

Pozen Committee Update: Improvements to Financial Reporting

By M.E. Ellis, Adrian P. Fitzsimons and Arlene Joyce Furfero

International standards and more principles-based reporting are themes.

The Securities and Exchange Commission (SEC) solicited comments on the *Progress Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission* (progress report) at the request of its Advisory Committee on Improvements to Financial Reporting (the advisory committee or the Pozen committee, named for its chair, Robert C. Pozen). The SEC chartered the advisory committee in July 2007 to examine the U.S. financial reporting system and to make recommendations to increase the value of financial information to investors while reducing the complexity of the financial reporting system. The goal of the committee is to make a limited number of focused recommendations that address acknowledged problems rather than to address all of the shortcomings of the U.S. financial reporting system. The article describes the advisory committee's developed proposals to date.

The Committee's Developed Proposals to Date

To date, the advisory committee has developed 12 proposals:

- Convert guidance from industry-specific rules to activities-based principles.
- Eliminate alternative accounting treatments.
- Increase investor presence and participation in the standards-setting process.
- Increase SEC assistance to the Financial Accounting Foundation (FAF) for enhancing its

oversight of the Financial Accounting Standards Board (FASB).

- Improve the standard-setting process and make it more efficient.
- Consolidate interpretive authority and reduce the volume of interpretive implementation guidance.
- Merge global financial reporting systems.
- Establish guidance on materiality of errors and omissions.
- Establish guidance on error correction.
- Develop a framework for dealing with professional judgment.
- Implement XBRL filings by public companies.
- Enhance corporate Web sites for disclosing financial information to the public.

Convert Guidance from Industry-Specific Rules to Activities-Based Principles

The advisory committee notes that U.S. generally accepted accounting principles ("US GAAP")

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contains many detailed rules with several industry-specific exceptions. The committee believes that US GAAP have become unnecessarily cumbersome and overly burdensome to users. It recommends that the FASB switch from industry-specific guidance to activity-based guidance. For example, the advisory committee proposes that accounting for lending transactions move away from banking-specific guidance as an industry to a lending-specific activity that applies to any company involved in lending transactions, including finance, insurance and other companies. To facilitate the shift, the committee recommends that (1) any new projects undertaken jointly or separately by the FASB be scoped on the basis of business activities rather than industries; (2) any new project include the elimination of existing industry-specific guidance in relevant areas as a specific objective of those projects unless, in rare circumstances, retaining industry guidance can be justified on the basis of cost-benefit considerations; and (3) any new project the FASB adds to its agenda shall remove or minimize existing industry-specific guidance that conflicts with generalized US GAAP, taking into account the pace of the convergence efforts.

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Eliminate Alternative Accounting Treatments

The advisory committee notes that US GAAP contains many detailed rules with alternative accounting policies for the same transaction and that some of those rules have all-or-nothing results, which stem from bright-line tests. The advisory committee states that this combination may allow companies and auditors to reach a technically compliant conclusion that is inconsistent with the underlying economic substance of the transaction. For example, a transaction involving the right to use an asset for a promise to pay a series of payments in the future can be kept off a company's balance sheet if detailed rules are followed. This alternative accounting treatment could potentially

undermine an investor's complete and accurate understanding of the transaction.

The advisory committee recommends the FASB strive to reduce the number of alternative treatments available under US GAAP to account for the same transaction and that US GAAP be based on a presumption that formally promulgated alternative accounting policies should not exist. The advisory committee further recommends that any new projects to be undertaken jointly or separately by the FASB shall

(1) not provide a choice of accounting treatment unless, in rare circumstances, it can be justified and (2) eliminate existing alternative accounting policies in relevant areas as a specific objective of

those projects unless, in rare circumstances, the presence of the alternatives can be justified.

Increase Investor Presence and Participation in the Standards-Setting Process

The advisory committee believes that financial reporting systems should give preeminence to the needs of investors while not ignoring the interests of other relevant parties. The committee notes that the current U.S. financial reporting system is deficient in this area. The advisory committee further believes that additional investor representation on standards-setting bodies is central to improving financial reporting and concludes that only if investor perspectives are properly considered by all parties will the output of the financial reporting process meet the needs of those for whom it is primarily intended to serve. The advisory committee recommends the following changes to ensure that investors' perspectives have preeminence in standards-setting processes:

- Add investors to the FAF to give more weight to the views of different types of investors, both large and small.
- Give more representation on both the FASB and its staff to experienced investors who regularly use financial statements to make

investment decisions to ensure that standards setting considers fully the usefulness of the resulting information.

