



Trends and Challenges in U.S. Standard Setting

Identifying trends in the evolution of standard setting and challenges facing standard setters can help preparers and users of financial statements anticipate what might be in store for them. This edition of *Defining Issues* therefore identifies some of the more significant trends and challenges in setting U.S. GAAP and what they might mean for those who apply it.

The FASB's standard-setting priorities include improving financial reporting, simplifying accounting requirements, and reducing differences between U.S. and international accounting standards.¹ This edition of *Defining Issues* takes a closer look at simplification and reducing differences between FASB and IASB standards, as well as a trend that cuts across both, the trend toward requiring more fair-value measurements in the financial statements.

Simplifying Accounting Standards

Probably no challenge facing the FASB is as difficult as simplifying accounting standards, even though public statements in 2005 and earlier by standard setters, regulators, lawmakers, and other interested parties make the task a priority.

The reasons for the priority are clear. U.S. GAAP developed over a relatively long period of time into a highly complicated set of standards often characterized by detailed requirements. The process came about partly because transactions became more and more complex; requests for scope exceptions and treatment alternatives often led to different treatments for similar items; detailed standards were developed to address specific transactions; guidelines were developed for relatively narrow classes of transactions; and provisions in some standards were developed to limit the potential impact of new principles.

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¹ Robert H. Herz, Chairman, FASB, Remarks before the 2004 AICPA National Conference on Current SEC and PCAOB Developments, available at www.fasb.org.

Simplifying accounting standards is unquestionably a worthy objective for the FASB, but it will not be easy to accomplish. These steps must be taken if the effort is to be successful.

- The conceptual framework will have to be improved.
- Standards will have to effectively balance implementation guidance and requirements to apply judgment.
- Identifying the standards that may apply to a particular transaction or event will have to be made easier.
- The simplification process will have to be managed so that the participants in the financial-reporting process understand and adjust to the potential consequences of a standard-setting approach that would likely include more judgment in applying accounting principles.

Conceptual Framework. A fundamental challenge is to improve the FASB's conceptual framework in a way that serves the goal of simplifying accounting requirements. Merely having a conceptual framework will not do the job, as demonstrated by the complexity of the accounting standards that developed under the current conceptual framework. A framework that serves the goal of simplifying accounting requirements would help the FASB's constituents understand the objectives of specific standards and the underlying principles that need to be followed.

The need for improvements in the conceptual framework is clear, for example, in the case of the complex accounting requirements for instruments with both liability and equity characteristics. The relevant standards address specific transactions. No general model holds the individual requirements together. To simplify these requirements, the FASB will have to develop a framework for differentiating between liabilities and equity in the financial statements that serves as a basis for evaluating the characteristics of these instruments. The framework must be broad enough to address instruments that may be developed in the future as well as those in use today. The FASB will then need to develop requirements based on the framework to replace those now located in various authoritative documents. The outcome is likely to be less difficult to apply than the requirements in place today even if the new framework involves some complexities, such as those involved in separating components of financial instruments.

Implementation Guidance. The FASB will have to find the right balance between implementation guidance and the breadth of judgments required to apply that guidance. The SEC staff's study on principles-based accounting called for objectives-oriented standards that are backed by implementation guidance.² The recommendation recognized that a set of accounting generalizations without any

implementation guidance (referred to by the SEC staff as "principles-only" standards) would not be operational and would reduce the comparability of financial information.

New requirements and accompanying guidance will have to be drafted in a manner that embraces the full range of possible situations within the scope of those requirements, but does not mandate explicitly how each situation must be treated. Requirements that meet this goal would define clearly the class of transactions to which they apply and be clear in their application to the varying circumstances of that class of transactions. This approach may reduce the need to supplement Statements with follow-on guidance, clarifications, and amendments.

Accessible Standards. The FASB has a project underway to codify its standards. Doing so would simplify the task of locating relevant requirements now found in many different documents. Making it easier to locate requirements will be helpful to those who must apply them, even though codification will not simplify those requirements. The project's goal is to create a single, authoritative code of U.S. GAAP.

