

previously issued financial statements and as a practical matter obviate the need to debate whether the interim period is a discrete period, an integral part of an annual period, or some combination of both.

We also note that these principles will provide a mechanism, other than restatement, to correct through the current period a particular error that has often been at the center of the interim materiality debate – a newly-discovered error that has accumulated over one or more annual or interim periods, but was not material to any of those prior periods.

III. Judgment

Background

Overview

Judgment is not new to the areas of accounting, auditing, or securities regulation – the criteria for making and evaluating judgment have been a topic of discussion for many years. The recent increased focus on judgment, however, comes from several different developments, including changes in the regulation of auditors, more use of fair value estimates, and a focus on more principles-based standards. Investors are likely to benefit from more emphasis on principles-based standards, since rules-based standards (as discussed in chapters 1 and 2) may provide a method, such as through exceptions and bright-line tests, to avoid the accounting objectives underlying the standards. In other words, without the exercise of judgment, rules in the form of bright lines may result in a false consistency – that is, ostensibly uniform accounting for differing fact patterns. If properly implemented, “principles-based” standards should improve the information provided to investors while reducing investor concerns about “financial engineering” by companies using the rules to avoid accounting for the substance of a transaction. While preparers appear supportive of a move to less prescriptive guidance, they have expressed concern regarding the perception that current practice by regulators in evaluating judgments does not provide an environment in which such judgments may be generally respected.¹⁵⁵ This, in turn, can lead to repeated calls for more rules, so that the standards can be comfortably implemented.

Many regulators also appear to encourage a system in which preparers can use their judgment to determine the most appropriate accounting and disclosure for a particular transaction. Regulators assert that they do respect judgments, but also express concerns that some companies may attempt to inappropriately defend certain errors as “reasonable judgments.” Identifying how regulators evaluate judgments may provide an environment that promotes the use of judgment and encourages consistent evaluation practices among regulators.

¹⁵⁵ See, e.g., comment letters from Financial Executives International – Committee on Corporate Reporting (April 4, 2008) and Deloitte and Touche LLP (March 31, 2008).

Goals of Potential Guidance on Judgments

The following are several issues that any potential guidance related to judgments may help address:

- a. Investors' lack of confidence in the use of judgment – Guidance on judgments may provide investors with greater comfort that there is an acceptable rigor that companies follow in exercising reasonable judgment.
- b. Preparers' concern regarding whether reasonable judgments are respected – In the current environment, preparers may be afraid to exercise judgment for fear of having their judgments overruled, after the fact, by regulators.
- c. Lack of agreement in principle on the criteria for evaluating judgments – Identification of the criteria for evaluating reasonable judgments, including the appropriate role of hindsight in the evaluation, may not be clearly defined, which may lead to increased uncertainty.
- d. Concern over increased use of principles-based standards – Companies may be less comfortable with their ability to implement more “principles-based” standards if they are concerned about how reasonable judgments are reached and how they will be assessed.

Categories of Judgments that are Made in Preparing Financial Statements

There are many categories of accounting and auditing judgments that are made in preparing financial statements, and any guidance should encompass all of these categories, if practicable. Some of the categories of accounting judgment are as follows:

1. Selection of accounting standard

In many cases, the selection of the appropriate accounting standard under U.S. GAAP is not a highly complex judgment (e.g., leases would be accounted for using lease accounting standards and pensions would be accounted for using pension accounting standards). However, there are cases in which the selection of the appropriate accounting standard can be highly complex.

For example, the standards on accounting for derivatives contain a definition of a derivative and provide scope exceptions that limit the applicability of the standard to certain types of derivatives. To evaluate how to account for a contract that has at least some characteristics of a derivative, one would first have to determine if the contract met the definition of a derivative in the accounting standard and then determine if the contract would meet any of the scope exceptions that limited the applicability of the standard. Depending on the nature and terms of the contract, this could be a complex judgment to make, and one on which experienced accounting professionals can have legitimate differing, yet acceptable, opinions.

2. Implementation of an accounting standard

After the correct accounting standard is identified, there are judgments to be made during its implementation. Examples of implementation judgments include determining if a hedge is effective, if a lease is an operating or a capital lease, and what inputs and methodology should be utilized in a fair value calculation. Implementation judgments can be assisted by implementation guidance issued by standards-setters, regulators, and other bodies; however, this guidance could increase the complexity of selecting the correct accounting standard, as demonstrated by the guidance issued on accounting for derivatives.

