FINANCIAL ACCOUNTING STANDARDS ADVISORY COUNCIL
FASB Offices
Norwalk, Connecticut

June 24, 2008

Agenda*

8:30 am  Introductory Remarks (Mr. Dennis Chookaszian)

8:35 pm  Quarterly Status Reports

- Report of the FASB Chairman (Mr. Bob Herz)
- Report of the SEC (Mr. Conrad Hewitt)
- Report of the PCAOB (Mr. Thomas Ray)

9:30 am  Convergence: Current Issues on Implementation and Application
          Guidance and Timing Considerations

          Session Objective: To obtain FASAC members' input on specific
          convergence issues.

11:45 am  LUNCH

12:30 pm  Recent Studies and Proposals on Restatements

          Session Objective: To obtain FASAC members' input on any standard-
          setting implications that the FASB should consider related to the
          preliminary recommendations regarding the assessment of the
          materiality of errors to financial statements and the correction of
          financial statements for errors from SEC Advisory Committee on
          Improvements to Financial Reporting (Audit Process and Compliance
          Subcommittee).

1:30 pm  Contingency Disclosures (Mr. Russ Golden)

          Session Objective: To obtain FASAC members' input on the
          operationality of the disclosures proposed in the project.

2:30 pm  ADJOURNMENT

*Times are approximate.
FASAC MEETING

FASB CHAIRMAN’S REPORT

JUNE 24, 2008

- TECHNICAL ACTIVITIES
- INTERNATIONAL
- WASHINGTON, D.C.
- PEOPLE AND PROCESS MATTERS
ITEM 1: TECHNICAL ACTIVITIES

BOARD AND STAFF ACTIVITIES

a. Documents issued:

1. Final Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities.
3. Final FSP FAS 142-3, Determination of the Useful Life of Intangible Assets.
4. Final FSP FAS 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13.
5. Final FSP FAS 157-2, Effective Date of FASB Statement No. 157.
6. Final FSP FIN 48-2, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises.
7. Final FSP SOP 90-7-1, An Amendment of AICPA Statement of Position 90-7.
8. Final FSP SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1.
9. Proposed FSP FAS 117-a, Endowments of Not-for Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures. The comment period ended April 18, 2008.

b. Projects added to the Board’s agenda:

1. Project to address a conflict between AICPA Statement of Position 90-7, Financial Reporting by Entities in Reorganization under the Bankruptcy Code, and other authoritative accounting standards that expressly prohibit early adoption.
2. Project to reconsider FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities. This will be addressed together with the existing project on potential changes to Statement 140 on transfers of financial assets.
3. Project to consider improvements to disclosures about credit derivatives accounted for under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities.

c. A project that would have created one definition of a public/nonpublic entity to be used throughout all FASB literature was removed from the Board’s agenda.

d. Emerging Issues Task Force (EITF):

1. At the March 26, 2008 Board meeting, the Board ratified the consensus reached at the March 12, 2008 EITF meeting on Issue No. 07-4, “Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships.”

2. The Board also ratified the consensuses-for-exposure reached by the Task Force on Issues No. 07-5, “Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity’s Own Stock,” No. 08-3, "Accounting by Lessees for Nonrefundable Maintenance Deposits," and No. 08-4, "Transition Guidance for Conforming Changes to EITF Issue No. 98-5. The comment period for the draft abstracts posted to the FASB website for each of those Issues ends on May 5, 2008.

3. All seven Board members participated in the March EITF meeting.

4. The EITF chairman and several members of the staff met with the EITF Working Group on Issue 07-5.

e. Seven Board members, several staff members, and invited guests participated in the March meeting of the Financial Accounting Standards Advisory Council. For the closed portion of the meeting, the FASB directors provided an overview of the FASB’s structure, procedures, and technical agenda. Members of the FASB’s technical staff gave brief updates on major projects, such as the conceptual framework, financial statement performance, revenue recognition, and liabilities and equity.

f. Two Board members and staff held a closed meeting with the Senior Roundtable Steering Committee of the National Investor Relations Institute to discuss several topics, including financial statement presentation, revenue recognition, and liabilities and equity.

g. Three Board members, a director, and eight staff members met in a closed session with representatives of the Equipment Leasing and Finance Association (ELFA) to discuss the leases project.

h. Two Board members and the director of MP&T met in a closed meeting with the Investor Technical Advisory Committee. That committee provided investor perspectives on a variety of on-going Board projects including international convergence, improvements to Statement 140, and a potential project to provide a framework for disclosures.
i. The chairman, one Board member, the director of TA&I, and the director of PD&S met with representatives of the Big 4 firms to discuss fair value practice issues.

j. The TA&I director and staff met with the Valuation Resource Group to discuss Statement 157 implementation issues.

k. A staff member participated in a meeting of the Connecticut UPMIFA Working Group.

INTERNATIONAL ACTIVITIES

a. The chairman participated in the Global Public Policy Symposium of the major international audit networks in New York.

b. The FASB and the IASB held a semiannual joint meeting in London. The Boards’ discussions included various technical issues on the Boards’ joint projects on the conceptual framework and revenue recognition, discussions also included the updated Memorandum of Understanding and the Boards’ responses to reporting issues arising from the credit crisis.

c. FASB staff participated in IASB Board meetings and discussed various technical issues on the Boards’ joint projects on revenue recognition, amendments to IFRS 5, and financial statement presentation.

d. The FASB’s conceptual framework Board advisors met with the IASB via video conference and discussed technical matters.

e. The FASB and IASB directors continued their ongoing series of weekly conference calls to discuss technical and administrative matters.

f. The chairman and a staff member participated in the IASC Foundation Conference in Toronto.

g. A staff member participated in the Insurance Working Group meeting in London.

h. The chairman and two Board members met with a delegation from the Ministry of Finance (China) to discuss matters relating to international convergence of accounting standards.

i. The chairman, two FASB staff members, and an IASB staff member met with representatives of EFRAG to discuss several matters, including the FASB Preliminary Views, Financial Instruments with Characteristics of Equity.

OTHER ACTIVITIES

a. The following professional development sessions were presented to the Board and staff:
1. The Proposed IFRS for Small- and Medium-Sized Entities. Paul Pacter, Director of Standards for Small and Medium-sized Entities (SMEs) at the IASB, and Director of Global IFRS Office of Deloitte Touche Tohmatsu in Hong Kong, discussed the need for and the benefits of global standards for SMEs. In his presentation he also discussed issues raised in the course of the deliberations leading up to the February 2007 Exposure Draft, how the full IFRS was adapted to SMEs, comments received on the Exposure Draft, field test results, and the world’s movement toward adoption. He also covered the next steps in issuing a final standard.

2. Accounting for and in the Subprime Loan Crisis. Dr. Stephen Ryan, Professor of Accounting, Peat Marwick Faculty Fellow—New York University, Leonard N. Stern School of Business discussed the accounting for and in the subprime loan crisis. He also covered issues relating to fair value such as fair valuing assets in illiquid markets. In addition, he discussed the effect of the subprime crisis on securitisations and the application of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*.

3. NY Law and Ethics. Timothy F. Gearty, Becker Gearty CPE, presented a course on New York Law and Ethics. This course met the specific state ethic requirements for the State of New York and also satisfied most states’ ethics requirements where general ethics courses are acceptable.

4. Transitioning Canada into IFRS. Peter Martin, Accounting Standards Director, and Karen McCardle, Principal of the Canadian Accounting Standards Board, discussed the CICA’s plan for incorporating IFRSs into Canadian GAAP. The presentation highlighted the challenges Canada's Accounting Standards Board faced in its decision to adopt IFRSs to replace Canadian GAAP and the plan the Board developed to ensure the country will be ready for the changeover by 2011. The presentation included a discussion of how Canada decided when to adopt IFRSs, how to adopt them (in stages or all at once), who should be required to prepare financial statements in accordance with IFRS, what resources would be needed to ensure a successful transition, and a number of other key areas in the transition process.

**ITEM 2: ADMINISTRATIVE AND STRATEGIC ACTIVITIES**

a. All Board members attended the February FAF Trustees meeting.

**ITEM 3: WASHINGTON ACTIVITIES**

a. The chairman conferred with Members of the United States Senate and with Congressional staff members on international convergence, major project activities, and other technical activities of the Board.

b. Staff members met in separate meetings with various staff of Congressional committees and representatives of Washington, DC-based trade associations to discuss the role of the FASB, various current projects, and other matters of mutual interest.
c. The chairman participated as an official observer to the SEC Advisory Committee on Improvements to Financial Reporting. Board members are also acting as observers to the subcommittees of this committee.

d. The TA&I director participated as a senior advisor to the SEC Advisory Committee on Improvements to Financial Reporting.

e. The chairman participated as an official observer to the U.S. Department of the Treasury’s Advisory Committee on the Auditing Profession. Board members are also acting as observers to the subcommittees of this committee.

f. The chairman, two Board members, the director of TA&I, the director of MP&T, and a staff member held quarterly meetings with the SEC and the PCAOB to discuss current FASB activities and other matters of mutual interest.

g. The chairman provided a lengthy written letter to Senator Reed in response to the Senator’s inquiries relating to various reporting issues arising from the credit crisis.

**ITEM 4: SPEECHES DELIVERED**

Principal platforms addressed by the Board and staff members during the February 2008 through April 2008 period include:

- AICPA Webcast
- AICPA Webcast on Endowments, IPMIFA & Proposed FSP FAS 117-c
- American Accounting Association – APLG/FSA Meeting
- American Accounting Association – Midwest Regional Meeting
- American Bar Association’s Section of Business Law
- American Council of Life Insurers (ACLI)
- American Enterprise Institute (AEI) Fair Value Accounting Conference
- API Accounting Committee
- Becker Gearty for Professor and Students
- Bentley College
- Brigham Young University Advanced Financial Reporting Conference
- Center for Business Intelligence – Pharmaceutical Accounting & Reporting Congress
- College of Business, DeKalb, IL
- CPE Inc. 2008 Conference on Fair Value Accounting
- Connecticut State Society’s Not-for-Profit Committee
- Deloitte & American Accounting Assoc. Trueblood Seminars for Professors
- Directors Roundtable National Conference
- EuroFinance Conferences Ltd. International Cash & Treasury Management Conference
- Financial Executives International (FEI) Central PA Chapter
- Financial Executives International – FEI/CCR Meeting
- Financial Executives International Oklahoma City Chapter
- Financial Executives International Pittsburgh Chapter
ITEM 5: ADDITIONAL COMMUNICATIONS ACTIVITIES

a. The FASB, through the Communications Department, issued the following nine press releases:  
   - Financial Accounting Foundation Board of Trustees Approves Changes to Oversight, Structure and Operations of FAF, FASB and GASB (2/26/08):  
   - FASB Issues Proposed FASB Staff Position FAS 117-a, Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures (2/22/08):  
Reporting (4/17/08); and The Financial Accounting Standards Board and the China Accounting Standards Committee Sign Memorandum of Understanding (4/28/08).

b. The Communications Department spent a significant amount of time on media issues on fair value accounting and its role in the economic downturn. In addition to interviewing key FASB members and staff to prepare talking points and related materials on the subject, the department participated in publicizing a CFA Institute Media Roundtable on the subject, which counterbalanced criticism of fair value with input from the investor point of view. Media inquiries from a large number of publications were also handled, including an interview with Bob Herz by Ian Katz of Bloomberg and a NY Times interview with Russ Golden.

c. At the conclusion of the first quarterly FAF Trustee meeting of 2008, the Communications Department hosted a press conference at the Roosevelt Hotel in New York City to discuss acceptance by Trustees of proposed improvements to the FAF, FASB, and GASB.

d. The FASB and the Communications team continued to educate reporters from key outlets on the Board’s activities and mission and independent process. Specific meetings or conference calls were held with reporters on IFRS (Bob Herz interviewed by CFO.com on February 1; business combinations project (Sue Bielstein interviewed for Accounting and Business Magazine and FEI publication); Bob Herz profile (NJ CPA magazine); auction rate securities (Wall Street Journal interview with Russ Golden); VIEs (Dow Jones Newswire interview with Chris Roberge); participating securities (Compliance Week interview with Christopher Bolash); non-profit accounting issues (Investment News interview with Jeffrey Mechanick); Statement 161 (CFO.com and Business Week interviews with Kevin Stoklosa); FSP 157-c (CFO.com interview with Ron Maples); XBRL (Thomson Tax & Accounting interview with Dennis Chookaszian); and derivatives (Asset & Securitization Report interview with Bob Bhave).

e. The Communications Department worked with the FASB on developing and promoting the second FASB webcast held on March 13, 2008, titled “The Move to Codification of U.S. GAAP.”

f. On April 30, the Department provided a tour to a group of accounting students from Nyack College.

