

**SEC Advisory Committee on Improvements to Financial Reporting
Substantive Complexity Subcommittee Update
May 2, 2008 Full Committee Meeting**

I. Introduction

The SEC's Advisory Committee on Improvements to Financial Reporting (Committee) issued a progress report (Progress Report) on February 14, 2008.¹ In chapter 1 of the Progress Report, the Committee discussed its work-to-date in the area of substantive complexity, namely, its developed proposals related to industry-specific guidance and alternative accounting policies; its conceptual approaches regarding the use of bright lines and the mixed attribute model; and its future considerations related to scope exceptions² and competing models.

Since the issuance of the Progress Report, the substantive complexity subcommittee (Subcommittee I) has deliberated each of these areas further, particularly its conceptual approaches and future considerations, and refined them accordingly. This report represents Subcommittee I's latest thinking. The Subcommittee's consideration of comment letters received thus far by the Committee is ongoing and may result in additional changes. The purpose of this report is to update the full Committee, and also to serve as a basis for the substantive complexity panel discussions scheduled for May 2, 2008 in Chicago. Subject to further public comment, Subcommittee I intends to deliberate whether to recommend these preliminary hypotheses to the full Committee for its consideration in developing the final report, which it expects to issue in July 2008.

II. Exceptions to General Principles

II.A. Industry-Specific Guidance

In the Progress Report, the Committee issued a developed proposal related to industry-specific guidance (developed proposal 1.1). Refer to the Progress Report for additional discussion of this developed proposal. Subcommittee I will consider the panel discussions on May 2, 2008, as well as the public comment letters received, before submitting a final recommendation to the Committee, but at this time, is not intending to propose any significant revisions.

II.B. Alternative Accounting Policies

In the Progress Report, the Committee issued a developed proposal related to alternative accounting policies (developed proposal 1.2). Refer to the Progress Report for additional discussion of this developed proposal. Subcommittee I will consider the panel discussions on May 2, 2008, as well as the public comment letters received, before

¹ Refer to Progress Report at <http://www.sec.gov/rules/other/2008/33-8896.pdf>.

² Throughout this report, the term "scope exceptions" refers to scope exceptions other than industry-specific guidance.

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submitting a final recommendation to the Committee, but at this time, is not intending to propose any significant revisions.

II.C. Scope Exceptions

Preliminary Hypothesis 1: GAAP should be based on a presumption that scope exceptions should not exist. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB should not provide additional scope exceptions, except in rare circumstances. Any new projects should also include the elimination of existing scope exceptions in relevant areas as a specific objective of these projects, except in rare circumstances.

Background

Scope exceptions represent departures from the application of a principle to certain transactions. For example:³

- SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, excludes certain financial guarantee contracts, employee share-based payments, and contingent consideration from a business combination, among others.
- SFAS No. 157, *Fair Value Measurements*, excludes employee share-based payments and lease classification and measurement, among others.
- FIN 46R, *Consolidation of Variable Interest Entities*, excludes employee benefit plans, qualifying special-purpose entities,⁴ certain entities for which the company is unable to obtain the information necessary to apply FIN 46R, and certain businesses, among others.

Similar to other exceptions to general principles, scope exceptions arise for a number of reasons. These reasons include: (1) cost-benefit considerations, (2) the need for temporary measures to quickly minimize the effect of unacceptable practices, rather than waiting for a final “perfect” standard to be developed, (3) avoidance of conflicts with standards that would otherwise overlap, and (4) political pressure.

Scope exceptions contribute to avoidable complexity in several ways. First, where accounting standards specify the treatment of transactions that would otherwise be within scope, exceptions may result in different accounting for similar activities (refer to competing models section below for further discussion). Second, scope exceptions contribute to avoidable complexity because of difficulty in defining the bounds of the scope exception. As a result, scope exceptions require detailed analyses to determine whether they apply in particular situations, and consequently, increase the volume of

³ Refer to appendix A for additional examples.

⁴ Subcommittee I notes that the FASB has tentatively decided to remove the qualifying special-purpose entity concept from U.S. GAAP and its exception from consolidation.

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accounting literature. For example, the Derivatives Implementation Group has issued guidance on twenty implementation issues related to the scope exceptions in SFAS No. 133. Further, companies may try to justify aggressive accounting by analogizing to scope exceptions, rather than more generalized principles.