Further, many accounting standards use wording such as “substantially all” or “generally.” The use of such qualifying language can increase the amount of judgment required to implement an accounting standard. In addition, some standards may have potentially conflicting statements.

3. Lack of applicable accounting standards

There are some transactions that may not readily fit into a particular accounting standard. Dealing with these “gray” areas of U.S. GAAP is typically highly complex and requires a great deal of judgment and accounting expertise. In particular, many of these judgments use analogies from existing standards that require a careful consideration of the facts and circumstances involved in the judgment.

4. Financial statement presentation

The appropriate method to present, classify and disclose the accounting for a transaction in a financial statement can be highly subjective and can require a great deal of judgment.

5. Estimating the actual amount to record

Even when there is little debate as to which accounting standard to apply to a transaction, there can be significant judgments that need to be made in estimating the actual amount to record.

For example, opinions on the appropriate standard to account for loan losses or to measure impairments of assets typically do not differ. However, the assumptions and methodology used by management to actually determine the allowance for loan losses or to determine an impairment of an asset can be a highly judgmental area.

6. Evaluating the sufficiency of evidence

Not only must one make a judgment about how to account for a transaction, but the sufficiency of the evidence used to support the conclusion must also be evaluated. In practice, this is typically one of the most subjective and difficult judgments to make.

Examples include determining if there is sufficient evidence to estimate sales returns or to support the collectability of a loan.

Levels of Judgment

There are many levels of judgment that occur related to accounting matters. Preparers must make initial judgments about uncertain accounting issues; the preparer's judgment may then be evaluated or challenged by auditors, investors, regulators, legal claimants, and even others, such as the media. Guidance should not suggest that those who evaluate a judgment must re-perform the judgment according to the guidance. Instead, guidance should provide clarity to those who would make a judgment on factors that those who would evaluate the judgment would consider while making that evaluation.

Hindsight

The use of hindsight to evaluate a judgment where the relevant facts were not available at the time of the initial release of the financial statements (including interim financial statements) is not appropriate.¹⁵⁶ Determining at what point the relevant facts were known to management, *or should have been known*,¹⁵⁷ can be difficult, particularly for regulators who are often evaluating these circumstances after substantial time has passed. Therefore, hindsight should be based only on the facts reasonably available at the time the relevant annual or interim financial statements were issued.

Form of Potential Guidance

We believe that there are many different ways that potential guidance on judgment could be provided. To be successful, however, we believe that guidance on judgment should not eliminate debate, nor be inflexible or mechanical in application. Rather, the guidance should encourage preparers to organize their analysis and focus preparers and others on areas to be addressed, thereby improving the quality of the judgment and likelihood that regulators will accept the judgment. Any guidance issued should be designed to stimulate a rigorous, thoughtful and deliberate process rather than a checklist-based approach for making and evaluating judgments.¹⁵⁸

¹⁵⁶ See, e.g., comment letter from Deloitte and Touche LLP (March 31, 2008).

¹⁵⁷ We believe that those making a judgment should be expected to exercise due care in gathering all of the relevant facts prior to making the judgment.

¹⁵⁸ See, e.g., comment letter from CALPERS (March 13, 2008).

A preferred way to accomplish the goals we set forth earlier as well as to guard against the potential that such guidance would develop into a checklist-based approach is for the SEC to articulate its approach to evaluating judgments. As discussed earlier in this report, one of the major concerns surrounding the use of judgment is the possibility of a regulator “second-guessing” the reasonableness of a judgment after the fact. We believe that a primary cause of this concern is a lack of clarity and transparency into the approach the SEC uses to evaluate the reasonableness of judgments. The SEC has articulated its policies in the past with success. Examples of previous articulations of policy by the SEC include the “Seaboard” report (October 23, 2001) relating to the impact of a company’s cooperation on a potential SEC enforcement case and the SEC’s framework for assessing the appropriateness of corporate penalties (January 4, 2006). We believe that a statement of policy¹⁵⁹ could implement the goals we have articulated and therefore recommend that the SEC and the PCAOB issue statements of policy describing how they evaluate the reasonableness of accounting and auditing judgments.

