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RECORD OF PROCEEDINGS OF

SEC ADVISORY COMMITTEE ON IMPROVEMENTS
TO FINANCIAL REPORTING
OPEN MEETING

Friday, November 2, 2007

9:30 a.m.- 3:00 p.m.

United States Securities and Exchange Commission
100 F Street, Northeast
Washington, D.C.

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COMMITTEE MEMBERS PRESENT

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Robert Pozen, Committee Chairman

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Dennis R. Beresford

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Susan Schmidt Bies

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J. Michael Cook

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Jeffrey J. Diermier

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Scott C. Evans

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Linda L. Griggs

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Joseph A. Grundfest

12

Gregory J. Jonas

13

G. Edward McClammy

14

Edward E. Nusbaum

15

James H. Quigley (by telephone)

16

David Sidwell

17

Peter J. Wallison

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Thomas Weatherford

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COMMITTEE MEMBERS ABSENT

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Christopher Liddell

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William H. Mann, III

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OFFICIAL OBSERVERS PRESENT

Robert Herz
Charles Holm
Kristen Jaconi
Philip Laskawy
Mark Olson

SEC AND COMMITTEE STAFF

Conrad Hewitt, SEC Chief Accountant
Jim Kroeker, SEC Deputy Chief Accountant
Russell Golden, FASB Senior Advisor to Committee Chairman
John White, SEC Director of Division of Corporate Finance

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P R O C E E D I N G S

1
2 MR. KROEKER: I'll open the meeting formally and thank
3 everyone for attending. For those in the audience, there are
4 papers available - the discussion papers. They look like
5 this thing here. If you don't have it already, there are
6 copies available.

7 I would also like to thank the people who are
8 participating via webcast. And, for those, the discussion
9 papers for today are available online, so you can follow
10 along in the discussion.

11 With that, I will turn it over to Conrad to make
12 some introductory remarks.

13 MR. HEWITT: Good morning, everyone. On behalf of
14 Chairman Cox and the rest of us at the SEC, we welcome you to
15 your second open hearing.

16 We know also that, for the last two months, the
17 four subcommittees have been working very diligently on
18 various topics, and we look forward to your deliberations on
19 those topics today.

20 At this time, the meeting has been formally opened
21 by our designated federal officer, Jim Kroeker, so, Mr.
22 Chairman, I'll turn it back to you.

23 MR. POZEN: Well, thank you very much. We
24 appreciate all the work of the members of the committee. I
25 think there has been a huge effort to really bring things

1 forward. And we also appreciate the staff leadership of Russ
2 Golden and Jim Kroeker and then all the other people who have
3 been involved.

4 I think, if we turn to this book, to the agenda on
5 the first page, I'll keep my introductory remarks very short.

6 Basically, the point of this meeting is twofold.
7 One is to have the various subcommittees report as to the
8 work they have been doing over the last few months. And
9 then, second of all, is to get some sense of where these
10 subcommittees would be going between now and the next public
11 meeting, which will be, I think, January 11th.

12 So those are the purposes. And the way we will
13 proceed is to have each subcommittee, starting with I, moving
14 to II, III, and IV, in logical order, make a short
15 presentation of the issues, which will follow this book, and
16 then we really are hoping to have some very good discussion
17 from the other members of the committee, so we can reach a
18 consensus on some of these issues.

19 I think the next matter on the agenda is review of
20 the comment letters received. These are at the back of the
21 book. I think these are - sorry, they are not at the back
22 of the book. They are posted on the Web. They are posted on
23 the Web, and I think they have been disseminated to all the
24 committee members.

25 And I guess I would say that we have taken the

1 input of these various comment letters and, unless someone
2 has a question about the comment letters, I was going to go
3 on to have the reports of the subcommittees.

4 So are there any questions about any of the comment
5 letters?

6 MR. POZEN: Okay. I think we should emphasize
7 that, in 2008, the full committee will hold meetings in San
8 Francisco, New York, and Chicago, in which case, we will take
9 testimony, and various groups will have a chance to present
10 their views.

11 And also, a number of the subcommittees have
12 solicited input from various people in the financial
13 industry, and in auditing, and in various other groups, so
14 that we are in the process, not just through the comment
15 letter process, but through actual testimony and discussions,
16 of really making a big effort to canvass what is out there
17 and what people's views are.

18 MR. KROEKER: There is also an open box on the web
19 site, or an open link, for anybody that wants to provide
20 comments at any point in time.

21 MR. POZEN: Okay. So, without further ado, I'm
22 going to ask the subcommittee chairman, Sue Bies, from
23 Subcommittee I - Subcommittee I is looking at the area of
24 substantive complexity. And just to give you an overview,
25 Subcommittee II is looking at the process of standard

1 setting. Subcommittee III is looking at audit compliance and
2 restatements. And Subcommittee IV is looking at information
3 delivery, including XBRL and summary documents.

4 So this first presentation will be on the area of
5 substantive complexity. So, Sue, if you wouldn't mind
6 leading off.

7 MS. BIES: Thank you, Bob.

8 Well, the first subcommittee, given we're trying to
9 deal with what is complexity, we are going to tee up the
10 discussion on these various things and try to, really,
11 approach it, initially, around two issues.

12 Number one, what do we mean by complexity? And we
13 are going to talk about that first in the summary.

14 And second, then, given that definition, what are
15 the key drivers that are creating complexity, and what can we
16 do to address any of those specific issues?

17 And we have already sort of keyed up four broad
18 areas that we believe are part of the problem with
19 complexity. And we also identified some areas where there is
20 an overlap with some of the other subcommittees, and we will
21 be mentioning those as we go along to encourage our fellow
22 committee members of the big committee to continue to pursue
23 some of these other issues.

24 So let me first put to the full committee the issue
25 of complexity. As you can see, on page 2 of our summary, we

1 have sort of teed up an initial definition, and we would like
2 to get the full committee's feedback on this to start.

3 Let me just sort of talk about the different
4 points. We think that complexity has to be viewed from both
5 the preparer's side, as well as the user's side, and then
6 also thinking about the auditability of any accounting
7 standard, and if it is difficult to prepare statements or to
8 understand the transactions, whether they really reflect the
9 business economics - that that is an issue.

10 We want to make sure that the accounting principles
11 really clearly demonstrate why transactions happened, in
12 terms of the results of those transactions.

13 So what we want to do is think about the causes of
14 complexity. And we know that some of them are due to the
15 complexity of business transactions themselves. They have
16 gotten more difficult. More things are being bundled, more
17 things are being structured, and it's the complexity of the
18 underlying business that creates some these problems, so that
19 preparers are trying to decide what accounting standard is
20 the appropriate one to follow.

21 Given the environment that we have been in in the
22 last several years - and, clearly, in the last couple months
23 -- there is also this fear of being second-guessed, because a
24 lot of what we are moving toward is more of a mark-to-model
25 kind of framework in some areas, and all of the reserving,

1 all of the accrual, all of the fair value kind of issues
2 create some second-guessing risk for companies.

3 We also know that there is structuring that goes
4 on, where people will do a deal in order to achieve a certain
5 accounting result, and that can create complexity in and of
6 itself and, clearly, for users of financial statements, can
7 obscure the real risk of business results.

8 And then, finally, the last one - and this one
9 overlaps with another subcommittee - is just the vast number
10 of accounting standards that are out there that, both formal
11 and informal, multiple bodies that have issued them. And we
12 would really encourage the FASB and all of the other bodies
13 to be - and the other subcommittees who touch on this - to
14 really, at a minimum, get a codified set of accounting
15 standards, so someone can go and look by topic and find out
16 what is the relevant literature because, given the vast
17 amount out there, some of it informal, through speeches -
18 say, by SEC staff members, and so on - it makes it difficult
19 to know what the appropriate accounting is.

20 So, at a minimum, we would hope that gets
21 addressed, in terms of a process, along the way.

22 Let me sort of start with just feedback from the
23 general committee. Do you think, given our initial scope and
24 the initial definition of complexity, are we headed in the
25 right direction? Is this the way you would expect our

1 subcommittee to proceed? Are we teeing up the right issues?

2 MS. GRIGGS: Sue, it's Linda. I think you are
3 teeing up the right issues.

4 The one area that I thought I would have expected
5 to see in the definition and in the causes of complexity was
6 just the difficulty of fair-valuing non-traded assets and
7 liabilities. And I'm wondering if you gave consideration to
8 that and whether that would fit. And I think it could fit
9 into your definition of the causes.

10 MS. BIES: We have talked about it a bit as we have
11 started to discuss fair value issues, but you're right, we
12 didn't capture that probably in the definition, and we should
13 bring that forward. I think that's a good suggestion.

14 MR. DIERMIER: Sue, this is Jeff. I think you have
15 captured the scope very nicely, as well.

16 I would just - in the area of causes of
17 complexity, I think it might be good if there was an addition
18 that would address the fact that an additional cause,
19 basically, comes from the standpoint of the investors,
20 themselves, that multiple choices, difficult navigation, and
21 changing accounting treatments, lack of clarity between
22 operating and investing results, lack of segments, difficulty
23 in comparing - this is an important element of complexity,
24 as well. So it's complexity, certainly, for the preparers,
25 but also for the users, as well. I think that would be my

1 suggestion.

2 And then a really small nit. But I've been
3 spending some time trying to understand - we all know what
4 second-guessing means, right? But, obviously, it's okay for
5 people to ask questions. So is that second-guessing? So if
6 the group might think a little bit more about what the
7 fundamental underpinning of second-guessing is, that might be
8 helpful to, I think, all the parties involved.

9 MR. EVANS: I wanted to tag on to Jeff's comments
10 because I think perspective of users - who are, after all,
11 the ultimate beneficiaries of financial statements - needs
12 to come through in a little bit more strong fashion, so that
13 it's not - there's an awful lot of focus on the perspective
14 of the preparers and the auditors, but if financial
15 statements are not useful to the users, if they are not
16 understandable to users, they fail on a number of levels. And
17 it's the real cause of the complexity.

18 MR. POZEN: Yes, Greg?

19 MR. JONAS: Sue, this is Greg. Two thoughts.
20 First, I thought the scope was very appropriate. I would
21 encourage us to think about one item that perhaps is here and
22 I didn't focus on it enough, but if it's missing, I would
23 encourage you to work at it, and that is the whole notion of
24 simplicity of communication of expression of planning, which
25 I think is a real barrier to users of understanding

1 the information.

2 I contrast, in face-to-face meetings with
3 management, the clarity of communications - the graphs, the
4 charts - I contrast that to what I think is often a very,
5 very needlessly complex way of communicating in the formal
6 filings. Some progress - the Commission did some wonderful
7 work on financial reporting a few years back, and I think
8 some of those concepts could - we could bring forward and
9 emphasize.

10 A second concept doesn't relate directly to the
11 agenda but, rather, how we tee up the entire issue of
12 complexity. And I really like the way that you have
13 identified the various players in the process and how
14 complexity relates to each, but some solutions to the
15 complexity problem serve only to transfer complexity from one
16 constituency to another. And our challenge, I think, is to
17 find solutions that actually take out complexity for all
18 constituencies and not just transfer it.

19 Let me just - my favorite example is the grand
20 debate over principle-based standards versus rules. You
21 know, the soft underbelly of principle-based standards is
22 boundless judgment. And boundless judgment might really, you
23 know, reduce complexity for those who prepare financial
24 statements, but it certainly does make life miserable for
25 those who are trying to compare one company against another.

1 It's just a transfer of complexity that really doesn't make
2 our lives easier.

3 MR. GRUNDFEST: Just a brief observation. In our
4 conversations on complexity, we actually did have one simple
5 observation, and that is there are, at least, two kinds of
6 complexity.

7 First, the real world is complicated. And there is
8 a sense in which, if you try to take the real world, which is
9 complicated, and present it in a simple depiction, you lose a
10 certain aspect of representational fidelity. So there is a
11 level of complexity which is necessary, if you are going to
12 maintain fidelity. And, at a certain point, trying to impose
13 simplicity really goes against the objective of fidelity.

14 Second, I think it's important to recognize that
15 accounting rules and regulations can create unnecessary
16 complexity. So, for example, when you've got a set of bright
17 line rules - and let's bring it home to an issue that
18 everybody is concerned about today.

19 Let's say, if you structure a SIV the following
20 way, you can keep it off your balance sheet and you don't
21 have to take a capital gain per Basel accounting standards.
22 Then you're going to have everybody structure SIVs right up
23 to that line, so they keep it off their balance sheet, and,
24 there, you've got a set of complexity that is actually
25 artificially induced into the financial system as a result of

1 the reporting rules and regulations we have.

2 One of our observations is that you can and should
3 think about ways of reducing the induced complexity - the
4 complexity that regulators actually drive into the financial
5 process - and then increase the mechanisms for accurately
6 describing the innate complexity - which comes about, you
7 know, when you invent Black-Scholes pricing, and, now, you
8 can do things with derivatives, and you're doing it
9 intelligently and not for regulatory reasons.

10 MR. POZEN: Well, I think that probably we have
11 pushed this as far as we can. This complexity definition is
12 the sort of thing that is very complex in itself.

13 And I think that I would like to ask Sue to move on
14 to - there are three or four more specific issues which the
15 subcommittee has been looking at. And I think the first one
16 has to do with industry-specific guidance, which is a very
17 concrete example of unnecessary complexity. And we might
18 focus on that. Thank you.

19 MS. BIES: Thanks, Bob. There is two issues that
20 -- as you can see by our summary of our deliberations so far
21 -- on industry-specific guidance and alternative accounting
22 policies that we think are examples of some of the complexity
23 that is out there.

24 And, when we look at them, what they do is,
25 basically, provide multiple ways to account for the same

1 economic transaction. And, to the extent that part of our
2 definition of complexity is to have multiple ways to account
3 for the same transaction, we teed up these two issues fairly
4 quickly.

5 I want to emphasize here that, when we talk about
6 the same economic transaction, we mean business transaction,
7 not asset or liability, to the extent that an asset or
8 liability can be used in different ways in different
9 businesses and different types of transactions. So we are
10 really defining this around activities.

11 And so, for example, when we see the term
12 "industry-specific guidance," part of the confusion is: Are
13 you primarily in that industry? Or are we really talking
14 about a type of activity which you might find in a certain
15 group of firms more than others, but if that same economic
16 business activity occurs in another company in a minor way,
17 shouldn't you follow the same accounting?

18 So, as we have teed this up, we are really talking
19 about the substance of a business activity being the same,
20 but having the potential for being accounted for in two
21 different ways. And we think that that, in and of itself, is
22 something that should be clarified by standard setters, given
23 the nature of the change in business going forward.

24 So let me talk about industry-specific guidance
25 and tee up the key issues here.

1 In some ways, some of this came about because
2 specific industries felt they were unique and heavily lobbied
3 the appropriate regulatory bodies and standards setters for
4 their uniqueness and unique accounting. Sometimes, it's a
5 practical issue, in that some new business practice has
6 arisen, and trying to get something out the door quickly for
7 preparers to follow doesn't give the standard setter a chance
8 to explore the whole realm of possibilities or related
9 transactions.

10 We think that we should - whenever there is more
11 than one potential out there, what we are initially thinking
12 about is it should be clear that this is a placeholder; that
13 this is there as an interim measure until the whole area can
14 be scoped out and decide whether this is just to clarify
15 something in the interim, and it will be scoped into
16 something bigger down the road.

17 To have multiple types of accounting can be very
18 difficult in the long run, but we can see a cost benefit
19 sometimes in the short run. And determining where that
20 trade-off occurs is one of the issues that we're going to
21 have to wrestle with as we think about this cause of
22 complexity.

23 Maybe I'll pause there, just -

24 MR. POZEN: I just think we should just clarify to
25 focus the discussion. There are two sort of related issues

1 here.

2 One is whether we should continue to have
3 industry-specific accounting standards, or whether we should
4 shift to activity-based.

5 And the second is, in those areas where, as you
6 say, there are alternative standards, whether there is an
7 adequate justification for alternative standards.

8 And, as you can see from the paper, we are
9 proposing in both cases that there be a presumption against
10 industry-specific standards and a presumption against
11 alternatives. But we recognize that there could be
12 circumstances where these are justified, and we ought to
13 recognize - and I'll say this, you know, as a member of one
14 industry - every industry is going to think they are unique,
15 so this would be quite a dramatic proposal.

16 And the same thing with alternatives. Those
17 alternatives, many of them came about because people pushed
18 pretty hard for them.

19 So recognizing the political realities, we would
20 still want to see if we could get to the right conceptual
21 place and then think about - and that would be our general
22 rule, and then, essentially, have really good reasons to
23 deviate from that.

24 So I think this is all laid out pretty well in the
25 book, but I think these are quite important issues, and I

1 would like to get some - there are two separate issues, but
2 they are parallel, and I would like to get some input from
3 the full committee.

4 MR. SIDWELL: Well, I would make the observation
5 that, in terms of industry-specific, I think one of the
6 things that the subcommittee chose to look at is the question
7 of field-testing to get a better understanding of the
8 applicability of standards to preparers, auditors, and users
9 of the standards.

10 I think that one of the things that can be done
11 going forward is by placing more emphasis on the need to do
12 field-testing of the cost benefit analysis, so that you can
13 better understand what are the valid differences and unique
14 characteristics of certain industries that should be
15 considered in providing a standard.

16 So I do think that we can view this as part of the
17 overall emphasis on making sure that we understand what the
18 activity is. And I think that can be driven through good
19 field-testing to understand all the nuances you would have to
20 consider in defining the standard.

21 MR. POZEN: Yes, Bob?

22 MR. HERZ: I gave a series of speeches on this
23 topic last spring. And I think I came to the same conclusion
24 that your committee is coming to, but I did have the - there
25 were some people in the investment world who said, you know,

1 "We follow a particular industry. We understand what they
2 do. Don't mess around with it."

3 For example, we have a large project on revenue
4 recognition, which aims at getting at one or a handful of
5 models - conceptual models that could be applied across all
6 sorts of activities, industries, and the like, but it would
7 have a common conceptual underpinning.

8 And that's very attractive, if you believe that
9 that is what investors ultimately would want versus people
10 who follow a particular industry and say, "I already
11 understand what they do. It may be slightly different for
12 the same thing in another industry, but I follow that
13 industry. I already understand it."

14 So I would be very interested in that topic and
15 understanding kind of what investors really think the
16 ultimate objective should be.

17 MR. POZEN: I think one thing that was discussed
18 with the subcommittee is, with a lot of companies - a good
19 example being financial services - being in a variety of
20 activities, the use of the industry category may, in itself,
21 raise a lot of definitional issues. And the subcommittee was
22 trying to get toward a notion of if it's more important what
23 the activity is than what the entity was.

24 Charles?

25 MR. HOLM: I would like to comment on this from a

1 perspective of a bank regulator. I certainly think the
2 recommendations, you know, overall are sensible. I certainly
3 can't argue that, just because an activity is in a different
4 industry, that it, therefore, should be accounted for
5 differently. Obviously, we would want similar accounting
6 across industries.

7 At the same time, I want to be careful about maybe
8 being too negative about industry guidance because, in many
9 cases, I think what it tries to do is just explain GAAP in
10 the context of the specific transactions of that industry,
11 and it's sort of like the squeaky wheel gets the grease.

12 I think, often, you know, Bob Herz and Con Hewitt
13 and all are focused on much bigger picture issues, and that's
14 what they should be, and they can't deal with every, you
15 know, nitty-gritty sort of industry issue along the way, but
16 there can be cries for that kind of guidance.

17 One other thing I want to say, too, is that bank
18 regulators - we often issue guidance. Now, I would not view
19 our guidance as being industry-specific guidance in the
20 context of GAAP that - we don't set GAAP.

21 What we do is issue guidance that affects the
22 prudential or regulatory boards that banking organizations
23 need them to file with us, and we find that guidance very
24 helpful because it creates much more comparability over
25 reports and allows us to make automated information, and what

1 have you.

2 But what happens is, when we issue that guidance -
3 and we think, largely, this is a good thing - that guidance
4 often becomes de facto GAAP. That is, institutions, they
5 want to file direct reports and have similar type of
6 information in their SEC reports. So, effectively, what we
7 say gets applied in their SEC report.

8 So I still think you're going to have this issue,
9 even if you reduce the so-called authoritative industry
10 guidance.

11 MR. POZEN: I think you make some good points. I
12 just would sort of urge you to page 5, where I think there is
13 an effort at the top to say there are certain industry guides
14 that may just be elaborating and detailing GAAP, and those
15 would be, I think, acceptable.

16 But there are those that are actually in conflict
17 with generalized GAAP, and I think those are the ones that
18 are the most problematic.

19 There are also areas in which there is no
20 generalizable GAAP, and so there's sort of a vacuum.

21 So those are three very different categories. I
22 think, to the extent that, whether it's the bank regulators
23 or anyone else would sort of be on the same wavelength with
24 GAAP but elaborate it and give more specific guidance - I
25 guess to the extent that - it's a Subcommittee II issue that

1 we can get that process right.

2 That's not an issue. But I think there are quite a
3 few examples in which there are either outright conflicts or
4 there are areas where the lack of a general standard - like
5 revenue recognition - has led to tremendous disparity. And
6 I think it's those areas that we are trying to focus on. And
7 I don't think the subcommittee was intending to try to
8 eliminate all guidance in particular industries.

9 MR. HOLM: I agree.

10 MS. GRIGGS: I don't disagree with these two
11 recommendations. I just wonder whether they are priorities.
12 I think there are some other issues that you have teed up
13 that I would think would be ones that we should focus on
14 first, rather than these two, because my sense is that these
15 two have not been big problems and that, perhaps, on an
16 interim basis - you know, I think the industry-specific
17 recommendation will require an enormous amount of work, and
18 perhaps we can focus on other areas that will give us some
19 progress in producing and improving financial reporting more
20 quickly.