ITEM 6: GASB LIAISON ACTIVITIES

a. FASB meeting minutes were sent to the GASB RTA director and certain GASB staff.

b. GASB meeting minutes were sent to the FASB chairman and two staff directors.

c. The GASB RTA director and the FASB PD&S director held monthly meetings and met quarterly with the FASB and GASB chairmen.

d. The FASB staff distributed the following drafts to the GASB for review:

- Final Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*
- Final Statement, *Accounting for Financial Guarantee Insurance Contracts*
- Final Statement, *The Hierarchy of Generally Accepted Accounting Principles*
- Final FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets*
- Final FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*
- Final FSP APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*
- Final FSP SOP 90-7-1, *An Amendment of AICPA Statement of Position 90-7*
- Final FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*
- Proposed revised Statement, *Earnings per Share*
- Proposed Statement, *Disclosure of Loss Contingencies*
- Proposed FSP FAS 117-a, *Endowments of Not-for-Profit Organizations: Net Assets Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures*
- Proposed FSP FAS 132(R)-a, *Employers’ Disclosures about Postretirement Benefit Plan Assets*
- Proposed FSP ARB 43-a, *Amendment of ARB No. 43*
- Proposed FSP SOP 94-3-1 and AAG HCO-1, *Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations.*
- Invitation to Comment, *Reducing Complexity in Reporting Financial Instruments*

e. The FASB staff received the following GASB draft for review:

- Exposure Draft, *Service Efforts and Accomplishments Reporting.*
Margaret M. Smyth  
Vice President, Controller  
United Technologies Corporation

Peggy Smyth is the Vice President, Controller of United Technologies. Peggy had previously been Vice President and Chief Accounting Officer of 3M in St. Paul, Minnesota and a senior partner at Deloitte & Touche and Arthur Andersen in New York City.

She has a B.A. from Fordham University, New York, and an M.S. in accounting from New York University, Leonard N. Stern School of Business, graduating Summa Cum Laude from both. She is a CPA in several states and a member of various professional organizations, including the Executive Board of the Financial Executives International Committee on Corporate Reporting, the International Accounting Standards Board (IASB) Global Preparers Forum and the International Financial Reporting Interpretations Committee.

Peggy has recently or currently serves as a Director/Trustee for the following not-for-profit organizations: Concern Worldwide (U.S.) Inc., Fordham University, Archdiocese of St. Paul and Minneapolis, Catholic Charities of the Archdiocese of New York and Ordway Center for the Performing Arts. Peggy is also an independent Director of Mutual of America Investment Corporation.

In 2006, Peggy was selected to participate in the Aspen Institute’s Henry Crown Fellowship Program for young leaders. She has also recently been honored by Irish Voice Newspaper as one of the 50 Most Influential Women and Irish America Magazine as one of the Business 100 Leaders. Peggy was named as one of Crain’s New York 40 Under Forty a few years ago.

Peggy is married and resides with her husband and two sons in a suburb of Hartford, CT. The family also owns a small farm in County Roscommon, Ireland. She is a dual citizen.
IFRS

UTC Background

Sales: $55 billion
Net income: $4.2 billion
Employees: Over 222,000
Market capitalization: $68 billion*
Operate in over 200 countries
Member of Dow 30
In 2009, UTC stock will have traded on NYSE for 75 years

* As of March 27, 2008
IFRS
Revenues – 2007 (US GAAP)

$55 billion
# Drivers of Interest in IFRS

<table>
<thead>
<tr>
<th>Demographics</th>
<th>Leadership</th>
<th>Investments</th>
<th>Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Significant portion of operations outside the U.S.</td>
<td>• Planning for the “inevitable”</td>
<td>• Active in cross-borderer M&amp;A transactions</td>
<td>• Subsidiaries may already file IFRS financials</td>
</tr>
<tr>
<td>• Operates in industries with extensive international competitors</td>
<td>• Embedding IFRS into larger finance transformation strategy</td>
<td>• Investments in joint ventures</td>
<td>• More subsidiaries will be subject to IFRS reporting</td>
</tr>
<tr>
<td></td>
<td>• Timely and thoughtful implementation</td>
<td></td>
<td>• Building efficiencies in global reporting processes, including statutory reporting</td>
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Opportunities:

– Standardize and streamline statutory reporting
– Provide global flexibility for capital raising, personnel deployment and systems
– Comparability with international peers
– Enhanced internal controls

Challenges:

– Tax relief for LIFO inventory
– Unknown market reaction
– Internal and external training
– Time and resources required
IFRS DOW 30 SURVEY
Executive Summary

In favor of adopting IFRS as the global standard – 85%

US filers are not yet ready for IFRS – 83%

- Revenues > $50 billion
- Revenues < $50 billion
- International revenues > 50%
- International revenues < 50%
IFRS DOW 30 SURVEY
Company Responses

Number of respondents

<table>
<thead>
<tr>
<th>Activity</th>
<th>Number of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies who responded</td>
<td>25</td>
</tr>
<tr>
<td>Discussed with senior mgmt or audit committee</td>
<td>20</td>
</tr>
<tr>
<td>Initiated a project to investigate adoption</td>
<td>15</td>
</tr>
<tr>
<td>Engaged an audit services firm to assist</td>
<td>10</td>
</tr>
</tbody>
</table>
IFRS DOW 30 SURVEY

First year companies would file in IFRS
“If each country continues to adopt their own version, we do not believe there is value of adopting IFRS”

“… too much uncertainty regarding how the … regulators will adjust to a conversion to IFRS”

“Market reaction … is completely unknown, LIFO conformity MUST be changed, systems work is necessary”
We are in favor of adopting a global accounting standard … more representative of a global framework

inevitable and we ought to do everything possible to accelerate it

Foreign investors may find US capital markets more attractive and less cumbersome
IFRS

Summary conclusions

• Right thing to do; will benefit global companies
• Takes time – get started now
• Educate and engage senior management and board members
CONVERGENCE: CURRENT ISSUES ON IMPLEMENTATION AND APPLICATION GUIDANCE AND TIMING CONSIDERATIONS

Financial Accounting Standards Advisory Council
June 24, 2008

Objective
To obtain FASAC members’ input on current financial reporting issues related to international convergence within the following areas:

1. Implementation and application guidance
2. Timing considerations

Background
The FAF-FASB held a forum called the “High-Quality Global Accounting Standards: Issues and Implications for U.S. Financial Reporting” on June 16, 2008 at Baruch College. The purpose of the forum was for the FAF and the FASB to open a dialogue with constituents about whether and how to continue to move the U.S. toward high-quality global accounting standards. Panelists included users of financial statements, representatives of small and large companies both public and private, auditors, regulators, educators, and others representing facets of the U.S. economy that would be affected if there were a move from U.S. Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS).

At the June FASAC Meeting, a brief oral summary of highlights from that meeting will be provided. Following that meeting, the September FASAC meeting, which will be an extended 2-day format, will provide further opportunity to discuss many of the strategic issues raised at that forum. The purpose of the June meeting will be to focus on two, near-term issues identified below for which the FASB is seeking further feedback.

Note: These materials are provided to facilitate understanding of the issues to be addressed at the June 24, 2008 FASAC meeting. These materials are presented for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.
Part 1: Implementation and Application Guidance

**IASB’s Approach**


The IASB issues International Financial Reporting Standards (IFRS). In addition to the accounting and reporting requirements within the standard section, those IFRS include:

- Application guidance that is mandatory, which is considered “an integral part of the IFRS and
- Illustrative examples that are not mandatory, which “accompany, but are not part of” IFRS.

Interpretative guidance is provided either within the IFRS or by the International Financial Reporting Interpretations Committee (IFRIC). IFRIC looks to whether reasonable people with reasonable judgment and good faith application would get significantly different financial reporting results. Very few issues are added to IFRIC’s agenda and some have observed that the IASB is reluctant to answer lots of questions.

**Live Case: Current Application and Implementation of Joint FASB/IASB Standards in the US**

The FASB and IASB have shared the same long-term strategic priority for years—a common set of high quality global standards. At their joint meeting in September 2002, the FASB and IASB pledged to “use their best efforts (a) to make their existing financial reporting standards fully compatible as soon as is practicable and (b) to co-ordinate their future work programmes to ensure that once achieved, compatibility is maintained.”

FASB Statement No. 141 (revised 2007), *Business Combinations*, was issued together with the IASB’s IFRS 3, Business Combinations (as revised in 2007). The issuance of those standards was a joint effort by the FASB and the IASB to improve financial

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1 Patricia O’Malley assumed the position of International Financial Reporting Interpretations Committee (IFRIC) Coordinator in July 2007 at the completion of her six-year term as a member of the International Accounting Standards Board.
reporting about business combinations and to promote the international convergence of accounting standards. Both the US and the International standards:

- Require use of the acquisition method rather than the pooling-of-interests method to account for business combinations
- Include the same conclusions on the more significant issues involving application of the acquisition method of accounting for a business combination.

Appendix G of Statement 141(R) describes the substantive differences between this Statement and IFRS 3.

Depending on the questions raised by constituents, the U.S post-issuance activities in general have included a mix of authoritative, non-authoritative, and educational activities, such as the:

- Issuance of additional guidance by the FASB (e.g., FSPs or EITF consensus')
- Narrowing of acceptable alternatives by regulators (e.g., industry-specific)
- Answering of technical inquiries
- Development of educational, industry-wide, and firm-wide resources.

Part 1 Discussion Questions: Implementation and Application Guidance

Current US Financial Reporting

Discussion Question 1: Should application and implementation issues be addressed by the FASB after the completion of a joint (converged) project?

Discussion Question 2: Prior to the adoption of IFRS, how should the FASB balance the relative importance of consistency of application (within the US) with avoiding the creation of a “U.S. version of IFRS”?

Discussion Question 3: Using 141(R) as a model, if no authoritative application and implementation guidance is provided by standard-setters for this statement, how will the US financial reporting system handle this change?

Part 2: Timing Considerations

At the FAF-FASB Forum, there seemed to be broad support for a specific and certain date for IFRS conversion by US companies. Participants discussed the current state of readiness and preparations that would be needed before that date, including action items related to: practicing US CPAs, corporate management/accountants, CPA exam and licensing, investor education, auditing standards, university education, securities
regulation, banking regulation, interaction of US tax code and GAAP, technology and information systems, and contract provisions and covenants based on GAAP. In thinking about timing considerations, we would like advisory group members input about standard-setting timing implications to the technical work plan.

**FASB-IASB Memorandum of Understanding**

In February 2006, the IASB and the FASB issued a Memorandum of Understanding (MoU) that described a joint work plan to expedite global convergence in accounting standards and established a series of milestones to be reached by 2008. Most of those milestones have now been reached or are due to be reached during 2008.

A number of jurisdictions have announced their intention to adopt or converge with IFRSs in the next five years. The chairmen of the IASB and the FASB agreed that the timeline contained within the existing MoU should be updated. Doing so will help to direct the work plan of the two Boards through to at least 2011. The two chairmen asked a small team of representatives from the IASB and the FASB to produce a paper on the subject for discussion at the joint board meeting.

