the discussion by business segment. Segment reporting of KPIs, given the logical connection to business line activities, could be very useful. The inclusion of tabular presentations showing current and prior periods should be seriously considered.

- *Comparability*—Encouraging companies to use industry-defined KPI’s would enable investors to compare companies within and across industries and would also be quite useful at the industry segment level. Once industry-defined KPIs are available, the Subcommittee would hope that investor interest would encourage companies to use commonly defined KPI terms.

The Subcommittee has heard that some companies may be hesitant about increased disclosure of KPIs because of concern that disclosure of these metrics may compromise competitive information.<sup>55</sup> Neither the Subcommittee nor investors want companies to give away the “crown jewels.” The Subcommittee has also heard questions about the validity of many of such competitive harm claims, particularly where information is widely known within a particular

<sup>53</sup> SEC, *Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations*, Securities Act Release No. 33-8350 (December 19, 2003) (2003 MD&A Interpretive Release).

<sup>54</sup> The Subcommittee notes that the SEC has provided guidance as to some of these matters as well in its 2003 MD&A Interpretive Release as discussed above. The SEC noted that “[t]he focus on key performance indicators can be enhanced not only through the language and content of the discussion, but also through a format that will enhance the understanding of the discussion and analysis.”

<sup>55</sup> The Subcommittee also heard a question as to the liability treatment of KPIs.



industry. The Subcommittee has heard that there is already so much information about companies that disclosure of unique competitive information would be rare. Nevertheless, the Subcommittee preliminarily believes that if a particular KPI could require the disclosure of competitively important information, the affected company could decline to disclose it.

In an ideal disclosure system, non-financial and financial indicators and elements would be presented within a cohesive framework that combines KPIs and other indicators with GAAP data and text discussion in order to create a complete picture of a company. At this time, the Subcommittee believes that having the Committee propose to mandate or suggest such an organized structure is outside the scope of what the Subcommittee is evaluating, might be premature and inappropriate for a regulator or standard setter, possibly being too prescriptive.

Rather, the Subcommittee's preliminary hypothesis believes that the SEC should encourage an industry driven initiative with significant investor involvement to develop best practices that companies could follow in developing and disclosing KPIs. Just as financial reporting standards and the recently developed XBRL taxonomy may improve business reporting by creating standardized language, the Subcommittee believes the development of a KPI dictionary, developed on an industry basis but also allowing for company-specific definitions, also could provide valuable information to investors.

Thus, the Subcommittee has developed a preliminary hypothesis that is based on a number of industry-driven initiatives, with significant investor involvement, to develop best practices and common definitions for KPIs that companies could follow in disclosing KPIs. The hypothesis suggests that companies, investors, and business reporting consortiums should work together to develop industry-wide and activity-specific KPIs that conform to uniform or standard definitions, as well as company-specific KPIs. These KPIs should then be disclosed in a company's periodic reports, as well as other disclosure formats such as earnings releases. The hypothesis suggests that the KPIs:

- Be clearly and consistently defined to allow investors understanding of the meanings of the KPIs;
- Be disclosed, as relevant, on a company and/or segment basis; and
- Permit cross-company and cross-industry comparisons.

The Subcommittee does not believe that the mandatory reporting of KPIs is desirable at this time. Instead, the Subcommittee believes that the Committee should consider encouraging the SEC to promote the development of commonly recognized and defined KPIs by industry groups.

#### Integration With Other Proposals

The Subcommittee preliminarily believes that the formalization of KPI disclosures through commonly recognized definitions, will enhance the benefits that will come from other proposals from the Committee. For example, disclosing KPIs on company Web sites would allow investors and other users of the reported information to gain an improved understanding of the prospects for a company and could lead to better capital market pricing.

### V. Improved Quarterly Press Release Disclosures and Timing

#### *Preliminary Hypothesis 2*

Industry groups, including the National Investor Relations Institute, FEI, and the CFA Institute should update their best practices for earnings releases. Such updated best practices guidance should cover, among other matters, the type of information that should be provided in earnings releases and the need for investors to receive information that is consistent from quarter to quarter, with an explanation of any changes in disclosures from quarter to quarter. Further, the best practices guidance should consider recommending that companies include in their earnings releases the income statement, balance sheet and cash flow tables, locate GAAP reconciliations in close proximity to any non-GAAP measures presented, and provide more industry and company specific key performance indicators.

The SEC should consider reinforcing its view that disclosures in connection with earnings calls posted on company Web sites should be maintained and available on such sites for at least 12 months.

