Summary of Responses to the Annual FASAC Survey

Priorities of the Financial Accounting Standards Board

October 2002

FASAC

Financial Accounting Standards Advisory Council

C O N T E N T S

RESULTS OF THE ANNUAL SURVEY ON THE PRIORITIES OF THE FASB

Financial Accounting Standards Advisory Council
September 2002

Highlights and Scope of Survey

The annual survey of the views of FASAC members on the priorities of the FASB provides valuable perspectives and observations about the Board's process and direction. This year's survey asked Council members, Board members, and other interested constituents for their views on:

- The FASB's priorities
- The financial reporting issues of tomorrow
- Principles-based standards
- The FASB's international activities.

Key observations and conclusions from the responses to the 2002 survey are:

- Council members most often mentioned revenue recognition as one of the five most important issues that the Board should address currently. All seven Board members also included revenue recognition as one of the most important issues for the Board.

- FASAC members most often cited valuation issues, such as the implication of using fair value measurements in financial statements, as one of the issues of tomorrow that the Board should start thinking about today.

- FASAC members generally are prepared to accept differences in interpretation of principles-based standards. They also are prepared to make the judgments necessary to apply less-detailed standards despite the risk that their judgment will be questioned. Some noted that for principles-based standards to become a reality, the SEC is the primary organization that needs to support the initiative.

- Nearly all FASAC members agree that the Board's international activities are an appropriate use of resources. All Board members also believe that those activities are an appropriate use of resources.

Twenty-two current Council members, 7 Board members, and 9 other constituents responded to the survey.

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Summary of Responses to Section A
The FASB's Priorities

Section A of the survey started with a blank sheet of paper. Given the current financial reporting environment—one of uncertainty and transition affected by corporate bankruptcies, accounting irregularities, and legislation to regulate the accounting profession—what are the five most important issues the Board should address if it was setting its agenda today?

The table below summarizes the five issues that appeared most often in Council members' responses. Board member responses are shown for comparison. (The number that appears in each column represents a tally of the number of responses that mentioned that issue.)

Topic	Council Members	Board Members
Revenue Recognition	19	7
Consolidations	13	4
Codification and Simplification of Standards	10	1
Financial Performance Reporting	8	7
Business Combinations—Purchase Method Procedures	7	1

Revenue Recognition

One response very clearly articulated the reason to address this issue. "Revenue recognition is a central accounting issue, and the literature on revenue recognition has become inadequate . . .The inadequacy of the current literature is evidenced by the number of restatements related to revenue recognition."

Consolidations

Now that the issue of special-purpose entities is being addressed by the Board, many Council members advocate addressing consolidation issues more broadly. "The broad area of consolidations is extremely difficult as evidenced by the fact a broader review has been periodically deferred by the FASB. As consolidation appears to be a part of certain recently identified accounting weaknesses it is probably time for a fundamental review of this accounting area."

Codification and Simplification of Standards

Supporters of this project note the need to develop a set of principles that can be applied consistently, resulting in financial statements that are an accurate reflection of a business's financial performance and strength. Those in favor of the Board's addressing this issue often mentioned the "principles-based standards" initiative as equally important.

Financial Performance Reporting

Those who support this project note that performance is, perhaps, the main focus of investors. They observe that the current financial reporting regime is criticized for a narrow focus on a single measure of performance—earnings per share. Some caution, though, that while there is a need to bring some elements of consistency and conformity to financial reporting, the project should not limit the flexibility of management to convey its financial information in the manner that it deems most meaningful to its investors.

Business Combinations—Purchase Method Procedures

Support can be summarized as follows: "Bring the project on business combinations to a timely conclusion."

Other Topics Raised

While the summary above represents the five most "popular" answers, many other topics were raised by respondents that will receive consideration by the Board when it reviews the comprehensive results of the survey. Some of those topics include:

- Cash flow reporting
- Fair value
- Disclosures about intangibles
- Lease accounting
- Principles-based standards
- New basis accounting
- Accounting for compensation costs, including pension accounting
- Research and development costs
- Accounting for contractual rights and obligations
- Disclosures about risks, estimates, and changes in accruals.

The complete text of respondents' comments on Section A begins on page 9.

Summary of Responses to Section B
Tomorrow's Issues

Section B of the survey posed two questions about the financial reporting issues of tomorrow.

What are the financial reporting issues of tomorrow that the Board should start thinking about today?

Many Council members believe that the Board should study valuation issues, particularly fair value. Some commented on the need for guidance in this area, noting that the area of fair value is very subjective, with the opportunity for significant differences in results coming from small differences in assumptions.

Several Council members also believe that the Board should devote substantial attention to strategic issues. For example, the Board should ensure that it is well structured and that the staff has the appropriate skill set for dealing with current issues. The Board also should examine its role in restoring investor confidence in the U.S. capital markets.

How can the Board position itself so as to become aware of potential financial reporting issues sooner?

Many Council members note that the Board's relationships with FASAC, AcSEC, EITF, constituent organizations, and the SEC should position the Board to become aware of financial reporting issues on a timely basis. Some suggest that the key to being responsive is to focus efforts on principles-based standards—less time will be spent on technical interpretations, resulting in more time available to address new strategic reporting issues.

Another suggestion is to convene a series of town meetings with investors to discuss problems they encounter and issues that concern them.

The complete text of respondents' comments on Section B begins on page 49.

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Summary of Responses to Section C
Principles-Based Standards

Section C of the survey asked two questions about issuing standards that are less detailed.

A move to standards that are less detailed would require an understanding of the implications for all the Board's constituencies. What are the implications that the Board should consider? What are the arguments for and against issuing less-detailed standards?

Council members note that the notion of "principles-based standards" means different things to different people. The primary question is whether principles-based standards will improve the quality of financial information in the market. One suggestion is to study the same standard drafted as both rules-based and principles-based.

Some Council members are skeptical of moving to principles-based standards, noting the need for robust conceptual underpinnings to avoid ambiguity. Some foresee that a move to principles-based standards will result in an increase in implementation questions to both the FASB and the SEC.

One result of moving to principles-based standards would be an increase in the need for judgment by an entity's management and its auditors to determine appropriate application of the standard. For this effort to succeed, the support of all participants in the financial reporting process—preparers, auditors, regulators, and users of financial information—would be required. From your position as a member in one or more of those constituencies, are you prepared to accept that there will be differences in interpretation of standards? Are you prepared to make the judgments necessary to apply less-detailed standards knowing there is the possibility that your judgment will be questioned?

Many Council members believe that a move to principles-based standards appropriately would allow preparers, auditors, and users, rather than financial engineers, to interpret the standards and apply professional judgment. They note, however, that such a move will succeed only if regulators make a commitment to accepting that judgment.

Several Council members warn that inconsistency in practice will increase under a principles-based approach, which can further devastate user confidence in the quality of financial reporting.

The complete text of respondents' comments on Section C begins on page 65.

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Summary of Responses to Section D
International Activities

Section D of the survey noted that the Board is active in many international accounting activities and expends significant (and increasing) resources to do so, and asked whether this is an appropriate use of the Board's resources.

Generally, Council members' responses can be summed up as "Yes, but . . ." Most Council members believe that the Board's participation in international activities is not only appropriate, but imperative. However, many note that the Board should continue to be a leader in striving for international convergence of accounting rules, and not compromise inappropriately.

Several Council members advocate a more restrained approach, with a primary focus on U.S. issues.

The complete text of respondents' comments on Section D begins on page 89.

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Section A—The FASB's Priorities
Views of Respondents

The current financial reporting environment is one of uncertainty and transition affected by, among other things, corporate bankruptcies, accounting irregularities, and legislation to regulate the accounting profession. Given that environment, this year's survey started with a blank sheet of paper. If the FASB was setting its agenda today, what are the five most important issues the Board should address?

The table below summarizes the five issues that appeared most often in Council members' responses. Board member responses are shown for comparison. (The number that appears in each column represents a tally of the number of responses that mentioned that issue.) Because this year's survey was more subjective than in the past (for example, we did not include a predetermined list of FASB projects to rank), the summarized information presented below is not as meaningful as the individual responses themselves. Many responses that we received are thoughtful and compelling but do not lend themselves to inclusion in a statistical summary. Therefore, we encourage our readers to focus less on the tabular summary below and more on each individual response.

Topic	Council Members	Board Members
Revenue Recognition	19	7
Consolidations	13	4
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Business Combinations—Purchase Method Procedures	7	1

Individual responses appear below. We have included a brief reference to the issues cited by the respondent, followed by more detailed comments (if any) on each issue.

Council Members

Anderson
- Revenue Recognition
- Financial Performance Reporting
- Cash Flow Reporting
- Disclosures about Intangibles
- Accounting for Leases

Revenue Recognition. Revenue recognition is a central accounting issue, and the literature on revenue recognition has become inadequate as a result of:

- The increased complexity of the structures of transactions (for example, multiple-element transactions)
- A seeming increase in the volume of transactions involving “soft” amounts (for example, fair value of consideration received) and of uncertainties as to realizability
- Changes in the importance attributed by investors to reported revenue and trends in reported revenue.

The inadequacy of the current literature is evidenced by the number of restatements related to revenue recognition.

Financial Performance Reporting. Performance is, perhaps, the main focus of investors, and much has been said about perceived shortcomings of net income as a measure of financial performance. Although the project will be controversial, I believe significant improvements can be made. Furthermore, improving the reporting of financial performance would have a positive effect on the Board’s ability to resolve other important issues, such as reporting financial instruments at fair value.

Cash Flow Reporting. Cash is the lifeblood of economic activity, and information about an entity’s cash needs and its ability to generate cash receipts is essential to fulfilling the objectives of financial reporting. Although FASB Statement No. 95, *Statement of Cash Flows* (as well as other pronouncements) produced improvements in the reporting of such information, further improvements are needed and should be given a high priority.

Disclosures about Intangibles. There is considerable evidence of a need for improved disclosures about intangibles, and experience with disclosure of intangibles would provide valuable information about whether and how to proceed with other intangibles projects.

Accounting for Leases. Leases are significant items for many reporting entities. Current guidance on accounting for leases is unnecessarily complex, and it is well known that transactions easily can be structured to avoid the intent of that guidance. I can think of no good reason not to reconsider the accounting for leases without further delay.

Although not a suggestion for a separate project, a continuing concern is the understandability of GAAP. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is often cited as a standard that only a handful of people understand. But similar problems exist with other standards, for example, FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. If preparers and auditors cannot understand the standards, they cannot be expected to apply them properly. And if preparers and auditors have difficulty understanding accounting standards, how can those standards result in financial statements that users can be expected to understand?

Balhoff

Revenue Recognition
Simplification and Codification
Consolidations
Liability and Equity
New Basis Accounting

Simplification and Codification. Including evaluation of cost-benefit of requirements for standards for nonpublic companies.

Blakely

Root Cause Analysis of Current Accounting Weaknesses
Collaboration with External Auditing Governing Bodies
Cash Flow Reporting
Consolidations
Principles-Based Standards
Financial Performance Reporting

Root Cause Analysis of Current Accounting Weaknesses. The FASB needs to be viewed as a proactive and constructive organization in leading change resulting from the current and recent events impacting the financial reporting environment. To that end, I believe the FASB needs to have its own baseline. I would recommend that the FASB conduct a formalized, root-cause analysis and diagnosis of the current accounting weaknesses or vulnerabilities that led to or might have contributed to the problems at Enron, WorldCom, Dynegy, Reliant, and other major corporations. This root cause analysis should be followed by a prescriptive analysis of what accounting weaknesses or vulnerabilities the FASB could proactively address. I do believe this work should be formal and thorough, *not* anecdotal.

Collaboration with External Auditing Governing Bodies. The current and recent events also suggest there are weaknesses in external auditing practices as well. I believe that the FASB in formulating new accounting policy must closely interface with external auditing governing bodies that will be studying in parallel the weaknesses/vulnerabilities relating to external auditing. I believe insights, conclusions, and proscriptive change agendas would be much stronger and more effective as a result of collaboration and joint work.

Cash Flow Reporting. In financial reporting, the three principal statements are the income statement, cash flow statement, and balance sheet. Clearly one of the current issues if not weaknesses/vulnerabilities is the noncash nature of equity income and mark-to-market accounting that is recorded as book income. The significant difference between income and operating cash flow can potentially result in liquidity issues. In addition, this problem can potentially be aggravated by the classification as operating cash flow of transactions that may be more appropriately classified as cash flow from investing or financing activities. It may be appropriate to rereview for clarity the rules and definitions prescribing cash flow category classification. One other thought; might there be a reconciling statement between the income statement and the cash flow statement that clearly maps one statement into the other that enhances understanding and clarity?

Consolidations. The issue of consolidations is now being specifically addressed as it relates to SPEs. The broad area of consolidations is extremely difficult as evidenced by the fact a broader review has been periodically deferred by the FASB. As consolidation appears to be a part of certain recently identified accounting weaknesses it is probably time for a fundamental review of this accounting area.

Principles-Based Standards. Principles-based accounting appears to be a central substantiative matter in reaching convergence with the IASB in working toward global standards. Deploying the resources and effort to determine if there is an acceptable common position for both the IASB and FASB is a strategically important critical path step.

Financial Performance Reporting. The FASB has undertaken an initial project on financial performance reporting. Acceleration of this effort might identify financial metrics that might highlight certain of the financial issues underlying the current financial reporting uncertainty.

Bromark

Strategic Issues
Principles-Based Standards
Collaboration with the IASB
Reevaluation of the FASB's Relationship with Other Domestic Standard-Setting Bodies
Revenue and Liability Recognition
Financial Performance Reporting
Accounting for SPEs
New Basis Accounting
Measuring Financial Instruments at Fair Value

Strategic Issues. Given a blank piece of paper, we would first encourage the Board to consider strategic issues. While we recognize that there are a number of technical issues that are worthy of the Board's consideration (many of which are currently on the Board's agenda), we encourage the Board to take a broader view and consider the strategic imperatives the Board must address in order to achieve its goal of developing a strong, transparent, and rigorous system of accounting standards.

Principles-Based Standards, Collaboration with the IASB, and Reevaluation of the FASB's Relationship with Other Domestic Standard-Setting Bodies. When the Financial Accounting Foundation solicited our views with respect to certain proposals to streamline the standard-setting process last spring, we provided our thoughts on a number of additional topics that we believed were worthy of the FAF's consideration. In that letter, we advocated the study of such initiatives as the development of principles-based accounting standards, increased collaboration with the IASB, and a reevaluation of the FASB's relationship with other domestic standard-setting bodies. We continue to believe that consideration of those critical strategic matters should be at the top of the FASB's agenda. Moreover, we believe that given the current environment, the Board should develop an aggressive timetable for addressing these strategic issues quickly.

Revenue and Liability Recognition. With respect to technical topics, we believe that the Board should restrict its activities to substantial issues that have broad implications for the current financial reporting model. For that reason, we applaud the Board for undertaking a project on revenue and liability recognition. As we noted in our comment letter, we believe this is an extremely important project and considering the many practice issues that arise with respect to the recognition of revenues and the complexity of the current literature, one that demands the Board's attention.

Financial Performance Reporting. We believe the Board should comprehensively address the issue of reporting financial performance. We observe that the current financial reporting regime is commonly criticized for a narrow focus on a single measure of performance, that is, earnings per share. We also observe that in the recent past, an increasing number of alternative measures of performance (EBITDA, cash earnings, and the like) have achieved prominence, as users seek other metrics that will enable them to allocate capital more efficiently. We encourage the Board to comprehensively consider this issue, particularly in light of some of the provocative ideas advanced by financial statement users, academics, and other constituents about reporting value creation and risk. We believe that recent publications, *The Value Reporting Revolution* and *Building Public Trust—The Future of Corporate Reporting*, could be of value to the Board as it considers this project.

Accounting for SPEs. We support the Board's decision to undertake a project related to accounting for special-purpose entities (SPEs). In light of recent adverse developments in the financial markets caused in part by the use of such entities to hide debt from users of financial statements, this is a project worthy of the Board's immediate attention. We are hopeful that the project will result in greater financial statement transparency and encourage the Board to bring the project to completion quickly.

New Basis Accounting. We encourage the Board to reinvigorate its project on new basis accounting. As stated in prior years' surveys, we believe this project should be assigned a high priority by the Board. Accountants continue to struggle with the lack of a comprehensive model that addresses those situations where it is appropriate to apply fresh-start accounting, for example, in multiparty business combinations or joint venture formations. We would encourage the Board to reintroduce this project into its busy schedule, even if its addition would require slowing its current efforts on the project on purchase methods.

Measuring Financial Instruments at Fair Value. Lastly, we encourage the Board to continue its efforts as they relate to measuring financial instruments at fair value. We share the Board's views that fair value is the most relevant attribute for financial instruments and that all financial instruments should be carried in the statement of financial position at fair value when the conceptual and measurement issues are resolved. We are also cognizant of the many issues that have arisen in trying to develop comprehensive guidance in this area. Nevertheless, we encourage the Board to continue to address the conceptual and measurement issues that underlie accounting for financial instruments. We would observe that quick progress in measuring and reporting financial instruments at fair value would provide the Board with the opportunity to reconsider and replace the current standard on derivative financial instruments and hedging, which we believe is a very detailed and rule-based standard that is overly complex and difficult to apply.

Demski

Independence
Back to the Basics of Measurement
Strategic Analysis
The Larger Picture

Independence. The FASB's independence, its independence from its constituencies, from other regulators, and from the Congress. The importance of the Board's independence has grown with the passage of the Sarbanes-Oxley Act, and the new board it creates. Financial reporting cannot maintain and foster integrity if its governance is subject to political intervention, both explicit and implicit. (The analogy to government statistical services is instructive.)

Back to the Basics of Measurement. To what question is GAAP income, as envisioned by the FASB, the answer? For example, why is GAAP income not used in the national income accounts? The revenue recognition project is, I think, a case in point.

Strategic Analysis. What is financial reporting's comparative advantage as a corporate financial measurement system? Identifying and understanding its comparative advantage, relative to other measurement and information sources, is essential to rational management of the reporting system.

The Larger Picture. Should audit considerations be a part of the FASB deliberations; more broadly, should GAAP and GAAS be more tightly integrated?

