FASB Response to SEC Study on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers

Introduction

In June 2005, the staff of the United States Securities and Exchange Commission (the SEC) submitted to the President of the United States, the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate, and the Committee of Financial Services of the U.S. House of Representatives its *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (the Report). The Report identifies several key initiatives aimed at improving the transparency of financial reports and makes several recommendations to accounting standard setters.

Although not requested to do so, the Financial Accounting Standards Board (the FASB or the Board) is pleased to provide comments on issues and recommendations included in the Report, pertaining to our accounting standard-setting activities and to broader challenges currently facing the U.S. reporting system. In this paper, we discuss a number of fundamental structural, institutional, cultural, and behavioral forces that we believe have caused and continue to cause complexity in the system and impede transparent financial reporting. We also describe our current and planned future actions to do our part to address those issues and challenges.

While the reforms created by the Sarbanes-Oxley Act and follow-up actions by the SEC, the FASB, and the Public Company Accounting Oversight Board (the PCAOB) have strengthened financial reporting and public confidence in the financial reporting system, we believe that further improvement and actions are needed. Accordingly, we believe that concerted and coordinated action by the SEC, the FASB, and the PCAOB, together with other parties in the financial reporting system, is critical if we are to achieve the types of changes that are suggested in the Report.

The rest of this paper discusses our current and planned actions regarding the specific standard-setting recommendations in the Report and provides our observations on key challenges facing the financial reporting system.

FASB Actions and Plans Relating to Accounting Standard-Setting Recommendations in the Report

The Report makes the following recommendations relating to technical accounting standard-setting activities:

1. Accounting for leases—reconsider the current accounting standards and guidance.
2. Accounting for defined benefit pension plans and other postemployment benefits—reconsider the current accounting standards and guidance.
3. Consolidation policy—continue working to develop a less complex and more consistent approach.
4. Accounting for financial instruments—continue exploring the feasibility of reporting all financial instruments at fair value.

The Report also suggests that a disclosure framework be developed to help foster the goal of better communication of information to investors in the notes to the financial statements.

We agree with these recommendations, which are consistent with our current and planned activities. The FASB and the International Accounting Standards Board (IASB) agreed at their April 2004 joint meeting on a list of potential future major projects to address standards that are outdated, overly complex, and in need of improvement. That list includes the four subjects noted in the Report (i.e., leases, defined benefit pensions and other postemployment benefits, consolidation policy, and financial instruments) as well as the topic of accounting for intangible assets. Although not discussed in the Report, intangible assets is another area where current reporting generally does not adequately capture or provide sufficient information on what, for many companies and industries, represent very significant economic assets. Prior to agreeing to that list of projects, both the FASB and the IASB consulted extensively with our respective advisory councils and other parties including the SEC staff.

The Board expects these projects would likely be conducted jointly with the IASB with our commitment to work toward convergence between U.S. and international accounting standards.

We summarize below our current and planned activities relating to each of the standard-setting recommendations in the Report:

1. Accounting for leases—The Board has instructed its staff to perform research and recommend potential alternatives for improving the current accounting guidance on leases. In the near future, the Board will discuss and decide at a public meeting whether to add a project to its agenda to address the accounting for leases and, if so, the scope of such a project.

2. Accounting for defined benefit pension plans and other postemployment benefits—At the November 10, 2005 public meeting, the Board decided to add a comprehensive project to its technical agenda on accounting for postretirement benefits including pensions and to conduct that project in two phases.

   The first phase is targeted for completion in the second half of 2006. The Board's objective in undertaking that phase is to address the fact that under current accounting guidance, important information about the financial status of a company's postretirement benefit plans is reported in the notes to the financial statements but not in the statement of financial position. Accordingly, this phase seeks to improve financial reporting by requiring that the funded or unfunded status of postretirement benefit plans, measured as the difference between the fair value of plan assets and the benefit obligation (for example, projected benefit obligation for pensions), be recognized in the statement of financial position.

   In the second, multiyear phase of the project, the Board expects to comprehensively consider a variety of issues related to the accounting for postretirement benefits. These issues include how the various elements that affect the cost of postretirement benefits are recognized and displayed in the financial statements to measure an entity's benefit obligations, including whether more or different guidance should be provided regarding assumptions used in measuring the benefit obligations, and whether postretirement benefit trusts should be consolidated by the plan sponsor.

Furthermore, consistent with our efforts toward international convergence, we expect to conduct this comprehensive phase collaboratively with the IASB.

