

Pozen Committee Update: Conceptual Approaches and Future Considerations

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

Excessive use of bright-line rules and the need to clarify the SEC's role in standards setting are among pending issues.

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* (“the progress report”) at the request of its Advisory Committee on Improvements to Financial Reporting (“the advisory committee”). In the June–July issue of *BANK ACCOUNTING & FINANCE*, we reported on the advisory committee’s proposals to date.¹ In this issue, we examine the committee’s conceptual approaches to developing additional proposals to be released later this year and to other matters that it has identified for future consideration but on which it has yet to begin research or deliberations.

Conceptual Approaches for Developing Proposals to Deal with Recognized Issues

The conceptual approaches represent the advisory committee’s initial views on how to deal with other recognized issues. Those conceptualizations are based solely on discussions of the issues to date and require additional vetting. The publication of the approaches is intended to stimulate further discussion and debate so that the committee can develop and release additional proposals later this year. The advisory committee has developed conceptual approaches for dealing with the following issues:

- Too many bright-line rules
- Need for increased education of students, investors, preparers and auditors

- Lack of standardized asset and liability valuation
- Issuance of unnecessary new standards and interpretations
- Inconsistencies in data aggregation in financial statements
- Too much uncertainty associated with fair value measures
- Lack of an effective disclosure framework
- Need to clarify the SEC’s role and responsibilities
- Need to write standards in plain English
- Reprioritization of the SEC’s standards-setting agenda

The summaries below consist, in general, of the advisory committee’s observations, beliefs and conceptual approaches for developing additional proposals.

Bright-Line Rules

The advisory committee notes that U.S. generally accepted accounting principles (GAAP) currently employ many bright-line rules for recognizing expenses because they (1) reduce the number of subjective professional judgments; (2) reduce

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second-guessing of preparers and auditors by inspectors, regulators and the trial bar; (3) limit aggressive accounting policies; (4) enhance perceived uniformity; and (5) restrict application of new accounting guidance to a small group of companies. However, the committee states it believes bright-line rules lead to arbitrary all-or-nothing recognition of some expenses and that proportionate recognition or enhanced disclosure may be preferred in many instances.

The selection of an accounting procedure within the current framework depends on whether the expense meets a quantified threshold or a pass/fail test. The advisory committee states that a quantified threshold is a hard-and-fast numerical cutoff, rule of thumb or presumption, often coupled with other considerations, that arbitrarily biases recognition.

It also notes that a pass/fail test does not involve quantification but similarly biases recognition.

The committee states that it does not favor the use of bright-line rules because they (1) make financial reports less comparable, (2) permit a specific financial reporting result and (3) increase the volume of accounting literature as standard-setters and regulators attempt to curb abusively structured transactions.

The advisory committee notes that it is debating when, if at all, bright lines are justified and acknowledges that limiting bright lines would require a culture shift toward acceptance of a more judgment-based accounting. The committee points out that narrowly scoped guidance and bright lines may serve as a short-term fix; however, it hopes to effectuate over the long term a professional judgment framework that will reduce and, in the ideal, eliminate bright-line rules.

Increased Education

The advisory committee notes that current GAAP with its myriad of bright-line rules merely requires mechanical compliance without context. A shift from bright-line rules to judgment-based accounting will

require increased education of students as well as the continuing education of investors, preparers and auditors on the economic substance and business purposes of transactions. The committee is considering how best to encourage such education and continuing education.

Asset and Liability Valuation

The advisory committee notes that GAAP currently supports a mixed-attribute model for valuing assets and liabilities. Some assets and liabilities are measured by historical cost, others at the lower of historical cost or current market and still others at fair market value. To add to the complexity of the situation, the committee notes that some adjustments to carrying amounts are recorded in earnings and

other adjustments are recorded in comprehensive income. Some market constituents advocate a mandatory and comprehensive use of fair market value instead of the mixed-attribute model. However, the advisory committee recognizes that while a complete shift to fair market value might reduce some avoidable complexity, it would increase other avoidable complexity.

The committee identified several advantages and disadvantages of using fair market valuation. The major advantage of fair market valuation is its better ability to evince management's perspective when management decisions are based on fair value. For example, fair market valuation reduces confusion related to measurement mismatches, especially in derivatives transactions, when the derivatives are bought especially to hedge exposure to changes in market value, and it eliminates issues surrounding management's intent, when management intends to hold an impaired investment long enough to allow for any anticipated recovery in market value. The major disadvantages of using fair market valuation are (1) loss of objectivity in valuation (no single set of generally accepted valuation standards exists); (2) the use of inputs to valuation models vary across companies, and significant variance exists in the

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quality, skill and reports of valuation specialists; (3) additional costs due to the use of valuation specialists, including auditors' tendency to use their own valuation specialists; (4) concerns about second-guessing by auditors, regulators and the courts; and (5) the effort and time needed to mark-to-model fair values. Moreover, the advisory committee notes that opponents of fair value believe its use would only shift the burden of avoidable complexity from investors to preparers and auditors, not reduce it.