Foster

Principles-Based Standards
Revenue Recognition
Shorten the Process and Volume

Principles-Based Standards. The Board should move to principles-based standards. This is a long-term but necessary project. Otherwise, it will take longer and longer with many more pages for each standard.

Revenue Recognition. For the reasons stated in your attachment.

Shorten the Process and Volume. This is not a standard but in order to be timely and avoid criticism, the process for standards must be shortened not only time-wise but the volume also. I really see this as the most important issue right now.

Goldman

Revenue Recognition—All rules in one place
Simplification of Accounting Standards—Organized in one series of pronouncements
Consolidation of SPEs
Consolidated Statements of Cash Flows—Revise to be more informative
Stock Option Accounting Disclosure
Goodwill—Methods to validate carrying at fair value

Guinan

Revenue Recognition
Business Combinations—Purchase Method Procedures
Accounting for Compensation Costs
Measuring All Financial Instruments at Fair Value
Fresh-Start (New Basis) Issues

Note: The Board is working on several important projects (including consolidation of SPEs, guarantor's accounting, and transition to a fair value measure of accounting for stock-based compensation) that will likely be completed by the end of 2002. We believe that those are worthwhile endeavors. However, because those projects will be completed in the short term and, thus, would not be an impediment to the Board's adopting its hypothetical "ideal" agenda in the long term, we have not included them in our list below. Rather, we have focused on issues that the Board should address to improve financial reporting in the long term.

Revenue Recognition. Issues surrounding revenue recognition should be among the Board's highest project priorities. Recent headlines suggest that SEC Staff Accounting Bulletin No. 101, *Revenue*

Recognition in Financial Statements, and various EITF consensuses related to the measurement or display of revenue are not consistently understood or applied.

We believe that an FASB project on revenue recognition should result in a standard that embodies broad general principles, which then could be used to address specialized industries and other specific issues. We believe that the FASB's project should focus on the threshold revenue recognition questions of when and how much. We concur with the Board's current approach to look at revenue recognition principles from the top-down and bottom-up.

We believe that whether gains should be defined separately from revenues is a fundamental issue that the Board would have to address in this project. We also believe that new disclosures would be inevitable as a result of the project.

<u>Business Combinations—Purchase Method Procedures</u>. In our response to last year's survey, we anticipated that eliminating the pooling-of-interests method of accounting for a business combination and replacing the amortization of goodwill and certain intangibles with an impairment test would raise numerous implementation issues that the Board would need to deal with in a project on purchase method procedures. We continue to believe that a project on purchase method procedures should be among the Board's highest priorities because of the relationship of the issues to those that the Board addressed in FASB Statement No. 141, *Business Combinations*.

<u>Accounting for Compensation Costs</u>. The significant swings in stock values over the last several years have caused radical swings in the funded status of pension plans. FASB Statement No. 87, *Employers' Accounting for Pensions*, permits the accounting for changes in both assets and obligations to be smoothed, thereby resulting in delayed financial statement recognition and measurement of pension costs. Pension costs are a significant cost of doing business in many industries. The smoothing effect in pension accounting may be more significant than the effect of not reporting the fair value of stock options as compensation expense. As reported in recent press accounts, the smoothing effect in the pension accounting area is more significant than the lack of fair value accounting for stock options, since pension funding deficiencies require cash funding notwithstanding the delayed cost recognition in financial statements.

At a minimum, we believe a reexamination of the pension accounting model is needed at this time. In addition, in view of the IASB's position on expense recognition for stock options, we believe that it would be appropriate for the Board to reconsider the accounting for stock options. Furthermore, the recent issuance of FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, has added yet another source of guidance for certain compensation costs. We believe that the time has come for the Board to conduct a broad review of the conceptual underpinnings of the accounting for all forms of compensation costs (Statement 87, FASB Statements No. 88*, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, No. 112, *Employers' Accounting for Postemployment Benefits*, and No. 123, *Accounting for Stock-Based Compensation,* and Statement 146), including considering the need for convergence with the IASB standards.

Measuring All Financial Instruments at Fair Value. The Board decided in Statement 133 that fair value is the most relevant attribute for financial instruments. Since reaching that decision, the Board issued a Preliminary Views and an FASB Special Report for comment. While those efforts are an important part of the Board's due process, much work remains to translate the Board's broad support for fair value measurement for financial instruments into an accounting standard. Instead of reactivating its efforts on the project in the later part of 2002 to issue an Exposure Draft that would replace FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, we urge the Board to set aside that effort in favor of working expeditiously to complete its broader agenda project on measuring all financial instruments at fair value and to reconsider whether Statement 133 should be superseded and replaced with a principles-based standard.

The Board's original support in Statement 133 for fair value as the measurement attribute for financial statements was tempered by a need to resolve conceptual and measurement issues. The scope of the Exposure Draft to supersede Statement 107 would have included, among other issues, providing more specific guidance about how to determine fair value for financial instruments. We believe that techniques for measuring fair value continue to develop rapidly and that the Board's project must keep pace with those developments. Thus, we urge the Board not to become bogged down by the myriad of issues that could further slow its efforts on this project. Consistent with our recommendation above on revenue recognition, we urge the Board to proceed with a principles-based standard on measuring all financial instruments at fair value and consider replacing Statement 133 with a principles-based standard for accounting for derivative instruments and hedging activities.

<u>Fresh-Start (New Basis) Issues</u>. We urge the Board to move forward expeditiously on its joint effort with the IASB. We would like to see the project on fresh-start (new basis) issues elevated from the Board's research agenda to its technical agenda in the short term. Financial engineers continue to create transactions that effect a change in ownership without a change in basis, and preparers and auditors need standards to deal with those situations.

We concur with the description in the Board's second quarter 2002 technical plan that the project should address multiparty business combinations or other new entity formations in which no single preexisting entity obtains majority ownership and control of the resulting new entity. The scope of the project also should include joint venture formations.

The Technical Plan also states that related issues that the Board might consider in this project are recognition and measurement of goodwill and other intangible assets in combinations or other transactions accounted for by the fresh-start method. In the interest of issuing timely guidance, we would be interested in seeing the Board adopt a dual-track project in which one project team would address the fundamental recognition and measurement questions and a second project team would address the so-called related issues, using the lessons learned from FASB Statement No. 142*, Goodwill and Other Intangible Assets*, as a starting point.

Humphreys

Fair Value
Codification and Simplification
Revenue Recognition

<u>Fair Value</u>. The predominant measurement principle required by recently issued standards is fair value. While the Board would argue that fair value is consistent with the conceptual framework, we believe that its impact is causing eroding confidence in the ability of financial statements to produce useful information. This is particularly true in those situations that require fair value measurement where there are no liquid markets or for certain remote or long-term liabilities that will never result in cash outlays equal to the amounts that are being recorded. It is time for the Board to undertake a project that will study the conceptual issues surrounding fair value measurements and that will be subject to full due process. We would expect this project to address the relationship of fair value measurement to the objectives of financial statements particularly taking into consideration usefulness and compliance costs. Until such a study is conducted, new standards issued under the mantra of fair value will have a declining relevancy to an expanding population of users.

<u>Codification and Simplification</u>. The projects outlined on the Board's research agenda for codification and simplification should be

undertaken immediately. However, the project on principles-based standards should have a higher priority than its description in the research agenda seems to imply.

<u>Revenue Recognition</u>. Until this project is completed, many companies, particularly in new technologies, will be in an uncertain environment.

Lackritz

Study of Restatements
Revenue Recognition
Accounting for Intangibles
Fair Value
Public Trust and Confidence

<u>Study of Restatements</u>. A study project on the causes of the large increase in earnings restatements from 1997 to 2002, along with recommendations for what should be fixed. Were most of the restatements a result of one or two standards? Because of ambiguity? Bending the standards? New transactions? Corporate or auditing fraud? There may already be much research on this, but I'm not familiar with it.

<u>Revenue Recognition</u>. With the growth of the information-based economy, financial engineering, new risk management techniques, etc., this standard ought to be reviewed, clarified, and simplified to the extent possible.

<u>Accounting for Intangibles</u>. This concept/standard has much greater urgency in an information-based economy with virtual companies with global reach.

<u>Fair Value</u>. Again, this project should get some steam under it, since "fair value" gives users/investors a much clearer understanding of the financial health of an enterprise than cost basis and the like. This effort should be accelerated and brought to conclusion.

<u>Public Trust and Confidence</u>. The FASB should undertake a project to ask broadly what other things the FASB can do specifically to help restore investor trust and confidence in the accounting numbers being released by issuers. This would be a broader inquiry that looked at substance, process, enforcement, education, and communication, for example.

Levin

Revenue Recognition
Financial Performance Reporting by Business Enterprises
Intangible Assets
Business Combinations—Purchase Method Procedures
Consolidation of SPEs

Revenue Recognition. Given that revenue recognition is the single largest category of financial statement restatements, we encourage the FASB to act with urgency on this project.

Financial Performance Reporting by Business Enterprises. I believe that one of the most vital roles of financial reporting is to allow readers to view the company's performance through the eyes of management. However, I also believe that there is a need for the FASB to bring some elements of consistency and conformity to those communications. Therefore, I believe that this project could represent an important advancement of financial reporting as long as the project doesn't limit, in any way, the flexibility of management to convey its financial information in the manner that it deems most meaningful to its investors.

Intangible Assets. As noted by the FASB, the amounts of intangible assets not reflected as assets on the balance sheet are very large. Further, those assets are among the most valuable holdings of modern-day companies. We support advancement in the area of disclosure, as long as the requirements are respectful of competitive concerns.

Business Combinations—Purchase Method Procedures. The issuance of Statement 142 will achieve an important goal of the FASB—the consistent use of a single method of accounting for business combinations. I believe that the project on purchase method procedures is important to further reducing inconsistencies in practice.

Livingston

Consolidation of SPEs
Revenue Recognition
Financial Instruments, Especially Measuring Fair Value
Simplification to Address Disclosure Overload
Business Combinations

Consolidation of SPEs. Given the high visibility of this project, priority should be given to completing it. With an Exposure Draft out for comment and the issues now being examined, hopefully the Board is in a position to finish deliberations and issue a Statement. However, the Board needs to be careful about the possible unintended consequences of the draft rules described in comment letters. In addition, there is a widely held view that the Exposure Draft is unreadable and not practical. I would encourage the Board to put some focused resources on a fast rewrite in plain English.

Revenue Recognition. Priority needs to be given to providing guidance to the many companies struggling with revenue recognition questions, especially those in the new technology sector. The acceptability of past practices continues to be a high profile issue. The numerous recent EITF rulings in this area need to be brought together under a strong "principles-based" standard in this area.

Financial Instruments, Especially Measuring Fair Value. There is a growing body of evidence pointing to problems associated with strict adherence to the concept of fair value in accounting standards. Maybe the time has come to step away from this conceptual purity. Situations requiring the fair value measurement of financial instruments where no liquid markets exist (for example, long-term energy contracts) and certain remote or long-term liabilities that will never result in cash outlays equal to the amounts being recorded (for example, certain loan guarantees and asset retirement obligations) appear to require an unacceptable level of subjectivity in financial statements and impair their comparability and usefulness. It's time to take another look at what we've done here.

Simplification to Address Disclosure Overload. This is a challenging project, but crucially important. It is disturbing to read in the press that financial disclosure has become so overblown that items are considered hidden when they appear in the footnotes. The time has come to take a fresh look, to clear out some of the redundancy and dead wood, and to incorporate a plain English approach to the statements and footnotes.

Business Combinations. Follow through and complete this project.

Nusbaum

Principles-Based Standards
Simplification of Standards
Convergence with the IASB
Stock Option Accounting
Revenue Recognition

Principles-Based Standards. The environment clearly indicates that we must go down the path of principles-based standards. None of us really knows exactly what this means or how it will be implemented; but I believe we will benefit by refocusing on principles and developing principles-based standards. Certainly the public expects us to develop principles-based on standards, and the FASB can either lead the effort or run the risk of having the process controlled by someone else.

Simplification of Standards. The hard part is that transactions are more complex than ever and will continue to get even more complex. Nevertheless, we need to develop standards that everyone can understand.

Convergence with the IASB. The world gets increasingly smaller, and we must try to develop standards consistent with the rest of the world. Having worked on global projects within my firm, I believe that results are better. However, the process takes longer, is more painful, and requires the commitment of all parties to succeed.

Stock Option Accounting. The time has come for expensing stock options. Nevertheless, we need to address a wide variety of issues before this is implemented. The valuation model needs work. Other aspects of Statement 123 should be reexamined. And, of course, the IASB standard should be considered.

Revenue Recognition. This is obviously a critical area and demands the Board's attention.

Parke

Revenue Recognition
Simplification and Codification
Consolidation of SPEs
Financial Performance Reporting by Business Enterprises
Stock Compensation Valuation

Revenue Recognition. The accounting rules for revenue recognition have not kept pace with the structure and complexity of sales transactions (for example, bundling arrangements in customer orders). The guidance in this area has evolved in an ad hoc manner and, thus, there is the need to ensure consistency across all of the narrowly focused pronouncements. As a result, this area suffers from the lack of a cohesive framework.

Simplification and Codification. There is a need to develop a set of principles that can be applied consistently resulting in financial statements that are an accurate reflection of a business's financial performance and strength. The objective in this project should be simplicity for the sake of accuracy and transparency. This project would also alleviate the current state of standards overload.

Consolidation of SPEs. It has become widely acknowledged that guidance is needed in this area because of the increasing volume of SPE transactions coupled with the fragmented and incomplete guidance in this area.

Financial Performance Reporting by Business Enterprises. This project needs to be broadened to include more preparer and user viewpoints on performance measurements, since the metrics will differ by industry. The FASB should obtain these viewpoints in the early stages of development of the project instead of waiting until a later field testing stage of development.

Stock Compensation Valuation. Given the level of recently announced implementation of the accounting (versus disclosures) required by Statement 123, we believe this is an area where better guidance on valuation issues is appropriate.

Pegg

Revenue Recognition
Expense Recognition
Consolidations Policy
Purchase Accounting
Research and Development Expenses

Revenue Recognition. There is inconsistent application of the available rules and guidance causing difficulty in understanding the earnings processes of companies and comparison of companies.

Expense Recognition. Hand-in-hand with revenue recognition, more guidance is needed on the matching of expenses with revenues.

Consolidations Policy. We need a rule that would require consolidation of entities controlled by another.

Purchase Accounting. There are numerous areas of purchase accounting that need to be addressed, including the measurement of assets and liabilities acquired, that cause confusion in understanding the post-acquisition impacts of a business acquisition.

Research and Development Expenses. Especially write-offs of in-process research and development. Although these expenses go through the income statement, too often they are ignored and disappear from the field of vision. Is the accounting treatment enabling this result?

Richards

Independent Standard-Setting Process
Financial Performance Reporting by Business Enterprises
Revenue Recognition
Disclosure of Intangible Assets
Business Combinations

Independent Standard-Setting Process. Spend more time actively defending and describing the independent standard-setting process. The FASB has done much good work. The business community, particularly the investment community, needs to be reminded of that. Both groups also need to know what we'll get if the private sector abdicates that responsibility. Everything starts here.

Financial Performance Reporting by Business Enterprises. Accelerate the project on financial performance reporting by business enterprises. Gresham's Law has been at work in recent years: ad hoc, incomplete, and unsupported measures of performance have been put forth, driving out older, more comprehensive measures. We need guidance in the form of an authoritative, coherent pronouncement on what is acceptable (and as important, what is not).

Revenue Recognition. Move ahead on the revenue recognition project. If it's going to take 10 years, or if the list of industry exceptions grows too long, the project will not succeed. But since improper or overstated revenue is the origin of many accounting irregularities, a clear Statement would do much to dispel some of the current mistrust of reported financial results.

Disclosure of Intangible Assets. Accelerate the work on disclosure of intangible assets. I'm probably in the minority here, but capital markets need more information about the source(s) of a company's competitive advantage. Software, biotechnology, and many service businesses depend in some measure on their intangible assets. The traditional accounting model doesn't tell us enough about what those are.

Business Combinations. Bring the project on business combinations to a timely conclusion.

Rickard

Stock Option Expense Valuation
Consolidation of SPEs
Revenue Recognition
Guarantor's Accounting and Disclosure Requirements for Guarantees
Recognition and Disclosures of Intangibles Assets

Stock Option Expense Valuation. The FASB should continue its recent fast-track efforts to revise Statement 123 by requiring the expensing of stock options. Particular attention should be paid to the valuation process. The inherent shortcomings of the current valuation guidance have been well published. Current rules are too subjective, plus many of the choices (for example, forfeiture rate assumptions), which can significantly impact the expense, are not required disclosures. These matters must be addressed to ensure a meaningful comparison between companies.

Consolidation of SPEs. SPE structures are continuing to play a large role in the operations and results of many companies. Compounding this fact is the increasingly complex nature of many SPE structures. The limited guidance that exists covering SPEs is clearly insufficient as has been demonstrated by the numerous companies disclosing SPE issues. Rules are urgently needed to help prevent the abuse of SPEs and to ensure companies that have valid business reasons to use SPEs have the appropriate information to make sound decisions.

Revenue Recognition. Revenue transactions are becoming increasingly complex (gross versus net, coupons, shipping and handling, middleman transactions, etc.). Revenue recognition guidance is clearly lacking as evidenced by the SEC's issuance of SAB 101 to assist companies with revenue issues. The need for revenue guidance is also evidenced by the fact that the single largest category of financial restatements is revenue recognition. Since revenue recognition is arguably the most important component of a company's results, and the fact that revenue transactions are continuing to increase in complexity, revenue recognition guidance should be a priority.

Guarantor's Accounting and Disclosure Requirements for Guarantees. Current rules are insufficient to deal with the complex guarantee structures that commonly exist today. In many cases these guarantees are material and present real risk that should be disclosed. The project should focus more on disclosure rather than recognition, since it is easier to describe a transaction versus valuing it. Although recognition is important, the more important consideration is disclosing the structure's existence. At the same time, prospective guidance should not unduly burden reporting entities that have numerous small guarantees, which are unlikely to have any material effect on future financial results. This project also should consider whether there are other off-balance-sheet transactions that do not use SPE structures or provide guarantees that need to be disclosed.