#### Background

As noted in the Progress Report, the quarterly earnings release, often the first corporate communication about the result of the quarter just ended, is viewed as an important corporate communication. This communication often receives more attention than the formal Form 10-Q submission which often occurs a week or two later.

The quarterly earnings release is not currently required to contain mandated information other than that required by

the application of Regulation G to the presentation of non-GAAP measures and the antifraud provisions of the federal securities laws. Industry groups have previously coordinated in developing best practices for reporting companies to follow in preparing their earnings releases. In addition, under SEC rules, companies must furnish earnings releases to the Commission on a Form 8-K. Investors and other market participants have expressed concern about the matters relating to earnings releases, including consistency of information provided in such releases, the timing of such releases in relation to the filing of the applicable periodic report, and the inclusion of earnings guidance in such earnings releases.

#### Discussion

The Subcommittee has been examining a number of issues relating to the earnings release, including with regard to its consistency, understandability, timeliness, and the continued public availability of earnings conference calls. The Subcommittee had an opportunity to discuss the quarterly earnings release and these related matters with investor and company representatives. In addition, the Subcommittee considered the consistent provision of income statement, balance sheet and cash flow tables in the quarterly earnings release as well as the positioning and prominence of GAAP and non-GAAP figures, GAAP reconciliation, the consistent placement of topics, and clear communication of any changes to accounting methods or key assumptions. The Subcommittee viewed the goal for the earnings release to be a consistent, reliable communication form that all investors can easily navigate.

The Subcommittee also briefly discussed the advisability of requiring the issuance of the earnings releases on the same day that the periodic report (e.g., Form 10-Q) is filed, in contrast to the current practice in which the earnings release often is issued before the periodic report is filed. The Subcommittee heard from company and investor representatives in this regard and took note of the comments that the SEC received in connection with a prior request for comment to tie the filing of the quarterly report to the issuance of an earnings release. The Subcommittee understood that the practices of companies in this regard may differ depending on the size of the company and the company's own disclosure practices. For example, the Subcommittee understands that some large companies issue their earnings release at the same time as the filing of

their quarterly reports. The Subcommittee also heard that smaller companies tended to wait to issue their earnings releases so that their news would not be eclipsed by news of larger and more well followed companies. While investors noted an interest in having the earnings release issued at the same time as the Form 10-Q is filed to avoid duplication of effort in analyzing the company's disclosures, representatives of companies and others expressed concern about the effect of delays in disclosing material non-public information about the quarter or year end. Investors also expressed concern regarding the trading of company stock by executives after the issuance of the earnings release but before the filing of the Form 10-Q and questioned whether executives could be prohibited from engaging in trading until after the Form 10-Q was filed.

The Subcommittee determined not to include a preliminary hypothesis that would change current market practice regarding the issuance of earnings releases but would suggest that, instead, the SEC monitor company practices in regard to the timing of the earnings release in relation to the filing of the relevant periodic report with the SEC.

The Subcommittee also heard concerns that companies were not keeping their earnings calls and related information posted on their Web sites for more than one quarter after the call, thus making quarterly comparisons difficult. The Subcommittee noted that the SEC had suggested that companies keep their Web site disclosures regarding GAAP reconciliations for non-GAAP measures presented on earnings calls available on their Web sites for at least a 12-month period and the Subcommittee's preliminary hypothesis would suggest that the SEC reiterate this guidance.<sup>56</sup>

The Subcommittee briefly discussed the practices of some companies in providing earnings guidance or public projections of next quarter's earnings by company officials, since some believe that this practice is an important underlying source of reporting complexity and other accounting problems. The Subcommittee also discussed the provision of annual guidance that may be updated quarterly. The Subcommittee does not intend to continue its evaluation of quarterly earnings guidance or to suggest any preliminary hypothesis regarding the provision of quarterly earnings guidance at this time because it notes that many

others are evaluating the issues arising from the provision of quarterly earnings guidance.