At the April 21, 2008 FASB/IASB Joint Board Meeting, the two Boards discussed that paper at their joint meeting and accepted the broad principles recommended in it. The Boards directed the staff to develop details for consideration in the technical plan update session at the IASB’s Board meeting in June. The FASB and IASB intend to publish an updated work plan after that meeting. Attachment B-1 is a copy of the April discussion paper. The focus of that memo was major agenda projects, rather than what have been called “short-term convergence” projects.

**Live Cases: US Approach for Certain MoU items**

In some of the short-term convergence projects, the project objectives can be met through different approaches. For example:

**Income Tax Project:** The objective of the Income Tax project is to improve the accounting for income taxes, while reducing the existing differences between FASB Statement No. 109, *Accounting for Income Taxes*, and IAS 12, *Income Taxes*. The FASB and the IASB (Boards) started the project as a short-term convergence project that was focused on a narrow set of differences. In the meantime: (1) the FASB issued FASB Interpretation No. 48, *Accounting for
Uncertainty in Income Taxes and (2) the IASB decided to rewrite IAS 12 and to improve its guidance on uncertain tax positions in a way that may result in a different approach than FIN 48. There are other differences in tax-related guidance that reside in other accounting standards, such as the tax treatment of share-based compensation arrangements.

Some alternative approaches include:

♦ Approach A: Amend Statement 109 to improve the accounting and reduce the differences by proceeding with the short-term convergence changes (gradual convergence through improvement and adoption). Under this approach, the accounting for income tax uncertainties could be different, depending on the IASB’s decisions.

♦ Approach B: Consider whether to adopt the improved version of IAS 12 and replace Statement 109 in its entirety (piecemeal convergence through the adoption of an improved IFRS standard). Under this approach, the accounting for income tax uncertainties would be the same, but may be different from FIN 48, depending on the IASB’s decisions.

♦ Approach C: Same as Approach B, except defer the effective date until IFRS is required/permitted in the US (a single omnibus adoption). Under this approach, the FASB would effectively remove the income tax project from its agenda and the changes to income taxes would occur when full IFRS is required/permitted.

Other potential examples of piecemeal convergence through the adoption of an IFRS standard include:

♦ Considering whether to adopt IAS 38, *Intangible Assets*, which includes a different approach to the accounting for in-process research and development than US GAAP

♦ Considering whether to adopt IAS 40, *Investment Property*, which requires a policy election approach for the measurement of investment property

♦ Considering whether to adopt IAS 17, *Leases*, for the accounting by lessors at the same time as any improvement for lessee accounting (Attachment B-1 recommends that the Boards improve lessee accounting by the mid-2011 goal. It observes that lessor accounting is an application of revenue recognition and should be dealt with in a manner that reflects the decisions reached in that project. That likely means that improved standards for lessor accounting would be completed after 2011.)

**Part 2 Discussion Questions: Timing Considerations**

**Discussion Question 4**: Using a 5-year time frame as a basis for public company adoption of IFRS, what projects on the MoU need to be completed beforehand to best serve US investors and other constituents? Are other improvements to IFRS needed before the US adopts IFRS more broadly?
**Discussion Question 5**: Prior to the adoption of IFRS, what approach should the FASB take on these types of projects (such as short-term convergence projects) in the meantime and why? Should the FASB amend US GAAP to improve and converge, adopt high-quality IFRS standards on a piecemeal basis, or defer all changes to a single omnibus adoption?

**Discussion Question 6**: On projects that are on the IASB’s agenda, but are not on the FASB’s agenda, should the FASB expose the documents resulting from those projects to solicit US-based constituents input?
1. Earlier this year, Bob Herz and David Tweedie agreed that the Boards should provide a progress report and develop a work plan for the completion of the February 2006 Memorandum of Understanding (MOU). When issued, the MOU set out joint project priorities and milestones only through 2008. Both Chairs agreed that constituents would want to know how the Boards intend to proceed beyond 2008 towards completion.

2. To develop the progress report, the Chairs agreed on the need to lay out the updated MOU through at least 2011 and called upon a small team (the Group) to set forth proposals, which are outlined in this paper. In developing proposals, the Chairs asked the Group to identify the relative priority of needed financial reporting improvements, the time frames for completing them, and the major milestones along the way. The two Chairs also agreed that the Boards should consider whether process changes can or should be implemented to reduce the time required to develop standards.
3. While the long-term objective of the MOU to develop improved and converged standards for IFRSs and US GAAP remains relevant, the Group recognized that a previous objective already has been achieved: progress toward improving standards so that the SEC would feel comfortable removing the reconciliation requirement for non-US companies that use IFRSs and are registered in the United States.¹ With the removal of the reconciliation, the Group decided that a logical starting point for any MOU progress report and completion plan (referred to as the MOU completion plan throughout) is to update the Boards’ medium-term objective. The Group recommends the following objective:

To outline the improvements to existing IFRS that are needed to facilitate mandatory adoption of IFRS in all major capital markets.

4. The Group was tasked with developing recommendations consistent with the following two assumptions:

   a. For capital markets not yet adopting IFRSs, the target date of mandatory adoption is no later than 2013.

   b. A “quiet period” of at least a year before that date is provided.

5. Those assumptions mean that the MOU completion plan should describe progress to be made between now and around mid-2011, a period of about 3 years (36 months). Three years sounds like a long time until you do some math:

   a. Issuing a due process document usually takes about 12 months away from deliberations/analysis—on average, it takes 3 months to prepare and ballot a due process document, 6 months for exposure, and another 3 months to read and summarize comments.

   b. If major projects (except those of exceptionally urgent nature) require two due process documents to complete it (a discussion paper and exposure draft), that leaves about 12 months for Board deliberations, ignoring preparation and

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¹ In April 2005, SEC Chief Accountant Don Nicholaison gave a speech that outlined a “roadmap” for removal of the 20-F reconciliation. That roadmap said that removal of the reconciliation would depend on, among other things, measurable progress in addressing priority issues on the IASB-FASB convergence work programme. The Boards developed the MOU to describe for the SEC and others the progress the Boards planned to achieve by 2008.
balloting of the final standard (36 months total less 24 months of due process). The Boards have yet to deliberate any phase of a joint project in less than 12 months (not even short-term convergence projects). It took 18 months to take business combinations from ED to final, and we didn’t even converge on all points.

c. Fortunately, discussion papers already have been issued (liabilities and equity) or will be issued by mid-2008 on several major projects (revenue recognition and financial statement presentation). The Boards should have at least 24 months to deliberate issues in those projects. However, the Boards have been deliberating issues in many of those projects for at least five years. The issues are many and controversial, and completing them in two years represents a significant challenge.

6. So, regardless of the type of project, a mid-2011 completion date goal requires that the Boards work more efficiently than they ever have. Discussions around improving efficiency of projects often revolve around issues of project administration—meeting frequency, staffing, or other work methods issues. Those are all worthy of discussion, and we will discuss them during the administrative portion of the joint meeting. However, there is another fundamental reason why projects take as long as they do: The Boards (and members within each Board) sometimes don’t agree on what they are trying to fix and how to fix it.

   a. There are often differences in views over issues of agenda size and project scope—progress is slowed by discussions about whether a project is worthwhile, or whether the issues within a project are worthwhile resolving, or often, expansion of project scope. Short-term convergence projects are good examples of this. Financial statement presentation might be another example of scope “creep” (the scope of the project expanded to include revisions to segment disclosures based on the view that existing segment disclosures were deficient).

   b. A second source of difference is over the approach to be taken, usually, differences in views about the need to develop a conceptual model as the basis for the revised standard. Revenue recognition is an example. Some see the problem as a lack of a robust conceptual model on which to base a principles-based standard, while others seem to see the problem as the lack of standards-
level guidance in specific areas such as multiple-element transactions for which a more focused patch-up effort is appropriate (or, in the US, an effort to codify and rationalize existing practices into three or four models).

c. A third is what we call “cross-cutting” issues—differences in views about whether and how similar issues in active projects should be resolved consistently. If internal consistency is the goal, no project can move any faster than any other to which it is related (for example, under this view, the IASB’s replacement business combination standard couldn’t be issued until the IASB completed fair value measurement).

7. Each of those differences essentially relates to the project objective—the deficiency the Boards are trying to fix and the way of fixing it. A significant amount of Board time is consumed re-debating those same issues.

8. The Group thus decided that if the Boards are going to be successful completing some set of projects by mid-2011, agreeing on project objectives in April is critical. Board members and staff on the losing end of those debates need to be willing to work hard to achieve an objective with which they don’t fully agree. We simply do not have time for “do-overs.” For that reason, the Group focused first on identifying and articulating project objectives—the improvements it believes can be accomplished by the mid-2011 goal date. The Group notes, however, that more will be required than defining project objectives. Meeting those improvement goals will require improving our meeting and work processes on some projects too.

9. As we analyzed projects, we found that our priorities, and we suspect the views of Board members, may be driven by two potentially conflicting views:

   a. The IASB agenda priorities should limit the possibility that a company adopting IFRS in 2013 would undergo two changes in a relatively short period (the first change being the adoption of IFRS and the second change being a major revision of an IFRS standard). Thus, work completed by 2011 should be designed to remain in place for three or more years after completion; any other changes to IFRS during the 3-year period after 2011 should be modest. Under this view:

      i. Significant, fundamental weaknesses in existing IFRS need to be prioritized for completion by mid-2011.
ii. Worthwhile improvements to IFRS can be deferred beyond 2011 if the existing IFRS and US standards are similar (leasing would be an example of this).

b. The IASB always should seek to improve financial reporting, regardless of the timing of IFRS adoption, whether by the US or any other major capital market. This suggests that the IASB should emphasize projects in which major improvements are needed. Under this view:

i. Significant, fundamental weaknesses in existing IFRS need to be prioritized for completion by mid-2011.

ii. Worthwhile improvements should not be delayed. For example, if leasing is broken, it should be fixed.

10. The Group concluded that achieving a mid-2011 completion goal will require revisions to scopes and objectives of at least some projects. Thus, the Group’s recommendations also considered a pervasive constraint. That is, the Group considered whether the changes that the Boards could reasonably expect to achieve by 2011 are a sufficient improvement in financial reporting to justify the cost those changes might impose on users and preparers of financial statements.

11. In analyzing the individual projects, the Group found it useful to divide them into three categories, listed below in what we see are their relative order of priority:

a. Projects that address areas where fundamental improvement in IFRS and possibly US GAAP are needed. This category includes revenue recognition and fair value measurement guidance. Given the current situation surrounding the credit crisis, we also include in this category consolidations (with special attention to special-purpose entities) and derecognition.

b. Projects that address areas for which there is a significant need for improvement in both IFRS and FASB standards. This group generally includes the balance of the MOU.

c. Projects that address areas in which IFRS currently does not provide guidance. This group includes insurance accounting and accounting for extractive industries. We have not included a separate discussion of this category in this memorandum. We question whether the insurance project can be completed by 2011, given the significant political opposition and demands for additional
field testing. A project on extractive industries is certainly beyond our ability to complete by 2011. At best, the IASB might agree to publish a discussion document on extractive industries prepared by the existing working group of national standards setters, so long as doing so does not consume any Board or staff resource.

The Group notes that it is not exactly true that IFRS does not provide guidance in these areas. IFRS 4 and IFRS 6 contain guidance that enables companies to continue reporting under their existing accounting policies, a status quo situation that new adopting countries presumably would accept. Moreover, provisions within those standards preclude voluntary accounting changes in accounting policies other than those that produce more relevant and no less reliable information. Those provisions should be an adequate safeguard against the adoption of IFRS resulting in a step backward in information content or quality.