3. Consolidation policy—The Board currently has on its agenda a long-term project to develop comprehensive accounting guidance on accounting for affiliations between entities, including reconsideration of ARB No. 51, *Consolidated Financial Statements.* The Board directed the staff to develop a plan for achieving its long-term objectives including recommendations for coordinating the FASB's activities with those of the IASB. The FASB staff recently has begun research. Additionally and very importantly, the FASB and IASB decided to accelerate work on the phase of their conceptual framework project that will explore conceptual issues relating to the "reporting entity."

4. Accounting for financial instruments—The FASB has previously stated its long-term objective of establishing standards that would require reporting all financial instruments at fair value in the financial statements, provided certain conceptual and practical issues relating to measurements and display can be satisfactorily resolved. The Board currently has a number of projects on its agenda directed toward that objective, including its project on *Fair Value Measurements* that addresses conceptual and practical issues relating to measurement, a project on *Financial Instruments: Liabilities and Equity,* and a project on *Financial Performance Reporting by Business Enterprises.*

   At a joint Board meeting, the FASB and the IASB agreed to a long-term objective to report all financial instruments at fair value. In addition, the FASB recently issued two documents that would alleviate some of the problems caused by the mixed-attribute measurement model by allowing enterprises to elect to report servicing rights and certain hybrid financial instruments at fair value. Moreover, in 2006, the FASB issued a "fair value option" Exposure Draft that would more broadly allow reporting of any financial instrument at fair value.

5. Disclosure framework—Development of a disclosure framework is one of the key objectives of the joint project between the FASB and the IASB to improve and merge our conceptual frameworks. Given the key role of SEC rules and regulations in determining the form and content of financial reports of registrants, any proposed changes in the approach to disclosures will need to be carefully coordinated with the SEC staff. Further, we believe that the role of technology in improving the information content and effective communication of disclosures will be critical in this effort. In the absence of an overall disclosure framework, the FASB has begun to state specific disclosure objectives in recent standards and proposals such as those relating to share-based payment, business combinations, and fair value measurement.

As discussed in the Report, proposed improvements in accounting standards are often controversial. We believe that there likely will be controversy and opposition to proposed improvements in some or all of the above noted areas. Accordingly, we appreciate the SEC's continued support as we try to improve accounting standards through our public due process.

Observations on Key Challenges Facing the Financial Reporting System

The Report includes a discussion of certain broad issues in financial reporting and identifies the following key objectives whose achievement would improve transparency in reporting:

1. Discourage transactions and transaction structures primarily motivated by accounting and reporting concerns rather than economics.

2. Expand the use of objectives-oriented standards, which would have the desirable effect of reducing complexity.

3. Improve the consistency and relevance of disclosures that supplement the basic financial statements.

4. Improve communication focus in financial reporting.

We agree with those objectives. In our view, despite the improvements in financial reporting resulting from the requirements of the Sarbanes-Oxley Act and related actions, our reporting system faces a number of important challenges. Perhaps most significant of these is the need to reduce complexity and improve the transparency and overall usefulness of reported financial information to investors and capital markets.

In the over 70 years that have elapsed since passage of the Securities Act of 1933, accounting, auditing, and reporting guidance has grown to encompass thousands of pronouncements that make up U.S. generally accepted accounting and auditing standards and SEC rules, regulations, and interpretations governing financial reporting. This complex system of standards, rules, and regulations reflects, in part, the complexity inherent in reporting on increasingly diverse and complicated business transactions and arrangements. But the complexity has also been building for many years as a result of various structural, institutional, cultural, and behavioral factors.

Long viewed as a strength of our reporting system, the volume and detail of accounting, auditing, and reporting standards, rules, and regulations now pose a major challenge to maintaining and enhancing the quality and transparency of financial reporting to investors and the capital markets. Many believe that the current system has engendered a form-over-substance approach to accounting, auditing, and reporting by preparers, auditors, and regulators, sapping professionalism and increasingly necessitating the involvement of technical experts to ensure compliance. This complexity has also added to the costs and effort involved in financial reporting, which often fall disproportionately on small and private companies, and is viewed as a contributory factor to the unacceptably high and increasing number of restatements of financial reports by public companies. For while many restatements are due to intentional misstatements and fraud, others reflect unintentional mistakes in implementing and auditing complex accounting and reporting requirements.

Among the powerful forces that generate complexity in the reporting system and impede improving financial reporting are the conflicting perspectives and agendas of the participants in the reporting process; resistance to change; an evolutionary approach to standard setting; a continuing focus and emphasis on short-term earnings; gaps in the education and training of accountants; additional disclosure requests; the continuing use of accounting-motivated transactions to burnish reported financial results; continuing attempts to politicize standard setting and regulation; and fear of being second-guessed by regulators, enforcers, and the trial bar. Many of those forces engender a culture that results in a constant demand for detailed rules, exceptions, bright lines, and safe harbors; deters preparers and auditors from exercising professional judgment; and results in disclosures that while lengthy and dense, all too often are boilerplate, are overly legalistic, and fail to effectively communicate important information. Efforts to counteract these forces will necessitate not only systematic, concerted, and coordinated action by the SEC, the FASB, and the PCAOB, but also fundamental cultural and behavioral changes by others. Accordingly, the support and cooperation of policymakers, the legal profession, legislators, and other key parties are necessary if there are to be needed changes in the direction of the reporting system suggested in the Report.