21 And on sort of an interim basis, I do think perhaps
22 disclosure about alternatives and the alternative area may go
23 a long way to alleviating some of the concerns about those
24 differences.

25 MS. BIES: If I could just respond. I think what

1 we were trying to do - at least, at this stage in our
2 subcommittee - is we were trying to both think about the
3 broad issues and where we want to go, but also try to get to
4 maybe a couple narrowly-defined specific issues, where sort
5 of a quick conclusion could be reached that could maybe lay
6 out some principles for the more complex issues that we are
7 still really wrestling with.

8 And in both the industry-specific and alternative
9 accounting policies, what we felt is here is something where
10 we think there are some clear principles that could be laid
11 out.

12 And so I don't want, by the priorities of what is
13 in this report, for us to say what is the most important. But
14 we were trying to see what we could put out quickly that
15 maybe could actually be implemented on a faster track -
16 realizing though, as Bob Herz just mentioned, that change, in
17 itself, adds to complexity, and so part of this is how the
18 change is going to be happening.

19 But I don't want this to imply that these are the
20 most important, but this is maybe sort of mulling it through
21 that helped us to find how we can lay out some principles
22 that deal with complexity.

23 MR. DIERMIER: I partly wanted to respond to Bob
24 Herz' question, just by stating that, in terms of the
25 underlying principle, I strongly agree with the principle and

1 with the preliminary recommendations that are put forward.

2 We all know that there are analysts and others who
3 have intellectual capital subclasses in certain structures,
4 and we certainly don't want to let their subclass basically
5 affect the public good.

6 MR. POZEN: Greg?

7 MR. JONAS: Just let me pile on to Bob's question
8 and Jeff's observation that we face this dilemma at the
9 rating agency every day - the dilemma being the trade-off
10 between industry-specific focus versus cross-industry
11 analysis.

12 And the family unit in the rating agencies are all
13 industry teams, so there is every risk that industry focus
14 becomes a siloed activity. But, yet, ratings are supposed to
15 be looking across industries, as well. And so we have
16 portfolios with reviews that specifically try to look at
17 those industries.

18 This is a long-winded introduction to say I
19 strongly support the recommendations because I think it would
20 really help cross-industry analysis, which a lot of users
21 seek.

22 MR. POZEN: I do think, Linda, that - just to
23 emphasize Sue's comment, I think that some of the other
24 issues that we will get to in Subcommittee I are much more
25 challenging. So I think the idea was that they may take much

1 longer.

2 But I think there was a strong consensus on the
3 subcommittee - and I hear it on the full committee - that
4 these two approaches make sense. And I think Bob Herz has
5 probably been the most articulate spokesperson for the point
6 of view that they do add a lot of complexity to the
7 situation.

8 I think the challenge is to find out how we could
9 actually do away with industry-specific guidance, and this
10 probably would take quite a long time.

11 But I think if we started to provide a principled
12 approach for FASB, then, over time, we could get to a
13 different place. And I think it would also add urgency to
14 things like revenue recognition, because that's an area where
15 the lack of general guidance has led to tremendous divergence
16 among specific industries.

17 So I think that this is quite a worthwhile
18 proposal, though I agree it's not - its difficulty is more
19 in the political sense than in the conceptual sense.

20 Denny?

21 MR. BERESFORD: Since, Sue, in your very last
22 paragraph, you refer transition issue to Subcommittee II,
23 could you please tell me what you think those are.

24 MS. BIES: Well, I think part of what we were
25 trying to consider as one of our criteria is just a cost

1 benefit issue; that whenever you change an accounting
2 standard, the preparers have to go through a tremendous
3 amount of work to get information flowing in a different way.
4 And auditors have to be geared, and users have to understand
5 it.

6 We, in our subcommittee, are not really trying to
7 look so much at the process. And so this is one of those
8 issues that we hope gets addressed in Subcommittee II, in
9 terms of thinking about change in and of itself.

10 What we were trying to look at is the accounting
11 standards that create complexity. And so what we are just
12 trying to do is to throw it to the appropriate subcommittee
13 to say, "How you answer that could affect what we want to
14 come out with on our principles, just because of the
15 challenge of change."

16 MR. BERESFORD: Would it be as simple as suggesting
17 that all such changes be prospective in nature, or is it
18 something more specific or complicated?

19 MS. BIES: I think prospective treatment probably
20 would be helpful in some cases because, again, I know, as a
21 former preparer, one of the challenges always is, if you
22 change the framework, finding the information historically
23 around which to structure the new information - you probably
24 never gathered it that way. So that is very difficult. So
25 that's one criteria.

1 I think the other is being realistic about the
2 length of time it takes to implement changes, especially if
3 you are small- and mid-sized companies, who our subcommittee
4 spends a lot of time worrying about. They don't have a huge
5 staff of accountants who can just deal with the accounting
6 reporting.

7 And so working it around all the other business
8 imperatives of an organization is an issue, and so we would
9 hope that there would be some reasonable consideration, when
10 standards are put out, to think about how long the change
11 could effectively be implemented.

12 I think, in the world of risk of financial
13 misstatements that have been in the last few years, too rapid
14 a change can create problems also. So I think that's the
15 other issue.

16 MR. POZEN: I think there might be, besides
17 prospective, which I think we would generally agree is the
18 way to go, the FASB should not be proposing things on an
19 industry basis, like, "Here's a proposal for the insurance
20 industry," so that, going forward, there should be a more
21 activity focus.

22 And, second of all, as I said, if there are areas,
23 like revenue recognition, which have tended to generate,
24 because of the vacuum, a lot of industry-specific guidance,
25 that those be higher on the priority list. And I know that

1 the agenda setting is important to Subcommittee II.

2 So I don't think there is something really dramatic
3 here. These are pretty practical procedural suggestions.

4 Yes, David?

5 MR. SIDWELL: One of the things that we have been
6 talking about is the codification project. And, actually, if
7 you think about that and look at, really, what it is today,
8 which is a compilation in one place of what the standards
9 should be.

10 I think phase two of the codification project is
11 being able to get to the standards that we want to have and
12 should differences be permitted or not in a very specific
13 way. Because I think, as you said earlier, there are
14 different causes, and I think it's hard to generalize. But
15 codification does provide an opportunity.

16 MR. MCCLAMMY: I think the other important point is
17 we have a recommendation that the FASB should analyze all
18 existing standards. And I think your committee needs to
19 decide where that ranks in the priority of the things that
20 come out of this committee, or for the FASB to focus on.

21 MR. POZEN: Well, why don't we -

22 MR. COOK: Could I just make one observation on
23 this point and then - a separate item. I'm supportive of
24 the notion of eliminating complexity, and, to the extent that
25 industry guidance and alternative accounting is a source of

1 that, I kind of feel like you shouldn't be against that.
2 That's kind of a fundamental principle.

3 But I also question and suggest that we not
4 sacrifice quality for the elimination of complexity. There
5 are some very industry-specific activities that you can
6 generalize them if you want. You can say "anybody who drills
7 for oil" and not say that that pertains only to oil
8 companies.

9 But, as a practical matter, there is a very real
10 need, I think, for some specific guidance in some of these
11 areas, whether it's insurance, or whether it's energy, or
12 what it might be. And I would hope that one of the things
13 that wouldn't happen is, by shifting from calling it an
14 industry practice to calling it an activity, we wouldn't lose
15 the guidance that needs to be there for how do you deal with
16 some of these very complex issues, and financial
17 institutions, and energy companies, and some of the others.

18 Now, I would also be the first to admit that there
19 is some pretty bad accounting that is masquerading around
20 these days under the heading of industry practice, and I'm
21 not suggesting that we perpetuate that.

22 But I would be a little cautious about this, only
23 from the standpoint of if we go away from it and we say,
24 "Wow, just a broad revenue recognition standard will solve
25 our problems here," without recognizing the uniqueness of the

1 application of that to particular types of products and
2 particular types of industries - I'm a little skeptical
3 about where that might take us.

4 So I would just say proceed with caution, I think,
5 is what -

6 MR. GRUNDFEST: I agree with all of that, but if I
7 just might share a political observation - you know, boil it
8 down. There is a lot of junk in these industry-specific
9 standards that have arisen over time for political reasons.
10 All right? You've got an industry, they want a particular
11 treatment. It makes no intellectual sense.

12 So the question, then, becomes: What is a rational
13 political strategy for flushing some of the junk out of the
14 system? Okay?

15 Now, the only way you're going to be able to do it
16 is by saying, "Look, we're taking a system-wide,
17 accounting-wide approach towards getting rid of these
18 industry-specific standards."

19 Now, ideally, what will happen is this becomes a
20 general way, not of targeting a specific industry - because
21 if you go out there and if you target oil and gas, you're
22 dead. All right? If you go out there and if you target
23 insurance, you're dead. Rather saying, "Guys, we've got a
24 principle problem. What we need to do is fix the accounting
25 system altogether."

1 Now, if we are intelligent about how we do it, we
2 will flush a lot of the bad accounting, while keeping the
3 industry-specific guidance where the industry really is
4 engaged in an activity that is unique.

5 So to the extent that you've got extractive
6 industries that need particular types of accounting -
7 whether it's oil, or gas, or coal, or what have you - great.
8 You deal with that. That's a unique activity.

9 But, as political matter, unless we call a spade a
10 spade and say there's a lot of bad accounting out there that
11 doesn't help anybody and, "Here is our strategy for getting
12 rid of it across all of these groups," we're going to be
13 stuck with it.

14 MR. POZEN: I think the subcommittee has tried to
15 recognize both Joe's point of view and Mike's point of view
16 in saying, "We want to move in that direction, but we want to
17 be cautious in really looking at it and see that we are not
18 throwing the baby out with the bath water."

19 Bob?

20 MR. HERZ: I think those are both good
21 observations. One of the ways we think about it is in terms
22 of convergence, because we have lots of industry-specific
23 standards that evolved over time, largely from the AICPA.
24 They are part of our literature now.

25 The IFRS literature did not develop that way. They

1 do have some industry standards for financial institutions,
2 broadly. They are working on insurance. They are working on
3 extractive industries. They have one for agriculture. But,
4 other than that, they have not developed - and I don't think
5 intend to develop - you know, within financial services,
6 each little pocket - not the big pocket, but
7 differentiations and all that.

8 And so if we were to go about doing this, I think
9 we would probably try to link it also into the convergence
10 effort, so that we could do both at the same time.

11 MR. POZEN: Yeah. I think that's a good point.

12 I would like to try to ask Susan to continue on and
13 look at pages 8 and 9, where we have the next proposal on
14 bright lines. I think it has particular applicability to
15 today's situation.

16 MR. QUIGLEY: Bob, I'm sorry. Jim Quigley. Can I
17 just make one comment before we leave this point?

18 MR. POZEN: Sure. Sure.

19 MR. QUIGLEY: In the underlying principle on page 5
20 of similarly activities being accounted for similarly, I
21 think that we should at least acknowledge and move with
22 caution - because I think these industry guides actually
23 help us accomplish that objective.

24 And what I mean by that is the insurance guide
25 provides guidance for accounting for insurance activities,

1 whether those activities are carried out by an insurance
2 company or whether they are carried out by an insurance
3 operation in a diversified enterprise.

4 And so I don't think we should just immediately
5 decide let's throw out all of the industry literature and we
6 will be able to accomplish this underlying principle. I
7 think the industry literature helps us accomplish that
8 principal in many ways.

9 MR. POZEN: Thank you, Jim. And I think that's an
10 appropriate caution.

11 In the interest of time, I would like to move on to
12 make sure we get a chance to cover all the other issues on
13 Subcommittee I.

14 MS. BIES: Thanks, Bob. The two big issues
15 remaining are the ones that we are really wrestling with.
16 Both of these - in terms of bright line testing and,
17 secondarily, the issue about the mixed attribute fair value
18 models - I think are going to be the bigger issues that this
19 subcommittee is going to wrestle with. And what -

20 MR. POZEN: Maybe we should take them up
21 separately.

22 MS. BIES: Yes, I'm going to take them in turn. But
23 I think what we were trying to do on both of these is to
24 really sort of get at sort of the root cause of a lot of the
25 issues that we are seeing that are happening because of the

1 changes in business. And some of these are due to recent
2 events that reminded us how important these issues are.

3 And we will take bright line first because I think
4 that is an issue that is more familiar to more folks.

5 Bright lines have been around a long time. And for
6 many of us, things like bright lines for lease accounting has
7 been around, and we have all had to wrestle with it for a
8 long time.

9 But, on the other hand, we also have bright lines
10 that have arisen in terms of some of the securitization
11 activities, so that deals are structured to get a particular
12 treatment. And one of the issues that I think has happened
13 in the last few months has reminded us that some of the
14 complexity is done to structure transactions to make sure the
15 transactions result in the right accounting that the company
16 chooses.

17 So when we teed up the bright line test, one of the
18 root causes, we think, of the complexity here is that it is a
19 bright line. It's a yes/no kind of a test. If you are over
20 the line, you do it one way. If you are not over the line,
21 you do it another way.

22 When, in fact, what you really have in these kinds
23 of transactions is a range of potential outcomes. The
24 accounting recognition today does not reflect that range of
25 potential exposures.

1 And so one of the notions under bright line that we
2 wanted to tee up for discussion is: Should we go away from
3 an on/off switch and move more toward a proportionality test,
4 where you recognize the proportion of an activity that is
5 influencing the financial results and, in the future, will
6 influence the financial results of the reporting entity?

7 And so you don't have an all-or-nothing test
8 anymore. As you move on a lease, it isn't a 90 percent test.
9 You just reflect that proportion of the economic obligation
10 that is due to the structure of your deal, and you don't have
11 an on/off switch.

12 We think that maybe would help, in the sense that
13 you're not going to have these big surprises because someone
14 hadn't bothered to look at some of the footnote disclosures.
15 Really, disclosures are also very important, but we think
16 recognition needs to be factored in here, too.

17 And so, really, under the bright line, what we were
18 trying to do is say: Should proportionality really dominate,
19 rather than on/off switches, for these bright line tests?

20 We recognize some of these have been there for
21 years as a way to sort of give preparers a safe harbor.
22 Here, if you test this way, you know you're okay. But we
23 think a proportionality test will actually help the preparers
24 in that it helps them understand the range of exposures they
25 truly have.

1 MR. POZEN: Yes, Ed?

2 MR. NUSBAUM: I'm particularly excited about this
3 recommendation because I think it's something unique and
4 different. Whenever there are bright lines, for better or
5 worse, transactions are going to be structured to work around
6 or deal with those bright lines. And this concept of a pro
7 rata proportionate accounting, I think, is something that we
8 should pursue.

9 I am a little concerned that it might add to
10 complexity, as opposed to simplify things. But, on the other
11 hand, it could solve a lot of problems.

12 I think the next step should be to somehow assess
13 the practicality of it and whether or not it does a better
14 job of reflecting the economic substance of a transaction,
15 which I think is what you're talking about and is a very
16 worthwhile objective that we should be seeking.

17 I think a lot of the problems associated with it
18 might be solved through disclosure and through the principle
19 framework that our subcommittee is working on. But whenever
20 you adhere to principle-based standards, there is going to be
21 some diversity of practice. And that's okay. And this pro
22 rata solution may address that.

23 MR. POZEN: Peter?

24 MR. WALLISON: I come to the complexity issue with
25 something like the perspective of a lawyer who has practiced

1 in the securities area for quite a while. And that is I
2 think complexity is induced very often by legal liability and
3 the problems of legal liability.

4 And when you get into something like, say,
5 proportionality, it raises questions of judgment, and legal
6 liabilities come from making misjudgments.

7 The advantage of bright line is that it allows
8 people to avoid legal liability by staying within the
9 standards prescribed. Once you open it up, so that
10 principles or proportionality become the test, then when
11 accountants and preparers get into the issue of making
12 judgments, they expose themselves to legal liability. And
13 that is one of the reasons why I think we have so much
14 complexity in financial disclosure and other kinds of
15 disclosure.

16 So I think we have to be a little bit cautious
17 about trying to eliminate the bright lines. I understand all
18 the problems with bright lines. But, on the other hand, it's
19 going to make it exceedingly difficult for people, in the
20 litigious environment that we have today in this country, to
21 function without some sort of very specific guidance.

22 MR. GRUNDFEST: Well, Peter is absolutely right, of
23 course, to blame everything on the lawyers. I'm surprised it
24 took this long for us to get to that fundamental truth.

25 MR. POZEN: And you're churning them out every day,

1 Joe.

2 MR. GRUNDFEST: At a furious pace. And all of you
3 keep wanting to hire them at ever higher and higher rates, so
4 the market is sending quite a signal here.

5 At the same time that we move away from the bright
6 lines, I think we do have to create safe harbors. All right?
7 So, you know, Peter is exactly right.

8 We are - if what we do - let's take maybe one of
9 the simplest examples, and that's lease accounting. Okay?
10 There's a certain bright line to keep leases off your books
11 if they meet certain standards. Well, you know, you say,
12 well, wait a minute. You've got 80 percent of the value or
13 90 percent of the value. Well, then, recognize 80 percent or
14 90 percent this way or that way. All right?

15 That's really fairly straight-forward. The math
16 behind it is pretty clear. And I think articulating what a
17 safe harbor might be for that is probably not very
18 complicated.

19 On the other hand, we have to understand that there
20 are other situations which are just, you know, hair-raisingly
21 complex. Let's look at the current situation with regard to
22 SIVs. All right? The problem that you're running into is
23 one that, if you would have described it a year ago, people,
24 in good faith, would have said, "This is a low probability,
25 high magnitude event." We wouldn't really know what

1 percentage of this potential exposure, which now resides
2 totally off the balance sheet, to pull through and recognize
3 anywhere in the financial statements.

4 Personally, I'd be of the view that, in that
5 situation, you don't go to any pro rata measure, or what have
6 you, but there is another disclosure approach that could be
7 taken because, at some level, the issues associated with
8 valuation and the like become such that they really aren't
9 susceptible of any clear method of quantification; rather,
10 they are better addressed through description, without
11 quantification.

12 And I think this is going to be one of the problems
13 we run into as we go down this path. There will be certain
14 types of situations where, okay, it makes sense, without
15 generating a lot of additional legal liability, to
16 proportionally allocate. In other situations, don't even try
17 to do it. Just describe what the issue is.

18 But I agree entirely that figuring out how to
19 reduce the legal liability associated with this stuff is
20 essential because so much of the problem we run into is the
21 accounting equivalent of defensive medicine. All right? It's
22 CYA because none of us can afford to be sued over this event
23 in the event a problem arises.

24 MR. POZEN: Ed, and then Mike.

25 MR. MCCLAMMY: I think the other thing that Joe

1 actually brought up to our subcommittee was that, if you look
2 at a lot of the litigation, it's people trying to prove that
3 someone, rather than being one percent on the right side of
4 the bright line, was really at one percent on the down side
5 of the bright line. And under what we are proposing, that
6 would make a two percent difference. Under the current
7 accounting, it makes a 100 percent difference because of the
8 on/off switch.

9 So I think he convinced us that, in some cases, it
10 actually may make the situation better.

11 MR. POZEN: Mike?

12 MR. COOK: Bob, I support this recommendation. I
13 think it has potential to really do something very good. I
14 would prefer - I think a lot of people would prefer, you
15 know, the broad principles, which would say, if we were
16 talking about leasing, if you own and operate an asset, put
17 it on your books. But by the time we finish defining what
18 owning and operating means, we are back to where we were.

19 I think this has an interesting appeal. I think
20 this proportionality will eliminate proportional - lots of
21 things, because if it doesn't matter whether you have 89
22 percent or 93 percent, you've still got to put it on your
23 books. The 11 percent other owners are going to, over time,
24 disappear, or they are going to be proven to truly be
25 substantive, and then there is going to be a difference.

1 But all of these things that are being created for
2 the purpose of, "Get me under X," or, "Get me above Y" - and
3 I'm reminded - I'm not up-to-date on this, but I'm reminded,
4 at one point in time, a little study was done that determined
5 that about two-thirds of all the airplanes that were flying
6 in the skies of the United States were not on the financial
7 statements of anybody because they weren't on the financial
8 statements of the people whose names were on the side of the
9 planes, and they weren't on the financial statements of the
10 people who financed those planes.

11 And something that would improve that situation in
12 steps would be a practical step forward, in my mind. I don't
13 know if that's still the condition today, but I wouldn't be
14 surprised.

15 MR. POZEN: Yes, Bob?

16 MR. HERZ: I think it's a good idea, and I would
17 ask the group, just from our point of view, as we go forward
18 -- the way we have been thinking about this is account for
19 rights and obligations that you have, rather than who has
20 enough of the ownership to put it on their books. Then you
21 have bright line tests, and all that. And then you get the
22 either/or thing.

23 Whereas, if you look at a lease, you say, "Gee,
24 I've got the use of this equipment for 10 years. I've got to
25 make 120 payments. Let's put those on the books because

1 that's what the contract says."

2 So we are thinking about proportionality as more of
3 kind of a rights and obligations way of thinking. And this
4 is very timely because that's exactly where we are in our
5 looking at the conceptual framework. So I would ask you to
6 think about whether your idea of proportionality matches the
7 way we are thinking about it or not.

8 MR. POZEN: I think we will be getting some input
9 from the FASB on where you are on that.

10 And I did also want to emphasize Joe's point that
11 there are situations, like with the SIV, where there is a
12 back-up liability, which is, really, more a probability
13 issue. And so this may not be amenable to proportionality.