The Nature and Limitations of U.S. GAAP

Some have suggested that a factor for evaluating judgments be a requirement to reflect the “economic substance” of a transaction. For example, there is general agreement that accounting should follow the substance and not just the form of a transaction or event. Many believe that this fundamental principle should be extended to require that all U.S. GAAP judgments reflect economic substance. However, reasonable people disagree on what economic substance actually is, and many would conclude that significant parts of current U.S. GAAP do not require and do not purport to measure economic substance (e.g., accounting for leases, pensions, certain financial instruments and internally developed intangible assets are often cited as examples of items reported in accordance with U.S. GAAP that would not meet many reasonable definitions of economic substance).

Similarly, some have suggested that a factor for evaluating judgments be a requirement to reflect the “high road” – to use the most preferable principle in all instances. Unfortunately, today a preparer is free to select from a variety of acceptable methods allowed by U.S. GAAP (e.g., costing inventory, measuring depreciation, and electing to apply hedge accounting are just some of the many varied methods allowed by U.S. GAAP) without any qualitative standard required in the selection process. In fact, a preferable method is required to be followed only when a change in accounting principle is made, and a less preferable alternative is fully acceptable absent such a change.

We agree that qualitative standards for U.S. GAAP such as these would be desirable and we encourage regulators and standards-setters to move financial reporting in this direction. However, such standards are not always present in financial reporting today, and we cannot recommend the articulation of such standards in an SEC statement of policy without anticipating a fundamental long-term revision of U.S. GAAP – a change that would be beyond our purview and one that would not be doable in the near- or

¹⁵⁹ See, e.g., comment letter from CALPERS (March 13, 2008).

intermediate-term. Our recommendation that the SEC issue a statement of policy relating to its evaluation of judgments could and we believe would enhance adherence to U.S. GAAP, but such a statement of policy cannot be expected to correct inherent weaknesses in the standards to which judgment would be applied.

Recommendation

Broadly speaking, preparers and auditors should abide by the principles that underlie accounting standards. To support this goal, we recommend the following:

Recommendation 3.5: The SEC should issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it considers when making this evaluation. The PCAOB should also adopt a similar approach with respect to auditing judgments.

The statement of policy applicable to accounting-related judgments should address the choice and application of accounting principles, as well as estimates and evidence related to the application of an accounting principle. We believe that a statement of policy that is consistent with the principles outlined in this recommendation to cover judgments made by auditors based on the application of PCAOB auditing standards would be beneficial to auditors. Therefore, we recommend that the PCAOB develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards. The PCAOB's statement of policy should acknowledge that the PCAOB would look to the SEC's statement of policy to the extent the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor's compliance with PCAOB auditing standards.

We believe that it would be useful if the SEC also set forth in the statement of policy factors that it looks to when evaluating the reasonableness of preparers' accounting judgments.

The Concept of Judgment in Accounting Matters

Judgment, with respect to accounting matters, should be exercised by a person or persons who have the appropriate level of knowledge, experience, and objectivity to form an opinion based on the relevant facts and circumstances within the context provided by applicable accounting standards. Judgments could differ between knowledgeable, experienced, and objective persons. Such differences between reasonable judgments do not, in themselves, suggest that one judgment is wrong and the other is correct.¹⁶⁰

¹⁶⁰ Some have asserted that the acceptance of reasonable judgments may result in a lack of comparability that is inconsistent with the principles expressed in chapter 1. However, regardless of the level of detail in accounting guidance, judgment will always be required. This is especially true in the context of newly-adopted standards, which cannot contemplate all implementation questions prior to issuance. As discussed

Therefore, those who evaluate judgments should evaluate the reasonableness of the judgment, and should not base their evaluation on whether the judgment is different from the opinion that would have been reached by the evaluator.