Recognition and Disclosure of Intangible Assets. Statements 141 and 142 address some issues concerning intangibles, but further guidance is needed to address implementation issues and inconsistencies. A major inconsistency exists between intangible assets that are recorded as assets when they are acquired but not when internally developed. Since many intangible assets result from internal development and hence are assigned little or no value, there are generally no disclosures covering these items despite their importance to many companies.

Rogero

Revenue Recognition
Lease Accounting
Business Combinations—Purchase Method Procedures
Worldwide Convergence of GAAP
Consolidation of SPEs

Revenue Recognition (including related costs associated with revenue). Several of the recent accounting debacles have dealt with revenue and cost recognition. Some explicit "principles" of revenue recognition could be very valuable. How should the "matching concept" be viewed? In some respects, there seems to be movement away from that concept.

Lease Accounting. For many years many constituents have been troubled by the overly prescriptive and mechanical approach we now have. If there was ever a chance for a principles-based approach, this would be it. A number of "off-balance-sheet" transactions were designed to just barely miss the capitalization criteria (for example, 89 percent versus 90 percent).

Business Combinations—Purchase Method Procedures. The FASB plan was to provide guidance about purchase method procedures, and that plan should be completed.

Worldwide Convergence of GAAP. This is a very important matter. I am very much against foreign public companies having the ability to register with the SEC and not account for transactions in a manner like U.S. counterparts, and vice versa in foreign nations. The tough issue will be determining the appropriate compromises, since most concerned people in this country don't want less appropriate standards even if done in the name of convergence. And alternative treatments should be the exception rather than the rule.

Consolidation of SPEs. This issue has taken on considerable significance in the wake of the Enron scandal. Opportunities to "creatively" remove liabilities from an entity's balance sheet should be limited.

Ryan

Revenue Recognition
Contractual Rights and Obligations
Recognize/Report Revisions of Accrual Estimates
Estimate Sensitivity and Risk Disclosures
Gross versus Net Accounting for Concentrated Risk Exposures

Revenue Recognition. The increasing prevalence of multiple-element sales agreements in which the elements are inseparable and the compensation is substitutable demands a single conceptually sound approach to revenue recognition. In addition, sales increasingly are of information goods (for example, entertainment content or software), which are distinct in various ways from real goods. For example, information goods often involve little incremental expenditures to provide to multiple purchasers, do not get "used up" in the conventional sense, and have an uncertain or indefinite economic life. Sale of information goods may involve significant opportunity costs or benefits, however. For example, entertainment content is licensed in both exclusive and nonexclusive arrangements. The opportunity cost of exclusive arrangements is generally higher. Should revenue be recognized differently in exclusive and nonexclusive arrangements, reflecting the different magnitude and nature of opportunity costs? Information goods are frequently subject to network externalities, which imply there might be opportunity benefits not costs to sale.

Contractual Rights and Obligations. Many of the issues arising from Enron *et al.* stem from weak or nonexistent accounting for contractual rights and obligations, of which financial instruments and guarantees are subsets. Signing contracts generally involves exchanges of rights and obligations. In many cases, the fair value of those rights and obligations can be estimated. I favor much broader fair value accounting for those rights and obligations, but at a minimum estimates of their fair value should be disclosed. Regardless of whether fair values are recognized or disclosed, revisions in those estimates should be reported on an ongoing basis. Relatedly, most SPEs are best thought of as (or perhaps should be defined as) conduits for contractual rights and obligations. In many cases accounting separately for the contractual rights and obligations is a better approach than consolidation (or not).

Recognize/Report Revisions of Accrual Estimates. A problem with accounting generally is that it is almost always impossible for users of financial reports to disentangle accruals made for new business with revisions of accruals for old business. (Property-casualty insurers loss reserve disclosures are a notable exception.) As a result, it is difficult to ascertain when accruals are manipulated. Revisions of all major accrual estimates (for example, loan loss allowances) for prior business should be disclosed separately. Relatedly, while I favor expanded fair value accounting for contractual rights and obligations, fair values are noisy and potentially biased estimates in many cases, and so separate reporting of revisions of prior fair value estimates is critical.

Estimation Sensitivity and Risk Disclosures. The quality and comprehensiveness of firms' estimation sensitivity and risk disclosures are almost uniformly abysmal. Most frequently, when they are made at all, those disclosures are made in boilerplate fashions that convey the minimal amount of information required under GAAP, rather than attempting to convey the accounting and economic uncertainty involved. A good example of this is the disclosures regarding retained interests from securitizations under Statement 140; virtually all firms report using a format used in an example in an appendix to that standard, despite the fact that this format is poorly conceived (for example, it does not reflect the fact that prepayment and interest rate risks are related). The FASB should devote considerably more time and care to required estimation sensitivity and risk disclosures when it writes standards, especially standards that involve fair value accounting.

Gross versus Net Accounting for Concentrated Risk Exposures. Increasingly, derivatives, securitizations, reinsurance, and other forms of structured finance partition the risks of underlying assets and liabilities across multiple parties. In many cases (for example, all derivatives and risky asset securitizations accounted for as sales), parties retaining substantial or most of the risk of the underlying assets record small net assets or liabilities despite having far larger gross economic exposures. In cases of sufficiently large risk retention, some form of gross accounting is preferable. Note that gross accounting is not inconsistent with sale accounting. For example, control over assets could transfer, allowing sale accounting, while risk is retained, making gross accounting preferable.

Sclafani

Consolidation of Certain SPEs
Simplification/Principles-Based Standards
International Convergence
Fair Value
Business Reporting Standardization

Note: We believe that these key items should be the FASB's priority and other projects currently on the Board's agenda, such as the amendment to Statement 133, should be reconsidered or be given a lesser priority.

Consolidation of Certain SPEs. The Board needs to develop a comprehensive model for consolidations that addresses the accounting and disclosure issues related to SPEs entities without negatively impacting the capital markets. Specifically, the Board should improve the recently issued Exposure Draft to develop a supportable consolidation model that improves comparability between enterprises engaged in similar activities. Of significant importance is the development of criteria for the financial SPE model that appropriately capture the substance of a risk dispersing entity.

Simplification/Principles-Based Standards. The complexity of recent accounting standards poses significant challenges for financial statement preparers. Preparers are required to become experts in an exhaustive series of technical rules to determine the appropriate accounting for common marketplace transactions. For example, the accounting standard for derivatives is almost 800 pages in length and continues to be interpreted today. In an effort to minimize or remove judgment from the accounting process, the FASB is establishing guidance that is significantly more difficult for preparers to implement, auditors to evaluate, and users to interpret. Further, an unintended consequence of the rules-based approach is that economically similar transactions may be accounted for in different manners. We do not believe that this result is appropriate. Please refer to Section C, Principles-Based Standards, of this survey for additional comments.

International Convergence. As multinational companies operate in many markets, the accounting standards need to be consistent. Convergence should not only be the goal for pronouncements already issued, but should be a factor for consideration in the current development of new GAAP. Incorporating the work of international standard setters in the development of U.S. GAAP will also accelerate the issuance of standards, since FASB can leverage from the work of others.

Fair Value. The Board should advance its overall fair value project, rather than addressing topical fair value issues individually through the EITF or other limited-scope projects. All related disclosures should be coordinated with other industry and regulatory bodies that are addressing reporting issues for fair value.

Further, we suggest that the FASB evaluate the recent efforts of the IASB with respect to IAS 39*, Financial Instruments: Recognition and Measurement,* where the IASB proposed a practical option to allow constituents to designate any financial asset or liability as a trading instrument. The IASB proposed this amendment in part because of the mixed-attribute accounting model for certain assets and liabilities.

Business Reporting Standardization. Standards need to be developed for key financial information statistics. GAAP net income provides some measure of comparability for financial information between companies; however, it may not always the best key financial indicator. Defined standards for key indicators need to be developed to ensure comparability and consistency between periods for a reporting company as well as among reporting companies. Furthermore, the Board should consider revisiting the working group study on the Business Reporting Research Project. The Board should seek further possible ways to eliminate or minimize current and future redundancies between GAAP and SEC disclosure requirements.

Stone

Framework for Identifying the Boundaries of the Reporting Entity
Revenue Recognition
Simplification Project

Note: The FASB is expected to address too many disparate issues each year. The Board could be more effective and efficient if its agenda were shorter and more focused. To the extent possible, the agenda should include conceptually related issues. This would allow Board members and staff to leverage their efforts, decrease start-up and training time, and increase comparability across standards. A possible agenda follows.

Provide a Framework for Identifying the Boundaries of the Reporting

Entity. This would be the key to addressing issues that will continue to arise because of the growth in alliance partnerships, outsourcing arrangements, and off-balance-sheet transactions. The Board's progress on the SPE project suggests they are working toward a framework. This framework needs to be articulated. The framework would provide a basis for issuing standards to correct the following problems.

- SPEs—a clear, coherent standard will be a first step in restoring users' confidence in accounting standards and the standard-setting process.

- Accounting for unconsolidated entities—this area of accounting needs an overhaul; trying to rationalize and refine the existing rules will not result in reporting that is transparent and reflects the underlying economic reality.

- Lease accounting—considered by many to be the prime exemplar of what is wrong with accounting standards.

Revenue Recognition. Completing this project will be another step in restoring users' confidence.

Simplification Project. This project should include clarifying the relationship between significant accounting policies (APB Opinion No. 22, *Disclosure of Accounting Policies*), critical accounting policies (SEC proposal for management's discussion and analysis), and AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. The intent behind all of these is to increase transparency; the result of all of them operating independently will be confusion for users and duplication of effort for preparers and auditors.

Wilhelm

Revenue Recognition
Business Combinations
Consolidation of SPEs
Standards Overload
Financial Performance Reporting by Business Enterprises

Revenue Recognition. Given the recent cases (Enron, Worldcom, etc.) defining exact rules in this area is the highest priority. In addition, this subject is developed together with the IASB.

Business Combinations. Phase II Purchase Accounting also is an issue of essential importance and should be finalized in a joint effort together with the IASB on a timely basis.

Consolidation of SPEs. For the reasons stated above, guidance on consolidation of SPEs has high priority.

Standards Overload. The growing complexity of the standards needs to be reduced. Also, please see Section C—Principles-Based Standards.

Financial Performance Reporting by Business Enterprises. Although this is a rather complex subject, there is a need for uniformizing key financial measures.

Board Members

Herz

Technical and Research Agenda
Improving U.S. Standard Setting
International Convergence
Constituent and Public Relations

An ongoing challenge for us is to properly balance the need to address the many urgent items on our agenda while also trying to move the ball forward toward our vision of the future of financial reporting.

Technical Research Agenda. While many, if not most, of the recent financial reporting scandals and wave of restatements have related to violations of existing rules and even fraud, I believe that some of them have highlighted areas for improvement in current U.S. accounting standards. These include the accounting and disclosures relating to special-purpose entities and guarantees, accounting for energy "trading" contracts and other long-term "trading" contracts, accounting for equity derivatives, the whole area of revenue recognition, and, of course, the subject of accounting for stock-based compensation.

Accordingly, I believe our highest priorities are to deal as quickly as possible with these problem areas. In that regard, we will shortly issue a final standard on guarantees, expect to issue a final standard on SPEs in the fourth quarter, have the EITF dealing with energy trading contracts, have undertaken a major project on revenue recognition, and are dealing with stock compensation—first with the transition rules for those voluntarily adopting the preferable fair value approach and then with whether to require that approach. And we are trying to enhance the disclosure requirements for all companies.

Next are other ongoing projects on our agenda that we need to finish up. These include our second-phase project on business combinations (purchase method procedures, etc.), disclosures about intangibles, and our projects on financial instruments—particularly the project on liabilities and equity because among other issues it deals with the accounting for equity derivatives and hybrid debt-equity instruments that have been a source of reporting problems and abuses in practice.

Third, I believe that there are a number of projects, some of which are on our current agenda and others not as yet, that are important in taking financial reporting to the next level. These include our projects on financial reporting by business enterprises and on disclosures about financial instruments. To those I would also add a project on the overall content of financial statements, aimed at improving the clarity and understandability of information in financial statements and the extent to which there should be additional disclosures of key information sought by users in quarterly financial statements. And I think we need to figure out the way forward on the whole subject of fair value accounting for financial instruments. The Board has stated that it believes this to be the end goal and evidenced by the continuing maintenance and implementation issues relating to FASB Statement No. 125*, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, Statement 133, FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and Statement 140, the existing mixed-attribute model is problematic. But it also is clear that many constituents (including some users) do not favor moving to a comprehensive fair value approach at this time. In my view, in order to move the ball forward, we need to develop a systematic plan to address the relevance and reliability concerns expressed by many. While our current project on improving the disclosures under Statement 107 is important in this respect, I think more will be needed, and I believe this is an area that is best explored on an international basis together with the IASB and other standard setters.

Next, there are a number of other major issues where I believe current accounting standards are deficient. I would put lease accounting at the top of the list, followed closely by pension accounting and accounting for intangibles. Again, because these are pervasive areas, consistent with our commitment to international convergence, I would have us address these together with the IASB. Similarly, I believe we need to address the subject of new basis accounting, given the inconsistent treatments that can arise for similar M&A transactions and the form over substance structuring opportunities that presents.

Finally, there is the subject of business reporting and greater disclosure of key nonfinancial information. While I strongly believe more needs to be done in this area, I do not think the FASB currently has the resources or is best positioned to lead these efforts. Rather, I think it will take some regulatory stimulus and cooperative efforts in the private sector on industry basis to move this forward.

Improving U.S. Standard Setting. U.S. standard setters, and in particular the FASB, have been criticized as being too slow, generating standards that are too lengthy, too complicated, and with too many exceptions and too many detailed rules, and for catering too much to the desires of preparers and auditors and too little to the needs of investors and other users. While I believe that many of these criticisms are valid, let's remember that the standards we currently have are largely a product of what people have asked for over the last 10 to 15 years in the context of the overall financial reporting, capital markets, and regulatory and legal systems in this country and that these standards and rules emanated not only from the FASB, but also from the EITF, AcSEC, and the SEC staff. Accordingly, any attempt to address the criticisms in order to improve U.S. standard setting must deal not only with how the FASB operates, but must also address the wider issues in the system. Thus, in my view, any proposed solutions must encompass:

- The FASB's agenda-setting and project-management processes—improving our speed and timeliness
- The structure of U.S. standard setting, including the roles and processes of the EITF, AcSEC, the SEC, and the major auditing firms
- Whether implementing a principles-based approach would be desirable, what it implies to other key constituents in the financial reporting system, potential advantages and disadvantages, and costs and benefits (See response in Section C—Principles-Based Standards.)
- Broadening the participation of users in our standard-setting processes.

The Board is committed to fully exploring these areas and to working with all key constituents in order to enhance U.S. standard setting and U.S. standards as part of improving our overall system of financial reporting in this country.

International Convergence. Please see my response under Section D—International Activities. Suffice it to say that I believe that international convergence and working with the IASB and other major national standard setters must be a high priority and must be an everyday part of what we do and how we operate.

Constituent and Public Relations. As noted above, the FASB operates within the broader context of the overall financial reporting and capital markets system. It is therefore critical that we work closely with and understand the needs and concerns of constituents, how our standards actually are implemented in practice, and how the information the standards produce are used in the real world. Over the years, the FASB has received relatively less input from investors and other users of financial statements than from other key constituents. To address this imbalance, we plan both to add additional users to FASAC and to create a series of user forums and user advisory groups. Similarly, it is very important that we get our key messages out and clearly understood—messages on the importance of independent standard setting and proper due process, messages about why sound and transparent financial reporting is so important to the proper operation of the capital markets and therefore to our economy and our society, messages about the importance of international convergence toward common high-quality financial reporting across the major capital markets, and messages that explain the whys and what-fors behind particular accounting standards. For all these reasons, I believe that active programs of constituent and public relations are important priorities for the FASB.

Crooch

Stock Compensation
International Convergence
Revenue Recognition
Financial Performance Reporting
Conceptual Framework

Stock Compensation. Expectations are high that we address. Must get to expense answer.

International Convergence. The FASB must work hard on convergence issues. SEC has political problems that they expect us to help them to address.

Foster

FASB's Conceptual Framework and Liability Recognition
Consolidations
Measuring Financial Instruments at Fair Value
Reporting Financial Performance
Lease Accounting

FASB's Conceptual Framework and Liability Recognition. The Board has a project on revenue recognition that encompasses a review of, and perhaps amendment of, FASB Concepts Statements No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* and No. 6*, Elements of Financial Statements*. This is an extremely important project because, in practice, the recognition criteria in Statement 5 often trump the definitions of assets and liabilities in Statement 6, even though it is clear the definitions have primacy. The Board needs to reconcile the two Concepts Statements to eliminate this conflict. The current emphasis of this project is on revenue recognition and that is appropriate. However, revenue recognition issues cannot be resolved without reference to assets and liabilities. Since the Board has to address the Concepts Statements, it would be appropriate to issue new standards addressing liability recognition based on the new definition of liabilities that results from the efforts in the project, particularly since the Board's constituents are not well-versed in the

Conceptual Framework and frequently recognize items as liabilities even though they do not meet the definitions.

Consolidations. This project has been on the Board's agenda for 20 years. The international standard setters are moving toward a consolidation policy based on effective control—which has been exposed by the Board twice. While the Board is attempting to shut-down SPE abuses, current consolidation practice permits controlled entities to be omitted from financial statements, thereby permitting off-balance-sheet transactions.

Measuring Financial Instruments at Fair Value. It is inarguable that fair value is a more relevant measurement attribute than any other. The Board needs to address the remaining measurement issues and get on with moving toward its goal of reporting all financial instruments at fair value.

Reporting Financial Performance. Completion of this project must be achieved before the Board will be successful in requiring all financial instruments to be measured at fair value in the income statement. In addition, this project presents an opportunity to provide information in a format that will override the reliance of analysts and investors on a single performance metric, such as earnings per share. It also presents an opportunity to provide some quantitative information about the effect that estimates have on reported information.

Lease Accounting. Much has been made about the problems of off-balance-sheet accounting. I do not have empirical evidence, but I suspect the amount of off-balance-sheet debt that is attributable to lease accounting vastly exceeds that resulting from SPEs. If transparency concerning an enterprise's obligations is desirable (and I believe it is), revising the leasing standard is imperative.