12. Group members have different views whether some or all of the Framework should be included in the MOU completion plan.

a. Some think that the MOU completion plan should focus on standards-level projects. The obstacles faced by companies in switching to IFRS in the near future will be at the standards level. Notwithstanding the hierarchy and IAS 8, work on the Framework, while important, has little effect on a company implementing IFRS.

b. Others think that some of the Framework, in particular measurement and a disclosure Framework, should be included in the MOU completion plan. The Framework will be the basis for developing standards in the future, and it is important that those major gaps be filled before mandatory adoption of IFRS is required.

13. Another question is whether the MOU completion plan should include other projects on which the Boards have committed to work jointly but were not included in the MOU. We also have not addressed these projects in this memorandum, including those like emission rights on which the Boards hope to work together. The importance of the 2011 date is such that all of those projects must take a subsidiary role to the ones addressed in this memorandum. For their part the IASB and FASB directors intend to make the projects in this memorandum their primary staffing priority. If necessary, they will remove staff
from other projects to serve the projects addressed in this memorandum and will not staff other projects unless and until staff become available.

14. Some Group members think the Boards should actively consider and make decisions about those other joint projects. The purpose of the MOU completion plan is to focus the agenda. If there is insufficient staff or Board time to focus on other joint projects, the Boards should consider removing them from the agenda or formally suspending them. Retaining projects on the agenda that the Boards do not plan to actively work on creates uncertainty for our constituents and can be demoralizing to the staff assigned to them.

15. One other note bears mention before we turn to the detailed analysis of projects. For some projects, the end game is clear and there appears to be significant Board support for achieving that objective. Defining the scope for these projects that can be achieved by 2011 is straightforward. For other projects a solution that would constitute a sufficient improvement in financial reporting is not clear. Those projects are more problematic and, in some cases, we have suggested that some specific decisions may need to be deferred to the October joint meeting.

16. In summary, the Group recommends that the Boards reach a decision on the scope of the MOU completion plan—whether it should include the Boards’ joint agenda in full and describe priorities, milestones, and completion dates for each project, or whether it should include only a priority subset of the joint agenda (as was the case with the MOU).

Projects that address fundamental deficiencies in IFRS that require completion as a high priority

17. Revenue recognition. We view completing the project to be critical to U.S. adoption of IFRS—revenue is fundamental to financial statement analysis, and the existing guidance in IAS 18 is incomplete, insufficient, and internally inconsistent. We need to recognize that IAS 18 often is applied with US GAAP as a backstop. Preparers who do not find a ready answer in IAS 18 often resort to the detailed guidance provided in US GAAP, so long as that guidance is not inconsistent with IAS 18.

18. In our view, the broad project objective is to develop a single model of revenue recognition that can be applied to a variety of transactions and can resolve current revenue recognition issues consistently.
Recommendation

19. A majority of Board members appear to support (or at least would not object to) the so-called customer consideration approach to measuring performance obligations. We, therefore, recommend that the Boards proceed on that basis. Building on that recommendation, the Boards should move expeditiously to address the following areas:

   a. The definition of a performance obligation
   b. When/how performance obligations are satisfied/extinguished
   c. When, if ever, the initial amount assigned to a performance obligation should change for reasons other than performance (for example, the accounting for arrangements with variable consideration such as volume or milestone-based pricing)
   d. The accounting for conditional obligations such as rights of return
   e. Disclosure
   f. Testing the conclusions reached against existing practice problems. A new revenue recognition model that does not resolve the practice problems recently raised for EITF or IFRIC consideration would not, in our view, represent an improvement in practice. The FASB staff, with its greater experience in topics considered by the EITF, is probably better positioned to perform this part of the work.

20. In our view, the items above (especially items a and b) must be resolved before the Boards issue a discussion document.

21. Given the number of significant issues outstanding, completing a revised revenue recognition standard by mid-2011 represents a major challenge. Focused effort is required to achieve it.

Alternatives considered

22. We also considered an option that focuses on improving disclosures. At the December 2007 FASB-AAA conference, many users identified inadequate disclosures as a glaring weakness of both US GAAP and IFRS. They said improving disclosures should be a
priority. An option for the Boards is to focus on improving disclosures about revenue by 2011, to be followed at a later date by improved standards of recognition and measurement. A primary disadvantage of this approach is that (a) disclosure is a poor substitute for recognition and measurement and (b) disclosure projects tend to reduce the interest in solving the more difficult standards issues.

23. We also observed that users’ comments about the need for disclosure tend to focus on the revenue recognition for a particular type of transaction. Crafting a disclosure package that would provide sufficient information about an entity that has perhaps 100 or more different revenue transactions would be daunting. It is not clear the result would satisfy the needs of users.

24. We considered a narrower scope, aimed at making targeted improvements to IAS 18. While a narrow scope might seem appealing, we rejected it. The Boards have not devoted any significant attention to identifying the targeted improvements to IAS 18 that might prove useful. Doing so would constitute a major change in course and would set aside much of the work that already has been done. Nor do we see the possibility that targeted changes might constitute a sufficient improvement in IAS 18 to overcome concerns expressed by the SEC and others.

25. **Fair value measurement.** The Group thinks this project is critical to the adoption of IFRS. Like US GAAP before the issuance of Statement 157, IFRS lacks a consistent/robust definition of fair value. Moreover, members of the FASB Investors Technical Advisory Committee have said the lack of “Statement 157 disclosures” in IFRS is a significant issue for investors.

**Recommendations**

26. The Group thinks this project should be completed by mid-2011 by limiting its objective to the following:

   a. Amending existing IFRS to replace the various measurement terms used with either entry price or exit price based on the intent of the existing standard

   b. Defining exit price identically to Statement 157
c. Defining a comparable entry price, and providing disclosures about entry and exit price measurements.

27. In our view, this project cannot be completed by 2011 if the IASB seeks to reconsider fundamental features of the FASB standard. Those include, for example, the idea of a market participant view, highest and best use, and principal market.

28. Board discussions of fair value easily and often migrate into conceptual discussions of matters such as

   a. Which measurement attribute should be used, rather than what existing standards require

   b. Whether gains on initial recognition are ever appropriate

   c. Is an entity-specific measure an attribute—what does an entity-specific measurement mean?

29. Completing a fair value measurement standard by 2011 requires that the Boards leave those conceptual discussions for the Conceptual Framework or other standards-level projects.

30. **Consolidation Policy.** The FASB has added a project to address identified weaknesses in FIN 46R and Statement 140. (However, that project is limited to narrow improvements and does not address the more basic needs.) The SEC and others expect those improvements to be completed within a year.

31. The IASB continues to discuss improvements to IAS 27. The critical issues are improved guidance relating to effective control and special-purpose entities. Most IASB members seem to agree that analysis of SPEs requires a risk and rewards as an indicator of control; however, some seem to be unsure about whether the principles developed to date would produce appropriate financial reporting results in all circumstances.

**Recommendations**

32. The goal by 2011 should be a consolidation policy standard that embraces the idea of effective control. A small group of IASB Board members and staff have held preliminary
discussions and outlined an approach. The team should bring that approach to the Board for consideration at the earliest possible time.

33. One possible way of accelerating progress on SPE’s might be to retain those who were intimately involved in developing FIN 46R to develop and articulate a set of principles that underpins FIN 46R that would retain the approach but reduce the standard’s complexity and perhaps make it suitable for international application. This analysis also should consider deficiencies identified by the FASB in its recent efforts to improve FIN 46R.

34. **Derecognition.** The Boards decided in 2006 that both of our derecognition standards needed improvement. Statement 140 was then deemed to be irretrievably broken, and still is despite ongoing repair and maintenance work. IAS 39 was then, and still is, viewed by many as internally inconsistent and anecdotal evidence indicates that it is inconsistently applied in practice. For those reasons, the Boards decided that jointly developing a replacement for both standards was the best path forward.

35. The perceived need for replacement standards has not changed since 2006; however, the current economic situation has changed the relative priority of that project. The US securitization market is several multiples the size of the market in other parts of the world, even recognizing the current credit crunch. Adoption of IAS 39 and SIC 12 by the US marketplace would likely trigger an avalanche of application inquiries and put a spotlight on inconsistent practices.

36. Significant progress toward a replacement standard has been made in the form of a staff research paper developed in consultation with a team of Board advisors. More work is needed, however, primarily to address securitization issues. In particular, the focus now is on who collects the cash, which causes issues in principal-agent relationships. Staff turnover has resulted in a loss of momentum, and progress will be slowed as new staff get up to speed.
Recommendations

37. The Financial Stability Forum has identified addressing off-balance sheet exposures as an urgent priority, in light of the ongoing credit crisis, and urged standard setters to make improvements on an accelerated basis. This may require making an exposure draft the first document provided for public commentary.

38. We recommend the Boards do so by undertaking the following actions steps in the very near term:

   a. Complete the staff research paper. This will require assigning more experienced staff to address the principal-agent issues. We cannot afford the luxury of waiting for the newly assigned staff to get up to speed on these issues.

   b. Consider comment letters on the FASB proposed revisions to Statement 140 for further insights.

   c. Based on steps a. and b., determine next steps at the October joint board meeting for accelerating development of a new standard.

   d. Consider establishing a small, focused working group of experienced investors, preparers, and auditors that can advise the staff, starting its work during the comment period.

Projects that address areas for which there is a significant need for improvement in IFRS

39. Financial statement presentation. The stated purpose of this project is to develop standards for presentation of financial information within the primary financial statements. Many Board members seem to agree that this project is important because of the potential it holds to increase the understandability of financial information produced by the use of fair values within the mixed-attribute measurement system.

40. The most challenging/contentious issue is whether to retain “net income/profit and loss” or some other intermediate measure of performance and the related recycling issue. The Boards need to decide when and where they want to tackle this issue.
a. Some seem to think that the issue is beyond the scope of a presentation project. They believe changes to “net income/profit and loss” are recognition matters to be dealt with in other projects.

b. Others seem to think that “net income/profit and loss” is a presentation issue. It is a matter of disaggregating comprehensive income into components or categories—net income/profit loss is no different than requiring an operating, financing, or discontinued operations category.

**Recommendations**

41. The project should not seek to determine whether a net income/profit and loss subtotal should be reported and, if so, the nature of the items that should be excluded from it. Financial statement presentation would not result in established principles that other projects would use in determining whether any recognized amounts should be reported outside of earnings (e.g., projects such as postretirement benefits and financial instruments.) We recognize the implication of this recommendation, that being the continued acceptance of an ad hoc approach to items reported outside of net income and differences in our approach to recycling. (See discussion of pensions below.)

42. The project scope should be returned to its original focus on presentation on the face of the financial statements and a limited number of disclosures directly related to presentation issues. Other issues such as improved segment/liquidity disclosures should be addressed in separate projects based on an evaluation of the relative need for improvement in those or other areas.

43. **Postretirement benefits.** The IASB recently has issued a discussion paper on phase 1 of its project focused on measuring cash balance plans, elimination of so-called smoothing devices, and income statement presentation of changes in plan assets and benefit obligations. The measurement issues for cash balance plans are challenging. The Group thinks resolution of those issues should be deferred, if necessary, to issue a final standard on other issues by 2011.
Recommendations

44. The IASB should continue its work on phase 1 of the project. If the issues surrounding cash balance plans prove to be as daunting following the discussion period as they were in the lead up to the discussion paper, then the IASB should consider dropping cash balance plans from the current project. Alternatively, the IASB may consider a definition that while less conceptually pure, leaves promises like those in career average plans untouched.

45. Phase 2 of this project should be suspended and staff resources allocated to MOU projects. The IASB should consider whether to restart work after phase 1 of its project is complete. The research work currently under way by the UK ASB and other national standard setters might be used to jump start progress on phase 2 once it commences.