We have listed below various factors that we believe preparers should consider when making accounting judgments. The SEC may want to take these factors into account in developing its statement of policy. We also believe that a suggestion by the SEC that preparers should carefully consider these factors when making accounting judgments would be beneficial in not only increasing the quality of judgments, but also in helping the SEC and preparers more efficiently resolve potential differences during the SEC's review of a preparer's filings. However, the mere consideration by a preparer of these factors in a SEC statement of policy would not prevent a regulator from asking appropriate questions about the accounting judgments made by the preparer or asking companies to correct unreasonable judgments. In fact, there is no guarantee that the preparer's consideration of the SEC's suggested factors articulated in a statement of policy would result in a reasonable judgment being reached. Rather, the statement of policy should be designed to encourage preparers to organize their analysis and focus preparers and others on areas that are likely to be addressed in the SEC's review, thereby improving the quality of the judgment and likelihood that regulators will accept the judgment. We encourage the SEC to seek to accept a range of alternative reasonable judgments when preparers make good faith attempts to reach a reasonable judgment. A preparer's failure to follow the SEC's suggested factors in its statement of policy, however, would not imply that the judgment is unreasonable.

We would expect that, in the evaluation of judgments made using the factors that are cited below, the focus would be on significant matters requiring judgment that could have a material effect on the financial statements taken as a whole. We recognize that the facts and circumstances of each judgment may indicate that certain factors are more important than others. These factors would have a greater influence in an evaluation of the reasonableness of a judgment made by a preparer.

Factors to Consider when Evaluating the Reasonableness of a Judgment

We believe that accounting judgments should be based on a critical and reasoned evaluation made in good faith and in a rigorous, thoughtful, and deliberate manner. We believe that preparers should have appropriate controls in place to ensure adequate consideration of all relevant factors. Factors applicable to the making of an accounting judgment include the following:

in chapter 2, we believe that the FASB should closely examine if a new accounting standard is being interpreted inconsistently and take appropriate action, if needed. To promote consistency, we also include factors 8 and 9 in our suggestions for an SEC statement of policy on the evaluation of the reasonableness of accounting judgments.

1. The preparer's analysis of the transaction, including the substance and business purpose of the transaction
2. The material facts reasonably available at the time that the financial statements are issued
3. The preparer's review and analysis of relevant literature, including the relevant underlying principles
4. The preparer's analysis of alternative views or estimates, including pros and cons for reasonable alternatives
5. The preparer's rationale for the choice selected, including reasons for the alternative or estimate selected and linkage of the rationale to investors' information needs and the judgments of competent external parties
6. Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated
7. The level of input from people with an appropriate level of professional expertise¹⁶¹
8. The preparer's consideration of known diversity in practice regarding the alternatives or estimates¹⁶²
9. The preparer's consistency of application of alternatives or estimates to similar transactions
10. The appropriateness and reliability of the assumptions and data used
11. The adequacy of the amount of time and effort spent to consider the judgment.

When considering these factors, it would be expected that the amount of documentation, disclosure, input from professional experts, and level of effort in making a judgment would vary based on the complexity, nature (routine versus non-routine), and materiality of a transaction or issue requiring judgment.

Material issues or transactions should be disclosed appropriately. We note that existing disclosure requirements should be sufficient to generate transparent disclosure that enables an investor to understand the transaction and assumptions that were critical to the judgment. The SEC has provided in the past, and should continue to consider providing, additional guidance on existing disclosure requirements to encourage more transparent disclosure. In addition, when evaluating the reasonableness of a judgment, regulators should take into account the disclosure relevant to the judgment.¹⁶³

¹⁶¹ In many cases, input from professional experts would include consultation with a preparer's independent auditors or other competent external parties, such as valuation specialists, actuaries or counsel.

¹⁶² If there is little diversity in practice, it would be significantly harder to select a different alternative.

¹⁶³ Existing disclosure requirements include the guidance on critical accounting estimates in the SEC's *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, SEC Release No. 33-8350 (December 19, 2003) (2003 MD&A Interpretive Release); the SEC's *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, SEC Release No. 33-8040 (December 12, 2001); and Accounting Principles Board Opinion No. 22, *Disclosure of Accounting Policies*. We also encourage the SEC to continue to remind preparers of ways to improve the transparency of disclosure, such as through statements like the Sample Letter sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements) issued by the Division of Corporation Finance in March 2008.

Documentation

The alternatives considered and the conclusions reached should be documented contemporaneously. This will ensure that the evaluation of the judgment is based on the same facts that were reasonably available at the time the judgment was made. The lack of contemporaneous documentation may not mean that a judgment was incorrect, but would complicate an explanation of the nature and propriety of a judgment made at the time of the release of the financial statements.