Schieneman

Principles-Based Standards
Revenue Recognition
Conceptual Framework
Fair Value
Financial Performance Reporting

Principles-Based Standards. A central issue in the post-Enron debate. Implications are very broad and would change behavior of auditors and preparers as well as the FASB. Principle-based standards, it is alleged, could reduce comparability in financial reporting. We should ask users how important comparability is. Consistency and comparability are used interchangeably by the Board and staff. They are separate attributes.

Revenue Recognition. Biggest gap in professional literature and causes majority of accounting problems.

Conceptual Framework. Essential for principles-based standards. I am particularly interested in:

- ♦ Better clarification of user needs—we should define decision usefulness from investor and creditor perspective.
- ♦ Clarify basis for trade-offs—relevance versus reliability; cost versus benefit.
- ♦ Pay more attention to needs of database users (databases derived from financial statements).

Fair Value. Project to update Statement 107 should be used to determine how and to what extent users desire fair value information. Accountants have decided fair value is the way to go and use the term indiscriminately without understanding implications. Will the current environment accept the degree of subjectivity and ability to manipulate inherent in fair value? Do users understand this and, if so, do they want it?

Financial Performance Reporting. Critical project in a fair value environment. Also, indirectly addresses pro forma issue.

Schipper

Consolidations
Reporting Revenues and Related Liabilities, with Appropriate Reconsideration of Certain Aspects of Concepts Statements 5 and 6
Revising the Format/Display/Aggregation/Classification of the Basic Financial Statements
Accounting for Employee Benefits
Reconsidering the Accounting for Off-Balance-Sheet Obligations Generally and Leases in Particular

Consolidations. The FASB has considered various aspects of this reporting issue for over a decade and has twice (1995 and 1999) exposed proposed standards on consolidations but has not been able to promulgate a final standard. The current project on SPE consolidations addresses an important element of the overall reporting issue, but SPEs represent only one aspect of the consolidations issue. There is a pressing need for a general standard on consolidation policy.

Reporting Revenues and Related Liabilities, with Appropriate Reconsideration of Certain Aspects of Concepts Statements 5 and 6. This issue has several components, including:

- Developing a general standard on timing of revenue recognition and the measurement of revenue; development of a general standard should considerably simplify the voluminous, complex, and largely industry-specific and transaction-specific existing guidance.
- Revising Concepts Statements 5 and 6 to eliminate inconsistencies between the earnings process/realized/realizable criteria of Statement 5 and the asset/liability criteria of Statement 6.
- Once Concepts Statements 5 and 6 have been revised, developing a general Statement on liability recognition, which would involve reconsidering FASB Statement No. 5, *Accounting for Contingencies*.

Revising the Format/Display/Aggregation/Classification of the Basic Financial Statements (Balance Sheet, Income Statement, Statement of Cash Flows, Statement of Shareholders' Equity). This project should also address at least some aspects of interim reporting (for example, what items that are currently reported annually should also be reported quarterly). This project represents a significant opportunity for international convergence, as well as a significant opportunity to increase the transparency and relevance of financial reports. Recasting the income statement to eliminate "other comprehensive income" as a catchall and to provide for appropriate classification, aggregation, and display of changes in fair values should also alleviate some concerns about increasing the use of fair value as a measurement attribute.

Accounting for Employee Benefits. To the extent the FASB adopts a principles-based approach to financial reporting, the various standards that lay out the accounting and disclosure requirements for these benefits (for example, Statements 87 and 88, FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and Statements 112 and 146) should be reconsidered in light of changes to the definition of liability undertaken as part of consolidations (item 1 above) and the adoption of Concepts Statement 7.

Reconsidering the Accounting for Off-Balance-Sheet Obligations Generally and Leases in Particular. Recent legislation (Section 401 of the Sarbanes-Oxley Act of 2002, which requires study and analysis of off-balance-sheet arrangements) has provided an impetus for this project.

Trott	Consolidation of SPEs Revenue Recognition

Improving the Definition of a Liability
Reporting Financial Performance
Interim Financial Reporting

Note: I would have listed guarantees as the number one priority but that work is essentially completed.

Consolidation of SPEs. This is and has been the major practice issue in the consolidation area for some time. It also is currently a political issue.

Revenue Recognition. This is a widely reported practice problem area. Current guidance is not consistent from industry to industry.

Improving the Definition of a Liability. The alternative of selling an obligation by issuing stock should not result in the obligation being treated as equity.

Reporting Financial Performance. This is an opportunity to get better communication of financial information into the capital markets.

Interim Financial Reporting. Quarterly financial statements have become a major communication to the capital markets. However, there has not been enough attention paid to how interim measurements are made and what information should be included in these communications.

Wulff

Simplification
Reporting Financial Performance
Revenue Recognition
Fair Value Measurement Guidance
International Convergence

Simplification. Transitioning to principles-based standards.

Reporting Financial Performance. Improving the usefulness of financial statements, especially the statement of income; include an amendment to Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, to better define decision usefulness to users.

Revenue Recognition. Including an amendment of Concepts Statements 5 and 6 to eliminate inconsistencies between the earnings model incorporated in Concepts Statement 5 and the definition of liabilities in Concepts Statement 6.

Fair Value Measurement Guidance. Including an amendment to FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, to clarify reliability versus relevance trade-off.

International Convergence. Development of an action plan (including agenda decisions) to achieve substantial progress in less than 5 years.

Other Constituents

Ciesielski

Reconsideration of Statement 123
Reconsideration of Statement 87
Quarterly Disclosure Needs of Users
Disclosure Adequacy of Accruals and Estimates
Financial Performance Reporting

Reconsideration of Statement 123. There's not much to discuss about this. Accounting treatment of options under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, has long been ludicrous, and Statement 123 represents a missed opportunity that does not need to be re-hashed here.

Presuming a value of zero for options granted is nonsense in the first place. Apart from just bad accounting, we've also seen its after-effects. There is no need to be a criminal psychologist to understand that the behavior of individuals can change for the worse when there is no monitoring of their actions. Opinion 25 does not permit market participants to efficiently monitor the actions of managements partaking in option awards.

This is the best chance that the FASB may ever have to reform the accounting. Whereas there was once widespread corporate opposition to the Statement 123 treatment, companies are now announcing their adoption of it on almost a daily basis. If you tune in analyst conference calls, you'll hear the question posed to management constantly: Are you going to expense stock options? Generally, the response is that it is being considered—but that any decision will be postponed until it is seen if everyone else is adopting that accounting policy.

I understand that the Board is monitoring the IASB share-based payment project with an eye toward convergence. But if there was any expedient way to accelerate the process of putting all companies on even footing by eliminating Opinion 25 option accounting once and for all, I'd strongly recommend it—without waiting for convergence.

Reconsideration of Statement 87. Much has been made about the shrinking contributions of pension assets to the bottom lines of American companies as a result of the bear market. Much has also been made of the desire to present earnings with smooth trends in them for the sake of appeasing Wall Street, and the fostering of "earnings management" mentalities.

Statement 87 is 15 years old, and while it was a vast improvement at the time of its implementation, it is now time to reexamine it. There are a number of things that deserve reexamination:

- The expected return on plan assets cost component is a dubious concept at best. Aside from smoothing swings in pension cost, it does not impart information about what happened during a particular accounting period. Rather, it obscures what actually happened with regard to plan asset performance.

- The amortization of certain items, that is, net actuarial gains and losses, transition amounts, and prior service costs, all aid in the presentation of smooth pension cost. It is also arguable that those items relate to events that provide no future benefit and might be more properly recognized immediately in pension cost rather than spread over future periods.

- The income statement geography of the components of pension cost is also an item that should be revisited. For instance, service cost is certainly something that belongs in operating expenses. Interest cost is related to financing, however, and it also doesn't relate to any debt the company carries. Perhaps it is time to consider whether interest cost belongs in pension cost at all; perhaps it's time to consider whether it might be better represented in another part of the financial statements.

- The income statement geography of net pension cost is unclear to users. For companies with significant inventories and/or self-constructed assets, there could be significant amounts of net pension cost on the balance sheet. Yet the footnotes will only show the aggregate results, which could lead to mistaken inferences about the effects of pension plans on net performance.

- The available choice of computing expected returns on a market-related value of plan assets lacks any reason for being other than to present a smoother trend in expected returns—which is not much of a reason for being, in my view.

- Statement 87 presents a view of the pension assets at fair value and the projected benefit obligation at a derived amount, which is probably as close to a fair value as one can get. The problem is that a firm's future pension contributions hinge on ERISA-based calculations of the pension liability, which differ from the Statement 87 calculation. One cannot look at the funding status presented in the GAAP financial statements and make a confident guess at whether or not additional contributions will be required in the near future—nor what the amounts will be. I can assure you that in the current climate, investors really want to get a handle on what future contributions might be necessary in firms.

I don't pretend to have answers to all of the issues I raise here, but I do believe that the size of pension plans and the murkiness of their accounting make the reexamination of Statement 87 an urgent agenda topic.

<u>Quarterly Disclosure Needs of Users</u>. Millions of investment decisions are made based on quarterly results each year; the quarterly reporting of results is a major event for investors and analysts. Yet the reporting

requirements for quarterly financial statements have never been addressed by the FASB or its predecessors. The closest attempt was by the Accounting Principles Board in 1973 with APB Opinion No. 28, *Interim Financial Reporting*, which really addressed the nature of interim accruals rather than reporting requirements.

FASB Statements are written with the annual reporting package in mind. For instance, the standards related to the two agenda suggestions above do not call for disclosure of the same kind of information on a quarterly basis as for annual reports. Yet significant amounts of option activity occur each quarter, and the net pension results can be significant relative to any one quarter's results. The presence of such information in quarterly financial reports could have a material effect on the judgments of investors and analysts, but there is no FASB-required disclosure—and there are no SEC-required disclosures that compensate for this lack.

When new standards are developed, quarterly disclosures are not given much consideration. (There is one exception: FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, on segment reporting. The quarterly reporting requirements of that standard actually seem to be designed with the financial statement user in mind.) I believe that there is never much impetus to require quarterly disclosures because there is a huge body of FASB literature that doesn't require it. The thinking seems to be "why should any new standard be different?"

A clean sheet of paper is needed. An agenda project should be added for the review of all existing standards to determine which disclosures should be added to a more complete quarterly earnings package. (Statements 133 and 140 provide good examples of Statements that should provide current disclosures more than just once a year.) I realize that the SEC has been working in the opposite direction in making quarterly reporting arrive sooner—but I believe that better quality information is needed, not necessarily poorer quality information arriving in investors' hands sooner.

Disclosure Adequacy of Accruals and Estimates. A firm can easily orchestrate its income by changing its estimate of warranty expense, its restructuring liabilities, its allowance for doubtful accounts, its loan loss reserves, or its expectation of goods to be returned. A single journal entry affecting any one of these accounts could bring about a desired result. Changes in assumptions about depreciable lives of assets, pension asset returns, and securitization transactions can also work bottom-line magic.

The fear of earnings management runs rampant these days, and by its very nature, accrual accounting lends itself to manipulation. It would be less likely to occur, however, if there was required disclosure of the activity in the accounts that are the easiest to manipulate. The FASB should consider a project that would require disclosure of activity for the sensitive accrual accounts that can affect earnings, such as the ones listed earlier. Analysts would then have insights into the ways these accounts affect net income—and would be better equipped to decide what those earnings are worth. In fact, earnings management might be somewhat neutralized: if management knows that earnings management actions are observable, then they might hesitate to partake in such activities.

This should be considered as part of the suggestion above for the study of quarterly disclosure adequacy.

Financial Performance Reporting. I believe that the FASB technical plan for this project should be expanded to take into account the above suggestions on quarterly disclosure needs of users and disclosure adequacy of accruals and estimates. I believe these projects could be discrete projects on their own, but they might be effectively woven into the existing project.

Durbin

Revise Statement 123—Options should be expensed.
Quarterly Disclosure—More 10-K-like details should be provided in the 10-Qs.
Revise Statement 87.
Disclosure Adequacy of Accruals and Estimates.

Disclosure Adequacy of Accruals and Estimates. Better disclosure on activities in the sensitive accrual accounts that can affect earnings. Any material changes should be made public and very clear.

Fender

International Convergence
Accounting for Employee Stock Compensation
Accounting for SPEs
Accounting for Leases

International Convergence. It is important for the IASB to succeed as an entity, and it is equally important for the FASB to work toward a single set of accounting standards in use throughout the world.

Accounting for Employee Stock Compensation. Particularly in light of the number of companies adopting the fair value expense model under Statement 123, the choice of providing significant expense information only in note disclosure is illogical.

Accounting for SPEs. Recognizing that this project is already under way, we believe it should be one of the highest priorities.

Accounting for Leases. The lease accounting literature is sorely in need of overhaul and could be a prime candidate for the emphasis shift from rules-based guidance to principles-based guidance.

Fisher

Defined Benefit Pension Plans
Accounting for Stock Options—Expensing stock options and a consistent valuation methodology
Accounting for SPEs and Off-Balance-Sheet Structured Finance Vehicles
Consolidation of Entities Effectively Controlled
Operating versus Nonoperating Income and Expenses—Sale of assets, hedging, pensions, etc.

Defined Benefit Pension Plans: Real-time asset and liability valuation, classifying pension cost components as operating or financial, and more clearly disclosing the off-balance-sheet liability if the pension is underfunded.

Joseph

Consolidations
Expensing of Stock Options
Estimates and Accrual Reversals
Cash Flow Reporting
Pension Accounting
Quarterly Disclosures
Restructuring Costs

Consolidations. From Boston Chicken to Enron, a whole raft of investors has been taken for a ride because of artful interpretation of the consolidation rules. Define control from an economic benefit point of view (which I believe was the intent of the consolidation project) rather than the cutoffs used in AICPA Accounting Research Bulletin

No. 51, *Consolidated Financial Statements*. Incidentally, PFIs have become the rage (at least till the market got spooked by Enron) in the UK. Convergence between FASB and IASB should address this issue.

Expensing of Stock Options. This is the golden moment! Kill Opinion 25 and tighten Statement 123 to require expensing. Let us see if the tech companies can wheel out the politicos in this environment. At a minimum show the impact on EPS at the bottom of the income statement rather than in the footnotes as we currently do for cash interest and taxes at the end of the cash flow statement.

Estimates and Accrual Reversals. Require management to disclose in a footnote the assumptions used to make estimates (pension mix between fixed and equity investments, bad debt estimates, tax provisions, inventory reserves, warranties, etc.). Also, disclose any accrual reversals and the effect on income. This should be mandatory for quarterly reports.

Cash Flow Reporting. I use the financial statements to forecast future operating cash flows. The presentation today is a mishmash of financing and operating cash flows that requires constant adjusting. For example, investing cash flows include sale and purchase of short-term securities. Technically, this is an investing decision but in economic reality it is a (temporary) allocation of excess funds to short-term investments that by itself is net present value neutral while capital expenditures is an investment in the operations of the business which is all I care about. Similarly, the interest expense component of pension expense should be reclassed into interest expense in the income statement. Ideally, I would love to have interest expense (from debt this time) to be reclassed in the cash flow statement from operating cash flows to cash flows from financing activities.

Pension Accounting. I have written about the reclass of interest expense from pensions. However, disclosing the mix of fixed and equity investments will allow me to gauge the reasonableness of the rate of return assumption. Rather than use actuarial assumptions of shortfall use the ERISA definition to compute the liability as this would be (I believe) actual cash liability that the firm needs to meet. The bottom line is that with the exception of the service cost all other Statement 87 items should be removed from operating expenses and shown in the other financial income/expense line.

Quarterly Disclosures. All the above should be disclosed quarterly. There is no reason why with today's information systems companies cannot do this within 10 days of the close. It would also be useful to get segment detail quarterly.

Restructuring Costs. Management should disclose in a footnote the actual cash restructuring costs in a year, the amount of the original provision, the accrual reversals, etc.

Landsman

Determining How and When Convergence with IASB Project Activities Is Appropriate
Consolidations
Accounting for Intangibles
Accounting for Compensation Using Stock Options and Other Contingent Claim Instruments
Accounting for Financial Instruments

Determining How and When Convergence with IASB Project Activities Is Appropriate. The FASB must take a leadership position in issuing accounting standards that ensure transparency of financial reporting by firms trading on U.S. exchanges—including foreign-based entities. Failure to be responsive to pressure from IASB initiatives could result in the FASB surrendering its leadership role in U.S. standard setting. To remain relevant, the FASB must develop a systematic way to determine when it should work jointly with the IASB and when it is appropriate to work separately.

Consolidations. Nearly four years ago the Board issued a revised Exposure Draft, *Consolidated Financial Statements: Purpose and Policy*, that would have required that a controlling entity (parent) consolidate all entities that it controls (subsidiaries) unless control is temporary at the time the entity becomes a subsidiary. The Exposure Draft also proposed a definition of control. Because of pressure from reporting entities and others who cited that the definition of control was difficult to operationalize, the Board backed off from the project. In response to the Enron scandal, the Board issued an Exposure Draft, *Consolidation of Certain Special-Purpose Entities*. Clearly, this is a band-aid for what is perceived by all to be a serious problem, but, by design, the proposed standard is limited in its application and the broad issues of control and consolidation need to be dealt with in a comprehensive standard.

Accounting for Intangibles. In the recent business combination standards, the Board deliberately limited issues of measurement and recognition of intangible assets to purchased intangibles. However, issues relating to accounting for internally generated intangibles and those intangibles acquired as part of a business combination are essentially the same or at least have much in common. The Board needs to develop a comprehensive standard because internally generated intangibles play an increasingly important role in equity valuation as the proportion of firms in the economy with large amounts of intangible assets—high tech, biotech and service firms—continues to grow. This might involve a multiple step project, with sequential disclosure, recognition and measurement standards.

Accounting for Compensation Using Stock Options and Other Contingent Claim Instruments. The Board should consider modifying

Statement 123 by requiring all affected firms to include the effects of fair-value-based measures of compensation in reported income. This is one example where it appears the IASB is taking the lead in developing a standard that requires recognition instead of pro forma disclosure. Given various bills have been introduced in Congress requiring conformity of tax and financial reporting measures of stock-based compensation expense, it's essential that the FASB act promptly so that GAAP accounting in this or any other area isn't made in the political arena.