14 But what I think Joe and the subcommittee is
15 thinking of is some way to alert the investing community that
16 there is a contingent liability here. We're not sure exactly
17 what the probabilities are, but, at least, to start to
18 delineate that there is something there, so, in that two or
19 three percent of the cases, when it comes to fruition that
20 it's not a surprise.

21 And this is a possible approach and would,
22 hopefully, not involve quite as much legal liability as
23 proportionality.

24 So I think that area - I sense a lot of support
25 for it, though I think we would all agree that the practical

1 working out of it would be quite a challenge, and that is
2 what we are going to try to do.

3 I think, Sue, if we could just try to get to page
4 10 and look at this very challenging issue that the
5 subcommittee has laid out here.

6 MS. BIES: Well, this, I think, is the toughest
7 issue that we have, at this stage, laid out - because this
8 sort of goes to the heart of the accounting framework and
9 presentation.

10 Let me sort of tee up a couple things that we
11 struggled with that are detailed in these pages, starting
12 with page 11 and continuing.

13 What we think - again, think of the different
14 constituencies here that we have. One of challenges, when we
15 have the mixed attribute model and the growing use of fair
16 value accounting is to say, "Why are we doing this? What is
17 the relevance of this for these kinds of activities?" And,
18 again, I want to stress activities, not assets and
19 liabilities. We are focusing on activities.

20 I think about it, you know, when I was a bank
21 regulator in terms of fair value may, at a moment in time,
22 represent an asset value on the balance sheet, but it is
23 nothing that, as a regulator, I could use to make any
24 insightful decisions about risk exposures or future
25 performance of a company because it doesn't give me enough

1 information.

2 So that carries me over into issues about how do
3 you use recognition versus how do you use disclosures.
4 Clearly, disclosures, I think, with some of the complexity,
5 could potentially provide a broader framework to describe
6 future events. Historic cost accounting and moment-in-time
7 fair value really measures where we are now and
8 backward-looking.

9 And so it isn't clear. The users of financial
10 statements, who clearly want to understand the ongoing
11 success of a company and where they are stumbling, struggle
12 when all of it is mixed up.

13 The other issues that they were struggling with, as
14 you can see in here, is: If we move more toward fair value,
15 how do we distinguish between what is realized and what
16 hasn't been realized?

17 And we have all known for years that there is not a
18 very good fit between the cash flow statements and the income
19 statement. And we think that some work around the geography,
20 I call it, of the income statement could be very helpful here
21 because you can do things like - say, you fair-value a loan
22 portfolio and it ends up being fair-valued above par value of
23 the loans, when we know no borrower will ever pay a bank more
24 than they borrowed. You know that that's just a timing
25 difference. And if that could be distinguished somehow, that

1 could help provide clarity, if we go the full fair value
2 route.

3 The other part is the way we just look at the
4 income statement per se. And our subcommittee has been using
5 the technical term "chunking."

6 What we are talking about is that: Are we really
7 grouping things together that are easily understood by users
8 of financial statements? Should we group revenue and
9 expenses more by activities perhaps than by personnel
10 expense, and equipment expense, and the different ways we
11 break things down? Would it be helpful to chunk them
12 together, so you could see what is the total revenue and the
13 total expense connected with an activity? Would that be more
14 helpful?

15 Segment reporting, we know, has gotten to be - we
16 have had several projects over the years to think about it.
17 And we do disclose it. And the way it's teed up now, every
18 time a company reorganizes and the segments get redefined, we
19 end up with the complexity problem of how do you look back
20 and restate going forward for the new business organization,
21 because companies are living entities.

22 So that is part of the issues that we are teeing
23 up.

24 But what we are trying to get to is also some
25 issues about: Should we tier the quality of the audit work

1 that is done? In other words, have companies spent more time
2 on what is material to that corporate entity and be more
3 general in aggregating information which is maybe less
4 material to the organization. So this tiered audit opinion
5 is something that we have thrown on the table to think a
6 little bit more about.

7 And then also these multiple performance measures,
8 because we know what goes in earnings releases is very
9 different, in many ways, than what goes into the official
10 financial statements. And there must be a business reason
11 for that and the users must like it. How do we look at that?

12 So this is a very broad-scoped issue, and that is
13 why we have teed up all of these points that we have
14 identified at this stage. And we would like any feedback and
15 guidance about just the general directions that we are trying
16 to go on this big issue that we are wrestling with.

17 MR. POZEN: That's a very good summary, and I
18 should just note that some of the points you made would
19 coordinate with other subcommittees. Obviously, earnings
20 releases and non-GAAP measures is something Jeff's group is
21 working on. And, to the extent there would be a different
22 audit type of opinion, that would be something that
23 Subcommittee III people might look at.

24 But I think this idea of chunking the different
25 chunks of the income statement is a very interesting and

1 challenging idea, and I would like to get people's reaction
2 to it.

3 MS. GRIGGS: I think the chunking idea is a great
4 idea. So I think that it would be helpful to the users of
5 financial statements to understand the different ways in
6 which values are being presented and the different quality to
7 those values.

8 And I think your summary of what you are looking at
9 is very helpful, and I would just encourage you to look at
10 fair value and whether there is a different - maybe not even
11 in an income statement, where certain changes in fair value
12 won't even go through the income statement. I know some
13 don't now, but whether that should be broadened.

14 MR. GRUNDFEST: Or make it much easier for
15 investors to decide whether a certain number should, in their
16 view, go through the income statement or not. I mean, there
17 is an artificial orthodoxy in the process that I think hurts
18 everybody.

19 MR. POZEN: I mean, you could think of something as
20 radical as having, essentially, two earnings per share -
21 one, which would sort of be like a core earnings per share,
22 where it would sort of be like what a financial analyst would
23 view as the sort of free cash flow number, and then you would
24 have all these others things, such as currency translations,
25 fair value changes - these sorts of things.

1 So I think part of the thinking was that a lot of
2 preparers have been very resistant to fair value because of
3 volatility, but if this was separated out from the cash flow
4 that maybe that would make it more palatable to preparers,
5 and so they could show that their core business didn't have
6 this volatility and would really start to have a much better
7 understanding of whether volatility is produced by events
8 beyond your control, or technical changes, like the currency
9 translations or the -

10 MR. GRUNDFEST: Bob, I think you are absolutely
11 right. In fact, the idea of two earnings per share numbers,
12 I think, doesn't go far enough. I think there are -

13 MR. POZEN: Oh, you always one-up me, Joe.

14 MR. GRUNDFEST: No, no, no, no, no. What I'm just
15 saying is you're being modest. Push farther. That there are
16 many situations where it is entirely legitimate and
17 beneficial for investors and preparers to report three, four,
18 or even five different earnings per share numbers. All
19 right? And that, believe it or not, I think will reduce
20 complexity in a variety of different ways.

21 At first blush, you say, you know, "My goodness,
22 you know, Citigroup reports four different earnings per share
23 numbers. Two of them are up and two of them are down." The
24 answer is hell, yes. All right? Because if you report one
25 number, it averages all of that stuff in a way that makes it

1 complicated to determine what is really going on.

2 MR. POZEN: Mike?

3 MR. COOK: Two responses. One, I'm less than
4 convinced - what Joe just said always sounds good, but I'm
5 less than convinced that this is going to reduce complexity
6 and that this is going to take us to a more understandable -
7 maybe, in some respects, more relevant, but I'm not sure more
8 understandable, and certainly not a more transparent form of
9 financial reporting.

10 But it certainly merits further discussion and
11 experimentation, so I'm not negative about it in the sense of
12 it's just a bad idea. It's just a question of, with our
13 mandate - things that are doable, things that are
14 actionable, things that are practical - this one may not get
15 within that set of principles.

16 I would also like to say, on behalf of Subcommittee
17 III, in respect to our colleagues on Subcommittee I, in
18 deference to their having lobbed this one over to us about
19 the tiered audit opinion, I assure you that we will give that
20 due consideration, and we will listen to the people we talk
21 to about the audit process. We will do some probing on that
22 subject.

23 I wouldn't think it likely, for the same reason
24 that I'm a little skeptical about the broader recommendation
25 -- I don't think it's likely, if we stick to our parameters

1 saying actionable, doable, reasonable period of time, that we
2 will be forthcoming with a recommendation on this subject.

3 So I think we will certainly look at it, as they
4 have asked us to do, but I'm not in the mood of raising
5 expectations that we are going to come forward with
6 something.

7 Until a lot of the parameters of what this would be
8 all about have been defined, it's very difficult - it's easy
9 to conceptualize a multi-tiered opinion. But I think this
10 may be a subject - we can hand off, just as they did - this
11 may be a subject for Kristen and the folks at the Treasury
12 group, who are going to study the accounting profession and
13 the auditing profession and its future viability. I think
14 that might be a topic more relevant for them than it is for
15 us.

16 So we'll look at it, but I don't -

17 MR. POZEN: I think it's perfectly reasonable to
18 wait until this is fleshed out a lot more before your
19 subcommittee takes it on.

20 But I do think - just in terms of do-abililty, I
21 think some of the thinking here is to sort of actually get
22 parallel to what a lot of the earnings releases now do for
23 companies, which is to strip out these other things.

24 So I don't think it's quite as theoretical. I
25 mean, the earnings releases by companies are going out a week

1 to 10 days before the 10-Qs, and markets are moving on the
2 basis of it. And they are choosing to sort of, in many ways,
3 bifurcate the number and to really strip out certain things.

4 So I think that there is some evidence that this is
5 happening already. So if we can understand - and I think
6 this would be a segue to Jeff - if we can understand what is
7 happening in those areas of why people are segmenting and
8 chunking numbers, I think that would be helpful.

9 MR. COOK: My view would be that that is true, but
10 I think a lot of what is happening there is because of the
11 deficiencies in GAAP, not the attractiveness of fair value.

12 MR. POZEN: Okay. Jeff?

13 MR. DIERMIER: I just want to support the comments
14 that were made - even Joe's, although maybe it's not doable.

15 The market is, without any question, trying to
16 chunk out the various segments of - as I have traveled in
17 many places in this role on this committee, as you might
18 imagine, a lot of our users, they really want to know, you
19 know, how much is coming from the operations, what is coming
20 from financing, what is coming from fair value markets -
21 they are all trying to make those estimations themselves.

22 MR. POZEN: So tell them.

23 MR. DIERMIER: And if we tell them we're in much
24 better shape - I also - just a couple of comments with the
25 paper. Sometimes, when I read things like, "Some preparers'

1 knowledge of valuation methodology is limited," blah, blah,
2 blah, I always worry if - you know, should they actually be
3 using some of these exotic instruments, if they really don't
4 have the sufficient knowledge by which to be able to describe
5 and account for them.

6 And I made a comment at the first session of this
7 group, and that is I think we are all agreement you do not
8 want to smooth anything that, in nature, is not smooth,
9 because that leads to - you know, that leads to big risks.

10 And I know you know there is a whole lot of
11 discussion out there. And companies, for too long, have been
12 told to try to manage earnings and make them smooth, but
13 that's not the right answer. You know, the marketplace will
14 be much better served if kind of the natural volatility comes
15 out. The market can recognize that. And, actually, that
16 will avoid big blowups because, you know, the little hiccups,
17 basically, are healthy things, and I think they prevent the
18 fat tail events.

19 MR. POZEN: I have Linda and then Scott and then
20 Peter.

21 MS. GRIGGS: Just a question. I notice the
22 subcommittee is considering disclosures and integrating
23 disclosures into the framework. Are you focusing on the
24 notes to the financial statements and the MD&A, or what is
25 the scope there?

1 MS. BIES: I don't think we have gotten that
2 specific yet. If you've got any particular thoughts on which
3 direction, we would love to get it.

4 MS. GRIGGS: Well, there is a tremendous amount of
5 redundancy now between the MD&A and the notes to the
6 financial statements. And, you know, maybe that's necessary.
7 I'm not reaching a judgment on whether it is or isn't. But I
8 do think it would be worth looking at that.

9 MR. POZEN: All right. Scott?

10 MR. EVANS: I'll just quickly add my voice to the
11 chorus supporting the direction of the chunking effect. I'd
12 like to also express some caution about taking it too far.

13 I think the primary thing that users and investors
14 want to do is to be able to distinguish the ongoing operating
15 cash flows from other aspects. If you take it too far, if
16 you introduce too much complexity, it will lose the value of
17 making that distinction.

18 But if we do make progress, it will standardize the
19 type of informal reports that are coming out of companies to
20 investors and guarantee that there is greater comparability.

21 MR. POZEN: Peter?

22 MR. WALLISON: I would like to second, really, what
23 Joe said before, because, again, from the standpoint of legal
24 liability, I think it's extremely important to reduce the
25 focus on a single bottom line EPS number. And this would

1 certainly be one way to do it, if there were a number of
2 different EPS numbers shown as a result of various changes in
3 the way major elements in the income statement are treated.

4 And what you can show, then, is that, if we treat a
5 pension obligation this way, this is our bottom line number.
6 If we treat some other major element another way, this would
7 be the bottom line.

8 And that actually reduces the potential liability
9 of the company because, if it turns out ultimately - and not
10 only the company, of course, but the preparer, too, and the
11 accountants. If it turns out that a mistake was made in
12 judgment, again, about how to treat something, at least, you
13 have exposed what a different treatment would produce.

14 And so I think there is a lot of good sense in what
15 Joe was suggesting here, and I think it ought to be seriously
16 considered by the subcommittee. Thank you.

17 MR. POZEN: I have Charles, and then Greg, and then
18 Bob. And I think then we're going to have to cut it off for
19 Subcommittee I.

20 MR. HOLM: I would like to comment on the issue of
21 fair value. I think the committee is taking, you know, a
22 cautious approach towards movements to fair value accounting,
23 which I think, overall, is consistent with the bank
24 regulators' view.

25 We see conceptual promise with fair value, but,

1 again, we have always cautioned a lot of concerns about the
2 reliability of the estimates when you get away from the
3 liquid and into the more illiquid products - the ability,
4 you know, to audit and verify that information.

5 And also it's the whole infrastructure there, for
6 the valuation expertise, but also the disclosures around fair
7 value. For example, in today's more historical cost world,
8 you know, with all its imperfections, if you look at, for
9 example, the loan loss allowance, with it, we get a lot of
10 comparisons we can do to problem loans, net charge-offs, and
11 various type of metrics and measures that we can
12 fundamentally analyze the information.

13 But as we move to fair value, we need similar type
14 of metrics and disclosures to fully understand those numbers,
15 especially when it's a liquid product.

16 So I'm glad that - I think the FASB and the SEC,
17 overall, have been taking a long-term view on this approach,
18 and I think the subcommittee is right - it's a good issue,
19 but it needs careful thought before we can get to the
20 conceptual promise of fair values.

21 MR. POZEN: Thank you. Greg?

22 MR. JONAS: As the subcommittee appropriately
23 noted, the FASB and the IASB have a joint project for
24 financial statement presentation. And I really would
25 encourage the subcommittee to study that project closely.

1 It offers, I think, the single biggest chance for
2 improvement, from a user's perspective, for standard
3 reporting in many years. And it does so because standard
4 setters have really never given much attention to chunking.
5 And this project is doing that. The tentative thinking by
6 the two boards, I think, is absolutely outstanding, and it
7 really goes a long way toward achieving many of the
8 objectives that commenters today and the paper has alluded
9 to.

10 One other point. And that is I thought the
11 discussion on pages 12 and 13 was very substantive. There
12 was one notion, though, I just wanted to mention for caution.
13 And that is the concept of a moratorium. A moratorium is
14 appropriate if there is a light at the end of tunnel when the
15 moratorium comes off. And this moratorium would be a
16 function of the progress on the decision framework on the use
17 of fair values.

18 That decision framework is badly needed, but it is
19 the most controversial thing going in the world of accounting
20 and reporting, in my view. And history tells me that that
21 project could go for a very long time, and a moratorium could
22 turn into a funeral. I think we need to make some progress
23 on fair values in the meantime. So just - I'm a little
24 nervous about moratoriums in this case. Thank you.

25 MR. POZEN: Thank you. Bob?

1 MR. HERZ: I had two comments. One was the one
2 that Greg made about our financial statement presentation
3 project because that is - we have developed a number of
4 chunking principles.

5 MR. POZEN: I guess "chunking" is becoming a real
6 term of art.

7 MR. HERZ: Yeah. That's not the words we use, but
8 this grouping principle, whether it be operating versus
9 financing versus investing, whether it be fair value and
10 other types of remeasurements - because there are all sorts
11 of other remeasurements that go on in historical cost
12 accounting that have nothing to do with the ongoing business.
13 And those are hidden right now, so that other type of
14 information - the quality of the measurements versus, you
15 know, harder versus softer, and all those.

16 So, again, it's just my selfish plea. If you look
17 at this, you can look at our chunking principles and comment
18 on which ways you think those are most useful.

19 MR. POZEN: Well, I think this clearly is going to
20 be a very controversial and challenging subject.

21 John, did you want to say something?

22 MR. WHITE: Yes. I guess I like the idea of
23 addressing chunking in the financial statements, if that's
what
24 you are suggesting here, because, at the moment, we end up,
25 basically, in Corp. Fin. Addressing, or looking at it, and it

1 appears in the MD&A, or more likely in the press releases
2 where all the input is, applying, really, the non-GAAP rules.
3 And we have very few standards for that. It's a pretty hard
4 task for us, in terms of the way we interact. And if you
5 would address chunking in the financial statements, I think
6 that would be very helpful.

7 MR. POZEN: Thank you. I think we are going to go
8 on to Subcommittee II. Are people prepared to go on, or do
9 they want to take a break? Are there people who want to take
10 a break, or do you think we can get through II and then take
11 a break after II? It sounds like we can get through II.
12 Okay.

13 David, why don't you kick this off on the standard
14 setting process, Subcommittee II.

15 MR. SIDWELL: Thank you. Let me just say thank you
16 to the participants in this, particularly Mark and Bob, who
17 have attended most of the meetings that we have had. Jim
18 Quigley is on the phone, by the way, if anyone wants to
19 direct a question at him.

20 In terms of scope, the first area I propose to
21 raise with you, I think probably the most important aspect of
22 this is what we chose not to do at this point in time, which
23 is to focus on the international arena. And I don't think we
24 are doing that from being naive that the world isn't
25 changing, but more from the practical view that there is a

1 huge amount going on, in terms of the invitation for comments
2 that the SEC has had both with foreign providers and also
3 with potential domestic companies involved under IFRS.

4 Obviously, in the landscape that we are talking
5 about, the processes can change very significantly. We
6 didn't want to deal with some of the what-if around that. We
7 recognize it. We will come back to it, as necessary.

8 However, having said that, the way that we have
9 approached the questions of the process is to say you need to
10 look at this holistically and think about the process in
11 terms of what is your governance structure, what is your
12 process around setting the agenda, what is your process for
13 actually disseminating standards, and how do you think about
14 the communication of standards.

15 So to really think about, if you like, the entire
16 process in a way that I think, when we get to the question
17 that we are dealing with, the international environment and
18 any changes that we make here in the U.S. based on some of
19 the decisions that are yet to be made - I think we would
20 think that you would want to slot it in the same conceptual
21 framework of what is a good standard setting process.

22 So we have from the scope perspective of the
23 committee focused mainly around governance, around how the
24 agenda is set, how the standard setting process is, how
25 interpretations are offset, and then to frame a little bit

1 this hard question of when you think about what is our ideal
2 standard and what are some of the principles that we should
3 be using.

4 So I guess that's the first question for the full
5 committee: Does the scope of it sound appropriate?

6 I know there are lots the hypotheses laid out in
7 our paper. We did that pretty much to be clear about what we
8 meant. I think we all felt that we could give very
9 high-level general statements, which I think everyone would
10 interpret differently. We thought it was important to be
11 reasonably specific within the categories that we identified,
12 so that you could really understand what we were driving
13 towards.

14 MR. POZEN: Do we have comments on the scope here?
15 I think most of the points on scope are pretty consensus
16 issues. I do think this question, as David has enunciated,
17 about the international is an area where our committee is
18 struggling. On the one hand, we all recognize that IFRS is
19 alive and well, and IASB is there, but I guess my personal
20 view is that we need to sort of proceed on the structure that
21 is in place.

22 It may be the case that, 5 or 10 years down the
23 road, this structure will change. And we ought to, as David
24 says, keep that in mind and try to design processes that
25 would be appropriate. But I'm a little concerned about our

1 trying to shoot at two moving targets at the same time. That
2 would be a little difficult.

3 Bob?

4 MR. HERZ: I think I partially agree with you -
5 not completely. I think that it really -

6 MR. POZEN: I had a sense I wouldn't get your full
7 agreement.

8 MR. HERZ: There are issues of overall governance
9 of standard setting, approach to standards - things like
10 that - that would apply to us, apply to the IASB, apply to
11 the Martian standard setter, whether we are in a convergence
12 mode or not.

13 But there are things relating to agenda, staffing,
14 things like that, that one has versus the other. In other
15 words, if we were to continue on convergence, or even, you
16 know, decide to accelerate it because of SEC decisions or
17 comments that are made there on their release, some of those
18 things, the path chosen would make a big difference over the
19 next three, five years, at that level.

20 So I'm agreeing with the broad things around the
21 governance - the ingredients of a good standard, good
22 process for standard setting, and all of that - but the more
23 detailed things about our agenda, our standard setting, those
24 would - one path versus the other would make a very big
25 difference.