- Base the determination of how to correct financial statement errors on the needs of current investors, who should, in any event, be provided with more disclosure regarding such errors.

Increase SEC Assistance to the FAF for Enhancing Its Oversight of the FASB

The advisory committee notes that the FAF maintains oversight of the FASB as one of its main priorities. The advisory committee recommends that the SEC assist the FAF with enhancing its governance of the FASB as follows:

- Encourage the FAF to develop performance metrics to assess the FASB's adherence to the goals in its mission statement, objectives and precepts and to improve its efficiency.
- Support the FAF's changes outlined in its "Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB," with minor modifications regarding composition of the FAF and the FASB and agenda setting.
- Encourage the FAF to amend the FASB's mission statement, stated objectives and precepts to emphasize an additional goal to minimize avoidable complexity.

Improve the Standard-Setting Process and Make It More Efficient

The advisory committee notes that the current financial reporting system is characterized by a large

volume of standards, interpretations and detailed application guidance from a variety of public and private sources. It notes that the volume and complexity of the financial reporting system has led to concerns about whether the FASB is following appropriate priorities within a consistent conceptual framework in adopting standards. In addition, the committee raises its own concern as to whether market constituents (preparers, auditors, analysts and investors) can efficiently find the complete body of authoritative literature on an accounting issue.

While the FASB has made considerable progress in addressing both concerns, the advisory committee believes that certain measures are needed to enhance the process for adopting new standards and issuing interpretations of existing standards. The advisory committee recommends the SEC encourage the FASB to

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further improve the standards-setting process and timeliness as follows:

- Create a formal agenda advisory group that would include strong representation from investors, the SEC, the Public Company Accounting Oversight Board (PCAOB) and other constituents (such as preparers or auditors) to make recommendations for actively managing U.S. standards-setting priorities.
- Refine procedures for issuing new standards as follows: (1) Implement investor reviews designed to assess perceived benefits to investors; (2) enhance cost-benefit analyses by explaining the process for conducting cost-benefit studies; and (3) require improved field interviews and testing before making final any significant new accounting standard.
- Improve review processes for new standards by conducting postadoption reviews of every significant new standard to determine if the standard is operating as intended. Generally, the reviews, which would be conducted within one to two years of a standard's effective date, would address interpretive questions and reduce the diversity of practice in applying the standard, if needed.

- Improve processes to keep existing standards current and to reflect changes in the business environment by conducting periodic assessments of existing standards.

Consolidate Interpretive Authority and Reduce the Volume of Interpretive Implementation Guidance

The advisory committee notes that the number of parties that either formally or informally interprets US GAAP and the volume of interpretive implementation guidance are overly extensive. The committee recommends that the number of parties that either formally or informally interprets US GAAP and the volume of interpretive implementation guidance be reduced. The committee also recommends that, to the extent practicable, the FASB should be the sole standards setter for US GAAP and the primary source of broad interpretations of existing accounting standards, and should perform those functions with a high degree of independence, and that the SEC should coordinate closely with the FASB (including through the proposed agenda advisory group) to clarify roles and responsibilities regarding the issuance of interpretive implementation guidance as follows:

- The FASB codification efforts should be completed in a timely manner and the SEC should ensure that the literature it deems to be authoritative is integrated into the codification to the extent possible, or separately recodified, as necessary. The authoritative source of US GAAP should be limited, as much as possible, to the contents of the FASB's codification project, which should be updated on a regular basis.
- To the extent practical, a single agency or organization should be responsible for setting all accounting standards and promulgating all interpretive implementation guidance that is applicable to a particular set of accounting standards, such as US GAAP or International Financial Reporting Standards (IFRS). To that end, the SEC should only issue broadly applicable interpretive implementation guidance in limited situations. When such guidance is necessary, the SEC should reconsider the man-

ner in which it develops and communicates its interpretations. The SEC should continue to provide comments on registrant-specific matters, but those comments should not be viewed as broadly applicable.

- All other sources of interpretive implementation guidance should be considered nonauthoritative and should not be required to be given more credence than any other nonauthoritative sources that are evaluated using well-reasoned, documented professional judgments made in good faith.

Merge Global Financial Reporting Systems

The advisory committee notes that US companies use US GAAP for financial reporting but that publicly traded companies in most other countries increasingly use IFRS. The major differences between US GAAP and IFRS are the orientation of the principles and the details in the principles: US GAAP are industry oriented; IFRS are activity oriented. US GAAP principles are more encumbered by detailed industry-specific rules than are IFRS principles. IFRS principles have little industry-specific guidance.

