

The FASB's Efforts Toward Simplification

By Lawrence W. Smith



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Just imagine you are the CFO of a medium-sized company, and a business unit sent you a contract for a fairly sizable sales transaction. The terms of the transaction have some peculiarities that cause you to check the accounting literature because you want to be sure to record the transaction correctly. You enter fasb.org into your internet browser, click on the “GAAP” icon, click on “revenue,” and

there you are—everything you always wanted to know about revenue accounting. You read the overview, scroll down to the section on “recognition,” then check the section on “measurement,” and finally check the disclosure requirements summarized in the section on “disclosure.” You scan the implementation issues that follow the basic requirements. You note there are few exceptions related to the requirements for this transaction; therefore, you feel comfortable with your understanding of how to record the transaction. Nevertheless, your curiosity gets to you, so you click on the icon “conceptual basis” and read the fundamental Concepts Statements leading to the prescribed accounting. Okay, you now know how to record the transaction and you are confident you can explain the accounting to your CEO as well as why that accounting makes sense.

We at the FASB understand that an active imagination would be required today to dream up that scenario; however, we are hopeful that in the not-too-distant future that scenario will be much closer to reality.

Bob Herz, FASB chairman, believes there are three fundamental considerations the FASB must keep in mind in its standard-setting activities: improvement in financial reporting, simplification of the accounting literature and the standard-setting process, and international convergence. This article explains what the FASB has done over the past two-and-one-half years to address simplification and what it has planned for the future. But first let us look at the challenges posed by the current state of affairs.

Consider the revenue transaction discussed above. The first question would be where to start looking. Revenue recognition is addressed in 180 different pieces of accounting literature. Some

are pronouncements created by the FASB, some by the Accounting Principles Board (APB), yet others by the Accounting Standards Executive Committee of the AICPA (AcSEC), the Emerging Issues Task Force (EITF), and let us not forget about the Securities and Exchange Commission (SEC). The fact is that current U.S. “GAAP” comprises of over 2,000 “pronouncements” issued by these different organizations in a variety of forms: FASB Statements, Technical Bulletins, Interpretations, and staff implementation guides (Q&As); APB Opinions and Accounting Interpretations; AcSEC Statements of Position (SOPs) and Technical Practice Aids; SEC Staff Accounting Bulletins, and so forth.

Who Sets Accounting Standards?

Over the last two years there have been three fundamental changes in how accounting standards are set or, more specifically, by whom they are set. The first fundamental change is a relatively subtle one. Over the last 10 years the prominence of the role played by the SEC in setting accounting standards has varied over time, with some “administrations” taking a very active role, and others taking more of an oversight role. One need only review the number and source of EITF “D Topics” addressed over that time period to understand different administrations’ philosophies about oversight of the FASB.

The Sarbanes-Oxley Act of 2002 required the SEC to designate an organization(s) as having the authority to promulgate accounting standards for public companies in the United States, which it did in April 2003 when it reaffirmed the FASB as the designated private-sector standard setter for public companies. We have established a working protocol with the SEC for its staff to first refer issues it identifies that may have accounting standard-setting implications to the FASB for consideration, with the understanding that the SEC staff reserves the right to exercise its legislative authority to deal with any issues it identifies.

The second fundamental change in standard setting began in the fall of 2002 when the FASB and the AICPA agreed that, after a transition period, the AICPA and AcSEC would no longer issue authoritative accounting guidance. Previously, SOPs and Industry Accounting and Audit Guides “cleared” by the FASB were level B under the GAAP hierarchy. Going forward (except for transition projects), the Board will not be asked to clear any AICPA or AcSEC documents; consequently, any such documents will fall under level D in the current GAAP hierarchy.

And third, beginning in 2003, the operation of the EITF was fundamentally changed. In an effort to provide greater direction to the EITF in terms of the issues addressed by that group, two Board members were added to the EITF Agenda Committee. The FASB also took greater direct ownership of GAAP established by the EITF by requiring that consensus positions be ratified by the Board.

The objective of those changes was to simplify the accounting standard-setting process by eliminating the various organizations that might potentially deal with an accounting issue and giving constituents the ability to do “one-stop shopping” at the FASB. In so doing, we also looked at how we issue accounting guidance and acknowledged that we had contributed to the complexity of GAAP by issuing accounting guidance in a variety of forms. For example, our arsenal of guidance included Statements, Interpretations, Technical Bulletins, “D-Topic announcements,” staff implementation guides (Q&As), Derivatives Implementation Guidance Issues, *Action Alert* announcements, and *The FASB Report* articles.

We might have added to that confusion in 2002 (although hopefully only temporarily) by instituting a new form of guidance, FASB Staff Positions (FSPs). The original reason for introducing FSPs was to eliminate further use of many of the tools in our arsenal of guidance. Another reason was to have a means to solicit constituent comments on proposed staff guidance, which had not been the practice with some of the prior forms of guidance.