1 MR. POZEN: Well, I think, for better or worse, I
2 mean, we are assuming, on the one hand, that there is a
3 movement toward convergence. But, on the other hand, I guess
4 those of us - and I'll say personally - are a little more
5 cynical about how fast that is going to come; that we are not
6 planning on it happening in 3 years and, you know, sort of
7 view it as a more long-term goal - "long-term" being maybe 5
8 to 10 years.

9 So I think, Bob, we just need to have some working
10 assumption here, so we will be thinking in terms of, you
11 know, moving toward convergence. I just don't think it's
12 really realistic for us to assume these boards are going to
13 merge in two or three years.

14 MR. HERZ: That may be the case, but let me give
15 you a real - at least, from my perspective, the real life
16 dilemma. The real life dilemma is that, not only we, but our
17 whole system, is riding two horses right now. We're riding
18 to improve and maintain U.S. GAAP. We are also riding to
19 improve and converge an international approach.

20 Now, if you look at our agenda, it has 41 projects
21 on it, and a lot of that occurs because, when you draw those
22 circles, they're not exactly - those that have been
23 diagrammed, it's not exactly overlapping.

24 Now, that may be the way the system wants to
25 continue to proceed, and that's the debate that I think needs

1 to be had, after the SEC gets all of their responses and
2 analyzes, and all that.

3 But I'm just saying that I think some of the - not
4 the fundamental things around the governance of standard
5 setting, around the ingredients of the process, around the
6 ingredients of good standards - those are immutable, should
7 be immutable, almost immutable - but the issues of agenda,
8 staffing, and things like that, are invariably going to be
9 related to whatever the path that is chosen.

10 MR. POZEN: Ed? Ed and then Ed.

11 MR. MCCLAMMY: I do think it's important, either
12 whether we address it or someone else addresses it. But we
13 have to address it, if we continue to converge. Or do we set
14 a date in which we say, "We adopt"?

15 Because this - you know, whether it's from your
16 process where you're talking about balancing all these
17 projects and from the users, and particularly representing
18 mid-size preparers, it's a death from many changes.

19 And, you know, in some ways, I think we would be
20 better off to bite the bullet and just say, at some date,
21 even if it's 5 or 10 years from now, you know, everyone will
22 be on one set of standards and don't try to gradually get
23 there. Everyone just should be there.

24 MR. SIDWELL: Can I just say one thing?

25 MR. POZEN: Sure.

1 MR. SIDWELL: Obviously, I think this a debate that
2 could go on a while. What we're saying is we need to be
3 fluid. I think that many of the things we are considering
4 would be applicable as an offset in any system. I think that
5 is helping us frame a view on those things, and I think we
6 would be very willing to come back to this post January and
7 really give more thought to it.

8 I think, by definition, it probably needs many
9 recommendations, per se, at a reasonably high level, because
10 I think we could be wasting a lot of bandwidth getting very
11 specific on some of the details, when the system is going to
12 change. But I still think we can frame some very meaningful
13 recommendations that would help us think about how
14 international standards would work. And that's what we
15 wanted to do.

16 MR. POZEN: And I think we will have the benefits
17 after January of the comments on the conceptual things.

18 Ed?

19 MR. NUSBAUM: I agree with David's last comment to
20 stay at a high level. The convergence, while we may not
21 immediately, or even in the next few years, adopt all the
22 IFRS standards, as we develop new standards, we are trying to
23 do it on a joint basis.

24 MR. POZEN: Right.

25 MR. NUSBAUM: So if we are trying to move towards

1 pro rata accounting - for example, for leasing - we can't
2 ignore the IFRS because we want to - certainly, for most of
3 us, we believe, it would be preferable to have a global
4 standard that we all buy into. And so we want to reduce
5 complexity on a global basis, and I think this committee
6 should look at how we do that.

7 MR. POZEN: Mark?

8 MR. OLSON: Just to supplement some of the
9 discussion here, when you talk about governance issues, I
10 think it implies a couple of things. It implies a need, on
11 the one hand, but also it implies that you are looking at the
12 structure of your decision-making process.

13 From the PCAOB's perspective, being in an industry,
14 if the industry is audit oversight - a mandated audit
15 oversight, it is an industry group that has sprung up within
16 the last five years, for the most part.

17 And what we discovered was that there was almost an
18 immediate need for some kind of an international cooperation,
19 not because of the fact that we were looking for things to do
20 with our time, but because we recognized the fact that it's a
21 global economy and that, as a result of it being a global
22 economy, we needed to work together. So the group has
23 started and is functioning pretty well for a nascent group.

24 The point is that I think we ought to recognize
25 that convergence, or adoption, or whatever way we want to go

1 is a function of the global economy and that there will be a
2 -- I think there will be a continual move toward single
3 standards. And so I think that it is the result of the
4 environment we are in, and we are not creating the
5 environment.

6 And I think that, where accounting goes, audit will
7 probably follow it, to some extent, either just because we
8 are working together, or the fact that there will be an
9 effort - a specific effort to try to bring it about.

10 MR. POZEN: Okay. I think we probably have pressed
11 that as far as we can. David, do you want to continue on?

12 MR. SIDWELL: Yes. We provided an overview section
13 because I think some of the hypotheses that we are developing
14 really do fit together, and I really would encourage people
15 to look at the overview.

16 The one thing I would like to emphasize here is
17 that - and I think Sue and her team went through it very
18 well - some of the causes of complexity. And many of them
19 have in their roots in our fear that good faith judgments are
20 going to be second-guessed; that that significantly
21 influences the behavior of many participants in the system.

22 So I think for our recommendations to have any
23 chance of really significantly changing the way the system
24 works it is going to require a change in behavior along the
25 way. And I think that is extremely fundamental; that if we

1 don't move away from a system where people feel they are
2 second-guessed with a proliferation of interpretations, the
3 desire for bright lines, as such, will continue.

4 So some of what we have tried to do as we have
5 framed our recommendations is to, hopefully, expect some
6 degree of willingness to change behavior.

7 We have tried, again, to set out in this overview,
8 to base our recommendations on, really, a very proactive
9 feedback loop, so users are much more involved and many of
10 our recommendations are framed around an understanding that
11 users will be represented at all level of the process,
12 whether it's the FASB, actively involving the advisory
13 committees, but then also when we think about the way
14 standards are set and the degree of interpretation that
15 follow this occurrence, that we are engaging in having much
16 more involvement of the SEC, the FASB, and principal
17 participants in the system, actively saying, "What are the
18 key agenda items? Who is going to give the authoritative
19 literature? How do we think about practices that are
20 developing, and whether some of the what I call informal
21 guidance that is being given should be considered as we think
22 about the standards?"

23 So to think a much more proactive environment,
24 where, again, it's not just that a standard is issued by the
25 FASB, and you don't think about and come back to it 10 years

1 later, but that there is a much more active dialogue between
2 all participants in the process to make sure there is a
3 continual refresh, where it is appropriate to make that
4 refresh, and to try and help draw the line better about what
5 is significant enough to require formal guidance and what
6 isn't, and the diversity in practice that results is
7 acceptable. And that was - as you go through our
8 hypotheses, that's a fairly significant part of it.

9 Having said that, maybe let me just begin with the
10 -- which is on bottom of page 4 - governance. We felt that,
11 if one of the objectives of the work we are all doing is to
12 address the needs of users, then it goes without saying that
13 we should be encouraging more user participation throughout
14 the entire process.

15 And some of the active steps we thought that could
16 be taken here is that, when we think about the FAF, when we
17 think about the FASB itself, and when we also think about the
18 number of advisory committees that the FASB has been trying
19 to engage, there is, I think, in our view, considerable
20 benefits to be had by having more user representation.

21 And I don't think that that is just necessarily -
22 and I might ask any of my committee members to join in this
23 -- saying that it would force us to write things more simply,
24 because these are not technical accountants writing laws, but
25 that we would really benefit from having much more active

1 engagement of users. And that would go through the whole
2 process, including more active field-testing, so that we
3 really do get the benefits, as we go along.

4 So that's, really, the first premise that we have,
5 which is around the governance - involving more users. We
6 think, overall, that the process, in terms of delegated
7 responsibility for the SEC to the private standard setting, I
8 think, in general terms, we don't see that as something that
9 we should spend lot of time on.

10 By definition, a lot of the other recommendations
11 we have we hope will tighten up the process that makes that
12 more effective. But that was, really, the first body of
13 recommendations.

14 MR. POZEN: And I think, as you point out here, FAF
15 is also in the process of reconsidering and would be coming
16 to your subcommittee to give us a report.

17 Anyone have reactions to that? Greg?

18 MR. JONAS: I just - violent agreement. Here is
19 an area where I think our own FASB is well ahead of many
20 other standard setters. FASB has done, I think, some
21 terrific things in the last five years to bring users into
22 the process. It has historically been a very difficult route
23 to get standards into the process, and Bob and his team have
24 found ways to do that that I think have been extremely
25 useful. And I would encourage the subcommittee to study

1 those a little bit because I think it is excellent.

2 MR. POZEN: I think we ought to go on to the next
3 -- I think that's sort of a -

4 MS. GRIGGS: I just know that BDO recommended in
5 their comment letter that there be both full-time and
6 part-time user members of the FASB and that users be, you
7 know, maybe part of the FASB. I don't know if that's
8 workable, but it's certainly worth giving consideration.

9 MR. POZEN: I think that is an interesting
10 suggestion because we have talked about the difficulty of
11 getting really top-notch users to be full-time. It's
12 difficult to give up, you know, that sort of private sector.
13 And so that's surely something that ought to be on the table.

14 But let's move on to agenda and standard setting -
15 a pretty meaty area.

16 MR. SIDWELL: Yes. This area is really focusing on
17 a number of areas. I'd like to start with the area of how
18 the agenda is set with some of our preliminary presumptions
19 around what the authorities of the FASB should be.

20 We, in the subcommittee, have spent a fair amount
21 of time saying that, if we want to get the best thinking of,
22 not just the FASB, but the SEC, regulators, and others as to
23 what the agenda should be - and probably most importantly,
24 what is the priority, what items should the FASB put most of
25 their effort behind? How do we accelerate getting done those

1 things that everything would say is a high priority?

2 And we thought that having a very active advisory
3 agenda committee could really help in that. And we certainly
4 need to talk a lot more about who is on that. We certainly
5 had a very active discussion about, in any way, does it
6 actually set the agenda and then FASB has to follow it. I
7 think, to that, we said no.

8 But I think the whole intention here would be to
9 get principal participants very actively engaged in saying,
10 "This is the agenda. These are the priorities," and it
11 enables, hopefully, the energy of the FASB to be directed to
12 those things that are critical.

13 It becomes very important because, later on, one of
14 our hypotheses here is that we would like to see most of the
15 authoritative standard setting coming out of the FASB. So,
16 by definition, you need more active help in managing their
17 agenda, if you are going to say, "We would like you to be the
18 primary body of authoritative guidance."

19 But the first recommendation is about setting out
20 some type of formal agenda committee on an advisory basis to
21 help with the setting of the agenda.

22 MR. POZEN: David, in the interest of time, could
23 you go through all the parts in this section, and then
24 discuss them together.

25 MR. SIDWELL: On page 6, you then see some of our

1 views, in terms of our giving some help to the FASB on how to
2 prioritize. And, obviously, this does change significantly,
3 if there is a drive towards international standards. That
4 clearly has to go without saying. But, obviously, there are
5 other recommendations coming out of this committee that
6 should also take priority.

7 A lot of the emphasis and discussion we had in the
8 committee is how much effort the FASB is putting on looking
9 at and correcting things that are already in existence and
10 how much energy is directed towards these things.

11 We actually felt that, between ensuring that the
12 convergence efforts continue, that the codification efforts
13 continue, the conceptual framework is actually completed,
14 that there is a fair amount of work that we think is fairly
15 important to be on the agenda for a while.

16 And we do encourage the FASB, as part of that, to
17 -- I addressed this a little bit earlier; it's point 5 of
18 that Hypothesis 3 - that there should be a section in this
19 codification project to really look at what redundancies
20 should be removed, what complexities should be removed. I'd
21 say this is an area where getting rid of industry-specific
22 guidance would fit.

23 We also believe that it isn't just the standards
24 that should be looked at here. It is the huge body of effort
25 around disclosures.

1 I started addressing the FASB. We then continue
2 that on the top of page 7, saying that it would be good to
3 have a much - in that effort, for the SEC to participate. So
4 instead of, again, codification being a compilation, that the
5 FASB and SEC work together to integrate, where appropriate,
6 the guidance that the SEC and the FASB have given.

7 And, similarly - and I think the point earlier
8 raised this - there is a huge amount of duplication of the
9 companies in their disclosures. So we think there is a huge
10 amount of progress and benefit that can be made from, in a
11 way, using the rear-view mirror to get after whatever
12 guidance is already out there and really change the way that
13 it operates.

14 MR. COOK: Just a question before you get too far
15 away from page 6 on the notion about the agenda committee. It
16 raised a question: Does FASAC not exist anymore? Because
17 this has so many attributes that are common to that.

18 But setting that aside, I just would like a
19 clarification on item 3 about the super-majority. Are we
20 talking about a super-majority of the Board members?

21 MR. SIDWELL: Of the FASB, yes.

22 MR. COOK: Of the Board members.

23 MR. SIDWELL: Yes.

24 MR. COOK: This agenda committee would be an
25 advisory committee --

1 MR. SIDWELL: Yes.

2 MR. COOK: -- and the Board would still have the
3 authority to decide what goes on its agenda.

4 MR. SIDWELL: That's our current thinking. And we
5 did try to contrast what we were talking about here - it's
6 not in the paper, but in one of our meetings - between FASAC
7 and what we're talking about here.

8 And I think we're talking here about something that
9 meets regularly, is very much in the flow of the types of
10 issues that are being seen by the SEC, the types of questions
11 that the FASB staff are getting, and is much more willing to
12 say, "This is an area that we need to prioritize" and get
13 EITF to deal with, get the FASB staff to deal with, or
14 potentially, where the SEC say themselves, you know, "We
15 can't wait for you to do this. We want to do it ourselves."
16 But there is absolutely clarity about what is getting done
17 and who is doing it. And that was really the intent of this
18 agenda advisory committee.

19 In terms of the way standards then get developed,
20 which is the idea on page 8 - you'll be very clear about
21 what the agenda is, you'll be clear about how you set that
22 agenda - one of the ingredients, then, in developing
23 standards from a process perspective that we think is very
24 important is to try and have much more meaningful
25 field-testing cost benefit analysis done throughout the

1 development of the standard.

2 I think that the way we have talked about this, if
3 look at the development of any standard, preparers, users,
4 auditors spend a huge amount of time, anyway, following what
5 the discussion is. Is there a way that we can link that more
6 holistically, so that you have real learning of, "Well, how
7 will this work in practice?"

8 I think it would address some of the questions we
9 have raised about are there difference, even though an
10 activity may be consistent, that you need to consider by
11 different industries.

12 If you then follow our logic, what we are saying,
13 hopefully, you have - because you have developed a standard,
14 you have been much more aware of the issues that are going to
15 be raised by implementations.

16 But we also think - and this really picks up in
17 terms of page 9 - two other aspects that we think that there
18 would be real benefits from always going back two to three
19 years after a standard is issued and say, "What are the
20 issues that have arisen during that period? What are the
21 types of questions the SEC is getting? When Corp. Fin. Looks
22 at specific items, what are the things they're seeing? Has
too
23 much diversity in practice of applying the rules been seen,
24 so that we need to change some of our guidance so that there
25 is more consistency?"

1 We think that, if you think about that two- or
2 three-year period, in many ways it's an extended
3 implementation period. I have to be a bit careful how to
4 define that because, obviously, the standard would be
5 implemented.

6 But you want to have a period during which it's
7 viewed much more as this is a learning period. This is where
8 we are really trying to define where changes need to be made,
9 where from, the actual application of the standard, there is
10 a real benefit of learning. What non-authoritative guidance
11 has been delivered? What are the accounting firms saying
12 and what are the analysts saying about that guidance?

13 So then, at the end of the period, the FASB can
14 address those issues. Then you move to a period where, you
15 know, the questions are being raised. And then one of the
16 premises that you see here is that, during that two- to
17 three-year period, you would expect to see less restatement
18 activity while, if you like, being consulted on the standard.
19 But then, after a post-implementation period, I think that
20 you would expect to have seen the rules really be better
21 understood.

22 I do want to say, against all of that, I don't
23 think we are any way recommending that there is a move away
24 from, if the SEC sees any specific registrant matters, that
25 that process be changed. I think we are talking here about

1 broadly applicable guidance, as opposed to
2 registrant-specific standards.

3 MR. POZEN: Let me just emphasize that I think that
4 this is a pretty far-reaching proposal. It's really saying
5 that you can only know so much in the proposal period, and we
6 really learn how these standards operate when they go into
7 practice. And it takes two or three years before the kinks
8 are worked out.

9 And maybe the subcommittee's view was, one way to
10 put sort of maybe less freight on the whole process by which
11 you sort of try to come up the right answer is to
12 realistically view this three-year period - whether it's
13 called a transition period or something - which would
14 involve perhaps more flexible standards for restatements,
15 more flexibility in the enforcement process - these sorts of
16 things - as these things got worked out.

17 So I think that would be a quite a different
18 approach than is taken now, and I think people should have a
19 chance to react to that, as well as the other points that
20 were made in this very good presentation here.

21 Ed?

22 MR. NUSBAUM: First of all, I strongly support all
23 the movement towards the practical field-testing, the testing
24 after the standards are done, continuing to monitor. I
25 think, all - and I know that the FASB tries to do that, the

1 Board tries to do that, but it's very difficult.

2 And so any means we can use to improve the
3 practical testing, both before and after the standard is set,
4 I strongly support.

5 I think, with respect to the agenda committee,
6 probably the last thing Bob Herz wants is another committee.
7 But I do think it has some merit, and I would extend it, not
8 just to look at the agendas, but also to look at the projects
9 and sort of maybe serve as an independent project management
10 oversight committee, as well as agenda committee, because I
11 think the more people you have looking at the project
12 management and the hurdles and the roadblocks to getting the
13 various 41 or other projects done and overcoming those
14 hurdles, the better off we all can be.

15 MR. POZEN: John White?

16 MR. WHITE: Is there evidence that restatements
17 come during the implementation period of new standards -
18 which I think is underlying what was just said? I just
19 didn't know that there was evidence of that.

20 MR. COOK: I think it might depend on how you
21 define a standard. There is a lot of restatements that come
22 from people changing GAAP, but often that's not the FASB. I'm
23 not trying to be evasive. It's somebody's interpretative
24 GAAP, and that has caused restatements because that's not the
25 way it has been applied.

1 I don't think the FASB is the principal source of
2 that. I think it's other participants, and that is discussed
3 elsewhere in the papers, as well.

4 I think restatements happen because people have
5 different views about things that are out there - maybe more
6 so than new pronouncements. I think new pronouncements would
7 not tend to do that.

8 MR. SIDWELL: And I think the cause here was that
9 we would like to have this be a much more interactive
10 process. So, for instance, if Corp. Fin. Is seeing things on
11 a registrant basis which really are broadly applicable, that
12 there is very active feedback flow, that the FASB would
13 address that issue very quickly.

14 MR. KROEKER: An example might be Statement 157 that
15 the FASB just issued on fair value. Many are concerned that
16 there are open questions and fear that, if they get smarter
17 in terms of how they apply that standard, somebody will come
18 in and say, "Well, you got smarter. You should have known
19 this when you adopted it."

20 Sitting in the subcommittee meeting, that was part
21 of the discussion - if you can take that pressure off of
22 getting smarter, if you will, when you adopt a new standard
23 that is fairly, you know, broad-based.

24 MR. POZEN: I think, John, you are probably right.
25 It's not really a restatement issue. It's really people

1 looking for more concrete guidance as these things are
2 initially applied and trying to build a little flex and
3 feedback into the system, so that people will view this as
4 more of a sort of a collective working out, rather than an
5 adversarial process during these first years.

6 MR. WEATHERFORD: I think a good example of where
7 this has been used successfully is Section 404, where we went
8 from Auditing Standard 2 to 5, where we did get feedback, and
9 the rules were changed. And it has been, I think, a
10 successful effort.

11 MS. BIES: Yes. I think this is a really important
12 recommendation, in terms of, you know, going back and looking
13 after two to three years, especially if we really want to
14 consider moving more to principles-based accounting.

15 When you go into, whether it's a new standard or
16 changes in standards, a lot of times, the preparers and the
17 users need time to understand how the standard works under
18 different kinds of activities or different circumstances.

19 The more we go to judgment-based types of
20 accounting, there is going to be a range of results that all
21 could be reasonable, given the assumptions that are used. And
22 I think there is anxiety in the early periods that we want to
23 build that common understanding of how to apply any new
24 standard.

25 And I think a two- to three-year time frame is long

1 enough for folks to get comfortable with it, see it applied
2 in different circumstances, and be able to provide meaningful
3 input back to the FASB on the issues and allow us to sort of
4 do sort of a fatal flaw kind of review down the road or
5 clarify the issue through some process that - you know, when
6 I was on EITF, very often saw issues that, you know, you
7 would scratch your head and say, "Why is this coming to the
8 EITF?" It was either very narrow - but you realized that it
9 was important to a certain group of people.

10 I think the statement this committee made on page 4
11 about reasonable judgment is very important. And that's why I
12 like this concept of looking back after two to three years on
13 anything new. I think it supports this reasonable judgment
14 and would support a principles-based approach.

15 MR. POZEN: I have Phil and then Denny and then Joe
16 and then Scott and then Jeff.

17 MR. LASKAWY: Just speaking for the international
18 community that I am representing here, we, obviously, are
19 very interested in this area. And, as David knows very well,
20 we are very focused on these same types of governance issues.
21 So, convergence aside, we are very anxious to see what comes
22 from this.