## VI. Use of Executive Summaries in Exchange Act Periodic Reports

### *Preliminary Hypothesis 3*

The SEC should mandate the inclusion of an executive summary in the forepart of a reporting company's filed annual and quarterly reports. The executive summary should provide summary information, in plain English, in a narrative and perhaps tabular format of the most important information about a reporting company's business, financial condition, and operations. As with the MD&A, the executive summary should be required to use a layered approach that would present information in a manner that emphasizes the most important information about the reporting company and include cross-references to the location of the fuller discussion in the annual report. The requirement for the executive summary should build on the company's MD&A overview and essentially be principles-based, other than a limited number of required disclosure items such as:

- A summary of a company's current financial statements;
- A digest of the company's GAAP and non-GAAP KPIs (to the extent disclosed in the company's 10-Q or 10-K);
- A summary of key aspects of company performance;
- A summary of business outlook;
- A brief description of the company's business, sales and marketing; and
- Page number references to more detailed information contained in the document (which, if the report is provided electronically, could be hyperlinks).

### Background

Reporting companies are not currently required to include any type of summary in their periodic reports, although a summary of the company and the securities it is offering is a line-item disclosure in Securities Act registration statements. Companies, therefore, are familiar with the concept of summarizing the important aspects of their business and operations at the time they are raising capital. The Subcommittee has heard that retail investors find it difficult at times to navigate through a company's periodic reports, including its Form 10-K annual report. The Subcommittee has been evaluating the use of an executive summary in the forepart of a company's

annual and quarterly Exchange Act reports to facilitate the ready delivery of important information to investors by providing them a roadmap of the disclosures contained in such reports.

### Discussion

The Subcommittee has been exploring a requirement to include an executive summary in reporting company annual and quarterly Exchange Act reports (Forms 10-K and 10-Q). The Subcommittee has met with investor and company representatives as well as securities counsel. The Subcommittee understands that a summary report prepared on a stand-alone basis would not necessarily provide investors with information they need in a desired format and that investors would not use such a summary. However, the Subcommittee understands that an executive summary included in the forepart of an Exchange Act periodic report may provide investors, particularly retail investors, with an important roadmap to the company's disclosures located in the body of such a report.<sup>57</sup> The executive summary in the Exchange Act periodic report would provide summary information, in plain English, in a narrative and perhaps tabular format of the most important information about a reporting company's business, financial condition, and operations. As with the MD&A, the executive summary would use a layered approach that would present information in a manner that emphasizes the most important information about the reporting company and include cross-references to the location of the fuller discussion in the annual report.

As noted in the Progress Report and as contemplated in the Subcommittee's preliminary hypothesis, the goal of the executive summary would be to help investors fundamentally understand a company's businesses and activities through a relatively short, plain English presentation. An executive summary in a periodic report may be most useful if it includes high-level summaries across a broad range of key components of the annual or quarterly report, rather than detailed discussion of a limited number of variables. The executive summary approach may be an efficient way to provide all investors, including retail investors, with a concise overview of a company, its business, and its financial condition. For the more sophisticated investor, an executive summary may be

<sup>56</sup> See SEC *Conditions for Use of Non-GAAP Measures*, Exchange Act Release No. 34-47226 (Jan. 22, 2003).

<sup>57</sup> Such reports generally are posted on company Web sites as well so that the executive summaries would be electronically available with hyperlinks to the more detailed information in the relevant report.

helpful in presenting the company's unique story which the sophisticated investor could consider as it engages in a more detailed analysis of the company, its business and financial condition.

The executive summary in a periodic report should be brief, and it might fruitfully build on the overview that the SEC has identified should be in the forefront of the MD&A disclosure. The MD&A overview is expected to "include the most important matters on which a company's executives focus in evaluating the financial condition and operating performance and provide context."<sup>58</sup> The executive summary should build on the MD&A overview disclosure and include the following:

1. A summary of a company's current financial statements;
2. A digest of the company's GAAP and non-GAAP KPIs (to the extent disclosed in the company's 10-Q or 10-K);
3. A summary of key aspects of company performance;
4. A summary of business outlook;
5. A brief description of the company's business, sales and marketing;
6. Page number references to more detailed information contained in the document (which, if the report is provided electronically, could be hyperlinks).

The Subcommittee's preliminary hypothesis provides that the executive summary should be required to be included in the forefront of a reporting company's annual or quarterly report filed with the SEC or, if a reporting company files its annual report on an integrated basis (the glossy annual report is provided as a wraparound to the filed annual report), the executive summary instead could be included in the forefront of the glossy annual report. If the executive summary was included in the glossy annual report, it would not be considered filed with the SEC. The Subcommittee understands that the inclusion of a summary in the body of the periodic report should not give rise to additional liability implications.