Observers of our process may have noticed that the use of FSPs has evolved rapidly over their short history such that they are not only being used to provide interpretive guidance, but also to make minor amendments to existing standards. I would like to take this opportunity to point out that the due process used to issue an FSP is the same as the due process used to issue a new standard. Thus, it really does not matter whether something gets issued as an FASB Statement or an FSP on Topic “X.” Regardless of the form of the final guidance, the FASB staff will study the issue, the Board will deliberate the issue and expose it for public comment, the staff will analyze the comments, and the Board will redeliberate the issue before the guidance is finalized. Our ultimate vision for simplification of standard setting is one process and one form of guidance.

The GAAP Hierarchy and the Codification Project

While the FASB is charged with setting accounting standards, the authoritative guidance on what constitutes generally accepted accounting principles and the relative authority of those principles (i.e., the GAAP hierarchy) resides in the auditing literature. After concentrating standard setting with the FASB, it became obvious to the FASB (and the SEC) that the GAAP hierarchy should be embedded in the accounting literature, not the auditing literature. The FASB is in the process of preparing an Exposure Draft of a standard that will move the GAAP hierarchy into the accounting literature. The FASB has discussed this with representatives of both the AICPA and the Public Company Accounting Oversight Board (PCAOB), who have agreed to take actions necessary to effectively acknowledge the GAAP hierarchy once it becomes a part of the accounting literature.

The Board decided to adopt the GAAP hierarchy in the same fundamental form as it now exists in the auditing literature. However, the Exposure Draft will include the Board’s vision of the future GAAP hierarchy—only two levels, authoritative and nonauthoritative. Users of GAAP will no longer have to worry about what literature trumps other literature. In fact, there will be only one set of “authoritative” literature, which we are currently referring to as the Codification.

During the summer of 2004, the trustees of the Financial Accounting Foundation approved the largest project ever addressed by the FASB. Prior to obtaining that approval, we had cleared with both the AICPA and the SEC the right to use in the Codification their literature that is currently part of GAAP. The Codification will be a compilation of existing U.S. GAAP, organized by accounting topic, regardless of its source (i.e., FASB Statement, EITF consensus, AcSEC SOP, etc.). There will be a standard structure to the Codification, such that users will quickly know what subsections address the specific aspects of a topic (e.g., recognition, measurement, disclosure, implementation guidance, etc.).¹

While the Codification will present existing GAAP differently, its purpose is not to change the requirements of GAAP. Nevertheless, as the various sources of literature are put together to prepare the Codification, inconsistencies in accounting requirements will be identified and resolved by the Board. Constituents will have an opportunity to comment on the resolution of identified inconsistencies, as well as other aspects of the Codification, during an extended “verification process.” The verification process will begin once a sufficient portion of the Codification has been completed. The Codification is a multiple-year project whose time is long overdue.

Principles-Based Standards

The last and perhaps most challenging aspect of our journey to simplification of accounting standards relates to the topic of “principles-based” standards, or “objectives oriented” (the term the SEC used in its report to Congress on the topic). I am not going to recap here all that has been said for and against principles-based standards. Quite frankly, its time for some action, not words. The problem is that while it may appear that this action is totally within the control of the FASB as the promulgator of accounting standards, in reality, it is not. To understand why it is not within the control of the FASB, just read some comment letters we receive relative to a particular issue, or sit in a meeting with some constituents from a specific industry asking to be excluded from the scope of a standard, or talk to some auditors that are seeking specific guidance on the application of a standard, or talk to a regulatory body, or, worse yet, just listen to a plaintiff’s attorney argue that your interpretation of

what was intended by a particular “principle” was wrong and that the financial statements you issued or audited were not in conformity with GAAP.

A number of factors will influence how successful the Board is in moving toward principles-based standards, and that success will be subject to each individual’s interpretation of what is meant by “principles based.” The goal, in my mind, should be that there are few scope exceptions, few bright lines, and understandable objectives upon which reasonable people can exercise judgment that will not be the subject of second guessing by auditors, regulators, and the plaintiffs’ bar supported by good implementation guidance. Our hope is that the other forces that influence the financial reporting system will allow us to move toward that goal.

Summary

We often hear from constituents that they believe U.S. GAAP has become too complex and too voluminous. My purpose in writing

this article is to demonstrate that the FASB is concerned about the proliferation of and complexity of accounting standards. Unfortunately, we cannot control the increasing complexity of commercial arrangements. However, we can influence (1) the complexity of the standard-setting process and of the standards themselves; (2) the organization of the variety of standards, rules, and guidance that constitute what we now refer to as GAAP; and (3) how modifications are made to that guidance to reflect current thinking on the appropriate accounting for commercial arrangements. As described in this article, we have initiated some significant steps toward simplifying both the process and the organization of GAAP. We appreciate the support we have received thus far in our move toward simplification, and we ask for your continued input and support as we move forward.

¹ Private enterprises should note that while SEC literature will be included in the Codification, it will be included as a separate subsection within each topic to distinguish it from other GAAP requirements.