23 But we just, literally, adopted this
24 post-implementation review, which we're going to do on every
25 new substantive standard that we issue after two years to get

1 feedback and determine whether there are changes that are
2 necessary.

3 So we think it's a wonderful idea, so I just urge
4 serious consideration of that.

5 MR. POZEN: Thank you. Denny?

6 MR. BERESFORD: I think it's important to keep this
7 in context so this is sort of a package deal. And we want
8 there to be some sort of guidance on reasonable judgments,
9 and things of that nature.

10 But the tone of the last several comments would
11 lead me to believe, or would perhaps would lead people to
12 infer that this three-year period would lead to lots and lots
13 and lots and lots of additional guidance.

14 That's not what we have in mind. I think we have
15 in mind that these things can be talked out and, in practice,
16 we would be willing to live with some reasonable differences
17 of opinion on some of the things, as long as it didn't get
18 too far out of hand.

19 We want them to be reasonable, but we don't think
20 that we need 800 pages on derivatives, for example, or to
21 answer every single question about 157, or whatever it might
22 be. Getting that in the right balance is obviously the key
23 to this.

24 MR. POZEN: Thank you. Joe?

25 MR. GRUNDFEST: With all respect to Thom and the

1 observations with regard to AS2 and AS5, I really don't think
2 there is anything at all successful about -

3 MR. POZEN: I think we ought to defer that subject.

4 MR. WEATHERFORD: We'll talk offline.

5 MR. GRUNDFEST: We will do that offline. But, just
6 very briefly, you've got to look at this whole process in
7 terms of the system. You can have a situation where there is
8 a great idea at the FASB and the standard setting level, but
9 then you look at what happens as you feed it out into the
10 process and what are the natural profit-maximizing incentives
11 of all of the participants in the process, and with all of
12 the best intentions in the world, you can create a monster
13 that you will never be able to get back into the cage. That's
14 what has happened before.

15 MR. POZEN: Scott?

16 MR. EVANS: I just wanted to emphasize something
17 that we do have in the paper. From a user's perspective, you
18 want to watch comparability, and you want to make sure that
19 this flexibility that we introduce doesn't come at the
20 expense of comparability.

21 And, quite the contrary, we think that, if we
22 introduce enough flexibility, enough informal discussions in
23 studying the issues, that, by actively managing
24 comparability, we can get to a more uniform place than the
25 current process gets us to.

1 MR. POZEN: Jeff? And then Bob.

2 MR. DIERMIER: Just quickly - and I'm not trying
3 to make Bob Herz' life better, but -

4 MR. POZEN: We wouldn't want to do that.

5 MR. DIERMIER: No. You might consider the
6 governance issue of the post-adoption reviews actually being
7 done by an independent group, not part of the FASB.

8 MR. POZEN: That's an interesting idea. Bob?

9 MR. HERZ: I'm going to throw out an equally
10 radical idea, but I think you might want to look at how, in
11 certain other countries, they've had like what they call a
12 financial reporting council. The U.K., Australia - now,
13 those aren't great examples anymore because they're going to
14 IFRS, but they used to have something like that, and they
15 still have it.

16 It intertwines the accounting standard setter, the
17 auditing standard setter, the equivalent of the PCAOB, the
18 SEC regulator, probably the bank guys in our environment, to
19 kind of say, "Okay. Let's look at the whole issues
20 holistically of our reporting system," which is what this
21 committee is doing. So it's almost like perpetuating
22 something like this committee a little bit.

23 MR. POZEN: You think we should have a permanent
24 committee that should just be -

25 MR. HERZ: Yeah. And I can go part time then. But

1 I think there is a lot of promise in that idea, but I think
2 it's kind of a view of looking at the system holistically,
3 not just the accounting standards and not - because all
4 these things kind of are interconnected.

5 MR. POZEN: We are going to have a comment from
6 Con, and then I'm going to ask David to continue on to page
7 11.

8 MR. HEWITT: Bob and the committee members, I would
9 like to just point out, you can have a perfect accounting and
10 auditing standard, but if the implementation is lousy, you
11 have a lousy standard.

12 And on any new standard, it takes a lot of training
13 and change in behavior and understanding to implement that
14 standard. So the transition - something has to be done to
15 provide some time to do this and make sure that standard
16 really works.

17 MR. POZEN: I think that is what this subcommittee
18 is trying to grapple with through having this transitional
19 period, having a review after a few years, and trying to
20 improve that. So I think it's very much on that wavelength.

21 David, do you want to talk now about proliferation
22 of accounting interpretations?

23 MR. SIDWELL: You can tell by our choice of words
24 we have a judgment that was a proliferation of issues and
25 mutual interpretations.

1 I think the main thrust of this next body is to say
2 let's try and be much crisper about what is authoritative and
3 what isn't. And we start by saying, obviously, the
4 codification project enables the FASB, at this point, to draw
5 a pretty good bright line around what they think is
6 authoritative or not, as we talked about earlier. It would
7 be very useful to loop the SEC into that, so that there is
8 one body of codification of FASB and SEC, and there's really
9 a refreshed outlook.

10 MR. HERZ: The SEC are going through a process to
11 put their stuff into the codification. It's going to be by
12 topic and separated because our standards apply also to
13 private companies. But they're going through an internal
14 process to figure out, of their stuff, what they believe
15 needs to be put in there.

16 MR. SIDWELL: I think I'm framing maybe this next
17 step, which is to make it a more integrated approach than
18 just separate sections. And, obviously, this is early days
19 of codification, but I think we are saying the more
20 integrated guidance can be, the clearer it will be for the
21 users.

22 A lot of this is premised on the fact that the
23 principal place we would like to see authoritative accounting
24 guidance come from is the FASB. And, by that, we also mean
25 the EITF, to the extent that it is delegated. To the extent

1 that the SEC has registered specific matters, obviously, that
2 process should continue. We think that is the right
3 approach. But to the extent that there are rules that need
4 to be disseminated more broadly, that should be primarily
5 done by the FASB.

6 We, however, recognize that you have to be
7 pragmatic. There may be some items that the FASB doesn't
8 want to take on, and that, through this agenda setting
9 process, there is agreement that it would make a lot of sense
10 for the SEC to go ahead and issue guidance. And we would
11 just encourage that that follow a due diligence process in
12 the same way that the FASB does.

13 That makes sense if you like a body of
14 authoritative guidance. We then believe that everything else
15 is not authoritative and that it shouldn't be that making a
16 speech, or by one of the accounting firms issuing guidance -
17 that that should be viewed as any more preferable to
18 something that is documented, well-reasoned from an
19 individual registrant.

20 And I think, again, the whole process of this
21 feedback loop is, to the extent that there is divergence
22 occurring in implementation, to use Con's term, that this
23 whole agenda process is designed where, if it gets to a point
24 that it is viewed as unacceptable, then it is addressed.
25 So a much more active dialogue on what is actually

1 happening in practice and that immediately causing a
2 discussion of who should deal with it and how it should be
3 dealt with.

4 This is clearly a big change from where we are, in
5 terms of, really, separating authoritative and
6 non-authoritative. And, obviously, I don't think in any way
7 are we saying that it's not hugely useful for things like
8 firms to put out their interpretation, their help. All that
9 is useful. We just don't think it should take the stature of
10 being viewed as more authoritative.

11 MR. POZEN: Maybe there should be a warning label,
12 "This is not authoritative guidance."

13 So I think these are well laid out by the committee
14 on pages 11, 12, 13, and 14 on interpretative guidance. So
15 do we want to have any commentary on that? Ed?

16 MR. MCCLAMMY: I agree with - in fact, I thought
17 this whole section coming from the committee was extremely
18 well laid out and thought through. I agree with all of your
19 recommendations.

20 On the point of the clearance within the SEC, on
21 the single point, I agree with that. It may have been
22 contemplated, but I think should be clear that it should also
23 come through one common medium, as well. And it shouldn't
24 come through speeches. There should be some formal way of
25 here is how it gets put out to the preparer and the user

1 communities.

2 And I almost think of it as like FD for companies;
3 that you wouldn't want that going out and saying, "Well, you,
4 investor, go find it." It should come out through one
5 source. So if it's going to go out in a speech on a day, it
6 should also go out through a standard mechanism, so people
7 don't have to be aware of that speech to know what the SEC is
8 thinking.

9 MR. POZEN: Yes, Ed?

10 MR. NUSBAUM: I also agree with the
11 recommendations. I think they are excellent.

12 I think we have to be careful, though, to make that
13 we allow the accounting firms, and even like the AICPA, which
14 answers questions for a lot of the smaller firms and smaller
15 companies out there, privately helping them - I wouldn't
16 want to shut that off, but make sure that it is clear this
17 it's not authoritative and all that guidance does not cover
18 everyone.

19 MR. SIDWELL: Can I just ask Jim Quigley if he has
20 anything to add on this because this was an area he felt very
21 strongly about.

22 MR. QUIGLEY: Thank you, David. I just want to
23 emphasize the points that were made on pages 2 and 3 before
24 we get to proliferation of standards.

25 And that is, I think the root cause analysis of how

1 we have gotten to where we are has been driven in large part
2 by this fear of second-guessing or having a conclusion
3 challenged, and then a restatement occur and then have that
4 cascade through the system.

5 And if we could actually get to the point where
6 there was a meaningful judgment framework and that that
7 judgment framework could become part of the basis of the
8 test, I think auditors and preparers would be less prone to
9 go to various bodies and ask for a bright line rule that
10 would then provide a basis of defense.

11 Because if we have this judgment framework, we
12 could then have a basis of defense. And then all of the
13 recommendations that are laid out could improve the financial
14 reporting process.

15 And I think, without that judgment framework, it is
16 very difficult - this proliferation that we deal with and
17 that we label as one of the sources of complexity, it's
18 difficult to see an environment where that goes away, because
19 it becomes the basis of defense, it becomes the basis of
20 survival, and it becomes the document on which we end up with
21 an obsession with compliance and trying to run down all of
22 these various forms of guidance that are out there.

23 So I think that we could take a big step forward,
24 but the underpinning of that judgment framework and then
25 having that be able to stand is really critical to be able to

1 move forward with these recommendations.

2 MR. POZEN: Thank you, Jim.

3 MS. GRIGGS: I just want to echo Jim's view. I do
4 think judgment is necessary and the framework will be very
5 helpful in this area.

6 I also want to just caution - you know, the SEC
7 staff gives a lot of guidance because registrants ask for it.
8 And when the staff sees that there is an issue that should be
9 brought to the attention of other registrants, it may not be
10 appropriate to go through a formal process. It may be more
11 helpful for there to be a more expedient way for that
12 communication to then be known.

13 So while I think formal processes are important, in
14 some cases, we really don't have the luxury of that. So I
15 just want to hesitate to try to restrict the staff because I
16 know that the staff provides a very helpful role to
17 registrants working out issues.

18 MR. SIDWELL: I think, just to use that as an
19 example of what we were contemplating here, that is where, if
20 done properly, this agenda committee could be very useful
21 because it meets regularly enough, and that becomes a
22 sounding board for any proposed practice items that the SEC
23 is seeing. And it's just where, "We think we need guidance
24 on this. Are you going to do it?" FASB says no. "We're
25 going to go ahead with this. Is everyone on board? Let's go.

1 Are we missing anyone?"

2 It's really actually - it sounds formal, but I
3 think the goal would be that it's much more timely in just
4 getting everyone on board with the guidance that is given.

5 MR. POZEN: There aren't any more comments on that
6 area, so I think we might move to design of standards on
7 pages 14 and 15.

8 MR. SIDWELL: Yeah. I feel this, at this point, is
9 a little bit motherhood and apple pie, in terms of,
10 obviously, if you move to the point where there is more
11 recognition of professional judgment along the lines that Jim
12 just spent time talking about, we do think, in the design of
13 a standard, there are a number of premises that we think are
14 important that are laid out on page 14, under Hypothesis 21.

15 Obviously, I think there will be a huge interaction
16 with some of the other groups as we develop this, in terms of
17 bright lines, safe harbors, et cetera. So this is really
18 just preliminary thinking, that we do think it would be
19 useful to try and continue to develop the idea of what is an
20 ideal standard, and some of the thoughts that we have are
21 laid out here in detail until we come to the time to develop
22 these.

23 MR. POZEN: Do we have anyone who wants to comment
24 on that? I think we probably pushed that around. And then
25 international considerations is, I guess --

1 MR. SIDWELL: We dealt with that at the beginning.

2 MR. POZEN: Well, I think maybe we ought to just
3 take a short break for 10 minutes or so, and then we will
4 come back and do Subcommittee III. Does that make sense to
5 people?

6 COMMITTEE MEMBERS: (Nodding.)

7 MR. POZEN: Okay. Why don't we do that. Thank you.

8 (A break was taken from 11:40 a.m. until 11:50
9 a.m.)

10 MR. POZEN: We are going to start here and go
11 through Subcommittee III, and then we are going to take a
12 break for lunch. And then we will come back and do
13 Subcommittee IV afterwards, and then leave us a little time
14 at the end to discuss where we go from here. So we are
15 slowly gathering here.

16 We are now at the Audit Process and Compliance,
17 Subcommittee III. And I'd ask Mike Cook, as the subcommittee
18 chair, to lead off.

19 MR. COOK: Thank you, Bob. I was going to just say
20 this is the point at which you thank everybody who has helped
21 you, and that would like take a long time to do that. And I
22 was surrounded by committee members until Greg ducked out,
23 but he's coming back.

24 We have a great committee - Ed and Greg and Linda
25 -- working on this. We have great staff support. Thank you.

1 I would mention Bert Fox, who is very new to the SEC, came to
2 that position - I think he was there one day before he took
3 over our first subcommittee meeting. He has done a great
4 job. So everybody else will have to live with the Academy
5 Award sort of you-know-who-you-are kind of a thank you. But
6 Bert, thank you. Great job. And we do appreciate it.

7 MR. POZEN: I think we should say that each of the
8 people working with the subcommittees has been excellent.
9 Adam Brown and Amy on No. IV and Brett on No. II. And there
10 have been a number of other people - Sharon and Holly.

11 MR. COOK: See, I told you it was - we would be
12 off if we said, "You know who you are," and -

13 MR. POZEN: Okay.

14 MR. COOK: This subcommittee did something that I
15 didn't know what it was until this morning: We chunked our
16 agenda. I didn't even know what chunking was.

17 But we sort of took the scope of our work and
18 divided it into three components, and we have given the
19 highest level of our time and attention to the subject of
20 restatements, with an objective of trying to bring final
21 recommendations to the full committee at our next full
22 committee meeting.

23 And so most of what you will hear about and,
24 hopefully, provide us input about will be the subject of
25 restatements. That is the principal thrust of the paper.

1 We are well aware of the importance of this
2 framework for judgment, and we have given very limited
3 attention to this point. It is the next top item on our
4 priority list, and we will consult with the other committees
5 that have referred this to us or asked us to be sure to do
6 this well, and we will be sure we understand their needs and
7 expectations also.

8 The third phase, which we have not touched at this
9 point, is the issue about compliance and the various people
10 who influence accounting and accounting complexity, including
11 the SEC, the PCAOB, the FASB, the accounting firms. That is
12 the third phase in the process, which we have nothing to
13 bring to you or talk about this morning.

14 The principal topic, as I indicated, is
15 restatements. I won't go into much detail here. What do we
16 know? What have we learned?

17 What we know is there are an awful lot of
18 restatements. There are slightly differing accounts, but
19 take our word for it that, last year, there were about 1500,
20 1600 restatements by 1300 to 1400 different companies -
21 about 10 percent of all the companies of all the registrants
22 having restatements. And in addition to there being a lot of
23 them, they have increased dramatically in - approximately
24 three times what they were five years ago.
25 Restatements are very visible. They have been

1 studied by lots and lots of different folk, from lots and
2 lots of different perspectives. And so we have a lot of
3 input on the subject of restatements in work that has already
4 been done - not for us, but we have tapped into all of these
5 different studies and analyses.

6 We believe restatements are of considerable concern
7 for, essentially, three reasons.

8 One is just the sheer numbers - just the sheer
9 number of 1600 restatements, if you'll accept that number.
10 Why do we have so many situations in which financial
11 reporting is being changed because of errors in the financial
12 reporting previously?

13 Secondly, we think that the number of restatements
14 has a pretty significant impact on the public perception of
15 the quality of financial reporting - the public's confidence
16 in financial reporting. If 10 percent of the companies in
17 the United States, to accept one characterization, can't get
18 their books right, what does that tell you about the level of
19 confidence that you would have in financial reporting? So we
20 need to be concern about it for that reason.

21 And, finally, in our deliberations, we reached the
22 point of saying we have a reason to be concerned, as well, if
23 the number of restatements, the sheer magnitude of
24 restatements, include many of them that are not material. And
25 I'll explain our classification.

1 If lots and lots of them are not material, they
2 have a tendency to obscure the ones that are. And people
3 aren't getting the attention to the items that they should,
4 in terms of restatements, and they are not getting, they tell
5 us, the kind of information that they should be getting to
6 better understand restatements, why they happen, and so on.
7 And the sheer number, again, is overwhelming people's focus
8 on things that really do matter.

9 We all know the definition of materiality is not 5
10 percent of this or 10 percent of that. It's none of those
11 things. Those are surrogates for what people believe would
12 be an investor's judgment - what information would, put into
13 the mix, change an investor's perception about the company,
14 its future prospects, and so on.

15 And so the assumption is that, if we are dealing
16 with items that are material, they are items which influence
17 investor judgment. And our conclusion, based on the studies
18 that have been done and the work that we have done, is that
19 that is not true of perhaps the majority. We don't have a
20 quantification of this, but a large number of the
21 restatements that are taking place today are not material by
22 that definition. They do not influence investors. They do
23 not change market perceptions of companies.

24 Again, studies have been done in the GAO, the
25 PCAOB, and others who have studied market impact. And we did

1 something that - you know, a novel idea. We went and talked
2 to investors and creditors - people who represent investors
3 and creditors, and had a group of them in to talk with us,
4 and it was very revealing to us, and a number of their
5 observations are included in the paper that has been provided
6 to you.

7 But the bottom line of that discussion was
8 confirming the notion that an awful lot of what is in the
9 restatement category today is not material to them. It might
10 be interesting, but they are concerned also about being sure
11 they get the information about the things that really do
12 matter in a different format than they are getting it today,
13 and not getting a lot of things that don't influence their
14 judgment about companies.

15 And why that is - a lot of different reasons. Some
16 of them is because the items are very technical. They are
17 mundane. They are accounting changes that don't affect
18 anybody's judgment about the performance or the future
19 prospects of a company.

20 In some instances, they told us they get a lot of
21 old news. They are getting restatements of things that are
22 years ago - interim periods years ago, which aren't very
23 relevant to their current judgments about the company and its
24 future prospects.

25 So we kind of asked ourselves: At this stage, what

1 can be done to change the situation if, in fact, we have too
2 many restatements and restatements which are not material to
3 investors? And two things come to the top of the list for
4 us.

5 One is we think the people who are making judgments
6 about the need for restatements - registrants, their
7 auditors, the regulators who are being consulted on these
8 subjects, various advisors - need to step in the shoes of
9 the investor and think like an investor as to whether or not
10 this matters, whether or not that is something that is going
11 to change someone's perception about the company in a
12 meaningful way.

13 And we don't believe that that takes place very
14 often today. We think there are mechanisms - and we suggest
15 some in the paper - that could be used by credit and equity
16 analysts to try to get that point of view and have the people
17 who are making decisions about materiality thinking that way.
18 So that is one element of it.

19 The second element of it is a substantial
20 improvement and expansion of the guidance that is given to
21 the various participants in that decision-making process with
22 respect to materiality.

23 Today, the principal guidance - virtually, the
24 only guidance on this particular subject is Staff Accounting
25 Bulletin 99, which has now been codified into some other

1 description, which I don't recall, but just call it SAB 99
2 for the purpose of discussion. A very useful discussion
3 about materiality - it does embrace a number of the concepts
4 that we have here - but, essentially, a single directional
5 guidance.

6 It, essentially, tells people when things that are
7 not quantitatively material become material because of
8 qualitative factors. And there is an extensive discussion
9 about that in that statement.

10 There is little or no suggestion - and, certainly,
11 no discussion - of the opposite side of the equation, which
12 says there are things that may be quantitatively material by
13 traditional measures that are not qualitatively material
14 because they aren't going to matter to the people who are
15 going to be the recipients of that financial information.

16 And what we believe - based on experience, talking
17 to people, and what we heard - is that, almost without
18 exception, something that is defined as quantitatively
19 material today - and we will use five percent of some
20 relevant measure, and you can pick what that relevant measure
21 is; often income - if it's over five percent, it's getting
22 restated. It is being defined, virtually automatically, as
23 being material.

24 And it also is joined by other items which are
25 below that level, which are being brought up because of

1 quantitative considerations. But it is the absence of any
2 judgment being applied above that five percent level to say,
3 "Hey, that might be eight percent, but it really just doesn't
4 matter because - " and there are lots of reasons why you
5 might reach that "because."

6 We tried to illustrate, in part, some of our
7 thinking here by the sliding scale analysis, which is in the
8 paper that you have - a suggestion that we have thresholds
9 above and below which rebuttable presumptions should come
10 into play. If it's something that is less than five percent,
11 there ought to be a rebuttable presumption that it's not
12 material. "Rebuttable" meaning if qualitative factors are
13 compelling that it could be a material item, even if it's
14 less than five percent - perhaps a lot less than five
15 percent, depending on the item.