<u>Accounting for Financial Instruments</u>. The Board has been working on this project for at least a decade. This is another example where the IASB might set the agenda or arrive at a conclusion with which the Board might not be fully comfortable. In my view, a comprehensive standard that addresses issues of recognition and measurement of fair value changes in income will render the derivatives standard obsolete in that the hedge accounting band-aid will no longer be needed.

Rosenfield

Simplification!!! (and retrievability of *all* accounting rules)
International Convergence
Recognition by the FASB of the differences between publicly and privately held entities. Exclude privately held entities from most of your pronouncements.
Become a bit more conservative—worry less about what financial analysts want.
Think "long-haul" rather than one quarter or one year.
Revisit all old pronouncements per your charter.

Wallace

1. Develop a dictionary of terms within GAAP and proscribe alternative definitions within any presentation claiming conformance with GAAP. Include threshold guidance but in all cases address the dominance of economic substance, prudent man, and fairness of presentation in jointly assessing quantitative and qualitative factors in the specific context being evaluated.

2. Develop an omnibus opinion that removes the proliferation within the standards of legal form guidance rather than a focus on economic substance. Let lawyers issue legal opinions and accountants measure economic activity. Legal structure may not reflect economic substance, and too often accountants have been directed to elevate the former via explicit guidance.

3. Related to 2, both revenue recognition and executory contracts are areas where both SAB 101 and the Exposure Draft, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, appear to be elevating legal form over economic substance. Think of economics as offering a structure conceptually, in need of practical measurement, and law as designing a structure tailored to compliance with legislation. Accounting evolved as the practical and careful reflection of the substance of economic activity, measured in relevant time frames of use to a broad spectrum of stakeholders. This focus is in need of restoration.

4. The friction between relevance and reliability will persist in standard setting and I urge consideration of two-column reporting on (1) a pure historical cost basis and (2) a pure market basis, rather than the current hybrid approach to accounting. This will effectively communicate sources of volatility, the role of management decisions relative to market movements, and the result of actual market exchanges alongside hypothetical exchanges.

5. The recent SEC proposals and discussions of transparency appear to ignore two key research findings: (1) numbers appearing on financial statements are used to a far greater extent than those appearing in notes to the financial statements and (2) benchmarking and data mining activities value quantifiable and comparable attributes. In other words, a few pages describing how uncertainty could influence a few estimates reflected in accounting reports do not provide a systematic or holistic picture of uncertainty that might be compared either across time or industries. Standard setters should not leave alternatives as to where information is located and ought to prescribe tabular and quantified depictions rather than narratives whenever feasible. Thought should be accorded to historical literature that suggested the reporting of intervals and ranges rather than point estimates for entire financial statement presentations. At least that would have some chance of providing an integrated reflection of uncertainty's effects on the entity's operations, financial position, and cash flows. The pick-and-choose discussion approaches now proposed will add little information.

Woodyatt

Disclosures about Intangible Assets
Revenue Recognition
Financial Performance Reporting
Purchase Method Procedures
Measuring Financial Assets and Liabilities at Fair Value

Disclosures about Intangible Assets. This is one of those areas where investors need more information despite corporate concerns of "disclosure overload" as "hidden" assets are often a subject of considerable investor interest but with limited information available.

Revenue Recognition. This is in need of comprehensive review. The SEC obviously thinks so, and many of the major accounting irregularities that have recently come to light seem to involve this area. Congress and the public would presumably like to see this effort.

Financial Performance Reporting. This is an important issue. It is most important, however, with regard to press releases at quarterly reporting time, which, unfortunately, seems to be outside FASB's sphere of influence.

Purchase Method Procedures. This is an important project not only from the standpoint of international harmonization but also due to the impact on capital flows between countries and fairness in competition for cross-border mergers and acquisitions.

Measuring Financial Assets and Liabilities at Fair Value. Success in measuring financial assets and liabilities at fair value will result in a better residual indication of what the acquiring entity is paying for goodwill and/or other intangibles, which can then be the focus of investor analysis.

♦ ♦ ♦ ♦ ♦

Section B—Tomorrow's Issues
Views of Respondents

Some have criticized the FASB for being reactive rather than proactive, responding to financial reporting problems after practices have become entrenched and then taking a long time to address the issues. Section B of the survey asked for respondents' views on the following two questions:

What are the financial reporting issues of tomorrow that the Board should start thinking about today?

Comments of Council Members

Anderson — The Board should continue its work on the forward-looking financial reporting issues it is already aware of, such as intangibles, valuation, nonfinancial metrics, and the implications of technology for business reporting in the future.

Balhoff — Is the financial reporting model appropriate for the users of tomorrow? Does it capture the information necessary to analyze the performance and potential of an entity, and should it?

Blakely — Do we have the appropriate accounting rule-making groups in place with governance processes in place to insure proper coordination among rule-making groups, regulatory bodies, external auditors, stock exchanges, Congress, and preparers? I appreciate this is a process-architecture issue, but it will importantly set the framework.

Mark-to-market accounting. I don't know what the answer is, but there is a growing community of cynics out there who believe it is not working. Among the issues are earnings that are not cash and the objectivity of the estimating process.

As discussed earlier, I worry the current three principal financial statements—income, cash flow, and balance sheet—do not always adequately allow the user to understand the issues in reconciling the income statement to the cash flow statement.

The chief financial officer, in conjunction with the controller and other senior officers and finance staff, continually use judgment and estimates in preparing financial statements. I do not believe a sufficient percentage of the user community fully appreciates the extent of estimates and their impact on reported financial results. Consequently, I think a high future priority is the role of estimates, their disclosure, and the parametric impact of alternate reasonable assumptions.

Bromark

Some of the items noted in our response to the previous question are also items that the Board will necessarily be considering well into the future. For example, we suggested that the Board undertake studies of certain key strategic initiatives, including principles-based standards and international convergence. Any plans arising from those studies would necessarily require periodic updating in response to the rapidly changing, increasingly globalized business world.

Consistent with our earlier recommendation about a comprehensive project on reporting financial performance, we believe the Board should continue to consider the integration of information that lies outside the financial statements but that is necessary for a user to make informed decisions about a company's current operations and prospects for the future. We observe that the Board has undertaken similar projects in the past, most recently in its business reporting research project. We note that the Board has a project on disclosure about intangibles on its agenda currently. We encourage the Board to continue its efforts in this area with a goal of developing a comprehensive model for business reporting.

We encourage the Board to continue to reassess the current "mixed" model, which includes historical cost, amortized cost, net realizable value, and fair value measures. We concur with the Board's view that fair value measures provide the most relevant information for investors, creditors, and other users of financial statements. We therefore expect that over time, the financial reporting model will continue to require greater use of fair value measures. We observe, however, that there is very little guidance about how "fair value" is to be determined, particularly in instances where there is not a quoted price that can be obtained through an active market. There is likewise little guidance about the valuation of individual separable assets and liabilities (for example, those that are identified in a purchase business combination) when each of those components contributes to the aggregate cash flows that are representative of the value that exists. As part of its efforts in this area, we encourage the Board to consider providing a principles-based framework with respect to valuation methodologies so that current (and future) standards that require use of fair value measures are consistently applied.

Finally, we encourage the Board to reconsider existing standards that may no longer be sufficiently robust to render transparent financial information. We suggest the Board identify those standards (for example, the current standard on lease accounting) and begin to replace them with standards based upon broad principles (for example, a principles-based standard on accounting for executory contracts that would supersede the current leasing standard) that more closely reflect the economics of the underlying transaction.

Goldman — See responses to Section A.

Guinan — A threshold issue that the Board needs to consider is its role in restoring investor confidence in the U.S capital markets. The Board's project on financial performance reporting by business enterprises would serve as a keystone in providing investors and creditors with improved information on financial performance and cash flows. We encourage the Board to implement the recommendation of the project task force to expedite certain aspects of the project to provide fast-track solutions to facilitate the needs of investors and creditors. Another threshold issue is how the FASB's and IASB's existing standards should converge in the intermediate or long-term. We urge the Board to add this effort to its research agenda in the short term.

Lackritz — Financial engineering continues to create many new opportunities to manage risk more effectively. How should these innovations be accounted for? Should financial services have separate rules?

Real time reporting—how to make such disclosures as helpful as possible

International issues—continued emphasis

Levin — Fair value reporting

Livingston — Simplification to address disclosure overload

Reexamine the advisability of a "conceptual pure" approach to standard setting, starting with fair value

A guide to implementing hierarchical, HTML financial statements.

Nusbaum — Pension accounting—with the volatility of the investment markets, we need to reconsider if the accounting for pension and other retirement plans should be reexamined.

Fair value versus historical cost accounting and cash flows—we have an inconsistent usage of fair value versus historical cost accounting. From a practical standpoint, that inconsistency must continue. We need to constantly reexamine what is appropriate in each circumstance. In addition, we need to look at the disclosure issues related to historical cost, fair values, and cash flows. Increased disclosure in this area, presented in an understandable format, might help users without adding undue costs or burdens.

Depreciation and basic accounting issues—the Board should begin reexamining some of the basic accounting issues. Depreciation standards have not been looked at in many years. Similarly, other basic accounting issues should be reexamined.

The Board needs to become aware of the next set of complicated transactions that investment bankers will be selling or developing. While that is somewhat reactive, trying to predict these economic trends and products will allow the Board to constantly look into the future.

Parke — The Board should consider adding a project on accounting for bartering transactions, especially given the recent publicized issues in this area.

Pegg — Performance reporting (already on agenda)—the use of "adjusted" earnings has become more prevalent in valuation. The FASB, as it is doing, should stay abreast of evolving valuation methodologies with an eye toward ensuring that the information provided by GAAP is being interpreted correctly, and whether useful additional information could be made available in an effective manner.

Richards — Accounting for postemployment benefits—a protracted period of poor investment returns or losses combined with optimistic actuarial assumptions may raise questions about the adequacy and relevance of the smoothing approach used in the current pronouncements.

Though I've given a specific example above of an existing pronouncement that might require some tweaking and fine-tuning to improve its relevance, I do not favor a standard-setting approach that requires the Board to scan the horizon for the next "big issue." I support the conceptual framework project not because it provides a detailed roadmap (it doesn't), but because it provides general arguments and approaches that offer some guidance in handling many issues. My hope, perhaps unrealistic, is that, given almost any accounting issue, we have enough of a conceptual understanding in hand to craft a reasonable first pass at a solution.

Rickard — I think the premise of the question is wrong, that is, that it takes the time it takes, so let's start earlier. The issue is the process. The FASB needs to increase its efforts under its project on codification and simplification. It also needs to address the rule-making process itself since many issues take too long to address. This is the most serious issue facing the FASB in terms of its continued existence and credibility.

Rogero — The entire area of "fair value" is very subjective, with the opportunity for significant differences in results coming from apparently small differences in assumptions. For example, a 1 percent swing in assumptions as to growth, discount rates, and similar matters can cause a company to impair (or not impair) goodwill. It seems like much of accounting is moving to be more subjective and less objective. In the increasingly litigious environment of today, we need to be careful to not expose companies and their employees to the ravages of good-faith estimates being second-guessed.

Ryan — See responses to Section A.

Sclafani — We identified business reporting standardization as a priority of the Board. In this project scope, the Board has stated it is considering ways to coordinate GAAP disclosure requirements with SEC disclosure requirements to minimize redundancies and to present financial information in a comprehensive and understandable manner to users of financial statements.

An example of necessary coordination is the SEC's proposed rule, *Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting*, in which the Commission proposes the rules to determine what critical accounting estimates require disclosure.

A significant amount of disclosure is already provided for these items under existing requirements in the footnotes. Implementation of the SEC's proposed rules could require that current disclosures be repeated in a section of MD&A as critical estimates. To minimize the burden for preparers of financial statements as well as make financial statements clearer to users, such repetition needs to be minimized.

Stone — Although FASB members need to talk frequently with constituents and be aware of developments in business, finance, and the economy, I am not convinced that their time would be well spent trying to forecast future financial reporting problems. The details of the problems that lead to calls for new standards vary. However, the basic questions the FASB needs to answer in order to respond remain the same. (For example, is it within or outside the boundaries of the business entity? Is it an expense or an asset?) From this perspective, the FASB would be better off spending its time working to ensure that its conceptual framework provides a sound basis for reasoning to solutions to emerging problems.

Wilhelm Definitely principles-based accounting to reduce the complexity and the variety of the existing rules; furthermore, international convergence, given the 2005-2007 deadline for European companies in order to convert to IAS.

Comments of Board Members

Herz As implied in my response to Section A—The FASB's Priorities, I think that some of the financial reporting issues that the Board will need to address over the next few years will include:

- Better defining the content and organization of financial statements to improve understandability and to incorporate more of the information needed by users, such as additional quarterly data.

- Figuring out the way forward on financial instruments by either moving to a comprehensive fair value approach or by simplifying the current rules, particularly those relating to accounting for derivatives and securitizations. In this regard, we need to closely monitor the outcome of the IASB's project in this area.

- Looking at areas where the current accounting standards result in accounting that is not meeting needs of users and/or is very form-driven, such as leasing and new basis issues relating to M&A transactions, joint ventures and partial business combinations, and pension accounting.

I also think we need to monitor the development and spread of XBRL as a medium of reporting and financial analysis, as this could have implications to the world in which we set standards.

Crooch	Not sure I know. This criticism is a red herring. We rarely run out of issues (never) when we are trying to solve current problems. Constituents resist change most when the change is perceived as not needed, that is, before the issue is a problem!
Foster	I believe this is a red herring. Granted, the Board takes a long time to address issues and should try to accelerate its processes. However, the principal issues that need to be addressed have long been known. They are consolidations, reporting fair values, and lease accounting.
Schieneman	Continuous reporting—could lead to more emphasis on timely reporting of data as opposed to periodic financial statements. Most users use only selected parts of financial statements at the current time. XBRL—spread sheet environment. What are the implications to financial reporting? Comparability of classification implied by this conflicts with where we are going on performance reporting. Intangibles—need to better communicate the assets and the effect on profitability.
Schipper	There are two parts to this criticism. One part of the criticism concerns delay in responding, and this criticism is justified. The second part concerns lack of awareness of issues, and here I think the criticism is perhaps less justified. I believe that the Board is often aware of the general issues (although perhaps not directly aware of certain specific entrenched practices that sometimes give rise to colorful publicity in the financial press). For example, the Board has long been aware of the issues surrounding consolidations when the usual approach to analyzing "controlling financial interest" does not work; the publicity surrounding the use of SPEs just points to a specific instance of this general issue. I believe that issues surrounding valuation and measurement will become increasingly prominent. As the use of fair value estimates (as well as other estimates) in financial reports increases, the Board will have to consider whether to provide valuation and measurement guidance and, if so, what form this guidance should take. If the Board chooses *not* to provide valuation and measurement guidance, this decision also will have consequences.
Trott	Better reporting of liabilities and the impairment of receivables—

	this effort would include the replacement of Statement 5 and expanding the use of fair value for both initial and subsequent measurements.
	Determining how to deal with uncertainty in fair value measurements.
	Expanding financial reporting to include the identification and reporting of key nonfinancial metrics.
Wulff	The implication of increased real-time reporting capability on accounting and reporting standards, including changes to financial statement presentation, reliability versus relevance trade-offs, and cost versus benefit.

Comments of Other Constituents

Ciesielski	I have no suggestions as to what might be "tomorrow's financial reporting issues."
Fender	Working toward a single basis of accounting. The mixed model of some fair values and some historical costs in financial statements needs to be addressed such that both sides of the balance sheet are in sync. Moving toward more fair values is preferred.
Fisher	Debt disclosures with better off-balance-sheet tables. Disclosure of the status of key corporate governance factors, as these issues can set a company up for future accounting manipulation and other risks.
Landsman	I cannot think of any particular accounting issue beyond those listed in Section A. However, a key policy decision is whether the Board wants to continue to follow a rules-based standard-setting approach, a principles-based approach (as more or less practiced by the IASB), or a flexible approach that falls somewhere in between.
Rosenfield	You have a lot of "reactive" items to clean up before your become proactive. It shouldn't take six years to get a statement done!
Wallace	Standard setters' reaction tendencies have resulted in an other-than-neutral reflection of economic activity. The timing of Statement 5 led to embracing the low end of range in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, when a measure of central tendency would be more informative (in tandem with the width of the range). Likewise, when inflation waned, attention to its effects economically

similarly waned. The Board should identify economic factors affecting economic entities and objectively set neutral guidance before the fact. Issues include the avoidance of "off-the-financial-statement" activities, as well as known distortion of measurement theory (for example, use of intrinsic value rather than option model valuation).

Woodyatt — One reality of the capital markets is that the primary impact of quarterly results occurs when they are first announced, not when SEC filings are made. Corporations continue to increasingly ignore or belittle GAAP in these communications. The resulting proliferation of earnings-per-share concepts is now being added to by others trying to correct the problem because nobody with authority will step forward. This is not good for our capital markets!

How can the Board position itself so as to become aware of potential financial reporting issues sooner?

Comments of Council Members

Anderson — The Board's relationship with bodies such as FASAC, AcSEC, EITF, FEI, and the SEC staff should position the Board well to become aware of emerging financial reporting issues. The Board should continue to make maximum use of those resources.

Balhoff — I believe that input from FASAC should be helpful in making the Board aware of issues relating to each constituency.

Blakely — I believe the Board members have sufficient continuing dialogue with all relevant constituencies to know what the issues are in a timely manner. I believe the key to responsiveness is prioritization of the available time of the FASB Board and staff members so more time is spent on new strategic reporting issues and less on technical interpretations. In this regard I believe principles-based standards might be a help in freeing FASB Board and staff time.

Bromark — We had previously set forth our ideas about the FASB's relationship to other domestic standard-setting bodies in our aforementioned response letter to the FAF. In that letter, we described a structure in which standing industry and technical committees would be formed. Those committees would comprise individuals with deep industry and technical knowledge; such committees would be similar to those formerly utilized by the AICPA. Membership on the committees would rotate periodically in order to ensure a constant flow of fresh thinking. While we noted that those committees would provide industry-specific expertise to the Board during the standard-setting process, we also believe that those committees would be an excellent means for the Board to become aware of emerging financial reporting issues and, in so doing, address them more timely.