Consequences of Simplification. Eliminating treatment alternatives, scope exceptions, and smoothing mechanisms in existing standards can lead to greater volatility in reported

² SEC staff, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, July 2003, available at www.sec.gov/news/studies/principlesbasedstand.htm; FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System, July 2004, available at www.fasb.org/response_sec_study_july2004.pdf.

earnings. For example, the second phase of the FASB's project on postretirement benefit obligations will reconsider the model for pension accounting, a task that will include evaluating whether to eliminate income-statement smoothing alternatives from current requirements (e.g., amortization of pension "gains and losses" only when the unrecognized amounts exceed a "corridor" amount). Eliminating them would simplify the accounting requirements, but would increase the volatility of many companies' reported results.

Developing less detailed, objectives-oriented standards is likely to add to the need to apply judgment when preparing financial statements, which can affect the comparability of financial information. On the one hand, greater application of judgment by preparers could mean that similar transactions would be accounted for differently by companies. On the other hand, comparability can be improved by eliminating treatment alternatives, scope exceptions, and arbitrary "bright-lines" (i.e., explicit numerical or other conditions that qualify or disqualify transactions for an accounting treatment). This is because treatment alternatives, scope exceptions, and arbitrary bright-lines can cause similar transactions to receive very different accounting.

For example, a lease is a capital lease if the present value of the minimum lease payments is 90 percent of the fair value of the leased property, but it may be an operating lease if the present value is 89.9 percent of the fair value of the leased property. If GAAP demands more judgments from preparers, other participants in the financial-reporting process, including auditors, regulators, and users, will have to understand that different preparers may come to different good-faith judgments in applying the same standard to similar transactions.

Fair Value

Both the FASB and the SEC have linked fair-value measurement to the need to simplify accounting standards. In its report on off-balance-sheet arrangements mandated by the Sarbanes-Oxley Act, the SEC endorsed the goal of accounting for all financial instruments at fair value.³ The SEC's Acting Chief Accountant supported this position in recent speeches and observed that fair-value measurements could reduce financial-statement complexity in the case of financial instruments.⁴ The SEC staff points out that recording all financial instruments at fair value would potentially eliminate the need to identify and separate embedded derivatives and

would obviate the need for many of the complex rules on hedge accounting. Proponents of fair-value information have long argued that it is more useful to investors than historical-cost information.

Not surprisingly, then, a clear trend in current standard setting is adding requirements to use fair-value measures in financial reporting. A number of the FASB's recent decisions reflect this.

- The proposals on business combinations would replace the cost-accumulation (invested capital) model with a fair-value model as the basis for recording a company's initial investment in a subsidiary.⁵
- Statement 123R on accounting for share-based payments requires fair-value-based measures for share-based awards.⁶
- Statement 143 and Interpretation 47 require a fair-value measurement of asset-retirement obligations.⁷
- The Invitation to Comment on accounting for assets and liabilities with uncertainties, discusses aligning the measurement model for contingent assets and liabilities with a fair-value approach, rather than the approach in Statement 5.⁸
- The FASB's proposal on the "Fair Value Option" would permit entities an election,

³ SEC staff, 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, June 15, 2005, available at www.sec.gov.

⁴ Scott A. Taub, Acting Chief Accountant, SEC, Remarks before the 2005 AICPA National Conference on Current SEC and PCAOB Developments, December 2005, available at www.sec.gov.

⁵ FASB Proposed Statement, Business Combinations, June 30, 2005, and FASB Proposed Statement, Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries, June 30, 2005, both available at www.fasb.org.

⁶ FASB Statement No. 123 (revised 2004), Share-Based Payment, December 2004, available at www.fasb.org.

⁷ FASB Statement No. 143, Accounting for Asset Retirement Obligations, June 2001; FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, March 2005; both available at www.fasb.org.