16 Above 10 percent, the presumption should be that an
17 item is material, and for you to reach a conclusion that it's
18 not, the qualitative factors are going to have to be pretty
19 compelling.

20 And in that 5 to 10 percent range, you get a lot of
21 different circumstances. You're kind of in what we would
22 think would be the gray area and one in which qualitative
23 factors really have to be looked at very carefully.

24 But we do think that is a movement away from some
25 of what is taking place in practice today, but it is

1 representative of an outcome that does fit with this notion
2 of: Think about it like an investor and try to think about
3 whether this is going to matter to them.

4 We also suggest that there is an absence of current
5 guidance, a void which could be filled and would help a lot
6 in this area with some guidance around restatements in the
7 balance sheet, restatements in the cash flow statement,
8 restatements within statements that don't change the bottom
9 line of that particular statement. It doesn't change
10 stockholders' equity, it doesn't change total cash flow, but
11 it might move this line here and that line there. We think
12 some additional guidance there would be helpful.

13 And, finally, we think it would be very helpful to
14 have some current thinking and current guidance on
15 materiality for the purpose of judging restatements in
16 interim financial statements. The only time that has been
17 addressed was in APB 29 - which is older than, at least,
18 some of the people in this room; maybe the majority - issued
19 more than 30 years ago, when interim financial reporting was
20 a whole different ball game than it is today.

21 And what we heard from the folks that we talked to
22 is a general view that interim financial periods should be
23 treated as discrete periods. They should stand alone. They
24 are important on their own, not just in terms of trends, and
25 perhaps the materiality guidance with respect to those

1 periods should be reconsidered and tightened up.

2 We considered - I won't go into it, but we
3 considered whether, you know, some new approach to
4 restatements where they would all be done prospectively and
5 we wouldn't have restatements of prior periods and amendments
6 of filings, and things like that, and concluded that that was
7 not a good answer. It's a clear departure from GAAP today.
8 And we think, in the instance of restatements that really do
9 matter, we would be taking away from the user/investor
10 community information that really is important to them.

11 A more appropriate answer would be to eliminate
12 those which are not material, leave those which are material
13 -- which do require investor focus - and then deal with
14 those retrospectively.

15 Two other aspects of this - three, really. One is
16 just a recommendation we're going make for people to take a
17 look at the current filing requirements, particularly the 8-K
18 requirements - this issue about stealth restatements. Just
19 take a look. There has been some additional guidance issued.
20 Is it adequate? Have we taken away what are characterized as
21 stealth restatements?

22 But we heard consistently that people want to know
23 more about restatements that are meaningful, that are
24 material. When was the error discovered? How was the error
25 discovered? What are the weaknesses - whether or not they

1 are material weaknesses in internal control, what are the
2 weaknesses that allowed this to happen? And, very
3 importantly, what has been done, so this doesn't happen
4 again? What remediation steps have been taken?

5 And the investor group that we talked to felt they
6 really weren't getting that information. They were getting
7 just basic facts and boiler plate and not finding out,
8 really: What happened here? Why did it happen? And what
9 are you doing to be sure it isn't going to happen again?

10 And, finally, we got some very interesting comments
11 that we have reflected also in our paper about what happens
12 when a company discovers an error, and what happens, then, in
13 terms of their continuous flow of information to the
14 marketplace.

15 And, essentially, what we were told is that people
16 just go silent at that point, and that that is very - not
17 well received by the investor community, very disruptive to
18 the marketplace, for somebody to say, "We've got a big
19 problem. We're going to investigate it. We'll get back to
20 you when we know what it is," and they don't hear anything
21 from you for extended periods of time.

22 The suggestion here is that things can be done, but
23 we may need to help people out who are very concerned about
24 the disclosure of uncertain information. But keep the flow
25 of information going into the marketplace during that period

1 of time, when investor concern is at a very high level, and,
2 today, they are blacked out; they are not hearing anything.

3 I'm reminded of the old saying, "While under
4 repair, the store is still open." That is true about these
5 entities. These corporations are operating, and people need
6 to know what is going on - even if you can't tell them yet
7 what the specific outcome of a particular investigation might
8 be.

9 Our desired outcome here - just very quickly -
10 that the people who are participating in the decision-making
11 process around restatements are making better decisions; they
12 are doing it from the perspective of the investor, who really
13 is the one to judge the materiality of these things; and
14 enhanced guidance to help people to do that.

15 We think the end of that will be substantially
16 fewer restatements than we have today, and the ones we will
17 have in the future will be ones that really matter, with
18 enhanced disclosure about the restatement itself and the
19 restatement process to help investors understand what is
20 taking place.

21 So that is item No. 1. Item No. 2 -

22 MR. POZEN: I think we ought to just take -

23 MR. COOK: Take item No. 1. Item No. 2 will be the
24 judgment framework. We'll save that, I'll cool down, and
25 we'll take questions and observations about restatements.

1 MR. POZEN: As usual, Mike has done a brilliant job
2 of summarizing the deliberations on this issue of
3 restatements. But I think there are two very specific issues
4 that I think I would like to get the full committee's view
5 on.

6 One is that the subcommittee debated whether or
7 not, if something was material, maybe it didn't have to be
8 restated, maybe it could have a prospective approach, and
9 decided no, they weren't going to do that. If something was
10 really material, that it should be restated.

11 And then it went on to say that materiality should
12 be viewed as to current investors. And that is a very
13 critical difference, because some things might be material in
14 the past, but no longer in the future.

15 And then third of all, developed this notion that
16 Mike articulated of a sliding scale of qualitative and
17 quantitative.

18 So this is - I mean, there are other issues, but
19 this is a whole framework that the committee has done, and I
20 think we should have some feedback.

21 Denny?

22 MR. BERESFORD: I'm in favor of the general
23 approach that Mike has. I'm not in favor of the interim
24 reporting. First of all, I think it would lead to many more
25 restatements.

1 And I recognize that there is a difference of
2 opinion among accountants - and perhaps users, as well - as
3 to whether the discrete versus integral approach to interim
4 reporting provides the best information.

5 I can make a case for either one. I happen to like
6 the approach in Opinion 28, which is the integral approach.
7 I note that the footnote that was cited in the paper is
8 pretty clear with respect to how you view interim
9 materiality.

10 But I think it would be inappropriate for the Board
11 to take on that as a particular issue without going into the
12 basic premise of interim reporting and perhaps reconsidering
13 coming up with the discrete approach.

14 The problem with the discrete approach is I think
15 that it would take a lot longer for companies to do that on a
16 quarterly basis, and I think it would just be - either that,
17 or they would simply come up with estimates that would be
18 much more problematic on an interim basis and subject
19 themselves to more restatements.

20 So I just think that's one part of the package that
21 warrants reconsideration.

22 MR. POZEN: I happen to agree with you, Denny, on
23 that point, but I think we should have more opinions on that.
24 That's another important issue in terms of reporting.

25 MS. GRIGGS: I don't think we were saying that we

1 disagree with paragraph 28, paragraph, or whatever it is. I
2 think what we were saying was, in the area of interim
3 financials, what we heard some of the investor groups say is
4 that they thought interim financials were very important, and
5 we should not regard them as - just look at the annual
6 period.

7 So I think we are still looking at the impact of
8 errors on interim periods. We were reluctant to - we don't
9 believe that, if errors are discovered in an interim period,
10 you would simply consider those with reference to the annual
11 period and not fix them. We thought errors, generally, that
12 are discovered in a particular period affecting that period
13 should be fixed.

14 But it's historical errors that apply to a prior
15 interim period that we really thought we had to look at the
16 current investors' need for that information. And depending
17 upon when that interim period occurred, it may not be
18 appropriate to restate because it would not be relevant to
19 current investors.

20 MR. POZEN: Well, just to say - a different
21 viewpoint is, to the extent that we want people not to focus
22 that much on quarterly earnings, if we are judging the
23 materiality of an error relative to that particular quarter,
24 rather than the year, you are sort of encouraging people to
25 try to manage those quarterly earnings. And I guess I'm of

1 the view that I'm more interested in the impact of the error
2 on the annuals.

3 So that is a different, I think, point of view. I
4 agree all errors should be corrected. But the question of
5 whether an error in a quarter that would be immaterial for
6 the year should need restatement - which, if I understand
7 Denny, is what he was teeing up - I think it's a legitimate
8 debate.

9 MR. COOK: Bob, I don't think we're - we're not
10 going to, you know, write this guidance. We have the luxury
11 of being able to recommend that people issue guidance and
12 then go home. So we aren't going to write it. And there
13 needs to be more work done, I'm sure, before that particular
14 issue, or some of the others, get wrestled to the ground.

15 But what we heard - and we didn't have an
16 extensive sample - what we heard from the investor community
17 -- equity analysts, in particular - saying is that, "These
18 quarterly periods are really important. And we use them for
19 comparability."

20 We asked the question about, "Well, why would you
21 bother to go back and restate last year's second quarter?"
22 "Well, last year's second quarter is being put up next to
23 this year's second quarter, and those are in the annual
24 reports every year, and we need that information to be as
25 best it can be comparable" - as to material items; as to

1 things that matter to the investors. And they were quite
2 consistent in that point of view.

3 So, you know, one of the problems you have when you
4 ask users for their point of view, you have to listen to what
5 they tell you. And we did listen to what they told us, and
6 what they told us was those really do make a difference.

7 And they didn't say that every item has to be
8 measured by its materiality in a quarterly period, nor would
9 we suggest that. But it isn't just - it wouldn't matter on
10 an annual basis and, therefore, it doesn't need to be fixed
11 in the quarter would not be, to them, an acceptable answer.

12 MR. POZEN: I have Jeff and then Peter.

13 MR. DIERMIER: I think Mike did a very good job of
14 describing how I think most of the folks that I know would
15 feel about this. I tend to be more like Bob. I think things
16 should be viewed more on an annual basis.

17 And maybe a good intellectual construct, in terms
18 of the way you think about this is, even when people are
19 looking at their year-to-year comparisons on a quarterly
20 basis, or whatever, in their mind, they are always kind of
21 working on an annual run rate number. Okay?

22 So they are thinking about, you know, the
23 annualized run rate earnings, or cash flow of the company. So
24 it might help you for scaling purposes. So sure, they care
25 about the quarters, but, really, you can intellectually gross

1 Yes, Joe?

2 MR. GRUNDFEST: Well, on the different norms, you
3 know, Bob's point, I think, is actually more profound than
4 even he realizes because -

5 MR. HERZ: I don't know if that would be possible.

6 MR. GRUNDFEST: -- because the market has different
7 expectations. All right? And, you know, when you say that,
8 "Gee, you know, 10 percent of companies have restatements,"
9 you mean 10 percent of companies can't get their books right.

10 Well, I think that's as much a negative reflection
11 on whoever it is that made that statement as it is on the
12 restatement process, because, if we come to understand that
13 accounting is, by nature, an imperfect process, even if well
14 done, all right, you expect that, in a reasonable percentage
15 of situations, you will go back after the fact and you'll
16 say, "You know, it would have been better if we would have
17 put this number here and that number there, but we didn't see
18 that at the time."

19 And it doesn't reflect incompetence. It doesn't
20 reflect fraud. It just simply reflects the natural
21 imprecision of the process.

22 So I do think that a piece of what is going on
23 here, I hate to say, is a marketing problem. All right? The
24 idea that, you know, people scream about there being so many
25 restatements, when many of them are technical adjustments.

1 And I can only tell you at this point we have
2 eliminated two possibilities at the extremes. We have
3 eliminated perfection, and we have eliminated anything goes.
4 And everything between perfection and anything goes is still
5 on the table for that.

6 And we have widely disparate views among my
7 colleagues on the subcommittee and me and those who advise
8 us, and it's only because we really have not spent any
9 meaningful amount of time.

10 But when you make a judgment about the application
11 of generally accepted accounting principles, what is the
12 standard against which that judgment should be made?

13 Is it the highest common denominator? Is it
14 preferability? Is it transparency? Is it conformity with
15 the accounting literature? Is it - and, again, there's just
16 a whole array - conformity with economic substance of a
17 particular transaction or event?

18 What is the standard by which that judgment is
19 made? What would someone have to demonstrate that they have
20 achieved to have the benefit of whatever protections would
21 come around that professional judgment?

22 There are other elements in here that we talk
23 about, which we think, again, are - I wouldn't say they are
24 given, but they are generally agreed upon, which is that the
25 judgment process has to be timely.

1 So the notion that, somehow, this information could
2 be linked to other documents and other information would be
3 valuable for all investors. And that's why, in my remarks
4 and in the report, we talk about the fact that the
5 professional investor may very well like this summary quite
6 well, as well, and might use that as a starting point to do
7 their drilling down.

8 MR. POZEN: I think Greg's suggestion is quite good
9 because, if everyone started with the same document, then you
10 would eliminate the sense of, you know, somebody being a
11 second class citizen. And I hadn't understood the full angst
12 that had gone on in the past, so I think this is very much
13 worth considering. We ought to try to also touch base with
14 some other investor groups to see what their -

15 MR. DIERMIER: There are some investor associations
16 that might be -

17 MR. POZEN: Yeah, Mark Griese and some other people
18 -- so that we are on the same wavelength.

19 Mike?

20 MR. COOK: I was just going to give Jeff a point of
21 reference. That study and the work that was done in the '70s
22 or early '80s, something like that, was done by the Financial
23 Executives Institute and an accounting firm called Haskins &
24 Sells, which is - the firm is no longer in existence, but
25 FEI probably has that information.

1 MR. POZEN: Right.

2 MR. WHITE: And they're not exactly like you're
3 describing, but they are written to be investor-friendly
4 quite often. I mean, I guess I almost envisioned this as an
5 expanded version of the earnings release, where you might -
6 you know, you might want it to come out at the same time.
7 That's a pretty logical time for it to come out. But just go
8 and work on your earnings release to make it more useful in
9 the way you're talking about.

10 I mean, I just didn't think this was
11 liability-driven or mechanics-driven. I think I thought it
12 was much more just companies being willing to create the kind
13 of document you're talking about.

14 MS. GRIGGS: My experience is the same, John. I
15 think the clients that I have that use the summary report are
16 very, very few. Mostly, companies feel, in their annual
17 report to shareholders, they can put what they want to into
18 their chairman's letter, and they just don't think there's
19 any point in developing yet other document.

20 MR. WHITE: And, just as another piece of this,
21 with electronic proxy now in place, you can deliver all this
22 electronically. You no longer have to deliver the paper,
23 unless the individual investors specifically request it. We
24 also have - for the underlying documents, we have much
25 efficiency.

1 Normally, when they prepare their financial statements using
2 that data, they download it and then plug it into either a
3 Word document, or a spreadsheet, or something like that.

4 If they are using XBRL, they don't have to use a
5 person's time to do that - to add up the numbers, put it all
6 together into a package, and put it into a ledger or into
7 their -

8 MR. POZEN: It may be useful - because I think
9 Linda asked a very important question - to get some input
10 from Ed and Thom, who deal with a lot of the smaller
11 companies, as to whether you view this as a cost-saver or as
12 a burden.

13 MR. WEATHERFORD: Well, having spent five years as
14 this intelligence space was in its early stages, this is
15 something that is very close to me, in terms of data.

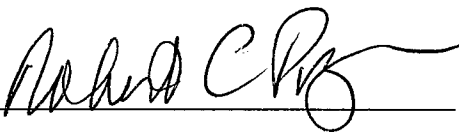
16 I think, any time you implement software in a
17 company, it always takes longer and costs more than you
18 originally assumed. And with XBRL, even though the intent
19 makes a lot of sense, I think to edict one way for companies
20 to analyze and to consolidate data is a major challenge. And
21 I'm not sure if companies that are smaller companies have the
22 bandwidth in which to do this.

23 MR. DIERMIER: That's why, in terms of phasing
24 things, we thought that there would have to be a small
25 company consideration phase, potentially.

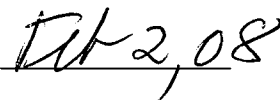
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I hereby certify the accuracy of this record of the proceedings of the SEC Advisory Committee on Improvements to Financial Reporting.



Robert C. Pozen
Committee Chair



Date

EXHIBIT A

EXHIBIT B

**SEC Advisory Committee on Improvements to Financial Reporting
Subcommittee I: Substantive Complexity
Report for Discussion at November 2, 2007 Full Committee Meeting**

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.

Introduction

Subsequent to the August 2, 2007 meeting of the SEC Advisory Committee on Improvements to Financial Reporting (Advisory Committee), committee members have formed four subcommittees to address the issues raised in Robert Pozen's discussion paper dated July 31, 2007 (Discussion Paper).

The attached report summarizes the efforts of the Substantive Complexity subcommittee thus far. At the November 2, 2007 full committee meeting, the subcommittee will present this report for discussion by the full committee.

Members: Susan Bies, Chair
Joseph Grundfest
Edward McClammy
Thomas Weatherford

Observers: Thomas Linsmeier, FASB (observer for FASB Chairman Robert Herz)
Charles Niemeier, PCAOB (observer for PCAOB Chairman Mark Olson)

Scope of Work Plan

Based on the Discussion Paper, the subcommittee identified the following areas for further deliberation:

- Industry-specific guidance
- Alternative accounting policies
- Bright lines and detailed guidance
- Mixed attribute model and the use of fair value
- Exceptions in GAAP other than industry-specific guidance
- Competing models¹

In order to finalize the scope of its work plan, the subcommittee is in the process of developing a definition of "complexity" to serve as a guiding principle underlying the

¹ Competing models are distinguished here from alternative accounting policies. The former refers to accounting models that are different, but not optional (e.g., different models for asset impairment testing such as inventory, goodwill, deferred tax assets, etc.). The latter refers to alternative accounting models that preparers are allowed to choose under existing GAAP (e.g., whether to apply the direct or indirect method of cash flows). The subcommittee intends to explore the role of the conceptual framework in future deliberations, in part as a cause of competing models.

Industry-specific guidance

The subcommittee's use of the term "industry-specific guidance" refers to (1) exceptions to general accounting standards for certain industries, (2) industry-specific guidance due to the lack of a single underlying standard or principle (e.g., industry-specific guidance on revenue recognition due to the lack of a generalized revenue recognition standard), and (3) industry practices not specifically addressed or based in GAAP. Industries covered by this guidance are far-reaching, including, but not limited to, insurance, utilities, oil and gas, mining, cable television companies, financial institutions, real estate, casinos, investment companies, broadcasters, and the film industry.

The subcommittee noted that industry-specific guidance has developed for a number of reasons, including:

- Numerous standard setting organizations.
- Desire by some to address and tailor required accounting to accommodate perceived special needs and desires of different industries (each industry believes it is unique).
- Desire by some, including preparers, users, standard-setters, and regulators, to enhance uniformity throughout an industry.
- A tendency by industries to develop their own practices in the absence of applicable authoritative literature, coupled with the documentation of such practices by standard-setting organizations (i.e., documentation of what preparers are doing rather than consideration of what they should be doing).
- Lack of overarching standards in certain areas of GAAP (e.g., a single comprehensive revenue recognition standard).

The subcommittee noted that industry-specific guidance contributes to complexity in the following ways:

- Increases the volume of literature. This volume, in turn, may result in:
 - Increased costs of implementing accounting literature.
 - Increased costs in maintaining accounting literature and standard-setting.
 - Increased costs of training accountants and retaining industry experts.
 - Complexity for users in understanding the variety of accounting and disclosure.
- Hinders more wide-spread use of XBRL, as it increases the number of different data tags that need to be created.
- May reduce comparability across different industries, if conflicting accounting models are used for transactions with similar or identical economic substance.
- May be used by analogy to either structure desired results or to require a more conservative answer (e.g., by auditors).
- Requires analysis of whether a company is within the scope of specific guidance. This issue becomes problematic for diversified companies who may be involved in a number of different industries with conflicting industry-specific guidance.

On the other hand, the subcommittee noted that industry-specific guidance may alleviate complexity in the following ways:

- May allow industry reporting to better meet the specific needs of the users of the financial statements in that industry.
- May result in comparability among entities within an industry.
- May reflect important differences in the economics of an industry, particularly where application of a generalized principle may not result in accounting that is representationally faithful to a transaction's economic substance.
- Provides guidance where it is otherwise lacking in generalized GAAP.
- May simplify or reduce the amount of guidance a preparer in an industry would need to consider, even though it might increase complexity across industries generally.
- Evolution of accounting – may allow for issues to be addressed more timely. Specifically, industry-specific guidance may be easier to issue on an accelerated basis due to its narrower audience than that of generalized GAAP.

The subcommittee believes that a reduction in the amount of industry-specific guidance would reduce unnecessary complexity, even though it acknowledges that such guidance has merit in certain situations. The subcommittee believes that such guidance should be scoped and applied on the basis of business activities, rather than industries, particularly as many conglomerates cut across several distinct industries.

Based on the above considerations, the subcommittee intends to finalize the following preliminary recommendation for a future full committee meeting:

Underlying principle: Similar activities should be accounted for similarly.

Preliminary Recommendation:

- 1) ***GAAP should be based on activities, rather than industries. Similarly, any exceptions included in GAAP should be based on activities, rather than industries.***
- 2) ***The FASB should analyze all existing industry-specific guidance and determine whether, and the extent to which, it should be retained.***

Possible justifications under consideration for retaining industry-specific guidance include:

- The guidance addresses an activity whose economics is sufficiently dissimilar from other business activities.
- There is not an appropriate general standard that applies to the activity or transaction. However, in this case, the FASB should develop an appropriate general standard within a defined period of time to address the specific accounting activity (i.e., any existing or new industry-specific guidance should be phased out with sunset provisions).
- Cost/benefit considerations.