Demski — The Board is, essentially, a governance device, and it should be well equipped to monitor the reporting environment and quickly and cogently respond as new governance issues arise. Dealing with tomorrow's issues is, in other words, more an issue of being organizationally prepared than being clairvoyant in anticipating the next set of issues. Is the organization well structured and well staffed in this respect? For example, is the skill set in the present staff appropriate? Does the Board spend an appropriate amount of its time on these "forward-looking" issues?

Foster — Perhaps an agenda item for FASAC at every meeting could be, what are the coming financing issues, crises, etc.? Most times probably nothing will be determined by these sessions, but when you get that one great idea then it will all have been worthwhile.

Goldman — Discuss with informed users of financial statements, including sell- and buy-side analysts as well as close dialogue with SEC.

Guinan — The EITF, as designed, is the Board's first line of defense in early identification of emerging issues. However, a majority of the EITF's efforts are devoted to addressing practice problems in implementing authoritative pronouncements. See our comments on a suggested solution under Section C.

Almost as important as identifying potential financial reporting issues sooner is having the resources to address those issues without diverting resources from the initiatives already on the Board's agenda. The Board has projects on its agenda (for example, consolidations and distinguishing between liabilities and equity) that have made slow progress, in part, because the Board frequently has to reallocate resources to the high priorities of the day (for example, SPEs, guarantor's accounting, derivatives, and stock options) which often take considerable Board and staff resources for long periods, even years. We urge the Board in about a year's timeframe to evaluate whether its recent staff realignment is working to achieve a proper allocation of resources between long-term projects and the day-to-day issues faced by the Board.

Lackritz — Continue to use FASAC and other outside groups, including groups of analysts and other buy-side professionals to flag potential reporting issues sooner, and do it systematically.

Livingston	Narrow the scope of projects and zero in on solving the specific issues that need to be addressed. Use modern project management techniques (time lines, milestones, critical decision dates) to complete projects on time. Projects that drag on too long get in the way of the Board's ability to deal with new emerging issues.
Nusbaum	Increased communication with the investment banking community Use of economists to predict trends (although frequently wrong, there is a benefit of considering different economic scenarios and the potential outcomes) Increased communication with user groups Increased communication with preparers and accounting firms.
Parke	I would recommend the Board develop a process to track the trends in categories of EITF issues and determine whether these trends are indicative of the need to establish new standards.
Pegg	Continued user interface—possibly a series of town meetings with investors discussing problems they encounter and issues that concern them.
Rogero	The Board and the staff should be alert to changes that seem to be going on in the general economy. Reading the financial press and periodically meeting with the SEC and various industry trade groups should provide information about major issues. Sometimes matters being deliberated by the EITF and noted in speeches and other publications provided by the SEC can provide information about likely future issues. Interacting routinely with the IASB might also aid in that effort.
Ryan	I think this is largely the wrong question. The FASB already has the EITF, which does a quite good job of identifying emerging issues. Unfortunately, the EITF frequently does a sloppy, insufficiently-insulated-from-pressures job of resolving those issues; for example, its previous decision that prepaid swaps are derivatives in their entirety exhibits no evidence of clear thinking. It is critical that the FASB get out of EITF mode, responding to the crisis du jour with poorly conceived rules. Relatedly, it is critical that the FASB write broader standards that do not separately compartmentalize highly related topics, as it is

currently doing by treating guarantees separately from entirely analogous insurance contracts. Poorly conceived, compartmentalized accounting rules that only appear to deal with the crisis du jour are fertile ground for subsequent accounting arbitrage. I think the EITF needs to be converted, in large part, from a writer of narrow rules that reflect specific emerging fact patterns to a framer of general problems that reflect those fact patterns. These general problems should then be considered by the FASB with its usual degree of care.

Sclafani — A greater number of the Board and staff members should be drawn from industry.

Shorter term limits on the Board could help ensure members are current in their knowledge of business issues. Additionally, the Board should consider whether term limits are necessary for staff members for the same reasons.

The Board should make greater use of industry resources as well as FASAC.

Wilhelm — I think the Board already is positioned well on this behalf. Close cooperation and communication with other standard setters, especially the IASB, is important.

Comments of Board Members

Herz — I think there are a number of steps we can take and are taking to better position ourselves to become aware of potential reporting issues:

- We are trying to increase the participation of users in our process by creating user forums and a user advisory group. I would also like to get some users on the EITF.

- We are likely to propose adding two members of the Board to the EITF agenda committee and increase the overall participation of the Board in the EITF's activities.

- We have done some refocusing of our quarterly meetings with the SEC staff to specifically include discussion of the types of issues and trends they are seeing, not only in the Chief Accountant's Office, but also in their filing reviews in the Division of Corporation Finance and in the SEC's enforcement activities that may have standard-setting implications for us.

- I believe we need a similar focus in the many liaison meetings we have with preparer and auditor groups.

- I don't know whether this would be possible, but I believe we could also get some very good intelligence on emerging financial reporting issues from the structuring people at the major public accounting firms, investment banks, and the lawyers who work with the investment banks in structuring new financial products and corporate finance and M&A transactions.

Finally, I expect that the new Public Company Accounting Oversight Board and its staff will be able to provide us with insights on how our standards are being implemented in practice, including any recurring problem areas that need our attention.

Crooch — This goal is one I thought the EITF served (and probably does). The Board, I believe, has an understanding of where the issues are from—the EITF and SEC. The problem may be that we don't formally attempt to isolate those issues.

Foster — The Board is aware of the issues. It simply hasn't addressed some of them.

Schieneman — Use liaison groups.

Board members should use contacts—particularly important for user members.

Closer relationship with the SEC—current problems

CPA firms—more formal feedback of current practice issues.

Schipper — I think the Board relies on its external constituencies, including FASAC, to advise the Board on financial reporting issues that should be addressed.

Trott	More candid and constructive discussions with the SEC, auditors, financial engineers, analysts.
Wulff	Better understand information technology trends as they relate to financial reporting.

Comments of Other Constituents

Ciesielski	Financial reporting issues seem to be instigated by preparers with the goal of goading users into believing that things are not what GAAP is telling them. One good example: pro forma earnings. If the FASB would like to get an "earlier" idea of what financial statement preparers are doing to endear themselves to investors, maybe there should be a dedicated staff person or two whose job is to be a sort of mock analyst: someone who tunes in 20 analyst calls per quarter and tries to function as an investor using financial statements. Think of it as an intelligence-gathering function. Also, consider having quarterly public meetings in New York that would be aimed at users. By cultivating more contacts with users, it might be easier to learn what issues are being seen by them in dealings with companies.
Fender	Periodic discussions with investors, CFOs, business school faculty, etc. Consider some other mechanism for responding to pressing issues other than EITF. It seems that between long-term projects and EITF, there aren't resources to address the larger-than-EITF issues in a timely manner.
Fisher	Be more aware of which industries are experiencing slowing revenue growth and rising capital needs. Companies in these industries are most prone to slowing growth and, thus, accounting manipulation.
Joseph	The investing community needs to be far more involved, and this is our fault as we have stood by and allowed CFOs and audit partners to hijack the process. While asking any investment person to give up his full-time job is probably utopian, regular contacts (every six months) with a group of users (credit and equity analysts) would be beneficial. Also, reading some of the "quality of earnings" type reports (such as CFRA, etc.) would shed some light on current abuses.

Landsman	Continue to meet with preparers and, particularly, user groups on a frequent basis.
Rosenfield	Pay more attention at EITF meetings.
Wallace	Establish a help line and track queries and responses in tandem with reviewing agenda suggestions generated by the EITF. Encourage regulators to communicate their concerns early on to facilitate timely attention and avoidance of a growing schism between public and nonpublic entities' reporting framework.
Woodyatt	As I've previously suggested, I think there should be at least one person on the FASB staff who works solely on disclosure and reporting issues and who has considerable liaison with users. In addition, creation of a users advisory council could be quite helpful.

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Section C—Principles-Based Standards
Views of Respondents

In January 2002, the Board agreed to undertake several actions in response to concerns raised by constituents about the quantity, complexity, and lack of easy retrievability of U.S. accounting literature. One of those actions is to evaluate the feasibility of issuing standards that are less detailed. Section C of the survey asked several questions concerning the issue of principles-based standards.

A move to standards that are less detailed would require an understanding of the implications for all the Board's constituencies. What are the implications that the Board should consider? What are the arguments for and against issuing less-detailed standards?

Comments of Council Members

Anderson

Arguments for:

- Less-detailed standards might be more understandable, which would be a significant benefit to preparers and auditors. More understandable standards might reduce the instances of inadvertent departures from GAAP.

- If making the standards less detailed involves reducing exceptions, that has the potential for improving the quality of reported information.

- Less-detailed standards might make it more difficult to structure transactions to circumvent the intent of an accounting standard.

- Less-detailed standards would allow auditors to use more judgment in determining the acceptability of an accounting method in particular circumstances. Auditors can currently avail themselves of an AICPA Rule 203, *Accounting Principles*, exception. However, the difficulty of justifying a Rule 203 exception discourages the use of such auditor judgment.

- Less-detailed standards might help mitigate standards overload. (However, standards overload might not be mitigated if mandatory implementation guidance were provided separately.)

Arguments against:

- Less-detailed standards might result in significant diversity in the way the standards are applied, especially before practice concerning a new standard has jelled.

- Less-detailed standards might result in more pressure on preparers to use, and on auditors to accept, aggressive accounting techniques.

- Less-detailed standards might be interpreted in practice in a way that most closely resembles what preparers would like the standard to be, which might be at odds with what the Board intended. Such interpretations might quickly become legitimized as predominant practice.

- It is unrealistic to believe that some standards, such as Statement 133, could be implemented in practice with a reasonable degree of consistency in the absence of detailed guidance.

- Deliberating implementation details forces the Board to consider more thoroughly whether the main principles of a standard are sound.

- The SEC may be unwilling to accept more diversity in the application of accounting standards. Resulting restatements may be disruptive to financial markets and may result in legal claims against preparers and auditors.

Balhoff — For less-detailed standards:

- Financial reporting that is designed to reflect the substance of transactions taken as a whole.

Against less-detailed standards:

- You will always have preparers, auditors, and regulators looking for rules.

Blakely — Use of estimates, judgments:

- What are the standards to be followed?
- Will there be safe-harbor provisions?
- What are the certifications/penalties?

What disclosures would be required?

- Key assumptions
- Impact of reasonable alternate assumptions.

Corporate governance:

- What are the rules and responsibilities of the external auditors, the audit committee, the board, the CFO, controller, and senior officers?

Bromark

As we have stated in prior correspondence with both the FASB and the FAF, we strongly support a move toward principles-based accounting standards. In our comment letter on the Board's project on the recognition of revenues and liabilities, for example, we expressed a view that the Board should "evaluate the feasibility of issuing standards that are less detailed and have few, if any, exceptions or alternatives to the underlying concepts." We remain committed to that view.

We acknowledge that today's more detailed standards do embody principles. However, those principles are frequently accompanied by detailed rules that attempt to address all issues associated with an accounting transaction. We believe that principles-based standards that eliminate such detailed rules will yield financial information of a higher quality, that is, information that is consistent with the notions embodied in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. Concepts Statement 2 sets forth such important notions as relevance, reliability, comparability, and consistency. We encourage the Board to develop principles-based standards that are consistent with the attributes embodied in Concepts Statement 2 as a key element in the Board's mission of developing standards that "provide information that is useful to present and potential investors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence." (See FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*.)

Principles-based accounting guidance will likely result in a simplification of accounting and financial reporting requirements and will refocus accountants on capturing and reporting values that are created by the substance of a transactions and any changes to those values. In other words, principles-based standards would bring focus to the economics and substance of transactions rather than the form. Such standards will therefore necessarily shift the responsibility for interpreting the broad guidance and its application to specific transactions to financial statement preparers and their auditors.

Auditors would ensure that preparers' accounting is appropriate and reflects the substance and spirit of the transaction and the accounting principle.

The coupling of principles-based accounting standards with improvements to the current financial reporting model, such as transparent disclosure of business activities and accounting policies, improved integration of information disclosed outside of the financial statements with information reported in the financial statements, and the use of plain English in all financial reports, we believe would provide the flexibility that is needed to give stakeholders information that is understandable, reflective of the economic intent of the transaction, and more relevant for today's decision-making purposes.

We also note that business leaders, investors, and other users of financial statements have recently become more vocal in supporting a migration to standards that are less detailed. We read with interest an editorial by Walter Wriston, the former chairman of Citicorp, "The Solution to Scandals? Simpler Rules," *The Wall Street Journal,* August 5, 2002, decrying "FASB rules that run to 700 pages on how to book a single transaction." In light of such criticisms and, more importantly, in light of the recent exposure of certain "structured transactions" that have been designed to meet the letter of a particular rule-based standard but that ultimately result in opaque financial reporting, we can envision few compelling arguments in favor of heavily rule-based standards.

Those who oppose the development of principles-based standards apparently fear that such standards will give preparers too much latitude in their application, diversity in their application, or the potential for an increase in disagreements among preparers, auditors, and regulators. As more fully discussed in our response to the next question, we do not believe that those fears are of sufficient weight to overcome the many benefits we believe would be derived from principles-based standards.

Demski — Transactions are surely designed with today's rules and guidance in place, and arguably "over-designed" in a variety of instances. It seems to me we have reached the point where variety in application should be substituted for "over-designed" transactions. Here I think the Board has a leadership role to play. It has not been overwhelmingly successful at writing detailed rules with lots of guidance. This suggests it experiment with more abstract rules, and leave the implementation to those on the front line. Notice this requires that the Board exercise some independence.

That said, this opens the door to increased heterogeneity in application, and second-guessing one's judgment. But it also means the response to the general, abstract guidance provided by the Board is more appropriately delegated to those who have responsibility for the report.

Goldman

I believe that in the United States it is best to state the underlying principles first, similar to the overview section of the MD&A, and then provide detail including examples. We continue to have very sharp accountants and bankers and lawyers that will attempt to meet the letter of the law, and it is best to spell it out, in my opinion, with hard rules and regulations.

Guinan

There always is a healthy tension between the scope and nature of a project, and the time necessary to complete a project. We believe that detailed rules-based standards, as contrasted with more principles-based standards, require more time to complete as the FASB or its staff often is asked to provide significant implementation guidance about follow-on issues either through FASB Technical Bulletins, FASB Interpretations, or EITF consensuses. In the long run, that adds considerable time to the standard-setting process. While that result may seem counterintuitive, it arises because financial engineers develop transactions that fall just short of the bright lines that often are drawn in detailed rules-based standards. Inevitably, there will be pressure on the FASB and its staff to provide ongoing implementation guidance about follow-on issues in those situations.

If the Board moves toward more principles-based standard setting, we believe that the Board must reconsider whether and how it continues to provide implementation guidance, particularly through its EITF (presumably Technical Bulletins and Interpretations would be issued far less frequently in a principles-based framework). Currently, the EITF assists the Board in (1) early identification of emerging issues that affect financial accounting and reporting and (2) addressing problems in implementing authoritative pronouncements. If the Board moves toward more principles-based standards, we believe that it would be appropriate to undertake a formal review of the mission and structure of the EITF to determine whether its mandate would continue to include addressing implementation problems.

Finally, if the Board were to pursue a more principles-based approach to standard setting, there likely would continue to be requests for initial implementation guidance or examples. We don't find these requests to be inconsistent with a principles-based approach, and we would encourage the Board to present implementation guidance and examples in future guidance to provide preparers, auditors, and others with a better understanding of the Board's principles. Stated in a different way, the Board should define what it means by "principles-based" standards to include initial implementation guidance and examples.

Humphreys — This project is needed. The proliferation of rules is staggering and it seems that the appetite for more is never satisfied. We recognize that there is not a common understanding of the definition of principles-based standards and that adopting such standards may be infinitely more difficult than might be expected. We would expect that principles-based standards will require changes in the way constituents prepare and use financial statements as more judgment and discipline will be needed. Also, there may be some deterioration in comparability among companies. However, if applied appropriately, we believe that principles-based standards will result in a more accurate reflection of the economics underlying transactions, which far outweighs any other consideration.

Lackritz — The primary question to answer is whether principles-based standards will improve the quality of information in the market place. The discussion cannot be had in a vacuum at 50,000 feet, but must focus on comparisons of the same standard drafted as "rules-based" versus "principles-based." Issues to consider are (1) ease of gaming the system, (2) ensuring consistent applications of "principles," and (3) how to bring simplicity and clarity to a complicated and complex world.

Levin — I support the approach currently used for standard setting—that is, standards based on a conceptual framework and supported by more detailed implementation guidance.

I look to the history of standard setting in the United States and observe that the Accounting Principles Board issued what I would call "conceptual-based standards" in the 1960s and early 70s. But these conceptual-based standards are apparently insufficient as evidenced by the (growing) demand for more detailed guidance and as well as substantive inconsistencies observed in practice.

The process evolved, therefore, into today's U.S. framework of Concepts Statements, standards, and implementation guidance (provided through a number of sources).

I would offer a suggestion for improvement, however. The FASB and the SEC must make clear that accounting *concepts* (principles) have the same weight and authority as rules. For example, if accountants apply certain prescribed rules and achieve a certain result, they must also stand back and question whether the outcome results in a faithful representation of the facts. If there is tension between the *concept* and the *rules*, that tension must be resolved and disclosed.

Further, as the United States continues to work with the IASB toward the international harmonization of accounting standards, we stress the importance of maintaining a balance between concepts and rules. As we have seen in the United States, there can be much diversity in practice over even very simple concepts. As the U.S. accounting stage broadens to an international one, the use of conceptual guidance only, we believe, would increase the risk of even greater diversity in practice.

Livingston

A move to principles-based standards is a worthy goal. It will require a change in approach by everyone involved—the SEC, auditors, and corporations. To some extent, the stage is being set for these changes, with the advent of increased public awareness of the importance of quality financial reporting, the pressure being felt by audit committees and corporate boards to show a strong commitment to quality financial reporting, establishment of a new public accounting oversight board to provide backbone to the profession, and new leadership at the SEC and FASB.