⁸ FASB Invitation to Comment, Selected Issues Relating to Assets and Liabilities with Uncertainties, September 30, 2005; FASB Statement No. 5, Accounting for Contingencies, March 1975; both available at www.fasb.org.

on a contract-by-contract basis, to report most types of financial instruments at fair value, with the changes in fair value included in earnings.⁹

The impetus behind fair-value measurements suggests that preparers, auditors, and others involved with financial reporting will need to become more accustomed to the use of fair-value information in financial reporting. Some argue that even if fair-value measurement simplifies accounting standards, it will create other challenges because financial-statement users will have to understand the various complex valuation techniques that companies use to value assets and liabilities that do not have observable market prices.

GAAP, however, contains limited guidance on how to measure fair value.¹⁰ The FASB is taking an important first step to improve the situation by creating more uniform, high-level, guidelines for determining fair value.¹¹

Cooperation with the IASB

The FASB announced its intention to work more closely with the IASB when it entered into the “Norwalk Agreement” in 2002,¹² but only recently have its stated goals begun to come to fruition. The primary goal is to

reduce differences between the FASB’s requirements and those the IASB establishes as international financial reporting standards, the set by now well known as IFRS. The appropriateness of this goal, commonly referred to as “convergence,” is recognized by the Sarbanes-Oxley Act.¹³

During 2005, cooperation with the IASB took three forms. First, progress on so-called “short-term convergence” projects, which are more narrowly focused than major projects, changed some U.S. standards to make them closer to the IASB’s and some IASB standards to make them closer to the FASB’s. Second, the FASB undertook major projects jointly with the IASB that seem likely to change both U.S. GAAP and IFRS fundamentally. Third, the two standard setters also coordinated their work on other projects that are not specifically designated joint projects.

Whether or not specific projects would have been undertaken by the FASB in the absence of the cooperative relationships with the IASB, cooperation on any project means that the outcome may be different from what it would be if it had been undertaken by the FASB alone. Not only is an additional stan-

dard-setting body involved, but the standard setters receive comments from a broader, more diverse constituent population. All in all, the cooperative effort effectively may be the biggest change in operating procedures and due process since the FASB assumed its responsibilities for U.S. GAAP.

The FASB’s commitment to the convergence process must be evaluated in light of the SEC’s current requirement that foreign private issuers filing with the SEC must reconcile their IFRS-based financial statements to U.S. GAAP-based information. As addressed in the SEC staff’s “roadmap,” the SEC views progress toward convergence as the prime enabler for eliminating the reconciliation requirement.¹⁴

Short-Term Convergence Projects. These projects are intended to arrive at a high-quality solution by selecting from recently established U.S. GAAP and IFRS. In some cases, the relevant IFRS requirements have been more recently developed than the U.S. GAAP counterparts, and in others the opposite is true. From the U.S. perspective, the short-term-convergence projects on inventory, nonmonetary asset exchanges, and account-

⁹ FASB Proposed Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*, January 25, 2006, available at www.fasb.org.

¹⁰ See, for example, FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, February 2000; FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, May 1993, both available at www.fasb.org.

¹¹ FASB Proposed Statement, *Fair Value Measurements*, June 23, 2004, available at www.fasb.org.

¹² Memorandum of Understanding, September 18, 2002, available at www.fasb.org.

¹³ Public Law 107-204, *Sarbanes-Oxley Act of 2002*, Title I, Sec. 108 (b)(1)(A)(v), says that the SEC may recognize the accounting principles produced by a body that “considers...the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and for the protection of investors.”

¹⁴ Donald T. Nicolaisen, Chief Accountant, SEC, *A Securities Regulator Looks at Convergence*, April 2005. Christopher Cox, Chairman, SEC, *Accounting Standards: SEC Chairman Cox and EU Commissioner McCreevy Affirm Commitment to Elimination of the Need for Reconciliation Requirements*, February 8, 2006; both available at www.sec.gov.

ing changes were very much a move to IFRS.¹⁵ From the IASB's perspective, the short-term convergence project on discontinued operations moves IFRS closer to U.S. GAAP.¹⁶ The FASB has also proposed changes to the requirements on earnings per share that would make the requirements in U.S. GAAP closer to those in IFRS.¹⁷ Other ongoing short-term convergence projects will address aspects of accounting for income taxes and accounting for research-and-development expenditures.