46. The FASB continues to evaluate how changes in plan assets and benefit obligations would be presented under the proposed presentation principles developed in the financial statement presentation project. That work should continue and can assist the IASB in resolving the open questions of presentation in its discussion document.

47. Leasing. The serious deficiencies in existing standards make the leasing project a priority for many. Significant lessee obligations are excluded from corporate balance sheets, distorting financial ratios and complicating financial analysis for investors. Lessor accounting raises many derecognition and revenue recognition issues, but appears to be a relative lower priority for investors and some Board members.

48. There seems to be little dispute that the “right to use” is an asset of the lessee, but the Boards have yet to resolve the difficult issues of the accounting for options (rights to terminate or renew), contingent rent, and other conditional obligations. Nor have the Boards made decisions on the fundamental issue in lessor accounting—whether the lessor should derecognize a portion of the asset subject to lease or recognize a long-term performance obligation.

Recommendations

49. The Boards should improve lessee accounting by the mid-2011 goal. Lessor accounting is an application of revenue recognition and should be dealt with in a manner that reflects the decisions reached in that project. That likely means that improved standards for lessor
accounting would be completed after 2011. We accept as a consequence of this recommendation that there may be a lack of symmetry and a different unit of account between lessee and lessor accounting for some time. We weighed that consequence against the improvement in financial reporting that would come from recognizing lease obligations in lessee’s financial statements.

50. In regards to lessee accounting, the Boards should pursue an approach that results in on-balance-sheet presentation of leases. In our view, an approach that views the substantive lease term as the unit of account offers significant promise. In effect, our recommendation would leave the classification of finance leases in IAS 17 unchanged. What were previously operating leases would then be reflected as the acquisition of an intangible asset—the right of use inherent in the lease.

51. We recommend that the Boards proceed without debating changes to amortization and depreciation accounting. We note that many in the leasing business are far more concerned with the pattern of recognized expense (straight line) than with the balance sheet presentation. This should come as no surprise to the IASB following the debate on service concession agreements or to the FASB following its recent meeting with the Equipment Leasing Finance Association.

52. The Boards should avoid reconsidering areas for which current lease accounting provides answers, even though those answers are imperfect. In particular we recommend that the Boards proceed using current definitions of what constitutes a lease and the treatment of contingent rentals.

53. The Group considered whether the Boards should publish the two G4+1 documents on lease accounting as the first stage of due process. We had serious reservations about whether a lease accounting project as currently described can be completed by 2011 if we must draft a new discussion document from scratch. However, we concluded that those documents will not provide a reasonable basis for comment if the Boards accept the idea that the substantive lease term is the unit of account. In our view, a limited project along the lines described above could be captured in a short discussion document without significantly imperilling our ability to make the 2011 deadline.

54. **Financial instruments.** The IASB has issued its discussion paper on complexity in the reporting of financial instruments. The FASB also has issued its comparable Invitation to
Comment. The multiple ways of measuring similar instruments is a source of complexity for many investors. Much of the existing complexity from a preparer perspective arises from existing hedge accounting requirements. The FASB has an active short-term project to address aspects of that complexity. While the discussion paper is open for comment, the IASB should hold education sessions on the FASB’s proposed approach.

55. In any event, the changes that the Boards might make to financial instrument accounting could be limited to simplifying hedge accounting and perhaps implementing some of the simplifications in measurement classification described in the discussion paper (a.k.a. the Ron Lott approach). We recommend that the Boards consider carefully whether those steps would meet the sufficient improvement constraint discussed at the beginning of this memorandum. In our view, any changes in financial instrument accounting made between now and 2011 could well be embedded in the literature for 10 years or more. Given that, it might be better to do nothing rather than to continue with a suboptimal solution, albeit one that is perhaps simpler than the solutions we have today.

56. We considered whether the Boards should press ahead with full fair value for all financial instruments. In our view, there are no significant technical obstacles to doing so. The obstacles that exist lie in the area of presentation and the Boards’ willingness to deal with the political outcry that would no doubt accompany such a move. We did not make this recommendation because we concluded that there is insufficient Board support for moving to a full fair value solution at this time.

57. In view of that conclusion, we have not identified any major changes to financial instrument accounting that would satisfy our constraint of significant improvements in financial reporting. There may be some changes that can be made, perhaps in hedge accounting or in measurement classification. Until we have received comments on the discussion document and seen the progress of the FASB’s work on simplifying hedge accounting, we do not have a basis for making a recommendation in this area. As with derecognition, we recommend that the Boards defer a decision on this topic to the October joint Board meeting when this additional information is available.

58. **Liabilities and equity.** This project is a priority for some in the US because US GAAP is complex, difficult to apply, and needs almost constant maintenance. It may be less of an issue internationally.
Recommendations

59. This is a high-priority project; however, our ability to make progress will depend on whether we can come to an early decision from among the three models included in the discussion paper. We recommend that the IASB focus its efforts during the comment period on developing a view with regard to the following:

   a. Does the IASB support the narrow view of equity adopted by the FASB? While the IASB has had an education session on the topic, it is not deliberated the point.

   b. Can the inconsistency that some perceived between the narrow view of equity and the Framework definition of a liability be resolved? Jim Leisenring has a suggested revision to the liabilities definition that might overcome the inconsistency.

   c. Would a standard based on the narrow view of equity preserve the solution to puttable shares recently published by the IASB? Tom Linsmeier and Sue Bielstein indicate that the FASB’s model espousing the narrow view of equity is not incompatible with the IASB conclusions. In addition, that model should be able to be tweaked to make this a non-issue.

60. Consistent with our view that we must come to a common conclusion from among the models, we recommend that the project team identify “lightning rod” instruments that are likely to prove difficult. The comment letters will make the population of those instruments obvious, and we should be able to begin Board discussions shortly before the analysis of comment letters is complete.

Short-Term Convergence Projects

61. Earnings per share. Like it or not, many investors think earnings per share is an important metric, and they would be better served if US GAAP and IFRS at least produced the same denominator in most cases (the goal of the short-term project). Moreover, the Boards’ proposed changes would simplify the EPS computation in some cases. That said, some respondents to past FASB exposure drafts think the proposals do not go far enough in simplifying the existing standards and recommend that the Boards reconsider EPS more fundamentally. Such a project would be a natural fit with the
Boards’ project on liabilities and equity. If that approach were taken, the Boards should consider whether narrow changes to converge EPS in the interim meet the sufficient improvement constraint described at the beginning of this paper.

62. We are of two views on this project. Some group members maintain that the work done to date would improve financial reporting. Other group members maintain that the computation of earnings per share necessarily will change as a result of the projects on liabilities and equity and financial statement presentation. Those members prefer deferring the work on earnings per share and including it in an exposure draft on liabilities and equity.

63. **Joint ventures.** The IASB should be able to complete this project if it stays true to the original objective of eliminating the option of using proportionate consolidation for joint ventures. The IASB should refrain from tinkering or reconsidering the equity method—that issue should be addressed either through the consolidations project or a financial instruments project.

64. **Taxes.** The Group supports continuing work on the income tax convergence project. The IASB made a commitment to its constituents to develop a principles-based replacement to the existing standard. The FASB may propose adopting the proposed IFRS as a demonstration of the move to a common, global, principles-based standard. Tom Linsmeier and Sue Bielstein observe that the issue of uncertain tax positions is of critical importance in the US context. The IASB always has been willing to address issues that are particularly important in certain jurisdictions, as was the case with puttable shares. While the IASB's upcoming exposure draft does not take the same approach on uncertain tax positions as did the FASB, it is nonetheless important to US adoption that IFRS address this issue.

65. **Other short-term convergence.** The MOU includes possible projects on impairment, a second stage of the fair value option, and research and development. The milestone required by the MOU was a decision about whether differences in those areas should be eliminated through one or more short-term standard-setting efforts. For two reasons, we recommend that the Boards not undertake those standard-setting efforts. First, we believe the Boards’ resources would be better spent on the other improvement priorities identified earlier in this memo. Second, the plan assumes that the remaining major capital markets,
including the US, will be adopting IFRSs in the next five years or so. Adoption of IFRS seems to eliminate the need to converge narrow differences in specific standards.

**A note on cross-cutting issues**

66. Earlier in this paper we acknowledge the importance of cross-cutting issues and the way failure to resolve those issues can slow progress. We acknowledge that IASB members have expressed a desire to separately address a number of cross-cutting issues. This almost certainly reflects frustration over the lack of significant progress in the Conceptual Framework. However, we are reluctant to recommend that any significant resources be devoted to this exercise. We observe that no Board of which we are aware has been able to approach cross-cutting issues outside of the context of individual projects and develop answers that “stick.”

67. In our view, achieving progress by 2011 means making some trade-offs, and one of those is the internal consistency of the resulting standard with other IFRS and the current and developing Framework. Internal inconsistencies are not new—they result from taking an incremental approach to improving standards in the absence of a robust Conceptual Framework. We realize our recommendations continue that practice. We are comfortable with that because we believe the results will be meaningful, although imperfect, improvements to financial reporting.

68. The recommended approaches in this memorandum do require that the Boards resolve some questions that certainly qualify as cross-cutting issues. For example, we cannot resolve revenue recognition without a definition of a performance obligation (and thus a better definition of a liability). However, on balance, our recommendations minimize the impact of cross-cutting issues.

69. As we consider the staffing implications of our recommendations, it seems clear to us that directors and senior project managers are critical to our ability to complete our work by 2011. The IASB's current plan was to divert one or two senior project managers to work on cross-cutting issues. That no longer seems to us the best use of resources. While it may be possible to single out one or two cross-cutting issues, we ask that the IASB reconsider its earlier decision to devote significant resources to cross-cutting issues.
## PROPOSED CHANGES TO FAS 140 AND FIN 46R

### CONSOLIDATION, SPECIAL PURPOSE ENTITIES (SPEs), AND DERECOGNITION

### COMPARISONS OF CURRENT GAAP, IFRS AND PROPOSED CHANGES

**Consolidation Model - FIN 46R**

<table>
<thead>
<tr>
<th>TOPIC</th>
<th>CURRENT GAAP</th>
<th>IFRS</th>
<th>PROPOSED CHANGES</th>
<th>DIVERGENT/ CONVERGENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Order of consolidation-derecognition testing</td>
<td>An entity performs the derecognition tests first in an asset transfer, and then performs the consolidation tests only if the transferee was not a QSPE.</td>
<td>An entity performs the consolidation analysis first before performing the derecognition tests to the consolidated entity.</td>
<td>Same as IFRS</td>
<td>Convergent</td>
</tr>
<tr>
<td>Number of consolidation Models</td>
<td>Uses two consolidation models (variable interest model and voting interest model)</td>
<td>Uses a single consolidation model.</td>
<td>Same as Current GAAP</td>
<td>Divergent</td>
</tr>
<tr>
<td>Linkage of control to obtaining benefits</td>
<td>There is no linkage between the ability to control and obtaining ownership benefits from the entity’s activities. Entity could control without obtaining benefits • All consolidation decisions are evaluated first under the variable interest entity (VIE) model. • If the entity is a VIE, guidance below under Special Purpose Entities is followed. • If the entity is not a VIE, voting interest model described in ARB 51 and FAS 94 is followed. • Majority owned entities must be consolidated.</td>
<td>There is a linkage between the ability to control an SPE and the ability to receive benefits from its activities. Control is defined as, “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.” “Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can clearly be demonstrated that such ownership interest does not constitute control.</td>
<td>Substantially the same as IFRS</td>
<td>Convergent</td>
</tr>
<tr>
<td>Effective control with a minority interest</td>
<td>“Effective control” can be established by “significant minority ownership, by contract, by lease, by agreement with other stockholder, by court degree or otherwise.” (FAS 94.10) “Effective control”, which has some similarities to</td>
<td>“De Facto” control also exists when the parent owns half or less of the voting power of an entity when there is: a) power over more than half of the voting rights by virtue of an agreement with other investors, b) power to govern the</td>
<td>Issues of “effective control” or “de facto control” have not been addressed to date.</td>
<td>Divergent</td>
</tr>
</tbody>
</table>