The advisory committee states that it supports the long-term goal of converging US GAAP with IFRS. It believes that convergence will reduce accounting costs to investors and others in an increasingly global business environment. However, the advisory committee recognizes various paths to convergence and understands that full convergence may take years to achieve. As a result, the advisory committee intends to propose enhancements to the U.S. financial reporting system later in 2008 and to identify and analyze some of the issues to be resolved in the move toward global convergence of accounting standards. In the meantime, the advisory committee encourages the International Accounting Standards Board (IASB) and the FASB to move away from industry-specific rules and closer to activities-based principles. US GAAP will need to become less rules based and less industry oriented to achieve the goal of global convergence.

Finally, the advisory committee notes that the IFRS contain a number of alternative accounting policies for the same activity and that certain

countries are applying political pressures to add exceptions. To achieve global convergence, the advisory committee urges the IASB to continue to reduce the number of alternative accounting policies currently available and to resist the political pressures for country exceptions.

Establish Guidance on Materiality of Errors and Omissions

Materiality relates errors and omissions in financial statements to investment decisions. Relying on two U.S. Supreme Court cases, the advisory committee defines a fact (or its omission) as material if there is a substantial likelihood that a reasonable investor would have considered it significant when making an investment decision. The advisory committee notes that the number of restated financials has increased in recent years but that not all restatements represent corrections for errors or omissions that investors consider to be material. Conversely, many financial statements may not have been restated, where investors would have considered the error or omission to be material. The advisory committee recommends that the FASB or the SEC, as appropriate, issue guidance for restating erroneous financials based upon the perspective of a reasonable investor and whether the reasonable investor would consider the error or omission to be material.

The advisory committee also notes that qualitative factors may lead to a conclusion that a quantitatively small error is material, just as qualitative factors may also lead to a conclusion that a quantitatively large error is not material. The advisory committee recommends evaluation of errors on a "sliding scale." The sliding scale trades off quantitative significance of the error for qualitative assessment of its materiality. The higher the quantitative significance of an error, the stronger the qualitative factors must be to result in a judgment that the error is not material. The lower the quantitative significance of an error,

the stronger the qualitative factors must be to result in a judgment that the error is material.

Finally, the advisory committee recommends that the FASB or the SEC, as appropriate, should conduct education sessions for financial statement preparers and auditors to raise awareness of materiality issues, to prevent misunderstandings among market constituents and to promote more consistent application of the concept of materiality for investor benefit.

Establish Guidance on Error Correction

The advisory committee observes that the practice of correcting errors in prior annual statements is inconsistent among companies and that the resulting restatements may be of little or no use to investors. The committee believes that errors should be corrected on the basis of materiality that affects investors' current investment decisions.

The advisory committee recommends the FASB or the SEC, as appropriate, issue guidance on how to correct errors consistent with the following principles:

- 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 investor's assessment of the annual financial statements would not require restatement of the annual financial statements in which the error occurred but would need to be disclosed in an appropriate document and, to the extent that the error remains uncorrected in the current period, corrected in the current period.
- If the next annual or interim report will be filed in the near future and that report will contain all of the relevant information, companies may not need to file amendments to previously filed

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annual or interim reports to reflect restated financial statements.

- Restatements of interim periods do not necessarily need to result in a restatement of an annual period.
- All errors, other than clearly insignificant errors, should be corrected no later than in the financial statements of the period in which the error is discovered, and all material errors should be disclosed when they are corrected.
- The current disclosure during the period in which the restatement is being prepared, about the need for a restatement and about the restatement itself, is not consistently adequate for the needs of investors and should be enhanced.

The advisory committee also recommends that the FASB or the SEC, as appropriate, develop and issue guidance on applying materiality to identify errors in prior interim reports and how to correct those errors, based on the principles that (1) materiality in interim-period reports must be assessed based on the perspective of the reasonable investor, and (2) when a material error occurs in an interim report, the guidance on how to correct that error should be consistent with the above principles.

Develop a Framework for Dealing with Professional Judgment

Professional judgment is the subjective valuation that preparers and auditors interject into the financial reporting process. The advisory committee notes that the preparation and audit of financial statements have always required the use of professional judgment but that the recent evolution of accounting requires even more professional judgment. For example, the more frequent use of fair value involves estimates of value that may be less objectively determined than historical cost measures. Similarly, the advisory committee notes the revised auditing standards recently issued by the PCAOB emphasize the need for professional judgment in taking a risk-based approach to performing internal control audits.