The committee states that it will not address when fair value is the appropriate measurement attribute, but it understands that the Financial Accounting Standards Board's (FASB's) joint conceptual framework project includes a measurement phase. The advisory committee states that it intends to study the FASB project further, plans to provide input to the project and is considering recommending the SEC endorse the project. The committee states that it believes the FASB should develop a decision framework to provide a systematic approach for consistently determining the most appropriate measurement attribute for similar activities or assets and liabilities, based on consideration of the trade-off between relevance and reliability, and for the various market constituents involved in the financial reporting process.

New Standards and Interpretations

The advisory committee notes problems with the continual use of fair value, including the need for guidance (1) whenever more than one measurement attribute is used, (2) whenever entities request exceptions from the use of fair value in financial reporting, and (3) whenever entities resist its use and/or attempt to limit earnings volatility by entering into transactions that they would not have otherwise undertaken. Due to the implementation complexities in the use of fair value, the committee is considering whether the SEC should request that the FASB be judicious about issuing new standards and interpretations that require the expanded use of fair value in areas where it is not already required until a measurement framework is completed. The committee notes that

eventually the framework will be used to determine measurement attributes systematically, and it is considering whether improvements related to certain existing, particularly complex, standards that incorporate fair value, such as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, are warranted in the near term.

Data Aggregation in Financial Statements

The advisory committee states that it believes more consistency of data aggregation in financial statements would alleviate some of the confusion and concerns regarding the use of fair value. The committee suggests that amounts and line items should be grouped by the nature of the activity and measurement attribute

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within and across financial statements. It notes that such grouping would more clearly delineate the nature of changes in income (for example, fair value volatility, changes in estimates and business activity), so that the presentation is more understandable to investors and helps investors assess the degree to which management controls each source of income.

The advisory committee notes that the FASB has already made tentative decisions to segregate the financial statements into business (further divided into operating and investing) and financing activities and to require a reconciliation of the statement of cash flows to the statement of comprehensive income. The reconciliation would disaggregate changes in assets and liabilities based on cash, accruals and changes in fair value, among others. The committee states that it intends to study the FASB's financial statement presentation project more closely to assess whether it adequately addresses the committee's concerns for consistency and sufficiently facilitates investors' understanding of fair value.

Fair Value Measures

The advisory committee notes that fair value techniques make information delivery more difficult. The committee is concerned that investors may not understand the uncertainty associated with fair value measures—that the measures are estimates and in many instances lack precision. The committee states it believes investors may not understand the quality of unrealized gains and losses in earnings that come from changes in fair value. The committee notes that the use of fair value may lead to counterintuitive results, that fair value for held-to-maturity investments may not have meaning and that preparers may view disclosures of some of the inputs to the assumptions as sensitive and competitively harmful.

The advisory committee has identified potential areas for additional disclosure to signal the level of uncertainty associated with fair value measurements in financial statements more effectively to investors. The committee notes that, in some cases, no “right” number in a probability distribution of figures exists and that some of those numbers may be more representative of fair value than others. The committee states that other areas it is targeting for disclosure include (1) the valuation model; (2) the statistical confidence intervals used with certain valuation models; (3) the key assumptions, including projections, of the models; (4) sensitivity analysis depending on the selection of key assumptions; and (5) the entity’s individual position versus that of the entire market.

Disclosure Framework

The advisory committee states that it believes recommendations requiring a systematic measurement framework and better communication of measurement attributes would more feasibly reduce avoidable complexity resulting from the

mixed-attribute model. Such communication would encompass footnote disclosure of each measurement attribute’s characteristic as well as a more systematic presentation of distinct measurement attributes on the face of the primary financial statement.