Nonetheless, scope exceptions may alleviate complexity in situations where the costs of a standard outweigh the benefits. For example, many constituents would contend that derivative accounting and disclosures for “normal purchases and normal sales” contracts are not meaningful, and thus, are appropriately excluded from the scope of SFAS No. 133.

Discussion

Subcommittee I preliminarily believes that scope exceptions should be minimized to the extent feasible. Possible justifications for retaining scope exceptions include: (1) cost-benefit considerations, (2) the need for temporary measures to quickly minimize the effect of unacceptable practices, rather than waiting for a final “perfect” standard to be developed, and (3) the need for temporary measures to avoid conflicts in GAAP. However, in cases where scope exceptions are provided as a temporary measure, they should be coupled with a long-term plan by the FASB to eliminate the scope exception through the use of sunset provisions.

Subcommittee I also notes that in certain areas, the SEC staff has issued guidance to address transactions that are not within the scope of FASB guidance, e.g., literature addressing the balance sheet classification of redeemable preferred stock not covered by SFAS No. 150.⁵ Accordingly, as the FASB develops standards to address these transactions, the SEC should eliminate its related guidance.

From an international perspective, Subcommittee I notes that IFRS currently has fewer scope exceptions than U.S. GAAP. Accordingly, the Subcommittee will draft language for the full Committee’s consideration, which if adopted, would encourage the SEC to affirm the IASB’s efforts on this path. However, Subcommittee I also notes that, in certain circumstances where IFRS includes scope exceptions, they are sometimes more expansive than those under U.S. GAAP. For example, IFRS 3, *Business Combinations*, scopes out business combinations involving entities under common control, which results in no on-point guidance for such transactions. Accordingly, Subcommittee I also believes that where IFRS provides scope exceptions, the IASB should ensure any significant business activities that are excluded from one standard are in fact addressed elsewhere. Said differently, the IASB should avoid leaving large areas of business activities unaddressed in the professional standards.

⁵ *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.*

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II.D. Competing Models

Preliminary Hypothesis 2: GAAP should be based on a presumption that similar activities should be accounted for in a similar manner. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB should not create additional competing models, except in rare circumstances. Any new projects should also include the elimination of competing models in relevant areas as a specific objective of these projects, except in rare circumstances.

Background

Competing models are distinguished here from alternative accounting policies. Alternative accounting policies, as explained in the Progress Report, refer to different accounting treatments that preparers are *allowed to choose* under existing GAAP (e.g., whether to apply the direct or indirect method of cash flows). By contrast, competing models refer to *requirements to apply* different accounting models to account for similar types of transactions or events, depending on the balance sheet or income statement items involved.

Examples of competing models⁶ include different methods of impairment testing for assets such as inventory, goodwill, and deferred tax assets.⁷ Other examples include different methods of revenue recognition in the absence of a general principle, as well as the derecognition of most liabilities (i.e., removal from the balance sheet) on the basis of legal extinguishment compared to the derecognition of a pension or other post-retirement benefit obligation via settlement, curtailment, or negative plan amendment.

⁶ Refer to appendix A for additional examples.

⁷ For instance, inventory is assessed for recoverability (i.e., potential loss of usefulness) and remeasured at the lower of cost or market value on a periodic basis. To the extent the value of inventory recorded on the balance sheet (i.e., its “cost”) exceeds a current market value, a loss is recorded. In contrast, goodwill is tested for impairment annually, unless there are indications of loss before the next annual test. To determine the amount of any loss, the fair value of a “reporting unit” (as defined in GAAP) is compared to its carrying value on the balance sheet. If fair value is greater than carrying value, no impairment exists. If fair value is less, then companies are required to allocate the fair value to the assets and liabilities in the reporting unit, similar to a purchase price allocation in a business combination. Any fair value remaining after the allocation represents “implied” goodwill. The excess of actual goodwill compared to implied goodwill, if any, is recorded as a loss. Deferred tax assets are tested for realizability on the basis of future expectations. The amount of tax assets is reduced if, based on the weight of available evidence, it is more likely than not (i.e., greater than 50% probability) that some portion or all of the deferred tax asset will not be realized. Future realization of a deferred tax asset ultimately depends on the existence of sufficient taxable income of the appropriate character (e.g., ordinary income or capital gain) within the carryback and carryforward periods available under the tax law.

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