Nusbaum

We are strong supporters of principles-based standards. The primary advantage is a focus on substance over form. The preparer and auditor would focus on complying with the principles rather than creating transactions to avoid rules. The obvious disadvantages would be less comparability and potential for abuse. The key ingredient for success or failure is the acceptance of diversity in practice by the SEC. The SEC may need to get more involved in some of the "unique" situations, or be willing to accept a wider range of potential accounting treatments. The Board must consider the right balance between principles and guidance. The Board should start with some examples and see how they evolve. Also, the Board must make sure that the principles are clear and easy to understand. Vague or overly complicated principles defeat the purpose. Also, the

Board must decide on its role in the implementation. Users and auditors will ask for (or develop) implementation guidance, including examples, and the Board must consider its role in these. Overall, principles-based standards have the potential to significantly improve accounting and reporting.

Parke Although principles-based standards are a sound and fundamental approach the Board should strive to achieve, the principles need to have a clear concept underlying them in order for this to succeed in order to avoid ambiguity. Principles, by their nature, require an underlying clear concept, whereas rules need far more interpretation and supplemental guidance. An example of a principles-based standard which has withstood the test of time is Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*.

Pegg The foremost concern would be a lack of consistent application. But I believe there is already inconsistent application of the underlying principle with many current "rules-based" standards. So if principles-based standards can be properly interpreted, inconsistency may be the result of valid underlying reasons. But users will need to be able to understand these reasons and the impact. Sufficient detail on accounting policies and practices would have to be provided to enable users to understand and compare companies' results.

An underlying concern would be if the principles are being properly applied. Companies, their management, accountants, and their auditors would all have to step up to ensure proper application. I believe a level of comfort on this issue can be achieved with sufficient disclosure.

Rickard Principles-based standards would be a mistake in my view. On the positive side, Statements would probably be issued quicker, since detailed guidance would not have to be resolved. On the negative side, principles-based standards defeat the purpose of the guidance, that is, to ensure proper and consistent recognition and disclosure. The most difficult and subjective part of most accounting rules is the implementation. Many unforeseen questions arise during implementation that require companies to interpret the guidance. This interpretation is typically where the problems are created. It seems many of the issues the SEC deals with involve interpretations of the rules. This puts companies in a difficult position in that they want to record the transaction properly but there is no guidance, which forces them to use judgment, which in turn opens them up to criticism of their judgment. If we move to a principles-based system, this will almost surely result in an increase in interpretation questions to both the FASB and SEC, which will ultimately force the FASB to issue interpretation guidance.

Rogero Issuing principles-based standards implies that organizations can easily understand a standard's true intent. Standards should state unequivocally the intent of a pronouncement. For example, all leases should be capitalized…period. Standards will only be effective if organizations have the "character" to follow the intent as opposed to looking for "work arounds." I have heard of situations in which companies and their consultants operate by thinking that if a standard does not expressly prohibit a practice with a specific rule, then it is "fair" to adopt that practice. All too often, financial services providers approach companies to provide ways to "beat the system." Perhaps the unfortunate events of the past eight months to a year will prompt organizations to take the principled approach. In the rapidly changing world, a principles-based standard could make imminent sense when it is issued but be less clear as time passes and new businesses and new ways of doing business come upon the scene. What that means is that all standards—rules-based and principles-based—need to be updated as the circumstances warrant.

Would it be possible for the national offices of the large CPA firms to take unified views of standards…in other words, no GAAP for sale?

The downside of principles-based standards is that all organizations are painted with the same broad brush. Could there be legitimate reasons why a literal interpretation of a standard would be appropriate for most companies but not appropriate for those in one industry?

Ryan I see no real downside to the FASB's issuing conceptually simpler, less detailed, and broader standards. Detailed standards lower the bar both for preparers and auditors, which as we have seen recently is not a good thing. Conceptually simpler, less detailed standards do require better managerial discussion and disclosure of financial reporting choices and estimates, of course, which is in the purview of both the SEC and the FASB.

Sclafani The detail and complexity of recent FASB standards hinder the effectiveness of the guidance. Under certain FASB standards, the accounting for a transaction may not be reflective of the economic substance of the transaction and economically similar transactions may be accounted for differently because of the form of the transaction. The FASB can reverse this trend through the creation of standards that set forth broad accounting principles. The detailed application and enforcement of these principles would then be left to the preparers, their auditors, and the SEC.

Furthermore, the recent trend of setting very detailed, prescriptive standards has considerably slowed the standard-setting process. Attempting to address specific product issues and implementation questions in the standards requires the staff to expend a significant effort in understanding and proposing guidance for matters better left to constituents and auditors to resolve in practice. A principles-based approach whereby the FASB establishes broad-based concepts that constituents can clearly understand would certainly help to improve the timeliness of issuing new standards. However, we do note that if the Board pursues a principles-based approach, it would have to consider contradictions with existing rules. To achieve the goal of principles-based standards, the Board would need to revisit many individual standards used in practice today.

Stone — The Board will need to consider its relationship with the EITF. Because the EITF is not an independent board and is not required to follow full due process, it would not be appropriate for the EITF to become the go-to source of detailed guidance for every principles-based standard the FASB produces.

The FASB will need to evaluate whether its existing conceptual framework is adequate to support the greater demands a more principles-based approach to standard setting will place on it.

Some members of the business press and accounting profession have tried to convince the public that moving to principles-based accounting standards will decrease the likelihood of future Enrons. This has created a demand for principles-based accounting standards. The FASB will be viewed positively, at least initially, if it responds promptly to this demand.

Wilhelm — The success of principles-based standards will heavily depend on a high-quality conceptual framework with exact definitions (assets, liabilities, and revenue). On this basis not all but a significant part of the standards could be simplified. Overriding principles for a transition period should be restricted to the absolutely necessary and should be very clearly defined.

Comments of Board Members

Herz — As noted in the lead-in to this question, in January 2002, the Board undertook a project on codification and simplification, which includes exploring the feasibility of moving to more "principles-based" accounting standards. Furthermore, the recently enacted corporate reform legislation specifically requires the SEC to evaluate the feasibility of implementing a principles-based approach in the United States, and the Board will be working closely with the SEC staff on this.

In order to properly evaluate this subject, I believe the Board and the SEC staff will need to:

- Clearly define what we mean by principles-based standards, including the format, style, content, and level of detail in standards and whether we need an overall standard similar to IAS 1*, Presentation of Financial Statements*, which guides the preparation and presentation of financial statements. We will need to show what the standards would look like; for example, whether they will use the black and gray lettering approach as in standards of the IASB and many other standard setters and that they will contain few, if any, scope and other exceptions.
- Explore the implications for the role, approach, and processes of the EITF and AcSEC and for the FASB's implementation activities.
- Examine the implications for the behavior and actions of other participants in the financial reporting system. The successful implementation of a principles-based approach will require some changes in ingrained behaviors by virtually all constituents. It requires preparers, auditors, audit committees, and boards to be willing to exercise professional judgment and to resist the urge to seek specific answers and rulings on every implementation issue, and to view accounting and reporting as an exercise in good communication and not just compliance. It requires investment bankers and the accountants and lawyers that work with them to stop trying to invent ways to create products and structures that loophole the standards. It necessitates that the SEC staff temper demands for bright lines to facilitate their review and enforcement activities and to resist the urge to second-guess professional judgments made in good faith by companies and auditors. It may also require some changes to the legal and litigation framework surrounding financial reporting and auditing.
- Discuss whether the implementation of a principles-based approach should be done only as new standards are developed versus the Board undertaking what would be a very major project to "principalize" existing GAAP.

- Lay out the related advantages and disadvantages and costs and benefits of implementing such an approach in the United States.

Having been an auditor both in the United States and in the United Kingdom and a standard setter in the United States and at the IASB, I believe there are many potential advantages to a more principles-based approach if properly implemented, including:

- Allowing (some might say forcing) companies and auditors to exercise professional judgment, thereby enhancing professionalism in both the reporting and auditing of financial statements. (However, pointing to recent events in the United States, some might say that companies and auditors cannot be trusted to properly exercise professional judgment.)

- Having accounting standards that are easier to understand and maintain and that focus more on economic substance.

- Reducing the opportunities for form-over-substance structuring and arbitraging of rules because there would be few exceptions to the principles and because of the reduction in the number of potentially conflicting rules.

- Avoiding the potential "double jeopardy" to preparers and auditors of the current system—where compliance with detailed rules may not be sufficient to avoid enforcement and litigation if the substance is lacking.

- Making it easier to converge with the IASB and other major national standard setters.

On the flipside, there are some potential disadvantages. Comparability could be reduced both because different good faith judgments about the appropriate accounting treatment can occur based on similar facts and because the generality of standards may leave more room for abuse by preparers and accommodation by auditors. And it may be harder to properly enforce a principles-based system. It also may require more disclosures in financial statements explaining how a company implemented the particular principles. And, as noted above, moving to a principles-based approach will require some pretty major changes, not only by standard setters, but by all constituents in the financial reporting system.

In the end, whether or not implementing a more principles-based system is worth the effort will depend on whether it results in financial statements and financial reporting that is more useful, understandable, and trustworthy to investors and other users.

Crooch To work, principles-based standards must be embraced and understood by all constituencies. The first and most important question is whether detailed guidance that results in only one correct answer will be required by any party in the financial reporting community. If auditors, preparers, analysts, or the SEC are not willing to make and accept the results of judgments that must result from principles-based standards, the process is doomed to fail. Some party(ies) will provide the detailed guidance and the process will have done nothing more than shifted the source of the detailed guidance.

The FASB must lead and monitor this issue and ensure that our standards are clear as to their objectives and intent. Others must be willing to try to attain that objective without the help of detailed guidance.

Foster The Board has recently prepared several memoranda regarding this subject, so my response will be brief. However, I am very skeptical that constituents will support less-detailed standards. Furthermore, unless the behavior of all parties involved—preparers, auditors, and regulators—is modified *significantly*, a move to principles-based standards will result in a deterioration of the quality of financial reporting.

Schieneman Implications:

- Decrease in comparability. Must find out how important this is.
- No exceptions to broad principles—will this result in areas where principles lead to less transparency because they are not appropriate in a specific situation?

Arguments for:

Cannot anticipate future transactions and therefore cannot write rules that are responsive to future needs. Also, principles-based standards could lead to fair presentation because of judgment. Rules lead to gaming.

Arguments against:

Our society requires rules; principles-based standards could be too flexible.

Schipper Those who favor less-detailed standards apparently believe that the result will be:

- Less complexity (that is, less costly to comply) with an acceptable reduction in comparability
- Less earnings management in the form of transaction structuring
- Greater transparency and representational faithfulness as preparers/attestors focus on the substance and intent of the standard and not on compliance with specific and detailed requirements.

Those who favor more-detailed standards apparently place a greater weight on comparability (that is, they apparently believe that detailed guidance increases the comparability of implementations) and they apparently also believe that transaction structuring is less costly than the idiosyncratic judgments and estimates that arguably would arise under less-detailed standards.

The FASB should not attempt to move to less-detailed guidance without a commitment from other parties to the financial reporting process, including (1) other sources of financial reporting guidance, such as AcSEC and the EITF; (2) preparers; (3) attestors; (4) the SEC. For example, AcSEC and the EITF would have to make the same kind of commitment as the FASB, or it is possible the source of detailed guidance would simply shift to either or both of these groups. As another example, the SEC would have to agree to tolerate a certain level of noncomparability and idiosyncratic judgment/estimation in implementations. Preparers and auditors would have to resist the temptation to request detailed guidance, and would also have to commit to implementations that are consistent with the stated intent of the standard.

Trott Less-detailed standards will place more reliance on preparers and auditors to exercise good, solid, professional judgment. Others, the SEC, users, and the courts will need to accept that judgments can differ. The issue for the Board is how to write standards that help to get good solid judgments being made. The argument against less-detailed standards is that implementation issues will need to be answered by someone.

Wulff

Implications:

- Fewer safe harbors for preparers
- Better leveraging of the skills of preparers and auditors
- More tension between preparers and auditors
- More chance for regulator second guessing
- Less "perceived" comparability (largely perception).

Comments of Other Constituents

Ciesielski

I think the issue of "principles-based" versus "rules-based" accounting standards is simply a case of the grass being greener on the other side of the fence. The thinking seems to go like this: since there hasn't been a disaster of the magnitude we've seen here with rules-based accounting standards, then principles-based standards must be superior. I don't think that's necessarily so. I don't think there's any economy or capital market that has been using principles-based standards for as long as we have used rules-based standards, with companies of the same size. I think that to a large degree, the sensational meltdowns occurred because the perpetrators violated existing rules and it wouldn't have mattered if they were formulated under a rules-based regime or principles-based regime.

I view the tension between principles-based standards versus rules-based standards as more of a difference between "general" standards instead of "specific" standards. I don't believe that a move to a general or principles-based model would work in the United States. Companies that complain about standards overload are also the same ones that request guidance and specificity on nearly every transaction that affects them. In fact, the former CEO of a large U.S. bank recently editorialized that the FASB has issued one standard that runs 700 pages on how to record one transaction. I believe that he was referring to Statement 133, and the reason it runs that long is that it covers the recording of nearly all possible permutations of derivatives transactions—largely at the request of U.S. banks like the one he used to run.

I simply don't believe that companies are willing to get what they wish for, and the same goes for auditors. I believe that firms and their auditors are addicted to specific guidance and are not prepared to make the tough judgments that would be required if generalized standards were the norm. They fear legal responsibility, and accounting rules printed in black and white provide defenses. I think that the specific guidance regime is particularly beneficial to auditors: it saves them from having to butt heads with clients on grey-shaded issues. It's much easier to blame the FASB for requiring a certain treatment that can be found in a book rather than debating an opposing position with a client.

That said, I think that the uniformity of financial reporting might suffer in a general/principles-based environment. I don't think this would greatly harm users, but I think it could add to confusion for some of them. All things considered, I think the system we have is what we deserve and I don't think it will change. I think that all of the FASB projects start out being principles-based but wind up looking like they are designed with specificity in mind after all the input is received from preparers and auditors. To change the approach, the change has to begin with those two constituents. I cannot envision it happening.

Fender

The SEC, securities litigation firms, audit firms, preparers, and users will all have to adjust to more judgmental standards.

For: Avoids technical compliance without economic sense, could speed up standard-setting process.

Against: Opens the door to different interpretations, and to manipulation by those desiring to do so; SEC could become arbiter or de facto standard setter; EITF may be asked to do even more.

Fisher

Auditors take on more of the burden. More judgment sophistication may be more costly for the SEC, companies, and auditors. There will, of course, be a variety of interpretations. The SEC should more aggressively, and on a more timely basis, challenge company filings that demonstrate poor transparency and simplicity.

Joseph

I do not agree with the current fad for less-detailed standards. As an investor in U.S. and non-U.S. stocks, I can see how "general" standards are interpreted abroad (read: Germany). The current "holier than thou" and "I told you so" feeling outside the United States is complete baloney! Without detailed standards, auditors will be under even more pressure to buckle under a forceful CFO. Details are usually at the request of the auditors and CFOs out to protect themselves or with a particular axe to grind!

Landsman — There are obvious tradeoffs between adopting a rules-based approach to standard setting vis-à-vis a principles-based approach. At one level, a rules-based approach reduces managerial discretion in putting together the financial statements. However, it also creates the incentive for managers to "game" the system by working around constraints imposed by bright lines (for example, rules for recognition of capital leases). More precise rules for things such as revenue and liability recognition and measurement potentially result in financial statements that are more comparable across firms, making it easier for investors and other users to conduct equity analysis. On the other hand, principles-based standards might enable managers to produce financial statements that more accurately portray their firms' financial position if they have more discretion in accounting for their business transactions.

Rosenfield — Stop trying to dance around the issue and just do it! Present FASB standards are just too complex. Try a simpler way!

Wallace — I believe a distinction is needed between legalistic and detailed, as well as between form and substance. In other words, detailed substance-focused standards would be applauded. The problem is not in the level of detail but rather in the elevation of legal form and structure over economic substance. This problem can be solved without denigrating the degree of helpful guidance.

One result of moving to principles-based standards would be an increase in the need for judgment by an entity's management and its auditors to determine appropriate application of the standard. From your position as a participant in the financial reporting process—preparer, auditor, regulator, and user of financial information, are you prepared to accept that there will be differences in interpretation of standards? Are you prepared to make the judgments necessary to apply less-detailed standards knowing there is the possibility that your judgment will be questioned?

Comments of Council Members

Anderson — Auditors in larger firms would have less difficulty in working with less-detailed accounting standards because they have more resources at their disposal. Auditors from smaller practices would most likely prefer more detailed guidance because they do not have the "national office" resource to call upon. Additionally, they would have fewer clients in a particular industry and therefore they would have less opportunity to observe best practices.

With respect to audit risk, although larger-firm auditors may be able to better deal with less specific accounting standards, they most likely would have higher audit risks. Less-detailed standards may cause inconsistency in practice and may allow regulators (not to mention plaintiffs' attorneys) greater opportunity to challenge the work of the auditor and preparer. Alternatively, less-detailed standards may allow auditors more leeway in preparing a defense when arguing the application of an accounting standard.

I believe auditors will adjust either way, and smaller firms will find ways to resolve application issues. The Board should have the flexibility to draft a standard, depending on the subject matter, in the way it believes will best influence preparers (and auditors) to look to the substance of a transaction or event over its form.

Balhoff — Yes. It would also be helpful if there is some source of "best practices" relating to principles-based standards.

Blakely — Yes, I believe sophisticated users of financial statements appreciate even today that judgments in preparing financial statements impact financial results. As a former CFO of two large industrial corporations, I would be prepared to make the judgments. As part of making the judgments, I believe a CFO must be prepared to defend them as a CFO typically does for an audit committee today. While the judgments may be questioned by a larger number of constituencies under principles-based accounting, I believe this is an acceptable and appropriate responsibility.

Bromark — We acknowledge that there is a risk that using less rule-based standards may result in differing interpretations. We would expect, however, that under a principles-based regime that follows the economics of transactions, similar transactions will be treated similarly. We observe that this is not always the case under current GAAP.