Major Projects. These joint projects are likely to result in major changes for those applying U.S. GAAP and international standards. In addition to the joint project on business combinations, major joint projects are under way on revenue recognition, the conceptual framework, and financial-performance reporting. The FASB and IASB jointly issued exposure drafts on business combinations and on consolidated financial statements that include accounting and reporting of noncontrolling interests in subsidiaries. The other three joint projects are in various stages of active development.

The business combinations exposure drafts illustrate the degree of fundamental change these projects are likely to create. They propose to move from a cost-accumulation or invested-capital model to a fair-value model

for determining the investment and to replace parent-entity reporting with an economic-entity approach to business combinations and consolidations. In addition, the proposals would require "full fair value" measurements for initial recognition for all assets and liabilities, including goodwill, in the acquiring company's financial statements, even when there is remaining minority interest that was not acquired. Minority interest, which would be renamed noncontrolling interest, would be considered an element of equity. The proposed requirements differ significantly from both existing U.S. GAAP and IFRS. However, the proposed changes would be much more significant for those who apply U.S. GAAP because, unlike U.S. GAAP, IFRS already reflects identifiable assets and liabilities at full fair value and includes minority interest within equity.

The performance-reporting project could have far-reaching effects. It could radically change the income statement as companies currently know it. The Boards are working to create a framework for displaying financial performance in a manner that would distinguish operating from financing and other nonoperating activities. The project represents an opportunity to create a presentation that distinguishes items recognized at fair value from those recognized at historical or amortized cost in order to help alleviate the

problems from the current "mixed attribute" model of financial reporting. If that happens, the project could ease the transition to new standards requiring additional fair-value information in the financial statements.

Coordinated Projects. The FASB and IASB agreed when they began their efforts to reduce differences between their accounting requirements that convergence would be considered in every project undertaken. Thus the Boards are working together outside the short-term and major convergence projects.

For example, the IASB released a proposal in June 2005 to amend IAS 37 on provisions, contingent liabilities, and contingent assets.¹⁸ The FASB subsequently issued an Invitation to Comment on accounting for assets and liabilities with uncertainties that includes many of the same questions and issues already published in the IASB proposal. The project could ultimately lead to fundamental changes in the approach now followed under Statement 5 on accounting for contingencies. Similarly, the FASB's proposal on fair-value measurements was followed by an IASB discussion document on measurement bases for financial reporting that contained similar ideas.¹⁹

The ongoing level of cooperation outside the short-term and major convergence projects will add to the influences the two standard

¹⁵ FASB Statements No. 151, *Inventory Costs*, December 2004; No. 153, *Exchanges of Nonmonetary Assets*, December 2004; and No. 154, *Accounting Changes and Error Corrections*, May 2005; all available at www.fasb.org.

¹⁶ IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, March 2004.

¹⁷ FASB Proposed Statement, *Earnings per Share*, September 30, 2005, available at www.fasb.org.

¹⁸ IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, March 2004.

¹⁹ IASB, *Discussion Paper, Measurement Bases for Financial Accounting—Measurement on Initial Recognition*, November 2005.



setters have on each other going forward. The likely result based on coordinated projects thus far is that if the IASB has acted on a subject, its prior thinking will influence the initial course of the project and vice versa.



The three subjects addressed above cover a lot of ground, but they do not sum up all the trends and challenges that face the FASB or the influences that affect it. The changing economy has always affected the need for new and changed standards, for example, and can be expected to in the future. Institutions other than the IASB, such as the SEC, affect the course of standard setting and its priorities, and suggestions come from various other groups and individuals. Given the support the FASB has received so far, we expect it will continue its work to simplify accounting standards, increase the applicability of fair-value measures, and establish greater convergence with international accounting standards.

The descriptive and summary statements above are not intended to be a substitute for the text of any of the cited documents or any other potential or actual requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. Those accounting for specific transactions or filing reports with the SEC should refer to the texts of the applicable documents that set out GAAP and SEC requirements and consult their accounting and legal advisors.

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