The advisory committee states that it seeks to balance additional disclosure requirements with (1) the perception that amounts recognized in financial statements are generally subjected to

more precise calculations by preparers and higher degrees of scrutiny by investors compared to merely disclosing such amounts in the footnotes and (2) concerns regarding disclosure redundancies. To minimize the effect of diminishing returns on potential new disclosure requirements, the advisory committee is considering recommendations that the SEC (1) request the FASB to

develop a disclosure framework that integrates existing disclosure requirements into a cohesive whole (for example, eliminate redundant disclosures and provide a single source of disclosure guidance across all accounting standards); (2) revise the piecemeal approach to establishing disclosures (that is, standard by standard); and (3) develop a process to regularly evaluate and, as appropriate, update its disclosure requirements as new FASB standards are issued.

SEC’s Role and Responsibilities

The advisory committee notes that the SEC sometimes issues rules and interpretations that comprise part of GAAP and that those rulemaking activities are generally open to public participation and observation. The committee notes that other SEC activities do not occur with the same level of transparency. For example, the committee points out that registrant-specific guidance is published as comment letters but appropriately does not need to be proposed in advance and is not subject to public

The SEC is reviewing its procedures in many of the areas of concern and expects to unveil a number of changes in the coming months, including new procedures to enhance the consistency of registrant-specific accounting interpretations during filing reviews and increasing the understanding and usefulness of its reconsideration processes.

comment. To the extent the SEC promulgates interpretative implementation guidance that is broadly applicable and is expected to change the application of GAAP significantly, the committee is considering whether the SEC should do so only after public notice and comment, whenever practicable.

In addition, the advisory committee is considering a proposal that the SEC further clarify its role *vis-à-vis* the FASB, as well as its internal roles and responsibilities, to mitigate the risk of its actions unintentionally driving market participants' behavior. In particular, the committee is considering the following proposals:

- The SEC should clarify that registrant-specific matters are not authoritative interpretative implementation guidance under GAAP and, accordingly, registrants other than the specific registrant in question are not required to take into account such registrant-specific matters.
- The SEC should refrain from informally communicating broadly applicable interpretative implementation guidance (for example, staff speeches) that is likely to be perceived as changing the application of GAAP. Such communications should be used only to highlight authoritative interpretative implementation guidance that has already been issued.
- When the SEC has identified registrant-specific accounting matters that it believes may result in the need for broader interpretative implementation guidance or a clarification of an accounting standard under GAAP, it should refer those items to the FASB as part of the Agenda Advisory Group.
- When the SEC finds it necessary to issue broadly applicable interpretative implementation guidance, it should try to provide such guidance (1) in a clear communication identified as authoritative, (2) so that it can easily and immediately be integrated into a codification of SEC literature, and, (3) when expected to significantly change the application of GAAP, only after transparent due process and public comment to the extent practicable.
- The SEC should revisit internal procedures and take further steps necessary to improve the consistency of its views on the application of GAAP.

The advisory committee states that it has not yet proposed a specific course of action, because it does

not want to limit the ability of the SEC to carry out its regulatory responsibilities in a timely fashion. The committee notes that the SEC is reviewing its procedures in many of the areas of concern and expects to unveil a number of changes in the coming months, including new procedures to enhance the consistency of registrant-specific accounting interpretations during filing reviews and increasing the understanding and usefulness of its reconsideration processes. The advisory committee states that it supports those efforts and plans to review progress with the SEC staff in the coming months as the committee continues its deliberations.

Plain English Standards

The advisory committee states that some participants in the U.S. financial reporting community believe that certain accounting standards do not clearly articulate the objectives and principles upon which they are based, because they are sometimes obscured by detailed rules, examples, scope exceptions, safe harbors, cliffs, thresholds and bright lines. The committee states it believes that uncertainty in the application of GAAP is caused because GAAP is often not written in plain English, rules cannot cover all possibilities, and the underlying principles and objectives may not be clear.

The advisory committee is considering proposals that would encourage the SEC to continue improving the way standards are written:

- Support the writing of accounting standards according to an agreed-upon framework of what constitutes an optimal standard. The committee states that standards should not strive to answer every question and close every loophole but should be written with more clearly stated objectives and principles that may be applied to broad categories of transactions.
- Support the writing of accounting standards in a manner that promotes trust and confidence in efficient markets by encouraging the use of professional judgments made in good faith. Specifically, preparers and auditors should apply the standards faithfully, and regulators should monitor and address abusive application of the standards.

The advisory committee notes that the question of how to design standards is at the center of a

decade-long, principles-based versus rules-based accounting standard debate and that the SEC, a frequent participant in the debate, supports principles-based standards. Rather than engage in a debate over terms such as “principles-based,” “objectives-oriented” or “rules-based,” the advisory committee states that it prefers to focus on the characteristics that standards possess. Given this objective, the committee is considering various suggestions for the optimal design of standards.