We also acknowledge that such standards will require greater exercise of judgment by preparers and their auditors. We believe that such a situation is superior to the current regime in which transactions can be structured within the detailed accounting rules in order to attain a particular accounting outcome, even if that outcome is inconsistent with the underlying economics of the transaction. Because preparers can justify such accounting by referring to specific GAAP, auditors are, at times, unable to oppose their client's accounting. We see a return to a world in which preparers and their auditors can exercise professional judgment to ensure that the accounting for a transaction reflects the underlying economics of a transaction as a positive development for preparers, the accounting profession, and for users of financial statements.

We also acknowledge that judgments made by the preparer and supported by the auditor could later be questioned by others. Once again, we observe that such questions of judgment by third parties, including regulators and trial attorneys, are a common occurrence in today's environment. We do not expect the frequency of such questions to increase under less-detailed standards. Moreover, we believe that in such situations, it may be easier to address such questions of judgment, as the conclusion reached by the preparer will be based upon the substance of the transaction, rather than the strict application of a particular rule.

Foster — The SEC is the primary organization that needs to support this initiative. I look at it as a long-term project. If the SEC is in agreement, then the other groups will follow.

Goldman — As noted above, I am concerned about this, as senior management continually will also request the rules to follow. I prefer more black and white and thus to tell management definitely what the rules are and then run the business accordingly, and certify the results to those rules as well. Thus, I am concerned about leaving too much for judgment that can be questioned and interpreted differently retrospectively.

Guinan — When transactions test the "letter of the law," standard setters are asked to clarify the concept that underlies the standard, that is, the so-called "spirit of the law." In contrast, we believe that more principles-based standards appropriately allow preparers, auditors, and users, rather than financial engineers, to interpret the standard and apply judgment about whether a transaction is being structured to achieve a stated accounting answer. We are prepared to accept the differences that will arise in interpretation of standards and are prepared to make the good-faith judgments necessary to apply less-detailed, principles-based standards knowing there is the possibility that those judgments will be questioned. However, we believe that a more principles-based system will succeed only if the regulators and others make a similar commitment to accepting those judgments.

Humphreys — Yes, if principles-based standards will lead to more understandable financial statements. See above discussion.

Lackritz — The essence of a profession—medicine, law, etc.—is applying judgment in the context of a discipline. With higher professional standards, and more focus on integrity, perhaps "judgment" will make a reappearance in the profession of accounting/auditing.

Levin

As a preparer, I am generally opposed to the idea that the FASB move to a principles-based approach only. From one perspective, it is my strong belief that management continues to be in the best position to judge the representational faithfulness of the accounting for a particular transaction. Therefore, I don't favor a rules-driven process that limits the flexibility of management to convey its financial information in the manner that it deems most *appropriate* to its investors.

However, I also recognize that inconsistency in practice has and will develop under an approach that limits guidance to principles only. And this inconsistency will likely be greater than the inconsistencies that develop in practice under our current system of concepts and rules.

This inconsistency in practice can be devastating to the confidence that users have in the quality and comparability of financial statements. Further, we have seen recently that even in situations where reasonable people can disagree, even a hint of a question by the SEC about an accounting approach can have a disastrous impact on a company's stock price, on the perception of a company's management, and on the overall confidence in U.S. capital markets.

As such, I don't believe that the marketplace will be willing to accept this level of uncertainty in financial statements, and I don't believe that preparers will be willing to accept this increased risk of being "second-guessed."

Livingston

A great deal of judgment already goes into developing financial statements. Preparers will be able to sell accounting treatment within their organizations if the standards clearly and simply set out the intent and overarching principles at the start of the document. Much of this burden will rest with the auditors. They will have to be willing to walk away from few problem clients that don't follow their recommendations. They will have to take tougher stands and stop the endless appeals.

Nusbaum

Of course, these are the tough questions. As an auditor, we are prepared to accept the differences and enforce the principles diligently. We are definitely prepared to make the judgments to implement the principles. The toughest question is how we avoid second-guessing and revisions. Most people recognize restatements as bad for all parties involved, including the user.

Therefore, we need a system that avoids restatements. The SEC must be involved in this process.

Parke — Application of principles-based standards resulting in a material effect to the financial statements should be captured in the disclosure of critical accounting policies. Although there will always be the risk of increased "second-guessing" by auditors and regulators, this risk would be mitigated by thorough contemporaneous preparer documentation (shared with their auditors) of the basis for the appropriate application of the standard as well as consistent application of the underlying principle.

Pegg — Yes, I would be prepared to accept differences in interpretation, as long as there is sufficient ability to recognize that differences exist, understand why the situations were interpreted differently, and have some basis to compare the two situations (or at least understand the differences between the two interpretations).

I am not in a position to apply less-detailed standards, but I would accept the judgments of those who have to make those decisions as long as there is sufficient ability to understand the situation.

Rogero I am greatly concerned about being second-guessed in today's increasingly litigious environment. Could the FASB and the SEC discuss how to provide a "safe harbor" when good faith judgments prove to be wrong? In some areas, FASB guidance could be straightforward enough to minimize this concern. A real concern would arise when a standard is promulgated in a very complex area, with the FASB determining later that the standard was not as comprehensive as it might have been. An example might be the general matter of revenue recognition. We could look at the chain of events around the promulgation of SAB 101 and the many EITF consensuses covering classifications, multiple-element transactions, and using coupons. It seems that business practices are continuously evolving, and the events that prompted the issuance of a standard today may not have considered later related events.

If a standard is explicit enough, the opportunity for differences in interpretation could be minimized. Could the FASB explicitly state the real intent of a standard?

Ryan Yes. (Although I note that as a professor, I am used to my judgment being questioned.)

Sclafani We believe that judgment is appropriate for determining the accounting for certain transactions, since judgment allows one to consider the substance of the contract and account for similar transactions in a similar manner. We realize that the Board has reservations about the level of judgment that one may apply in evaluating transactions. However, detailed standards cannot address every circumstance or entirely resolve those concerns and, in certain cases, they create additional accounting inconsistencies for transactions with similar economic profiles. We are comfortable applying judgment to determine the appropriate accounting for transactions.

Stone The FASB will work diligently to produce principles-based standards. However, the task will be more difficult than advocates of principles-based standards anticipate. Problems the FASB will face include:

- Lack of agreement on what constitutes a principles-based standard (suggested examples of standards from other countries often prove to be less principles-based in design and implementation when studied)

- Lack of agreement about the conceptual framework to be used as the basis for reasoning to principles-based standards

- Overhang of agenda items added to the agenda because preparers, auditors, and others wanted clearer (more detailed?) guidance

- Continued lobbying for industry-based exclusions

- Increasing number of legitimate, but resource-consuming, IASB-related demands.

Wilhelm — Assuming that the interpretation of standards will be done in good faith and in order to produce high-quality financial statements, over time differences in interpretations should become fewer as "leading opinions" for interpretations emerge.

I am prepared to accept potential differences in the interpretation of standards and to face possible questions related to the application of judgment in interpretations.

Comments of Board Members

Schieneman — My answer is as a former Merrill Lynch analyst—comparability is not as important as the Board believes. Consistency of application is much more important, since analysts are more concerned with year-to-year change rather than absolute amounts. Disclosure of critical accounting policies mandated by the SEC become more important in understanding how a particular entity has applied the principles.

Comments of Other Constituents

Fender — The increased level of responsibility will apply to all constituencies. We are prepared to accept different interpretations with adequate disclosure of the positions taken and the rationale. We also are prepared to make the judgements necessary.

Fisher — Yes. Clearly, there should be a balance between the level of interpretation versus clear guidance in principles-based accounting standards.

Landsman — I think the big key to ensuring a principles-based approach works is for the FASB to require sufficient disclosure of the judgments made by preparers. For example, if an entity (the "parent") is permitted not to consolidate an entity in which it has a large controlling interest (the "subsidiary") but not a majority stake, the parent should be required to disclose the full details of the relationship it has with the subsidiary, including lending arrangements, etc., as well as the justification for nonconsolidation. Obviously, its success also depends on whether auditors and regulators do their job of questioning managements' judgments with vigilance and independence.

Rosenfield — There should be no "differences" in interpretations. For example, no one misunderstood the old "doctrine of conservatism." Return to doctrines like that—that are easy to understand!

Wallace — Since context always matters, judgment cannot be removed from a professional endeavor. Any assertion that legalistic standards have lessened judgment is illusory—though arguably a result of shifting who makes such judgments has occurred. In order for substance to dominate reporting practices, both standard setters and regulators must refrain from supplanting economic substance with legal form and structure.

Woodyatt — It is ironic to me that there seems to be growing support for simpler, principles-based standards at the same time there seems to be growing criticism of corporate America for excessive liberality in interpreting existing standards. Financial executives complain of disclosure overload but for principles-based standards to work, greater disclosures would be needed for users to make reasoned judgments they're willing to stand behind.

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Section D—International Activities
Views of Respondents

The Board is active in many international accounting activities and expends significant (and increasing) resources to monitor and participate in the standard-setting activities of, for example, the International Accounting Standards Board. Section D of the survey asked whether this is an appropriate use of the Board's resources.

Comments of Council Members

Anderson	The Board's international activities are and will continue to be important. Monitoring and participating in the standard-setting activities of the IASB are an appropriate use of the Board's resources.
Balhoff	Yes.
Blakely	Work with the IASB is appropriate for the FASB, and an acceleration of this activity is, in my judgment, critical. Over time the NYSE, SEC and IASB will pressure for global accounting standards. I believe the FASB must be and importantly perceived as being proactive in driving this convergence.
Bromark	We strongly support the Board's efforts to achieve greater harmonization with the IASB, with the ultimate goal of a single set of high-quality, global accounting standards. However, to answer this question, we would have to understand how progress on convergence is to be measured. For example, is the Board's objective to achieve a single set of comprehensive, high-quality, global standards by a specified date in the future, say by December 31, 2010? As with any complex project, once a goal has been established, the evaluation of progress is made easier. Until such a goal has been established, accompanied by a comprehensive project plan with specific milestones, it is difficult to evaluate progress and, as a consequence, to determine whether the significant resources being expended by the Board are appropriate.
Demski	I think the move toward harmonization is a bit premature. The FASB and IASB are, in a larger sense, competing organizations. Given current events and the general rethinking of the way we manage financial reporting, I think the Board should focus on redesigning itself and its approach, to better serve the public interest.

Foster	Yes. I believe considerable progress has been made in this area and to pull back now would not be a good idea. It is important to have standardization of accounting principles.
Goldman	To the extent we can achieve alignment, that is great, but we should not compromise our positions for alignment, although there should be areas for compromise.
Guinan	Monitoring and participating in international accounting activities is not only an appropriate use of the Board's resources, it is a necessary use of those resources. As discussed in our response to Section B, Tomorrow's Issues, we believe that the Board needs to resolve whether and how the FASB's and IASB's standards should converge in the intermediate or long-term.
Humphreys	This is an appropriate use of the Board's resources.
Lackritz	Yes, absolutely. While globalization is not proceeding as rapidly as we forecast, harmonization of global accounting standards is an essential building block for a globalized economy and cross-border capital flows. The FASB should be integrally involved with this.
Levin	Yes, I support the movement towards the development of high-quality international accounting standards because discrepancies in methods of accounting for identical transactions undermine the transparency and comparability of financial statements. When accounting experts cannot agree on what constitutes a fair and true picture of a company's results of operations, what message is sent to the investing public? How is the investor served? Further, I support the continuation of the role of the FASB as a world leader in standard setting. I believe that the FASB has a responsibility to help ensure that international accounting standards eventually represent best-in-class guidance.
Livingston	Yes, currently this is an appropriate use of the Board's resources. I support the ongoing effort to reach one set of global accounting standards. But, until the IASB proves its ability to deliver high-quality standards, it is important for the FASB to be strong. This requires a full review and revision of the FASB's processes and governance mechanisms. This is a significant reform step that is open and not addressed on a timely basis by

the FAF and the FASB. Nothing substantial has changed at the FASB and FAF, and once again timeliness is an issue.

Nusbaum Yes! The Board must work with the IASB to develop global accounting standards. U.S. companies and the U.S. financial reporting system benefit from improvements in global accounting standards. We are an accounting firm that focuses primarily on middle-market companies, both public and private. Many of these companies are global and would benefit from the convergence of U.S. and international accounting standards. For example, our firm developed a new audit approach in the mid-1990s and did it on a global basis. The audit approach, including software, strategy, policies, and procedures, is consistently applied throughout the world. This allows us to better serve global middle-market companies. Another interesting consequence of the global development was that by using a team from around the world, we developed a better audit approach. If global standards and approaches are important to middle-market companies, they are obviously important to larger companies. I strongly support the continued involvement and increased commitment to working with the IASB.

Parke The Board should ensure that (1) the resources are properly leveraging the knowledge obtained by the international accounting standard setters and (2) the documentation of the disparities between the principles developed by the Board versus the IASB is continuously updated.

Pegg Yes. I believe the harmonization of accounting principles should be a high priority of the Board, and that working with the IASB (and other countries' standard setters) is extremely important. International investing is likely to continue increasing, and it is essential to aid users in their ability to help compare companies across borders, and help companies to access capital markets across borders. I do realize that the Board's resources are limited, but current work with the international bodies should help to create higher-level standards, as the Board will benefit from the expertise of the other entities.

Rickard If I were setting this up, I would not spend substantial time and resources. I would establish an open and supportive relationship, but deal with IASB outcomes only as decisions are reached, or when they request time to address the FASB or FASAC.

Rogero Like it or not, accounting principles need to become international in scope. Although I feel that U.S. standards are the most comprehensive, broad-based, and most transparent in the world, we need to find a way to operate effectively in the world standard-setting community. I think our efforts to date make sense.

Ryan — Yes, though ongoing, project-specific balancing of costs and benefits is and will remain necessary. Most of the remaining accounting issues are hard, and it helps considerably to have multiple parties (with different expertise, experience with fact patterns, and political pressures) working on them and talking to each other.

Sclafani — One of the FASB's priorities we identified in Section A, The FASB's Priorities, is convergence of accounting standards. As we believe that convergence is one of the highest priorities for the Board, it is an appropriate use of the Board's resources.

Stone — Given the continuing demand for global convergence of accounting standards, it is imperative that the FASB continue to monitor and participate in IASB activities. If FASB needs additional resources to monitor and participate effectively, efforts should be made to secure these resources.

Wilhelm — I definitely think it is, given the fact that the international capital markets are becoming more and more interrelated and that the IASB is on its way to developing globally accepted accounting standards. Supporting this process is important to improve the convergence process, and by doing that to implement U.S. GAAP experience where appropriate.

Comments of Board Members

Herz — I believe that international convergence is an appropriate and very necessary use of the Board's resources. The growth in cross-border investing and capital flows and the growing endorsement of international standards in many important parts of the world means that, on the one hand, the United States cannot go it alone in terms of the development of accounting standards, and that, on the other hand, the development of truly international standards across the major capital markets of the world requires that the United States be a very active participant in the process. Accordingly, the FASB is dedicating significant resources at various levels to this effort, including:

- Developing the procedures and protocols used not only by the FASB, but also by the IASB and other major national standard setters in working together
- Working with the IASB on several joint projects
- Closely monitoring the progress of the IASB on other key projects
- Undertaking a specific project with the IASB, with the help and support of the SEC staff, aimed at accelerating the convergence process by trying to eliminate or narrow some of the key areas of difference between current U.S. and international standards.

For the FASB, this is a major area of activity and one that is both logistically challenging and that necessitates an increase in both our people and monetary resources. But we need to do it. I think the trick is to do it in a way that doesn't significantly delay or dilute our efforts to improve U.S. standards and that, by working with our international colleagues, results in better standards that can be applied across the major capital markets of the world. It also requires the EITF and AcSEC to ensure that they consider the international aspects in their activities.

Crooch International convergence is a goal that must be achieved. The benefits of lower costs (both of preparation and cost of capital) are too important. Further, if the FASB does not support this process it will fail, in my view. We must request significant increased funds to ensure this process sufficient resources.

Foster Absolutely! I have actually been pleasantly surprised at how much support the IASB has received throughout the world. There is no question that ultimately there will be one set of global standards because that is what the markets demand. Anything the Board can do to hasten that outcome should be done.

Schieneman Yes, but we should see that convergence focuses on issues that are really important to global investors. In my experience as Director of Comparative Global Equity Valuation at Merrill Lynch, capital markets have worked fine with IAS standards even though they are not comparable to U.S. GAAP. In a majority of cases, differences have not been large enough to create comparative valuation problems. Is it possible that this is principally a regulatory problem?

Schipper	Given the mandate of convergence from the FAF Trustees and the SEC, as well as pressure and encouragement from other constituencies, this use of resources is, in my view, completely appropriate. There is, of course, a measurable opportunity cost of dedicating significant and increasing resources to convergence activities, in that time and money spent on these activities is taken directly from other FASB projects and activities.
Trott	Yes.
Wulff	Yes.

Comments of Other Constituents

Ciesielski	I believe this is an appropriate use of the Board's resources and that the Board should continue to pursue convergence with the IASB wherever possible, as long as it doesn't significantly delay progress on its own projects.
Durbin	We should look for convergence with the IASB wherever possible.
Fender	Absolutely. It is essential for the FASB to participate in creating a single set of accounting standards to be applied globally.
Fisher	Yes, if the IASB standards will successfully be enforced globally. We are in a global world with increasingly global risk factors to consider and account for.
Joseph	I believe it is very worthwhile to ensure a common approach between the IASB and the FASB. Economic fundamentals of value creation and destruction do not change when the users/preparers cross a border. As an investor in both U.S. and non-U.S. stocks, it would make my job a lot easier (and unfortunately, the markets more efficient).
Landsman	Yes, see my first point in Section A, The FASB's Priorities.
Rosenfield	You should join them—not run parallel.
Wallace	Yes. International harmonization of the language of business is an essential foundation for transparent, efficient global markets. The U.S. standard-setting community has much to offer (and learn from) the IASB initiatives. The more cooperative exchange that occurs in the standard-setting deliberations, the greater the chance of effective development of global standards.

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Identification of Individuals Who Provided Comments That Are Included in This Summary of Responses

Council Members	Affiliation
Alan W. Anderson	Senior Vice President—Member and Public Interests American Institute of Certified Public Accountants
William E. Balhoff	Audit Director Postlethwaite & Netterville
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