The advisory committee recommends the following:

- The SEC adopt a judgment framework for accounting judgments and the PCAOB adopt

a similar framework for auditing judgments. Careful consideration should be given in implementing any framework to ensure that the framework does not limit the ability of auditors and regulators to ask appropriate questions regarding judgments and to take actions to require correction of unreasonable judgments.

- The framework should be applicable to accounting-related judgments, including the choice and application of accounting principles as well as the estimates and evaluation of evidence related to the application of an accounting principle. A framework, consistent with the principles outlined in the proposal to cover judgments made by auditors based on the application of PCAOB auditing standards, would be very important and would be beneficial to investors, preparers and auditors.
- The PCAOB should develop a professional judgment framework for the application and evaluations of judgments made based on PCAOB auditing standards.

The advisory committee also recommends the following:

- The FASB conduct postadoption reviews of significant new standards, generally within one to two years of their effective dates, to ascertain the degree of diversity in practice in using judgment when applying those standards. If the diversity is too broad or otherwise inappropriate, the advisory committee expects the FASB to amend the standard or issue interpretive guidance.
- The SEC and the PCAOB adopt frameworks for reviewing the exercise of judgment. The framework applicable to accounting judgments would require a disciplined process that is documented contemporaneously with the making of the accounting judgment. The disciplined process would include: (1) the identification of available alternatives, (2) the analysis of the relevant literature, (3) a review of the pertinent facts and (4) a well-reasoned explanation of the conclusions.

Implement XBRL Tagging by Public Companies

The advisory committee notes that delivery of timely financial information to all market constituents

is important but that the informational needs of these constituents differ. XBRL, or “extensible business reporting language,” tagging is a standardized international interactive information technology that automates manual processes and facilitates the access, analysis and reporting of corporate information. It can generate comparative arrays of company information in standardized formats for constituents while minimizing the burdens on preparers (especially smaller companies).

The advisory committee recommends adoption of XBRL tagging. Except for one dissenting member, the committee recommends a gradual phase-in of XBRL tagging. A phase-in approach would allow time for enhanced understanding of the XBRL technology, successful implementation of the new XBRL US GAAP taxonomy and further development of tagging and rendering software.

The advisory committee recommends that phase-in start with the furnishing of XBRL reports by the largest 500 domestic public reporting companies (based on unaffiliated market capitalization or public float) and that, beginning one year after the start of phase-in, all domestic large accelerated filers be required to furnish XBRL reports. The advisory committee recommends *mandatory* use of XBRL by all reporting companies for *filed reports* after the satisfaction of certain preconditions, namely, (1) the successful testing of the XBRL US GAAP taxonomy, (2) the addition of sufficient capacity by reporting companies to file XBRL-tagged financial statements and (3) the successful integration of the SEC’s EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system with the XBRL technology.

(The dissenting member believes that delay is unwarranted and recommends that all companies should be required to adopt XBRL tagging simultaneously. He would also eliminate any distinction between furnished reports and filed reports, elimination of which would further reduce the need for delay of any full-scale implementation of XBRL tagging.)

Enhance Corporate Web Sites for Disclosing Financial Information to the Public

The advisory committee believes that corporate Web sites play an important role in delivering efficient, low-cost information about the companies to the public. The committee encourages companies to increase the use of their Web sites and recommends a tiered approach for disseminating the information. The committee also recommends that companies coordinate efforts among themselves to develop a set of best practices on uses of corporate Web sites.

The advisory committee recognizes the need for some Web site oversight and recommends that the SEC issue a new comprehensive interpretive release regarding the use of corporate Web sites for disclosures of corporate information that would address such issues as (1) liability for information presented in a summary format, (2) treatment of hyperlinked information from within or outside a company’s Web site, (3) treatment of non-GAAP disclosures and GAAP reconciliations and (4) clarification of the public availability of information disclosed on a reporting company’s Web site.

Conclusion

The advisory committee believes that the above proposals will enable the SEC and others to determine quickly and easily what, if any, regulatory actions in the identified areas are warranted. The advisory committee further believes that these proposals are efficient, because they can be implemented by the SEC, its staff or other bodies, as appropriate, to improve the US financial reporting system, without further legislative action. The advisory committee now welcomes comments on these proposals.

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