SEC’s Standards-Setting Agenda

The advisory committee is considering a proposal to request the SEC to reprioritize its standards-setting agenda to balance the need for international convergence, improvements to the conceptual framework and maintaining existing GAAP. Further, the committee is deliberating whether the FASB and the SEC should add to their agendas a second phase of the codification project to consider systematically revisiting GAAP to:

- Be more coherent after codification
- Remove conflicts between standards or with the conceptual framework
- Be less complex, where possible
- Be designed more optimally
- Readdress frequent practice problems (as identified by restatement volumes, input from the SEC, implementation guidance issued, or frequently asked questions)
- Remove redundancies between SEC disclosure requirements and other sources of GAAP
- Amend, replace or remove outdated standards

The advisory committee states that it is also considering a conceptual approach for establishing standards-setting priorities in the current environment. The committee plans to finalize a proposal after completing deliberations on international considerations later in 2008. The committee acknowledges that some U.S. market constituents have indicated that a full-scale adoption of International Financial Reporting Standards (IFRS) may be the most expeditious way to shorten the lengthy timeline that would be required to complete such a list of priorities.

Finally, the advisory committee is encouraging the FASB to complete its codification project in a timely manner. The committee understands that the

codification will not read consistently in all parts, because of the evolutionary nature of U.S. standards setting, but it sees opportunities to remove redundancies between SEC and FASB disclosure requirements and make other simplifications after the recodification. Therefore, the advisory committee states it is deliberating whether and when the FASB and the SEC should perform a second phase of the codification project, which would involve a comprehensive periodic assessment of existing accounting standards.

Other Matters for Future Consideration

The advisory committee has identified five matters for future research and deliberations:

- Scope exceptions in GAAP other than industry-specific guidance
- Competing models
- Optimal transition provisions
- Minimization of avoidable complexity in regulation and compliance
- Executive summaries for Exchange Act reports

Scope Exceptions in GAAP

The advisory committee notes that scope exceptions other than industry-specified guidance represent departures from a principle and require detailed analysis to determine where they apply. The committee states it believes that the scope exceptions contribute to avoidable complexity because they result in different accounting for similar activities, require detailed analyses to determine whether or not they apply in particular situations, and increase the volume of accounting literature.

Competing Models

The advisory committee distinguishes competing models from alternative accounting policies. The committee identifies alternative accounting policies as the different accounting treatments that preparers are allowed to choose under existing GAAP. The committee identifies competing models as the requirements to apply different accounting models to account for similar types of

transactions or events, depending on the balance sheet or income statement items involved. The advisory committee notes that the use of competing models requires all constituents to understand assorted implementation methods, even though they are based on similar fundamental principles. The committee states it believes that permissive use of competing models leads to inconsistent accounting for similar activities and to the increased volume of accounting literature.

The advisory committee intends to consider the value of competing models in light of cost-benefit considerations, practical approaches to issuing guidance in the near term before more principled standards are developed and the magnitude of change that would result from eliminating or reducing them. The committee also plans to explore the relationship between competing models and the FASB's conceptual framework.

Optimal Transition Provisions

The advisory committee states that it plans to deliberate what optimal transition provisions should be in the future and whether new standards should be applied prospectively or retrospectively. The committee's goal is to balance the investor's need for consistent information with preparer and auditor concerns about feasibility and the costs of recasting historical information.

Avoidable Complexity

The advisory committee intends to examine the area of regulation and compliance for issues that

create avoidable complexity in financial reporting. Some of the areas on which the committee intends to focus are (1) the interaction between companies and their auditors, the SEC and the Public Company Accounting Oversight Board (PCAOB); (2) the interaction between audit firms and the SEC and PCAOB; and (3) the levels of enforcement and regulation of standards in other developed markets around the world.

Executive Summaries for Exchange Act Reports

The advisory committee has been exploring a requirement to include an executive summary in Exchange Act reports (Forms 10-K and 10-Q). The committee states it understands that a summary report prepared on a stand-alone basis would not necessarily provide investors with necessary information in a desired format; however, an executive summary in the forepart of an Exchange Act periodic report may provide investors with an important road map to the company's disclosures located in the body of the report. The advisory committee states that the goal of the executive summary is to help investors fundamentally understand a company's businesses and activities through a relatively short, plain-English presentation.

Endnotes

- ¹ M.E. Ellis, Adrian P. Fitzsimons and Arlene Joyce Furfero, *Pozen Committee Update: Improvements to Financial Reporting*, BANK ACCOUNTING & FIN., June–July 2008, at 44–50.

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