### Consolidation Model - FIN 46R (continued)

<table>
<thead>
<tr>
<th>TOPIC</th>
<th>CURRENT GAAP</th>
<th>IFRS</th>
<th>PROPOSED CHANGES</th>
<th>DIVERGENT/ CONVERGENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effective control with a minority interest</td>
<td>the concept of “de facto control” in IFRS, is very rarely employed in the US GAAP.</td>
<td>financial and operating policies of the entity under a statute or an agreement, c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.” (IAS 27.13) A parent could have control over an entity in circumstances where it holds less than 50% of the voting rights and has no legal or contractual rights by which to control a majority of entity’s voting power (de facto control).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consideration of potential voting rights</td>
<td>Potential voting rights (warrants, options, etc.) are not considered in assessing control for voting interest entities.</td>
<td>Potential voting rights held by both the company and by other parties if those rights are exercisable, are considered in assessing control.</td>
<td>Issues of potential voting rights have not been addressed to date.</td>
<td>Divergent</td>
</tr>
</tbody>
</table>
## Special Purpose Entity – FIN 46R

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>QSPE framework</td>
<td>The QSPE framework exists in GAAP and is applicable when an entity transfers (sells) financial assets to an SPE meeting certain criteria defined in FAS 140. Qualifying SPEs that meet these criteria are excluded from consolidation analysis.</td>
<td>The QSPE framework does not exist in IFRS.</td>
<td>Same as IFRS</td>
<td>Convergent</td>
</tr>
<tr>
<td>VIE concept</td>
<td>There is a concept in FIN 46R of a variable interest entity (VIE). An entity is subject to the guidance of FIN 46R, if by design: 1) the total equity investment at risk is not sufficient to provide the holders of that investment with the characteristics of a controlling financial interest, 2) the holders of the equity investment at risk lack certain characteristics of a controlling financial interest (they lack the ability to make decisions affecting success of the entity), or 3) if the voting rights of some investors are not proportionate to their obligation to absorb losses or to benefit from gains.</td>
<td>The concept of VIEs does not exist in IFRS. Entities are evaluated as SPEs based on whether they have a narrow and well-defined objective. “An entity may be created to accomplish a narrow and well-defined objective (e.g. to effect a lease, research and development activities or a securitization of financial assets). Such a special purpose entity (SPE) may take the form of a corporation, trust, partnership or unincorporated entity.” (SIC 12.1.)</td>
<td>Same as Current GAAP</td>
<td>Divergent</td>
</tr>
<tr>
<td>Quantitative or qualitative Test for consolidation</td>
<td>An enterprise must first determine if it has a controlling financial interest in an entity by performing a one step quantitative analysis to determine if it is the primary beneficiary that would have to consolidate the entity. The primary beneficiary is the enterprise that absorbs a majority of the entity’s expected losses, receives a majority of the expected residual returns, or both.</td>
<td>A qualitative analysis is performed to determine if the SPE should be consolidated. Consolidation is required when the substance of the relationship between the entity and the SPE indicates that the SPE is controlled by that entity. “In the context of an SPE, control may arise through the predetermination of the activities of the SPE (operating on ‘autopilot’) or otherwise. IAS 27.13 indicates several circumstances which result in control even in cases where an entity owns one half or less of the voting power of another entity. Similarly, control may exist even in cases where an entity owns less than a majority of the voting power.</td>
<td>An enterprise must determine if it has a controlling financial interest in an entity by first performing a qualitative assessment of the entity’s variable interest characteristics and purpose of the entity. If the enterprise can not conclude whether or not it is the primary beneficiary, it would be required to perform a second step quantitative analysis (previously required) to determine if it absorbs a majority of the VIE’s expected losses, receives a majority of the</td>
<td>Divergent</td>
</tr>
<tr>
<td>TOPIC</td>
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<td>IFRS</td>
<td>PROPOSED CHANGES</td>
<td>DIVERGENT/CONVERGENT</td>
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<tr>
<td>Quantitative or qualitative test for consolidation</td>
<td>owns little or none of the SPE’s equity. The application of the control concept requires, in each case, judgment in the context of all relevant factors.” SIC 12.9. The following circumstances may indicate a relationship in which an entity controls an SPE and consequently should consolidate the SPE: “a) in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE’s operation; b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an ‘autopilot’ mechanism, the entity has delegated these decision-making powers; c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.” (SIC 12.10)</td>
<td>expected residual returns, or both. “The entity whose variable interest or interests provide the entity with (1) the power to direct the activities of the VIE and (2) the right to receive benefits from the VIE that could potentially be significant and/or the obligation to absorb losses of the VIE that could potentially be significant is the primary beneficiary. The purpose of the design of a VIE, should provide key indicators as to which entity, if any, is the primary beneficiary.” (Proposed amendments to FIN 46R.)</td>
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## Derecognition – FAS 140

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<tr>
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</thead>
<tbody>
<tr>
<td>Order of consolidation-derecognition testing</td>
<td>A true sale derecognition analysis is performed first before performing the consolidation analysis.</td>
<td>An entity will perform a consolidation analysis first, before performing the derecognition tests.</td>
<td>Same as IFRS.</td>
<td>Convergent</td>
</tr>
<tr>
<td>Derecognition criteria</td>
<td>Derecognition is primarily based on control using the following three tests: 1) legal isolation of the transferred asset from the transferor, 2) the ability of the transferee to pledge or sell the asset – the transferee has to be able to pledge or sell the transferred asset free from constraint and 3) there is no right or obligation of the transferor to repurchase the transferred assets.</td>
<td>Derecognition tests can only be applied to entire financial assets; or portions of a financial asset where the portions are fully proportionate to the cash flows from the borrower. For example, an entity can transfer 90% of the underlying cash collections proportionally to all beneficial interest holders. It can not transfer the first 90% of cash collections to some beneficial interest holders. The entity then determines if it has transferred the contractual rights to the cash flows or if it has retained the contractual rights to receive the cash flows but assumes a contractual right to pay the cash flows in a “pass-through arrangement” using a trust. If it has retained the cash flows in a “pass-through arrangement”, the entity can treat the arrangement as a transfer if all three following conditions are met:  • The transferor has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short term advances that are fully recoverable and lent at market rates do not violate this condition.  • The transferor is prohibited from selling or pledging the original</td>
<td>Derecognition is still based on 1) legal isolation, and 2) no right to repurchase transferred assets. In addition, derecognition tests can only be applied to entire financial assets or to a portion of a financial asset that meets the definition of a participating interest. A participating interest requires that:  • The cash flows received from the assets are divided among the beneficial interests in proportion to the share of ownership represented by each.  • The participating interest holders have no recourse, other than standard reps and warranties, to the transferor or to each other.  • No interest holder is subordinated to another.  • Neither the transferor nor any participating interest holder has the right to pledge or exchange the entire financial asset in which it owns a participating interest. Derecognition tests will be clarified to require that the</td>
<td>Divergent</td>
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### Derecognition FAS 140 (continued)

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</tr>
</thead>
<tbody>
<tr>
<td>Derecognition criteria</td>
<td></td>
<td>asset. The transferor has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay and any interest earned during this immaterial delay period must be passed on to the eventual recipients. The transferor derecognizes the asset if it transfers substantially all risks and rewards of ownership of the asset. The transferor continues to recognize the asset if it retains substantially all the risks and rewards of ownership. If a transferor neither transfers nor retains substantially all the risks and rewards of ownership of the asset, it needs to determine whether it has retained control of the asset. The asset is derecognized if the transferor has given up control. Control is based on the transferee’s practical ability to sell the assets.</td>
<td>transferred asset must be beyond the reach of the transferor or any of its consolidated affiliates. Additionally, the isolation analysis must consider all arrangements made in connection with the transfer. Derecognition requirement that transferee must have right to pledge or exchange the asset would be eliminated. Permits transfers using “pass-through arrangements” to obtain sale accounting.</td>
<td>Divergent</td>
</tr>
<tr>
<td>Partial derecognition</td>
<td>No ability to achieve partial derecognition of transferred financial assets.</td>
<td>IFRS permits partial derecognition. If the entity has retained control, it continues to recognize the asset to the extent of its continuing involvement. When an entity continues to recognize an asset to the extent of its continuing involvement, the entity also recognizes an associated liability not subject to offset, i.e. no linked presentation.</td>
<td>Issues related to partial derecognition have not been addressed.</td>
<td>Divergent</td>
</tr>
<tr>
<td>Mortgage servicing rights</td>
<td>Servicing rights recognized at fair value.</td>
<td>Servicing rights are recognized at allocated cost.</td>
<td>Servicing rights are recognized at fair value.</td>
<td>Divergent</td>
</tr>
</tbody>
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RECENT STUDIES AND PROPOSALS ON RESTATEMENTS

Financial Accounting Standards Advisory Council
June 24, 2008

Objective
To obtain FASAC members’ input on any standard-setting implications related to the developed proposals regarding:

♦ The assessment of the materiality of errors to financial statements and

♦ The correction of financial statements for errors

(From the Audit Process and Compliance Subcommittee of the SEC Advisory Committee on Improvements to Financial Reporting).

Current FASB Guidance
FASB Statement No. 154, Accounting Changes and Error Corrections, defines restatements as “[t]he process of revising previously issued financial statements to reflect the correction of an error in those financial statements.” Paragraph 25 of Statement 154 requires:

Any error in the financial statements of a prior period discovered subsequent to their issuance shall be reported as a prior-period adjustment by restating the prior-period financial statements. Restatement requires that:

a. The cumulative effect of the error on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.

b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.
c. Financial statements for each individual prior period presented shall be adjusted to reflect correction of the period-specific effects of the error.

As with all Statements, the provisions of Statement 154 need not be applied to immaterial items.

Convergence of US GAAP and IFRS for Restatements

Statement 154 and IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors, both require restatement to correct an error that exists in previously issued financial statements. However, in Statement 154 that requirement is absolute, while IAS 8 permits an exception to the restatement requirement in instances in which it is not practicable to determine the effect of the error on any or all prior periods.

Developed Proposals about Restatements

The SEC Advisory Committee on Improvements to Financial Reporting (CiFIR) discussed the developed proposals of the four subcommittees at their May 2, 2008 meeting. Attachment C-1 is the May 2 draft of the Audit Process and Compliance Subcommittee Update to CiFIR. Among those developed proposals are four that relate to financial restatements (emphasis added):

1. Developed Proposal 3.1:
   Proposes to supplement the existing guidance to reinforce the concepts that:
   ♦ “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.”

   (Excerpt from page 9 of Attachment C-1)

2. Developed Proposal 3.2
   Proposes six principles on how to correct an error. One of those principles is that:
   “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

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1 Under IAS 8, if restatement is impracticable, the correction of an error is effected by restating the opening balances of assets, liabilities, and equity or net assets for the earliest period for which retrospective restatement is practicable (which may be the current interim or annual period).
occurred, but would need to be promptly corrected and disclosed in the current period.”

(Excerpt from page 11 of Attachment C-1)

3. Developed Proposal 3.3
Proposes the development of guidance on disclosure during the period in which the restatement is being prepared (page 13 of Attachment C-1).

4. Developed Proposal 3.4
Proposes the development of guidance on applying materiality to errors identified in prior interim periods and how to correct these areas. The proposed principles for interim periods are consistent with those in Developed Principles 3.1 and 3.2. (page 15 of Attachment C-1).