To facilitate this analysis, the FASB should use the FASB's codification project to divide industry-specific guidance into one of three categories:

On the other hand, the subcommittee noted that alternative accounting policies may alleviate complexity in the following ways:

- May allow preparers to determine the best accounting for particular entities based on cost and economic substance, to the extent that more than one accounting policy is conceptually sound.
- May be developed more quickly than a final “perfect” standard, minimizing the effect of other unacceptable practices. In other words, alternative accounting policies may function as a short-term fix on the road to preferred/ideal accounting (evolution of accounting theory).

While the subcommittee believes that the elimination of alternative accounting policies would reduce unnecessary complexity, it acknowledges that such alternatives may have merit in certain circumstances. Accordingly, the subcommittee is in the process of developing the following preliminary recommendation for a future full committee meeting:

Preliminary Recommendation:

- 1) GAAP should be based on a presumption that formally promulgated alternative accounting policies should not exist, unless their presence can be justified.***
- 2) The FASB should analyze all existing alternative accounting policies and determine whether the optionality should be retained.***

A number of possible justifications under consideration include:

- Multiple accounting alternatives exist that are consistent with the conceptual framework, and none are determined to provide significantly better information to investors than others. Alternatives may, for example, differ based on their cost-effectiveness.
- The effect of applying the alternative policy not selected by the company can be clearly and succinctly presented, (i.e., either through financial statement presentation or footnote disclosure).
- An alternative or interim treatment can be developed more quickly than a final “perfect” standard, minimizing the effect of other unacceptable practices (evolution of accounting).
- The provision of alternative accounting principles is coupled with a long-term plan to eliminate the alternative(s) through the use of sunset provisions.

As part of its deliberations, the subcommittee is specifically considering the application of this preliminary recommendation to alternative accounting that arises from

- Convenience for preparers, auditors and regulators, in that they reduce the amount of effort that would otherwise be required in applying judgment (i.e., the effort in understanding a transaction, debating potential accounting applications, and documenting that judgment) and the belief that they reduce the chance of being second-guessed.
- The lack of a single, underlying principle.
- Requests for additional guidance on exactly how to apply the underlying principle. These requests often arise out of fear on the part of preparers and auditors of using judgment that may be second-guessed by inspectors, regulators, and the trial bar.
- Efforts to curb abuse.

The subcommittee noted that bright lines and detailed guidance contribute to complexity in the following ways:

- May result in accounting that is not representationally faithful to the economic substance of the arrangement.
- May reduce comparability, as two economically similar transactions may be accounted for differently (e.g., a lease arrangement where the present value of minimum lease payments is 89% of the fair value of the leased property vs. one at 90% of the fair value are virtually economically identical yet accounted for in a drastically different manner).
- Creates opportunities for structured transactions to achieve a specific accounting / reporting result (e.g., in lease accounting and hedge accounting whole industries have been developed to create structures that work around the rules).
- Requires additional guidance to curb abuse from structured transactions developed to work around the rules and to address circumstances that do not result in meaningful financial reporting of the economic substance of transactions to investors.
- Requires expertise to account for certain transactions given the volume of guidance, which increases the cost of accounting and the risk of restatement.

On the other hand, the subcommittee noted that bright lines and detailed guidance may alleviate complexity in the following ways:

- May reduce judgment, which may limit aggressive accounting policies.
- May enhance perceived comparability amongst companies.
- Convenience – see discussion above.
- Evolution of accounting – where no underlying standard exists, bright lines and detailed guidance may be used to limit the application of new accounting guidance to a small group of companies. In these situations, the issuance of narrowly-scoped guidance may allow for issues to be addressed more timely. In other words, narrowly-scoped guidance and the bright lines that accompany them may function as a short-term fix on the road to preferred/ideal accounting.

The subcommittee believes that the principles vs. rules dichotomy is a specious debate and that certain circumstances require more guidance than others. The subcommittee will seek to define these circumstances. The subcommittee noted that even if the FASB and

SEC limited issuance of bright lines and detailed guidance, audit firms and other parties would likely create non-authoritative guidance anyway. Any recommendations to limit bright lines and detailed guidance would require a cultural shift towards acceptance of more judgment. Accordingly, the subcommittee intends to follow the efforts of the Audit Process and Compliance subcommittee's deliberations of a professional judgment framework and the Standard Setting subcommittee's deliberations of the proliferation of interpretations. This will assist the subcommittee in development of a potential recommendation with respect to bright lines and detailed guidance.

In addition, the subcommittee is considering recommending the use of pro rata accounting (e.g., leases could be proportionally reflected on balance sheet, rather than completely on or off balance sheet) and rules of thumb coupled with additional considerations, as alternatives to replace the use of bright lines, to account for transactions based on their economic substance. The subcommittee has yet to define the possible scope of pro rata accounting, but it may extend to areas such as leases, consolidation policy, and off-balance sheet activity.

Question for the Full Committee:

- 1) Does the full committee agree with the direction of the subcommittee's efforts thus far regarding bright lines and detailed guidance? What revisions, if any, would the full committee suggest?

Mixed attribute model and the use of fair value

The mixed attribute model is one where the carrying amounts of some assets and liabilities are measured based on historical cost, some at lower of cost or market, and some at fair value. This complexity is exacerbated by the recognition of some adjustments to carrying amounts in earnings and others in comprehensive income. Some have advocated mandatory and comprehensive use of fair value as a solution to the complexities arising from the mixed attribute model.

The subcommittee noted that the use of fair value may contribute to complexity in the following ways:

- Understandability
 - Some users may not understand the uncertainty associated with measurements based on fair value (i.e., that they are merely estimates and in most instances lack precision), including the quality of unrealized gains and losses arising from changes in fair value.
 - Some question whether the use of fair value may lead to counter-intuitive results. For example, an entity that opts to fair value its debt may recognize a gain when its credit rating declines.
 - Some question whether the use of fair value for held to maturity investments is meaningful.

- Reliability, auditability, and quality of fair value estimates
 - Some argue that too much judgment is necessary in developing fair values and that many of the inputs are not easily verifiable. These factors significantly impact the auditability of the numbers.
 - Preparers are concerned with second guessing from auditors, regulators, and civil litigation, which is compounded by management certification requirements.
 - The quality, skill, and reports of valuation specialists vary greatly. Preparers have limited ability to assess this variety. Further, there is no licensing mechanism to ensure ongoing quality, training, and oversight of valuation specialists.
- Financial and other costs
 - Some preparers' knowledge of valuation methodology is limited, requiring the use of valuation specialists, which results in additional expenses.
 - Auditors often also require valuation specialists to support the audit. Some view the need for these valuation specialists as a duplication of efforts, at the expense of the preparer.
 - Preparers view disclosure of some of the inputs to the assumptions as sensitive and competitively harmful.
- Requests for detailed guidance and exceptions
 - Some entities question whether investors are averse to volatility or hold management responsible for unfavorable results created by volatility from markets that management does not control. Consequently, entities have demanded exceptions from the use of fair value in financial reporting, resisted the use of fair value in financial reporting, and/or entered into transactions that they otherwise would not have undertaken to limit earnings volatility.
 - There is no single set of generally accepted valuation standards for financial reporting purposes. Consequently, some have argued for additional, uniform guidance.

On the other hand, the subcommittee noted that the use of fair value may alleviate complexity in the following ways:

- Considered more relevant in many cases as historical cost is not meaningful for certain items.
- Helps to prevent some transaction structuring.
- Helps to achieve consistency.
- Would provide users with the same information as management, to the extent management makes decisions based on fair value.
- Alleviates issues related to the mixed attribute model, including addressing issues arising from measurement mismatches and the need for detailed application guidance explaining which instruments must be recorded at fair value.
- Would eliminate certain issues surrounding management's intent (e.g., when evaluating whether to write down the carrying value of certain investments in debt and equity securities, there would be no need to assess whether the holder has the intent and ability to retain its investment for a period of time sufficient to allow for any anticipated recovery in market value, as all financial instruments would be carried at fair value with changes flowing through earnings).

The subcommittee acknowledged the numerous implementation issues surrounding the use of fair value, such as the potential need for additional standard setting and a regulatory body overseeing valuation specialists. However, the subcommittee determined that, in light of the duration of the Advisory Committee, the mandate to develop do-able recommendations in the short-term, coupled with the developing nature of the valuation industry environment, it would focus its recommendations on broad concepts rather than specific implementation guidance.

Accordingly, the subcommittee intends to continue to explore the following preliminary hypotheses for a future full committee meeting:

- 1) Decision framework – The subcommittee intends to further understand the FASB’s conceptual framework project and consider recommending that, as part of this project, the FASB should develop a decision framework to provide a systematic approach for determining the most appropriate measurement attribute for various assets and liabilities based on consideration of the trade off between relevance and reliability, and the various constituents involved in the financial reporting process.
- 2) Moratorium – Due to implementation complexities, as noted above, the subcommittee is considering whether the FASB should refrain from issuing new standards and interpretations that require the expanded use of fair value in areas where it is not already required until completion of the decision framework. The subcommittee will also consider whether exceptions to this moratorium should be provided to facilitate necessary improvements to certain complex standards, such as SFAS No. 133 and SFAS No. 140.
- 3) Grouping by Measurement Attribute – As part of its financial statement presentation project, the FASB has tentatively decided to segregate the financial statements into business (further divided into operating and investing) and financing activities. The subcommittee is considering whether the FASB should require further groupings based on an internally consistent measurement attribute.
- 4) Multiple Performance Measures – The FASB has also tentatively decided, as part of its financial statement presentation project, to require a reconciliation of the statement of cash flows to the statement of comprehensive income. This reconciliation would disaggregate changes in assets and liabilities based on cash, accruals, and changes in fair value, among others. The subcommittee intends to further study this project and consider whether it would facilitate users’ understanding of fair value. As an alternative, the subcommittee will also explore the notion of presenting the income statement in two parts: a core earnings measure comprised of items within management’s control and a measure of all other items outside of management’s control.

- 5) Disclosure Framework – The subcommittee has identified potential areas for additional disclosure not necessarily required by current GAAP (e.g., disclosure of statistical confidence intervals associated with certain valuation models, which Statement 157 does not currently require). Consequently, the subcommittee is considering recommending that the FASB develop a disclosure framework that more effectively signals to users the level of uncertainty associated with fair value measurements (the subcommittee notes that in some cases, there is no “right” number in a probability distribution of figures, some of which may be more fairly representative of fair value than others). Potential areas for additional disclosure include the valuation model, the entity’s position vs. that of the entire market, the magnitude of variance around the recognized mean, sensitivity analyses, and key assumptions. The subcommittee acknowledges uncertainty also exists in other measurement attributes, such as historic cost, which may warrant similar disclosure.

To minimize the effect of diminishing returns on potential new disclosure improvements identified during the course of Advisory Committee’s efforts and future standard-setting activity, the subcommittee is considering recommending that the disclosure framework, more broadly, integrate existing disclosure requirements into a cohesive whole (e.g., eliminate redundant disclosures and provide a single source of disclosure guidance across all accounting standards), and perhaps referring this issue to another subcommittee.

- 6) Tiered audit opinion – The subcommittee also deliberated a recommendation for auditors to issue a tiered audit opinion, which would provide varying levels of attestation based on the inherent uncertainty of a measurement. The subcommittee considered this recommendation in light of concerns over the gap between the actual and expected assurance from auditors and auditors’ potentially inherent inability to audit fair value due to its subjectivity and auditors’ lack of first hand knowledge about an entity. The subcommittee concluded this area would be best considered by the Audit Process and Compliance subcommittee.
- 7) Hedge accounting – The subcommittee considered complexities arising from the application of hedge accounting. It noted that in certain situations, hedge accounting allows entities to mitigate reported volatility over the life of the hedge relationship, consistent with management’s intent to economically hedge its exposures over a specified term. As a result, the subcommittee tentatively agrees that it should be simplified rather than eliminated. In this regard, the subcommittee is debating a recommendation to eliminate the requirement to assess hedge effectiveness and instead, record the ineffective portion in earnings (i.e., a pro rata approach versus an all or nothing approach). The subcommittee is also monitoring the FASB’s derivatives project and will consider the effects of this project on its recommendation.

Questions for the Full Committee:

- 1) Does the full committee agree with the subcommittee's intention to refrain from deliberating implementation issues and to, instead, focus on broad concepts?
- 2) Does the full committee agree with the subcommittee's direction regarding measurement, disclosure and hedge accounting? What changes, if any, would the full committee suggest?

Current Status and Further Work

The subcommittee expects to finalize its recommendation regarding industry-specific guidance and alternative accounting policies for the January 2008 full committee meeting.

The subcommittee expects to undertake the following in subcommittee meetings following the January 2008 full committee meeting:

- Finalize its scope, including its definition of "complexity."
- Continue discussions regarding (a) bright lines and detailed guidance and (b) the mixed attribute model and the use of fair value.
- Commence discussions regarding other exceptions, competing models and the conceptual framework.

Coordination with Other Subcommittees

The subcommittee wishes to refer consideration of a tiered audit opinion, as discussed above, to the Audit Process and Compliance subcommittee.

The subcommittee also wishes to refer any transition issues created by its potential recommendations regarding industry-specific guidance and alternative accounting policies to the Standard Setting Process subcommittee.

EXHIBIT C

The subcommittee agreed that all of the topics in the Discussion Paper will be included within its scope but decided to organize its evaluation of each within the following broad categories:

- Governance.
- Agenda and standard setting processes.
- Proliferation of accounting interpretations.
- Design of standards.

rather than by attempting to prevent abuse. They should not strive to answer every question and close every loop-hole, but rather, should be written with clearly-stated objectives and principles that may be applied to broad categories of transactions.

- Standard setters should provide extended implementation periods for all new standards, which may allow the SEC to regulate compliance with new standards without forcing unwarranted restatements as long as the requirements in GAAP are followed.
- Formal post-adoption effectiveness reviews of new standards should be conducted within 2-3 years of implementation. By identifying divergence that developed during the implementation period that is perceived to be too great, the standard setters may take corrective action to reduce diversity through the authoritative amendment process, with appropriate transition provided to avoid unwarranted restatements.

The subcommittee believes that an appreciation of the complementary nature of the preliminary hypotheses above would provide insight into the importance of the same preliminary hypotheses described more fully, but individually, below.

GOVERNANCE

The subcommittee considered the potential ways in which (1) the SEC's delegation of standard setting authority to the FASB, and (2) the governance structure provided by the Financial Accounting Foundation (FAF) may be improved. The subcommittee believes that the SEC's delegation of standard setting to the FASB with oversight from the FAF (1) is appropriate, (2) is functioning as designed, and (3) does not contribute to complexity in a meaningful way. However, the subcommittee does have preliminary hypotheses regarding how the SEC and FASB should clarify roles and responsibilities going forward that will reduce uncertainty in the marketplace (see Preliminary Hypotheses 14-19).

Preliminary Hypothesis 1: The standard setting and regulatory processes need more individual user perspectives, which may be accomplished with more user representation, especially on both the FAF and the FASB. The subcommittee recognizes that user involvement is central to the issue of improved financial reporting, yet the intricacy of certain accounting matters and the complexity of the debate makes it difficult to attract individual users to participate in the standard setting and regulatory processes, which in turn reduces the perceived usefulness of financial statements themselves. However, it is important to strike an appropriate balance between the perspectives of users, preparers, and auditors. The subcommittee believes that the objective in the near-term should be to improve that balance by increasing consideration of the users' perspectives in the process, so that what results is an end product that meets the needs of those for which it is intended.

Future Considerations: The subcommittee will consider the role of sponsoring organizations in influencing the composition of the FAF, although the subcommittee recognizes that the sponsoring organizations currently serve in a vital nominating capacity. The subcommittee will also further consider whether and how individual FASB members represent particular constituencies and whether changes should be recommended that would increase their user focus. The subcommittee also plans to reflect on the preliminary findings of an external review of the FASB being sponsored by the FAF to determine if additional analysis of broad governance issues is justified.

Preliminary Hypothesis 3: Although highly dependent upon the conclusions reached in International Considerations as described below, the subcommittee is exploring a recommendation for the full committee to consider that the FASB re-prioritize its existing agenda, which may include the following:

1. *Consider the full committee's recommendations and the potential prioritization of those recommendations.*
2. *Finalize the codification of U.S. GAAP on a timely basis.*
3. *Continue efforts towards international convergence.*
4. *Complete the conceptual framework (jointly with the IASB).*
5. *As phase II of the codification project, consider whether GAAP should be systematically revisited, as follows:*
 - *To be more coherent post codification.*
 - *To remove redundancies.*
 - *To be less complex, where possible.*
 - *To be more principles-based.*
 - *To readdress frequent practice problems (as identified by restatement volumes, input from the SEC, recent interpretations, and frequently-asked questions).*
 - *To readdress outdated standards (i.e., sunseting).*
6. *Create a disclosure framework that may be used by the FASB in the future when assessing what types of disclosures are necessary based upon the type of information being conveyed.*
7. *Address emerging issues that urgently require attention (either directly or through the EITF as its delegate).*

Preliminary Hypothesis 4: In addition, the subcommittee may also recommend that the full committee consider recommending that the SEC work with the FASB to:

1. *Remove any redundancy between SEC disclosure requirements and other sources of GAAP.*
2. *Consider taking steps so that the SEC guidance to be included in the codification will conform to the extent possible with the rest of the format of the codification.*
3. *As phase II of the codification project, consider whether SEC literature should be systematically revisited and integrated with FASB guidance.*

Conceptual Framework: The subcommittee believes that the completion of the conceptual framework, and a reconsideration of conflicts between the revised framework and U.S. GAAP, will be an important step to reduce inconsistencies in GAAP and improve the coherence of the reporting framework. Specifically, Board members should have such a framework that they may refer back to over time when standard setting to ensure cohesiveness and consistency in GAAP. The subcommittee acknowledges that many of the issues currently being addressed by the Board as part of the conceptual framework project are challenging and will have a pervasive impact on U.S. GAAP. Therefore, it will be important that constituents agree with the direction of the FASB and to do so, there may be opportunities during Board deliberations to further clarify what the specific impact of recommended changes to the conceptual framework will have on the full body of GAAP.

Objectives: The subcommittee reflected on the FASB's published objectives and precepts for standard setting. The subcommittee plans to evaluate possible changes to the FASB's objectives and precepts that may provide guidance to the Board when balancing competing priorities in the future. *Preliminary Hypothesis 5: Two possible recommendations for the full committee to consider*

may be that (1) certain objectives should be given more emphasis, and (2) an objective should be added that accounting models should not introduce unnecessary complexity (i.e., not be more complex than the underlying transactions).

Advisory Groups: As noted above in Preliminary Hypothesis 1, the subcommittee believes that there is a need for greater individual user involvement throughout the standard setting process. The FASB has a number of standing advisory groups and committees that it consults on technical issues on the Board's agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces, and other matters. Future Considerations: The subcommittee is in the process of considering (1) whether the FASB makes effective use of its advisory groups, and (2) what other mechanisms may be effective in ensuring that sufficient input is received by appropriate parties and at the right time during the standard setting process. The subcommittee will also further consider how user involvement may be more effectively managed and made more transparent so that interested parties know when and how to engage the FASB and its staff to assist in standard setting.

Staffing: The subcommittee is also concerned that the organization and composition of its staff may constrain the FASB. Preliminary Hypothesis 6: *The FASB should consider an alternate staffing model that makes use of preparers, users, and auditors either directly or through task forces and resource groups (perhaps on a rotational basis) to bring additional subject matter expertise and recent business experience to each standard setting activity.* Such resources might be leveraged to do original thinking on new projects, assist in field testing, estimate the costs of implementing new standards, or serve as subject matter experts to the FASB's staff.

Preliminary Hypothesis 7: *The FASB's Major Projects and Technical Analysis & Interpretations groups should be combined and organized by subject matter expertise to:*

- *Ensure that major projects are led by subject matter experts.*
- *Ensure that interpretive issues are addressed by the same group involved in setting the standards.*
- *Facilitate inclusion of interpretive accounting guidance in the codified standards.*
- *Increase the interaction with relevant financial reporting constituents, resource groups, and alternate staff who have the same subject matter expertise.*

Field Testing and Cost Benefit Analysis: The FASB evaluates whether the benefits of each new standard justify its costs by determining that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the perceived overall benefits. However, participants in the standard setting process have long acknowledged that reliable, quantitative cost-benefit calculations may seldom be possible, in large part because of the lack of available information on the costs and the difficulty in quantifying the benefits. Further, the magnitude of the benefits and costs are difficult to assess prior to preparers using the standard in the preparation of financial statements, auditors auditing that information, and users assessing the benefits of the resulting accounting and disclosure. Preliminary Hypothesis 8: *The subcommittee is considering a recommendation to the full committee that the FASB improve its procedures for field testing, field visits, and cost-benefit analyses, such that:*

- *Field tests and field visits should be required to be integrated into the standard setting process for all new standards.*

Future Consideration: Once the subcommittee's perspectives about the design of standards is more complete, the subcommittee will further consider the approach that should be taken to migrate the codified version of U.S. GAAP to this ideal.

Questions for the Full Committee:

- 1) Does the full committee agree with the subcommittee's approach and preliminary hypotheses? What revisions, if any, would the full committee suggest?