For our part, the FASB, with the encouragement of the SEC, has undertaken a three-pronged effort aimed at addressing the current unsatisfactory state. First, the FASB has been systematically readdressing complex and outdated accounting standards. Second, the Board has three broad initiatives aimed at improving the understandability, consistency, and overall usability of the existing accounting literature. These include (1) a massive project to develop a comprehensive integrated codification of all existing accounting literature organized by subject matter that will become the single source for all of GAAP, (2) attempting to stem the proliferation of new pronouncements emanating from multiple sources by consolidating U.S. accounting standard setting under the FASB's auspices, and (3) developing new standards that take a "principles-based" or "objectives-oriented" approach. And, third, the FASB has undertaken a project to strengthen our existing conceptual framework in order to provide a more solid and consistent foundation for the development of future principles-based standards. Consistent with our commitment to international convergence of accounting standards, many of the FASB's technical projects are being conducted jointly with the IASB, whose standards are used in over 90 countries.

We recognize that the FASB's activities aimed at reducing complexity and improving accounting standards, taken alone, are unlikely to achieve the objectives and initiatives identified in the Report. Achieving those objectives and initiatives will require proactively addressing the institutional, cultural, and behavioral issues, through continued collaboration and coordination between the SEC, the FASB, and the PCAOB, and the active involvement and assistance of other key parties in the financial reporting system. For example, the FASB's effort to move toward a more principles-based system of "objectives-oriented" standards, as noted in its October 2002 proposal on Principles-Based Accounting Standard Setting and as reiterated in its response to the July 2003 SEC staff report on that subject, depends on the ability and willingness of preparers, auditors, audit committees and boards, and others to exercise sound professional judgment. Presently, many seem reluctant to do so for fear of the potential consequences of second-guessing by regulators, enforcers, and the trial bar. Indeed, over the last few years, counter to the goals of a principles-based system, we have experienced a constant flow of requests for detailed rules, bright lines, and safe harbors. Accordingly, some argue that significant reforms to the existing legal, regulatory, and enforcement frameworks surrounding financial reporting are prerequisites for any move to a more principles-based or objectives-oriented system.

We also continue to receive regular demands from public and private companies and industry groups for special exceptions and accounting treatments to suit their particular business models, practices, and objectives. Such exceptions add to the overall complexity of reporting and reduce the transparency and comparability of reported financial information.

A variety of solutions have been proposed to reduce complexity and increase transparency within our reporting system. Some, including professional investors, financial analysts, and accounting standard setters see fair value accounting as a way to simplify accounting standards and to improve the relevance and transparency of financial statements. However, many others oppose the use of fair value accounting, viewing it as introducing unacceptable subjectivity and misleading volatility into reported results. Some also are uncomfortable with fair value both because the resulting numbers are perceived as being difficult to verify and because many participants in the financial reporting process have not been trained in the economic, financial, and valuation concepts underlying fair value measurements. Others suggest that the future of financial reporting lies in the greater use of new technologies such as eXtensible Business Reporting Language and "click-down" approaches to providing information on a customized basis for different users, thereby potentially rendering today's general purpose financial statements a relic of the past.

Whatever the solution, and there are many potential solutions, continued progress on reducing complexity and improving the transparency and usefulness of reported financial information is imperative and consistent with our nation's longstanding commitment to the importance of high-quality financial reporting to the health and vitality of our capital markets and our economy.

Conclusion

In summary, the FASB agrees with the standard-setting recommendations and other objectives stated in the Report. We also strongly support the goal of reducing complexity and increasing the overall understandability, transparency, and usefulness of financial reporting. As discussed above, we have taken a number of steps to do our part to begin addressing these matters. However, progress toward achieving the initiatives identified in the Report will, in our view, require continued concerted and coordinated action by the SEC, the FASB, and the PCAOB, along with the ideas, support, and active involvement of other key parties in the reporting system. Given the many institutional, cultural, and behavioral forces that foster complexity, this effort will not be easy and will take time, but we believe it is one of national importance. Failure to begin the evolution will create more rules and less transparency, eventually leading to potentially less relevant and less useful financial information for our capital markets.

We look forward to continuing to work with the Commission and the SEC staff on our common goal of improving financial reporting.