Recent Studies and Proposals on Restatements
There have been a number of recent studies on restatements. Those mentioned in the Audit Process and Compliance Subcommittee Report include (page 7, footnote 7 of Attachment C-1):

a. An Analysis of the Underlying Causes of Restatements, by Marlene Plum and Teri Lombardi Yohn


c. GAO study, Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates (March 2007)

d. Glass Lewis & Co. study, The Errors of Their Ways (February 2007)

e. Two Audit Analytics studies, 2006 Financial Restatements A Six Year Comparison (February 2007) and Financial Restatements and Market Reactions (October 2007)

f. The PCAOB’s Office of Research and Analysis’s (ORA) working paper (preliminary findings), Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era (October 18, 2007)
Issues for Discussion

Some of the issues of interest for discussion are:

**Question 1:** What is your view about the importance restatements to companies, their investors, and the market as a whole? Should the goal of restatements be to:

a. Identify and correct errors that are likely to have a stock price impact, or
b. Ensure accurate financial statements that are comparable across multiple periods and companies?

**Question 2:** The principles in determining the materiality of an error, as well as how to correct an error involve “stepping into the shoes of a reasonable investor.”

a. What qualitative or quantitative characteristics should an issuer of financial statements consider in making those judgments?
b. Some areas of restatement elicit more severe market reactions (for example, revenue recognition). Are there certain types of errors or accounts that an issuer of financial statements should consider differently?

**Question 3:** Are there any financial reporting implications that the FASB should consider (for example, are certain financial reporting requirements in need of further clarity or revision)?
I. Introduction

The SEC’s Advisory Committee on Improvements to Financial Reporting (Committee) issued a progress report (Progress Report) on February 14, 2008.¹ 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 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.

This report has been prepared by the individual subcommittee and does 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.
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 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 as 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.

This report has been prepared by the individual subcommittee and does 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.
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 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 in the U.S. financial markets has been increasing significantly over recent years, reaching approximately 1,600 companies in 2006. 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

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2 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).

3 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.


This report has been prepared by the individual subcommittee and does 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.
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 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. 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 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.

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5 We use the term investor to include all people using financial statements to make investment decisions.

6 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.

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Our Research

We have considered several publicly-available studies 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. While there are limitations 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. Also, while there is recent evidence 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

7 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.

8 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.

9 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.

10 These trends are addressed in Professor Scholz’s study.

11 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.
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.12

12 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.

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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 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\textsuperscript{13}. 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.

\textsuperscript{13} 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.
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.

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

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14 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.

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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. 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 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 provide investors making current investment decisions with more timely financial reports and avoid 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

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15 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.

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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:

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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
- 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

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• 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*. 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.

**16** 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. 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.

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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 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.

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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,\(^{17}\) 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

\(^{17}\) 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.

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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.

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
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
8. The preparer’s consideration of known diversity in practice regarding the alternatives or estimates
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.

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18 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
19 If there is not diversity in practice, it would be significantly harder to select a different alternative.

This report has been prepared by the individual subcommittee and does 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.
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\textsuperscript{20} 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.

\textsuperscript{20} Existing disclosure requirements would include the guidance on critical accounting 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.
A “PRINCIPLES-BASED” DISCLOSURE STANDARD TEST CASE: DISCLOSURE OF CERTAIN LOSS CONTINGENCIES

Financial Accounting Standards Advisory Council
June 24, 2008

Objective

The objective of this meeting is two-fold: (a) for the FASB staff to obtain FASAC members’ input on the operatinality and decision-usefulness of the recently issued Exposure Draft of the proposed FASB Statement, Disclosure of Certain Loss Contingencies, and (b) for FASAC members to consider the contingency disclosure project in light of the proposal by the Investors Technical Advisory Committee (ITAC) for a “principles-based” disclosure standard (the Disclosure Framework proposal).

ITAC’s Proposal for a Disclosure Framework

Attachment D-1 includes a copy of ITAC’s letter to FASB Chairman Bob Herz dated December 11, 2007, proposing that the Board pursue a Disclosure Framework project. The Framework would set forth the disclosures that would be required for significant balance sheet, income statement, and cash flow items. Disclosures about a particular account would be divided into three broad categories: (a) general, covering the basis for presentation for that account; (b) composition, providing detail about what is included in the account and reconciling from the prior period to the current period when appropriate; and (c) assumptions and uncertainties, consisting of a qualitative discussion. For more detail on ITAC’s proposal, see Attachment D-1.

About the Exposure Draft

In September 2007, the Board added a project to its agenda to reconsider FASB Statement No. 5, Accounting for Contingencies, to be conducted in phases. In the first phase, the Board intends to improve the quality of financial reporting by expanding disclosures required about certain loss contingencies. Investors and other users of financial information expressed concerns that current disclosures made under Statement 5 do not provide sufficient information in a timely manner to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies. This proposed Statement attempts to expand disclosures about certain loss contingencies in the scope of Statement 5 or FASB Statement No. 141 (revised 2007), Business Combinations. The staff drafted its
proposal to the Board with ITAC’s proposed Disclosure Framework in mind. Attachment D-2 provides a summary of the key features of the Exposure Draft.

Issues for Discussion

Question 1: To what extent would the disclosure project for loss contingencies have been necessary if a Disclosure Framework were in place? Would it not have been necessary at all, or would it have been required to clarify the application of the Disclosure Framework to loss contingencies?

Question 2: How would a Disclosure Framework apply to different classes of similar liabilities? For example, should the disclosures required for asset retirement obligations accounted for under FASB Statement No. 143, Accounting for Asset Retirement Obligations, be the same as those for litigation reserves?

Question 3: Do you agree that an entity should disclose all loss contingencies whose resolution is expected to occur in the near term and could have a severe impact on the entity, regardless of the likelihood of loss?

Question 4: Do you believe a prejudicial exemption should be provided as described in the Exposure Draft? If not, what approach would you recommend and why?

Question 5: Do you agree with the quantitative disclosure requirements in the proposed Statement? If you disagree with the proposed requirements, what quantitative disclosures do you believe would best fulfill users' needs for quantitative information and at the same time not reveal significant information that may be prejudicial to an entity's position in a dispute?
December 11, 2007

Mr. Robert Herz  
Chairman  
Financial Accounting Standards Board  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116  

Re: Disclosure Framework Proposal

Dear Chairman Herz,

The Investors Technical Advisory Committee (ITAC) has developed a proposal for the promulgation of a “principles-based” disclosure standard under U.S. Generally Accepted Accounting Principles (U.S. GAAP). We recommend that the Financial Accounting Standards Board (FASB, or the Board) add a “fast-tracked” project, intended to enhance the disclosure framework currently residing within U.S. GAAP to its working agenda. This new “principles-based” disclosure framework establishes a framework to be used for disclosures in FASB standards. This letter outlines the details of our proposal and its rationale.

If pursued, we believe our proposal will serve to remedy many perceived critical shortcomings in the FASB’s existing financial reporting framework. It will enhance the quality, consistency, and format of financial information provided to users and has the potential to yield significant efficiencies in the Board’s standard setting activities by meaningfully reducing the time required to develop new standards. We further believe the proposal has great potential to meaningfully enhance the usefulness of financial statements in the short term, and accordingly suggest the Board assign a high priority to its consideration. Most importantly, it can be achieved in a reasonably short time, without greatly encumbering the Board’s staff resources.

Proposal Details
The envisioned framework encompasses the types of disclosures necessary for significant balance-sheet, income-statement, and statement-of-cash flow items. It also includes disclosures necessary to provide investors a transparent picture of the potential future impact on earnings and cash flows from financial transactions. The framework would articulate the principal disclosure requirements, and use examples from existing.

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1This letter represents the views of the Investors Technical Advisory Committee (“ITAC” or “Committee”) and does not necessarily represent the views of its individual members or the organizations by which they are employed. ITAC views are developed by the members of the Committee independent of the views of the FASB and its staff. For more information about the ITAC, including a listing of the current members and the organizations in which they are employed, see http://www.fasb.org/investors_technical_advisory_committee/itac_members.shtml
disclosure guidance for illustration (although this might require a bit of tailoring, we do not expect it to result in a cumbersome rework).

The disclosed information requirements for a particular account (assuming it is considered material to the reader of the financial statements) will include:

- The accounting principles used to account for the items and activity in the account(s), and the basis for their selection.
- Sufficient detail about the account to permit a user to understand the composition and nature of the items included (and/or netted) within a specific caption.
- A roll-forward of the activity in the account balances from period to period showing gross (un-netted) changes by the nature of the change (e.g., change in balance resulting from new issuances, repurchases, changes in interest rates and changes in credit quality).
- The principal estimates and assumptions used.
- The basis for selecting a particular assumption and any changes in assumptions that have a material impact in the determination of the underlying data and estimates.
- Risks and uncertainties related to the applicable account (unless immaterial or remote), including an estimate of the range of the potential impact those items could have on the results of operations, financial condition, or liquidity, in either a favorable or unfavorable manner.
- The nature and magnitude of nonrecurring transactions.
- For nondiscretionary or other commitments requiring use (or receipt) of resources (e.g., capital commitments, on or off the balance sheet financings, and pensions) that are considered likely to occur, a disclosure of the best estimate of the amount of those commitments for each of the next five years and in the aggregate thereafter.
- A “catch-all” proviso mandating that, when a transaction is not covered by a specific accounting standard, if information regarding it is considered material to investors, disclosure of the nature and magnitude of the transaction is required to keep the financial statements from being misleading.

The above could be presented by a company using a multi-layered approach to assist users in navigating the notes in a consistent fashion. In the future, it will allow users (with the aid of technology – e.g., XBRL) to suppress or present information pertinent to their analysis, thereby mitigating and managing information-overload concerns, without compromising the robustness and comprehensiveness of information provided in financial statements.

For example, the above information could be presented in three predominant areas as follows:

- "General" – outlining the basis of presentation for that particular account/financial statement line item (e.g., in a manner similar to information presented currently under “significant accounting policies” – this will serve to replace or substitute the information currently presented in that caption);
• "Composition" – outlining what is included in the account/line item (e.g., item breakdown and netting – such as loans net of provisions) and also providing a roll-forward when appropriate (including amounts attributed to increases or decreases arising from changes in estimates), and

• "Assumptions and Uncertainties" – outlining principal assumptions, estimates, sensitivity analyses, and a qualitative discussion regarding risks and uncertainties and the potential of the amounts to change over time.

We appreciate that some of this information already is provided in significant accounting policies and/or critical accounting policies sections, and can be built on and modified. We believe a more consistent disclosure framework, capturing all the above elements, is needed, because companies often still do not provide adequate information under today’s prevailing piecemeal disclosure guidance. See Appendix for an illustration of a possible approach to applying our concept.

As proficient and experienced users of financial statements, the ITAC’s members believe inclusion of additional information is essential to help users better understand financial risks and benefits, and provide them with a more complete picture of a company’s business prospects and the key assumptions used in reporting its financial performance. We believe this proposed disclosure standard could replace the disclosure guidance within existing individual standards and the need for specific guidance in new ones. Our goal is for the Board to create a framework requiring further disclosure of information reasonably prudent preparers already have on hand – we view current disclosures as lacking or incomplete under the current financial framework.

The ITAC believes a new disclosure standard could be drafted using concepts already in place in existing standards (such as Statements 123(R), 132(R), 157, and 159). We hope this standard could be developed and implemented in a relatively short (one to two year) timeframe, and would address numerous perceived deficiencies related to the lack of transparent disclosures, while allowing the FASB the flexibility to move ahead with the longer-term projects already in process.

Rationale
As background to our recommendation, the ITAC believes disclosures are a critical and integral part of the overall financial statements. The quality and completeness of disclosures continues to be an area of concern from the various users of financial statements, especially considering recent equity and debt market events that underscore the importance of robust disclosures (e.g., composition, sensitivity, and valuation methodologies) in addition to merely providing a financial statement amount. It would be helpful for users to be able to discern the potential for the financial-statement’s amount to change over time, especially given the vast complexity of the business environment and the broader migration toward fair-value measurements in financial reports.