INTERNATIONAL CONSIDERATIONS

Future Considerations: The subcommittee has deferred full discussion of international considerations until comments have been received and evaluated by the SEC on (1) the proposal to remove the U.S. GAAP reconciliation for foreign-private issuers reporting under IFRS as promulgated by the IASB, and (2) the concept release on the possibility of allowing domestic issuers to report under IFRS as promulgated by the IASB. The subcommittee believes that international considerations should be included within its scope, because:

- It would be difficult to address standard setting in the U.S. without discussing convergence matters, especially given that the FASB's agenda is heavily influenced by convergence efforts.
- Convergence matters have in the past created conflicts in the Board's priorities.
- Differences between U.S. GAAP and IFRS are an additional source of confusion.
- Allowing domestic issuers to report under IFRS as promulgated by the IASB would be a significant change from today's process.

The subcommittee believes that many of the preliminary hypotheses contained herein are equally applicable to the International Accounting Standards Board (IASB), with minor modifications. Therefore, international considerations are already implicit in the subcommittee's deliberations. Nevertheless, the subcommittee will defer in-depth discussion of international considerations until 2008.

Questions for the Full Committee:

- 1) Does the full committee agree with the subcommittee's intention to defer deliberations of international considerations associated with standard setting until 2008?

Current Status and Further Work

The subcommittee will continue to meet on a frequent basis with a goal of finalizing certain of its preliminary hypotheses for full committee consideration in January 2008 and publication as interim recommendations. The subcommittee is also planning to obtain further input on its preliminary hypotheses from various constituents in the financial reporting community. As noted above, international considerations will impact these recommendations and will be further deliberated in early 2008.

Coordination with Other Subcommittees

The subcommittee wishes to refer to the Audit Process and Compliance subcommittee work regarding a framework for professional judgment.

EXHIBIT D

**SEC Advisory Committee on Improvements to Financial Reporting
Subcommittee III: Audit Process and Compliance
Report for Discussion at November 2, 2007 Full Committee Meeting**

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Introduction

Subsequent to the August 2, 2007 meeting of the SEC Advisory Committee on Improvements to Financial Reporting (Advisory Committee), committee members have formed four subcommittees to address the issues raised in Robert Pozen's discussion paper dated July 31, 2007 (Discussion Paper).

The attached report summarizes the efforts of the Audit Process and Compliance subcommittee thus far. At the November 2, 2007 full committee meeting, the subcommittee will present this report for discussion by the full committee.

Members: Mike Cook, Chair
Ed Nusbaum
Greg Jonas
Linda Griggs

Observers: Larry Smith, FASB (Observer for FASB Chairman Robert Herz)
Dan Goelzer, PCAOB (Observer for PCAOB Chairman Mark Olson)

Scope of Work Plan

Based on the Discussion Paper, the subcommittee identified the following areas for further deliberation:

- Financial Restatements
- Use of Judgment
- Regulation and Compliance issues including
 - PCAOB
 - SEC
 - Audit Firms

The subcommittee has concentrated its efforts to date primarily on the subject of Financial Restatements and whether the provision of guidance with respect to the materiality of errors would be beneficial, with some limited discussion on the Use of Judgment and whether a judgment framework would enhance the exercise of judgment. The Subcommittee intends to finalize recommendations on Financial Restatements for the January full committee meeting, and then focus on the impact of the PCAOB, the SEC and audit firms on complexity of financial reporting and the exercise of judgment.

Questions for the Full Committee:

- 3) Does the full committee agree with the subcommittee's preliminary scope, which we believe is consistent with the original discussion paper?

Deliberations and Preliminary Hypotheses

Financial Restatements

Potential causes of restatements

A significant and increasing number of restatements have occurred in the U.S. financial markets over the past few years. Some have attributed these restatements to more rigorous interpretations of accounting and reporting standards by preparers, outside auditors, the SEC and the PCAOB, while others believe the concept of materiality⁴ (and discussions regarding materiality in SEC Staff Accounting Bulletin (SAB) 99 (as codified in SAB topic 1M)) is applied too broadly (i.e. resulting in errors being deemed to be material when an investor may not find them to be important). The subcommittee considered the potential causes of restatements and concluded that complex accounting standards, such as classification of equity instruments as liabilities or equity, do create an environment that leads to an increased potential for restatements. The subcommittee believes that standard setters should closely monitor restatement trends to determine if there are particular areas where the current accounting standards could be improved (for example, the FASB could consider prioritizing its liabilities and equity project due to the high number of restatements in this area) to prevent restatements. The subcommittee understands from Chairman Pozen's Discussion Paper that another CIFIIR subcommittee is looking into the standard setting process. The subcommittee believes that there is potential benefit in the short term in examining the concept, application and guidance regarding materiality, and the process for restatements.

Research by Subcommittee

The subcommittee undertook a review of several publicly available studies on restatements, including the U.S. Government Accountability Office (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). The subcommittee also reviewed findings from the PCAOB's Office of Research and Analysis's (ORA) working paper released October 18, 2007, "Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era," understanding that ORA's findings are still preliminary in nature as the study is still going through a peer review process. The subcommittee understands that the Treasury Department also has recently announced the selection of University of Kansas Professor Susan Scholz to conduct an examination of the impact of and the reasons

⁴ 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).

behind public company financial restatements. The subcommittee will monitor the Treasury Department's study and incorporate its findings as they are made available.

The restatement studies reviewed all indicate that the number of restatements has increased in recent years. The subcommittee believes that market reaction can be one factor relevant in evaluating materiality, and based on these studies it would appear that there may be many restatements occurring that investors do not consider important due to a lack of a statistically significant market reaction. While there are limitations to using market reaction as a proxy for materiality, the subcommittee believes that these studies indicate that a reduction in the number of restatements is appropriate and worth trying to achieve. Examples of the limitations 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) that the impact on the market of factors other than the restatement and 3) the disclosure at the time of the restatement of positive information, such as an earnings release, that may have an offsetting positive market reaction. The subcommittee believes that additional guidance on applying materiality in the context of determining whether a restatement is necessary may be beneficial to achieve that outcome.

The subcommittee also gathered input from equity and credit analysts and others about investor's views on materiality and how restatements are viewed in the marketplace. Feedback 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 or not.
- One of the major costs of restatements for investors is the amount of time between the restatement announcement and the final resolution of the restatement, including potential delisting of the company's stock.
- The disclosure provided on restatements is not adequate. Notably, the disclosure does not clearly explain how the error was detected and why the restatement occurred.
- Interim periods should be viewed as discrete periods for purposes of making materiality judgments.

Prospective Accounting for Errors

Some have suggested that current investors would be better served if certain accounting changes were made prospectively (for purposes of this discussion, prospective accounting refers only to the method by which an error is corrected, specifically a cumulative correction in the current period, and not the timing of when the correction is made, such as when a filing is amended with the Commission), rather than through restatement. This would reserve restatements for only the most severe errors (i.e., those that were made intentionally, involved fraud, significantly misrepresented a company's financial performance, etc.). Under such a view, misapplications of technical accounting literature would perhaps not always result in restatements of prior period financial statements. Under SFAS 154 (and previously APB 20), a correction of a material error must be reflected as a restatement. Since current GAAP requires that any material error be accounted for as a restatement, this issue may be inseparable from the consideration of materiality standards.

Questions for the Full Committee:

- 3) Does the full committee agree with the subcommittee's preliminary findings regarding materiality guidance with respect to the need for restatements of historical financial statements? What changes, if any, would the full committee suggest?
- 4) Does the full committee agree with the subcommittee's preliminary recommendations regarding the restatement process? What changes, if any, would the full committee suggest?
- 5) Does the full committee agree with the subcommittee's leanings regarding the areas still under further consideration? What changes, if any, would the full committee suggest?

Professional Judgment

Companies and auditors agree, in principle, that a system in which professionals can use their judgment to determine the most appropriate accounting and disclosure for a particular transaction is preferable to a checklist-based approach. However, both groups continue to express skepticism that such a system could be fully successful without confidence that reasonable judgments would be respected. Regulators assert that they do respect reasonable judgments, but also express concern that companies and auditors attempt to defend certain clear cut errors as "reasonable judgments."

The subcommittee is exploring the development of a recommendation to the full committee regarding a "professional judgment framework" that could potentially serve as a safe-harbor when accounting judgments are required. An agreed-upon framework may provide companies and auditors comfort that the chances of being second-guessed have been sufficiently mitigated. A framework could also potentially address concerns by investors and others by instilling discipline in management's processes.

Framework elements

The subcommittee is considering a framework with 3 broad elements; accounting; documentation; and disclosure. Are each of these elements valid? Should the Subcommittee consider other elements?

Accounting

- Should the proposed framework suggest that a judgment be made based on an assessment of the most transparent way to display the economic substance of the transaction or the accounting treatment that results in a "highest common denominator"? Would this imply that any conclusion that would not result in the most transparent way to display the economic substance of the transaction or the most preferable accounting could be questioned?
- Should the proposed framework suggest that a judgment be made based upon a reasonable analysis of the relevant accounting literature"?
- Should the framework include discussion of the business purpose related to the accounting or auditing issue subject to the judgment?

Questions for the Full Committee:

- 1) Does the full committee agree with the subcommittee's preliminary leanings that a professional judgment framework could be useful or should the subcommittee focus more on providing guidance on the use of professional judgment? What changes, if any, would the full committee suggest?
- 2) Does the full committee have any comments or inputs into the questions the subcommittee is deliberating regarding a potential professional judgment framework?

Current Status and Further Work

The subcommittee expects to finalize its findings regarding restatements and materiality guidance for the January 2008 full committee meeting.

The subcommittee expects to focus on the issue of professional judgment and attempt to have preliminary recommendations for the January 2008 full committee meeting.

The subcommittee plans to focus on regulation and compliance issues after the January 2008 full committee meeting.

Coordination with Other Subcommittees

The subcommittee is referring to Subcommittee II the issue of having standard setters review restatement studies to determine if there are areas, indicated by a high number of similar restatements, where either current standards need to be reassessed or new standards are needed.

Appendix A
Tentative List of Qualitative Factors that Could Result In
Large Errors Being Immaterial

Concepts:

- By definition, materiality is judged through the eyes of a “reasonable” investor. Thus, those that judge materiality to an investor must understand investors’ models and perspectives, to determine whether an error is material to an investors’ valuation or assessment of risk.
- Qualitative factors about an error can both lower and raise its relative importance to a reasonable investor. Thus, it is possible that errors could be quantitatively large, but still not be important to investors. This view is in contrast to how SAB Topic 1M is often applied in practice, which tends to view qualitative factors as a one-way street that can only scope in more items as material.

There follow examples of some of the qualitative factors that could result in concluding that a large error is not material. (Note that this is not an exhaustive list of factors, nor should this list be a “checklist” whereby the presence of any one of these items would make an error not material. Companies and their auditors should still look at the totality of all factors when making a materiality judgment):

- The error impacts metrics that do not drive the investors’ conclusions or are not important to the investors’ models.
- Errors that investors view as affecting a single period rather than affecting an ongoing trend.
- The misstatement does not impact investors’ impressions of key trends they deem important.
- The misstatement does not impact a business segment or other portion of the registrant's business that investors see as driving valuation or risks.
- Errors that occurred in the distant past (e.g. more than 5 years ago) for which the correction would not be useful to current investors.
- Errors that relate to financial statement items whose measurement are inherently highly imprecise.
- The market’s reaction to initial press release disclosures about the error are small.

EXHIBIT E

addition to the annual report to shareholders currently required under the federal proxy rules and the periodic reports filed with the SEC. The subcommittee contemplates that the summary report would be available to the public on a company's website and also may be provided to shareholders directly.

The subcommittee has not explored in detail the content of a summary report, but, at a minimum, such a summary report could summarize key information that is discussed in greater detail in a company's periodic reports filed under the Exchange Act or in a company's glossy annual report. Such a summary report also could contain additional information about a company and its financial condition and results of operations. Members of the subcommittee believe that the summary report would be most useful if it included high-level summaries across a broad range of key components of the underlying report or release, rather than detailed discussion of a limited number of variables. The summary report would not replicate a company's glossy annual report. For a summary of a company's annual report, among the items that subcommittee members noted that investors may want to see in a summary report include some or all of the following:

1. A letter from the CEO/Chairman;
2. Brief description of the company's business, sales and marketing;
3. A digest of the company's GAAP and non-GAAP key performance indicators (KPI's);
4. 10 year summary financial figures;
5. Summary of a company's current financial statements;
6. MD&A, including a list of the company's subsidiaries and brands discussions, as well as a summary of risk factors.

Interim summary reports could be used to provide updated information based on information contained in a company's Forms 10-Q or other public information releases. The subcommittee would expect such summary interim reports to be relatively short.

The subcommittee discussed the fact that a summary report should present information in a manner that emphasizes, within the universe of material information that is disclosed, the information and analysis that is most important to a company. The subcommittee views the summary report approach as an efficient way to provide retail investors a concise overview of a company, its business, and its financial condition. For the more sophisticated investor, the subcommittee believes that the summary report may be helpful in presenting the company's unique story which the sophisticated investor could consider as it engages in a more detailed analysis of the company, its business and financial condition.

The subcommittee believes that consideration of the treatment of the summary report under the federal securities laws is important. The subcommittee noted that issues to consider include whether the summary report would be required to be filed with or furnished to the SEC, and what liability reporting companies would have for the content of their summary reports. The subcommittee discussed ways in which reporting companies could use such summary reports and address concerns about increased liability under the antifraud provisions of the federal securities laws. In addition, to encourage the use of summary reports by reporting companies, the subcommittee believes that it is appropriate to permit the summary reports, without additional liability, to:

- ◆ reference previously filed company reports under the Exchange Act;
- ◆ include hyperlinks to such filed Exchange Act reports or other additional information about a company so that investors easily can obtain additional or more detailed information about the matters discussed in the summary report;
- ◆ be provided at or after the Exchange Act periodic report or earnings release on which it may be based has been filed with or furnished to the SEC;
- ◆ to aid accessibility, be available electronically to the public on a reporting company's website without being required to be filed with or furnished to the SEC; and
- ◆ not be considered a "solicitation" under the federal proxy rules if it is regularly released in the ordinary course.

Based on the above considerations, the subcommittee intends to finalize the following preliminary hypotheses for the January 2008 full committee meeting:

Underlying principle: Increase the usefulness of company reports to individual shareholders without raising either the cost to produce or the legal exposure for issuers.

Preliminary Hypotheses:

The SEC should confirm the ability of reporting companies to publicly provide summary reports of their periodic or current Exchange Act reports or other ongoing information releases provided to the public.

Such summary reports should be able to reference the filed, furnished, or other publicly available report or release on which the summary is based and provide active hyperlinks to such reports and additional information. Such references or hyperlinks should not affect a reporting company's liability under the federal securities laws and statements in the summary reports should be able to be evaluated in light of the reports or information that have been referenced.

Such summary reports should not be considered "solicitations" under the federal proxy rules if they are regularly released by the reporting company in the ordinary course.

Questions for the Full Committee:

Does the full committee agree with the subcommittee's preliminary hypotheses regarding summary reports? What revisions, if any, would the full committee suggest?

Use of Interactive Data (XBRL)

The subcommittee has been examining the use of XBRL by public reporting companies. XBRL is an international information format standard designed to help investors and analysts find, understand, and compare financial and non-financial information by making this information

machine-readable. It also offers benefits to companies by allowing them to better control how their financial or non-financial information is disseminated and, by integrating their operating data with their financial reporting disclosure, to reduce reporting costs. XBRL is a computer language that permits the automation of what are now largely manual steps for access, validation, analysis and reporting of disclosure. Because XBRL uses standardized XML (eXtensible Markup Language) technology, it can be read by a wide range of diverse software systems.

Under current technology, for example, if an investor or analyst wants to compare the sales of all the pharmaceutical companies, he must download the financial statements of these companies and input the sales data into a spreadsheet. With XBRL, however, widely available software application can go into the SEC's database, extract the sales numbers and download them directly to a spreadsheet. This process takes seconds rather than the hours or days that might be required using current methods.

XBRL does this through standardized definitions of terms, like a dictionary. For example, there might be several terms for the top line on an income statement, which might be called sales, turnover or revenues. All of these terms mean the same thing, and are translated in XBRL into a common symbol, readable by a computer. When reproduced as a financial statement from the XBRL source, the statement will look exactly like the statement that the company produced for reading by humans.

The standardized terms are then arranged in a logical structure called a taxonomy. Under sales, for example, there might be several subcategories, such as sales through retailers, sales over the Internet, etc. These would be similarly standardized and included under sales (or turnover or revenues) because they are all aggregated to produce the number for sales. That logical structure is a taxonomy. A GAAP financial statement itself, in that its underlying details are summarized in the line items of a balance sheet or income statement, is a kind of taxonomy. There are taxonomies for different kinds of businesses. For example, the banking industry sector taxonomy differs from that of a software industry sector company.

XBRL also contains standardized relationships, such as EBITDA, so that if an investor or analyst wants to know the EBITDA of each of the pharmaceutical companies he would simply query the SEC's database with the appropriate search application. The numbers would again be downloaded in seconds. There would be no need to download the complete financial statements, ferret out the constituents of EBITDA and do the necessary calculations. The standardized XBRL concept of EBITDA embedded in XBRL provides all the explicit rules that enable a search engine to find the specifically identified concepts necessary to compute the number.

The SEC has adopted a voluntary pilot program for use of XBRL. Over four dozen companies are participating in the pilot program and have agreed to voluntarily submit their annual, quarterly and other reports with interactive data for a period of one year. The SEC recently has expanded the voluntary filing program to include mutual funds which will file using both a U.S. GAAP taxonomy developed by XBRL-US and a risk and return taxonomy developed by the Investment Company Institute.

- Resolve the questions of auditor assurance
- Consider alternatives to auditor assurance
 - o Third-party verification structure
 - o Internal company verification/certification
 - o Development and use of self-checking software
- Liability for tagged data
 - Phase-in appropriate liability for tagged data
 - Retain auditor involvement and liability as today for filed audited financial statements
 - Consider future treatment of liability for tagged data once companies begin filing periodic and current reports with financial statements prepared on an integrated basis
- Early filers may move more quickly through the phases to help move up the learning curve

Questions for the Full Committee:

1. What views do the Committee members have on the benefits and challenges that the subcommittee has identified?
2. What additional suggestions do the Committee members have to address the identified challenges or other challenges the subcommittee has not noted?
3. What are the Committee's views on making XBRL mandatory or other ideas on achieving a belief in its wide scale adoption to clear the "wait and see" hurdle?
4. What are the Committee's views on the role that a company's auditors should have in a company's use of XBRL?

Current Status and Further Work

The subcommittee expects to finalize a recommendation to the full committee regarding the use of summary reports for the January 2008 full committee meeting. The subcommittee expects to continue discussions and develop preliminary recommendations to the full committee regarding XBRL, including assurance and phase-in issues as noted above, for the January 2008 full committee meeting.

The subcommittee expects to undertake the following in subcommittee meetings following the January 2008 full committee meeting:

- Finalize its scope;
- Continue discussions regarding the use of press releases and websites for providing information to investors;
- Consider potential recommendations as to the consistent layout and related matters for regular communications such as a reporting company's quarterly earnings press release;
- Address how MD&A is reported;

- Continue discussions regarding enhanced business reporting including the disclosure of key performance indicators by reporting companies as well as the use by reporting companies of non-GAAP financial measures;
- Consider the need for the SEC to issue guidance regarding the reporting liabilities of preparers; and
- Consider whether an ongoing dialogue between preparers and users on the subject of communications should be encouraged through a neutral party.

Coordination with Other Subcommittees

The subcommittee has not identified any issues at this time to be referred to other subcommittees for consideration.

EXHIBIT F

Index of Written Statements Received

Listed below are the written statements received by the Advisory Committee between its first meeting on August 2, 2007 and its second meeting on November 2, 2007 and the dates of receipt.

Nov. 2, 2007	Dr. Robert A. Howell, Distinguished Visiting Professor or Business Administration at the Tuck School of Business at Dartmouth
Oct. 24, 2007	Enhanced Business Reporting Consortium
Oct. 13, 2007	Sherman L. Rosenfield, CPA, Miami, Florida
Oct. 13, 2007	Sherman L. Rosenfield, CPA, Miami, Florida
Oct. 11, 2007	Jeff Mahoney, Investors Technical Advisory Committee
Oct. 10, 2007	Kenneth E. Bentsen, Jr., President, Equipment Leasing and Finance Association
Oct. 8, 2007	Richard S. Furlin, EQ Metrics
Oct. 3, 2007	Allan Cohen, Financial Reporting Committee, Institute of Management Accountants, New York, New York
Oct. 3, 2007	Paul Hazen, CEO, National Cooperative Business Association, Washington, District of Columbia
Oct. 1, 2007	June M. Johnson, Chair of the AFP Financial Accounting and Investor Relations Task Force and Maureen O'Boyle, Chair of the AFP Government Relations Committee
Oct. 1, 2007	BDO Seidman, LLP
Sep. 28, 2007	David A. Lifson, President, New York State Society of Certified Public Accountants
Sep. 26, 2007	Michael J. Ryan, Jr., U.S. Chamber of Commerce, Washington, District of Columbia
Sep. 26, 2007	Arnold C. Hanish, Chair, Committee on Corporate Reporting, Financial Executives International
Sep. 25, 2007	Richard S. Furlin, President, EQ Metrics
Sep. 21, 2007	David B. Armon, Chief Operating Office, PR Newswire, New York, New York
Sep. 20, 2007	Keith Boocock, Chief Executive Officer, Canadian Public Accountability Board
Sep. 20, 2007	Cathy Baron Tamraz, President and Chief Executive Officer, Business Wire
Aug. 29, 2007	David Erwin, Fort Worth, Texas
Aug. 23, 2007	Chris Carvalho, Aloha, Oregon
Aug. 14, 2007	Edward W. Dodds, Strategist, Systems Architect, Conmergence, Nashville, Tennessee