#### VII. Continued Need for Improvements in the MD&A and Other Public Company Financial Disclosures

The Committee noted in chapter 4 of the Progress Report that while investors and other market participants believe that while there has been some improvement in the MD&A disclosures since publication of the SEC's interpretive release in 2003, significant improvement is still needed. The

Subcommittee evaluated the MD&A and other public company disclosures in the context of its preliminary hypotheses regarding disclosures of key performance indicators, earnings releases, and use of executive summaries in periodic reports.

[FR Doc. E8-11276 Filed 5-21-08; 8:45 am]

BILLING CODE 8010-01-P

#### SMALL BUSINESS ADMINISTRATION

##### [Disaster Declaration #11249 and #11250]

##### Oklahoma Disaster #OK-00020

**AGENCY:** U.S. Small Business Administration.

**ACTION:** Notice.

**SUMMARY:** This is a Notice of the Presidential declaration of a major disaster for the State of Oklahoma (FEMA-1756-DR), dated 05/14/2008.

*Incident:* Severe Storms, Tornadoes, and Flooding

*Incident Period:* 05/10/2008 and continuing.

**EFFECTIVE DATE:** 05/14/2008.

*Physical Loan Application Deadline Date:* 07/14/2008.

*Economic Injury (EIDL) Loan Application Deadline Date:* 02/16/2009.

**ADDRESSES:** Submit completed loan applications to: U.S. Small Business Administration, Processing and Disbursement Center, 14925 Kingsport Road, Fort Worth, TX 76155.

**FOR FURTHER INFORMATION CONTACT:** A. Escobar, Office of Disaster Assistance, U.S. Small Business Administration, 409 3rd Street, SW., Suite 6050, Washington, DC 20416.

**SUPPLEMENTARY INFORMATION:** Notice is hereby given that as a result of the President's major disaster declaration on 05/14/2008, applications for disaster loans may be filed at the address listed above or other locally announced locations.

The following areas have been determined to be adversely affected by the disaster:

*Primary Counties (Physical Damage and Economic Injury Loans):* Ottawa.

*Contiguous Counties (Economic Injury Loans Only):*

Oklahoma: Craig, Delaware.

Kansas: Cherokee.

Missouri: McDonald, Newton.

*The Interest Rates are:*

	Percent
<i>For Physical Damage:</i>	
Homeowners With Credit Available Elsewhere .....	5.375

	Percent
Homeowners Without Credit Available Elsewhere .....	2.687
Businesses With Credit Available Elsewhere .....	8.000
Other (Including Non-Profit Organizations) With Credit Available Elsewhere: .....	5.250
Businesses and Non-Profit Organizations Without Credit Available Elsewhere .....	4.000
<i>For Economic Injury:</i>	
Businesses & Small Agricultural Cooperatives Without Credit Available Elsewhere: .....	4.000

The number assigned to this disaster for physical damage is 11249B and for economic injury is 112500.

(Catalog of Federal Domestic Assistance Numbers 59002 and 59008)

**James E. Rivera,**

*Acting Associate Administrator for Disaster Assistance.*

[FR Doc. E8-11466 Filed 5-21-08; 8:45 am]

BILLING CODE 8025-01-P

#### SMALL BUSINESS ADMINISTRATION

##### [Disaster Declaration #11199]

##### Missouri Disaster Number MO-00024

**AGENCY:** U.S. Small Business Administration.

**ACTION:** Amendment 1.

**SUMMARY:** This is an amendment of the Presidential declaration of a major disaster for Public Assistance Only for the State of Missouri (FEMA-1749-DR), dated 03/19/2008.

*Incident:* Severe Storms and Flooding.  
*Incident Period:* 03/17/2008 through 05/09/2008.

**EFFECTIVE DATE:** 05/09/2008.

*Physical Loan Application Deadline Date:* 05/19/2008.

**ADDRESSES:** Submit completed loan applications to: U.S. Small Business Administration, Processing and Disbursement Center, 14925 Kingsport Road, Fort Worth, TX 76155.

**FOR FURTHER INFORMATION CONTACT:** A. Escobar, Office of Disaster Assistance, U.S. Small Business Administration, 409 3rd Street, SW., Suite 6050, Washington, DC 20416.

**SUPPLEMENTARY INFORMATION:** The notice of the President's major disaster declaration for Private Non-Profit organizations in the State of Missouri, dated 03/19/2008, is hereby amended to establish the incident period for this disaster as beginning 03/17/2008 and continuing through 05/09/2008.

All other information in the original declaration remains unchanged.

<sup>58</sup> See 2003 MD&A Interpretive Release above.