We view the disclosure of composition, valuation assumptions, and potential future cash flow implications as equally applicable to all line items in the financial statements and not to only particular line items for which current ‘expanded’ disclosure requirements exist within GAAP (e.g., for securities measured at fair value, assumptions underlying
stock-options grant or pension assets and obligations). For example, we believe this need is evidenced by the scrutiny of loan-loss metrics and commitments/contingencies where investors, regulators, and politicians perceive disclosures to be vastly lacking or incomplete.

To illustrate our vision of how one principle-based standard could streamline the reporting process while providing additional information, consider the topics of manufacturer's warranty, product return provisions, and price concession reserves. Currently, we believe the specific disclosure requirements for these accounts is not as useful and certainly not as detailed when compared with, for example, those related to pension or asset-retirement obligations. Under existing practice, changes to guidance to formalize disclosure requirements would need to be made in both areas (warranty and contingent liabilities). However, if one standard along the lines we suggest was in place, companies that deem these items to be significant to users, would be required to apply the disclosure requirements.

The recommended disclosure framework should give regulators a more complete codification of disclosure rules as well as direct auditors to focus greater attention to disclosures. In our view, our proposal can also minimize financial reporting arbitrage, because pertinent information will be disclosed in the notes rather than hidden behind the numbers. We believe if investors were informed about a particular risk or an economic position (whether as part of the basic financial presentation or the disclosures); the unfortunate high level of financial reporting engineering that we currently observe will likely diminish. To illustrate, consider how uninformed users were about unconsolidated VIEs prior to implementation of FIN 46 disclosure requirements – since the assets or liabilities of VIEs (or SPEs at the time) were “off books” and disclosures sparse, investors were unaware of these risks, and financial-reporting arbitrage persisted.

The ITAC believes past attempts from various constituents to expand disclosure guidance have failed, because preparers typically do not include additional information if not required to do so. Accordingly, instead of expanding a particular disclosure standard, which may be inefficient and relatively slow (e.g., developing FAS 132(R)), we believe this shortfall should be addressed with a more encompassing separate and distinct principles-based standard.

The heightened focus on disclosure ultimately will lead to a more efficient and self correcting mechanism to financial reporting pursuant to which companies will receive market feedback and inquiries that would likely lead to companies providing more detailed and meaningful disclosures regarding items or transactions.

**Timing & Costs/Benefits Considerations**

Improved disclosures, consistent with those urged above, have been recommended in the past by such groups as the Cohen Commission of the 1970s, and the international auditing firms in proposals to the SEC in the 1980s and 2001. In light of the continued lack of a disclosure framework, which has contributed to the lack of transparency surrounding the current sub prime financial reporting issues, we believe it is appropriate for the Board to now undertake a project to remedy these disclosure shortcomings and more broadly, enhance the information disseminated to investors in financial statements.
We understand the Board currently is addressing the topic of disclosures as part of other projects in various stages of exploration or progress (both the joint FASB/IASB project on the Conceptual Framework and the FASB Financial Statement project). ITAC welcomes the opportunity to participate in reviewing the disclosure sections of each project and assist the Board in its activities regarding those projects as they progress. However, financial statement constituents require more immediate improvements while appreciating that similar concept will ultimately be incorporated in the other longer-term projects. Accordingly, we urge the Board to add to its agenda our proposed project in advance of completion of other FASB as well as the joint FASB/IASB conceptual framework project currently in process. We believe the concepts underpinning our proposal fit well within the to-be-developed joint conceptual framework with minor modifications, if any.

As part of our deliberations, we also contemplated the potential cost/benefit attributes we anticipate. As far as potential benefits, in addition to furthering users’ ability to assess the financial picture, risk assumptions, and key estimates more clearly, other benefits of our proposal include:

- Consideration of user concerns for more/better information regarding risk and judgmental areas of accounting estimates;
- Elimination of redundancies between the current critical accounting policy section of the management discussion and analysis (MD&A) section of SEC filings and the overall financial statements;
- Fostering of efficiency in FASB activity from the reduction of efforts to have disclosure requirements within each individual standards. This will substantially accelerate the “time-to-market” of new accounting standards and free Board resources to focus more promptly on emerging issues; and
- The heightened focus on disclosure will ultimately enforce a more efficient and self-correcting mechanism.

We feel that the information to be disclosed under a new framework is substantially available already, as most of the data typically is required for sound management of a company and is a part of a company’s normal data set, reconciliation, and presentation processes. Further, the proposed framework would not be prescriptive as to a particular format or content requirements (although we believe that over time certain consistency and best practices may be observed). For non-registrants, some required disclosures might already be made under SOP 94-3 covering risks and uncertainties. In addition, for SEC registrants, information often is also found under the critical accounting policies and estimates disclosures in their MD&A section. However, based on our experience, disclosures are (unfortunately) inconsistent and incomplete – so a new standard may, indeed, entail additional preparer costs. We believe these additional costs may be (already) required today as the current guidance is not fully or optimally complied with. Using materiality considerations (consistent with the current notion of materiality in financial reporting) would clearly be a factor to be considered which could limit any additional cost or time burden.
Thank you for your consideration of our proposal, which we view as critical in shoring the foundation of a robust financial reporting system designed to be useful to investors. If you need further information or require additional information, please feel free to contact any member of ITAC's Disclosure Subgroup. We would be happy to discuss our proposal and recommendations with members of the Board or its staff.

Sincerely,

[Signature]

Investors Technical Advisory Committee
By: Mike Gyure, Member

Cc: International Accounting Standards Board -- Mr. Wayne Upton, Director of Research
Appendix:

General:

Describe significant accounting policies underpinning a particular financial statement's account or line item. For example, for an account that includes benefits/deferred compensation it should describe the accounting policies for pensions, stock based compensation arrangements, and other incentive compensation calculations.

Composition:

Includes the account composition and what comprises this line item -- for example, as it relates to benefits/deferred compensation it may include:

Pension liabilities XXX
Pension assets (XXX)
Pension obligations net XXX

Deferred compensation:
Restricted shares XXX
Long term incentive-pay XXX
Total benefits/deferred compensation XXX

This section will also include roll-forwards for assets and liabilities in a manner similar to that required by Statement 132(R) and FAS 158.

Assumption and Uncertainties:

Includes a discussion of main assumptions and estimates in a manner similar to what is required by Statements 132(R) for postretirement and 123(R) for stock-based compensation, coupled with information on measurement attributes (e.g., Statement 157) as well as additional disclosures on future cash flows and sensitivities (some of which currently may be required).

Application of our approach:

As part of the (to be developed) Principles-Based Disclosure Statement we envision, the Board will prepare several examples (3-4) of disclosures to be included in the proposed statement to illustrate its application. We believe preparers will be able to easily apply the principles by analogy to other circumstances using these examples. Accordingly, an auto manufacturer, for example, that has meaningful warranty and return reserves (and these are part of its significant accounting policies) should be required to apply the standard and provide details on the composition of these accounts as well as main estimates, components of the accounts, expectations and changes thereof. This information, which we believe is substantially lacking today, would be of great use to financial statement users.
SUMMARY OF EXPOSURE DRAFT:

DISCLOSURE OF CERTAIN LOSS CONTINGENCIES

Financial Accounting Standards Advisory Council
June 24, 2008

Background on Disclosure Project

At the September 6, 2007 meeting, the Board decided to add to its technical agenda a comprehensive project on accounting for contingencies, consisting of two phases: (a) a short-term phase to enhance the disclosure requirements for certain loss contingencies and (b) a long-term phase to comprehensively reconsider the recognition and measurement of certain nonfinancial liabilities, including contingencies. On June 5, 2008, in connection with the short-term phase, the FASB issued an Exposure Draft of the proposed FASB Statement, Disclosure of Certain Loss Contingencies.

Significant Disclosure Amendments

The following paragraphs summarize and describe the proposed disclosure requirements included in the Exposure Draft.

Scope of Proposed Statement

The proposed Statement would apply to all loss contingencies that are within the scope of either FASB Statement No. 5, Accounting for Contingencies, or No. 141 (revised), Business Combinations, except for:

a. Loss contingencies that are (or would be) recognized as asset impairments in a statement of financial position. Such loss contingencies shall continue to be disclosed in accordance with Statement 5. Creditors shall continue to disclose information about impaired loans in accordance with FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan.

Note: These materials are provided to facilitate understanding of the issues to be addressed at the June 24, 2008 FASAC meeting. These materials are presented for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.
b. Guarantees within the scope of the disclosure requirements of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, including guarantees that are recognized either initially or subsequently based on the Statement 5 accounting guidance.


d. Liabilities for insurance-related assessments within the scope of AICPA Statement of Position 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*.

e. Liabilities for employment-related costs, including pensions and other postemployment benefits. However, obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligations would be disclosed in accordance with the proposed Statement.

*Threshold for Disclosure—General Rule*

The proposed Statement would recharacterize the existing threshold for disclosure in Statement 5. Rather than disclosing a loss contingency “when there is at least a reasonable possibility that a loss or an additional loss [beyond the amount accrued] may have been incurred” (existing paragraph 10), entities would be required to disclose a loss contingency unless management has made an assessment and determined that the likelihood of an unfavorable outcome is remote. It is understood that loss contingencies that are not material would not be disclosed, consistent with the statement at the end of each FASB pronouncement that the guidance need not be
applied to immaterial items. Additionally, the separate threshold for disclosure of unasserted claims and assessments would be retained.

Threshold for Disclosure—Near Term and Severe Impact

In addition to the general rule stated above, the proposed Statement would require that an entity also disclose a loss contingency, or a combination of loss contingencies, regardless of the likelihood of loss if (a) the contingency or contingencies are expected to be resolved in the *near term*, and (b) the contingency or contingencies could have a *severe impact* on the entity’s financial position, cash flows, or results of operations.

Qualitative Information

The proposed Statement would require an entity to provide qualitative information sufficient to enable users to understand the risks posed to the entity. At a minimum, an entity would be required to provide information including a description of the contingency, factors that are likely to affect the ultimate outcome of the contingency, and a qualitative assessment of the most likely outcome of the contingency (see paragraph 7(b) in the Exposure Draft for a complete list). Additionally, an entity would be required to provide qualitative information about recoveries such as relevant insurance or indemnification arrangements.

Quantitative Information

One of financial statement users’ most significant concerns about disclosures under Statement 5’s requirements is that the disclosures rarely include quantitative information. Rather, entities often state that the possible loss cannot be estimated. The proposed Statement would require an entity to disclose the amount of the claim against the entity or, if there is no claim amount, the entity’s best estimate of its maximum exposure to loss from the contingency. Additionally, an entity would be permitted, but not required, to disclose the possible loss or range of loss if it believes that the claim amount or its estimate of the maximum exposure to loss is not indicative of its actual exposure.
Aggregation

Under the proposed Statement, an entity would be allowed to aggregate the qualitative and quantitative disclosures described above by the nature of the loss contingency (for example, product liability or antitrust matters).

Tabular Reconciliation

Under the proposed Statement, an entity would be required to include a tabular reconciliation of recognized loss contingencies in both interim and annual financial statements, isolating key reasons for increases in total recognized loss contingencies and key reasons for decreases in total recognized loss contingencies. Amounts would be segregated into aggregate totals for loss contingencies recognized under Statement 5 and those recognized under Statement 141(R).

Prejudicial Exemption

The proposed Statement would provide a limited exemption from disclosing information that would be prejudicial to an entity’s position in a dispute. If information required to be disclosed under the proposed Statement is considered prejudicial, an entity would aggregate the disclosures at a higher level than otherwise allowed so that the information could not be linked to its specific case by a counterparty. However, if even the aggregated disclosure would be prejudicial, an entity would be allowed to forgo disclosing only the information that would be prejudicial. An entity would still be required to disclose certain information about the loss contingency. The circumstances under which disclosure may be forgone are characterized in the Exposure Draft as rare.