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FOSTERING ACCURACY AND TRANSPARENCY IN FINANCIAL REPORTING

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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FOSTERING ACCURACY AND TRANSPARENCY IN FINANCIAL REPORTING

Wednesday, March 29, 2006

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Castle, Biggert, Shays, Davis of Kentucky, Kanjorski, Velazquez, Hinojosa, Miller of North Carolina, Scott, and Wasserman-Schultz.

Ex officio: Representatives Oxley and Frank.

Also present: Representative Cleaver of Missouri.

Chairman BAKER. Good morning. Welcome, all of our distinguished participants this morning. I have been advised that Mr. Kanjorski is on his way, but did not express any concern about us convening the hearing in his absence, and we will proceed accordingly.

The purpose of the hearing this morning is to begin what I hope will be a helpful discussion relative to current corporate requirements for financial disclosures.

Since 1934, public companies have been required by the SEC to file certain financial information with the SEC. As is usually the case, over a considerable number of years, those reporting requirements have become increasingly complex, and much more sophisticated. All of this, of course, is disclosed in conformity with GAAP standards.

In addition to SEC requirements, of course, the Financial Accounting Standards Board, known as FASB, has also required the filing of certain supplementary information. The picture that is now presented every 90 days to the public, the "beat the Street" mentality, is a cause of some concern.

On the one hand, the intended purpose of the frequent financial disclosures is to enable an investor to create, in his own mind, an accurate assessment of the corporation's true financial condition. Because of the complexity of the disclosures, the typical investor, really, is overwhelmed by the data, and most don't really make much use of the inordinate amount of disclosure that is required.

On the other hand, it's my view that, at least during the 1990's, the effort to "beat the Street" every quarter by management incentivized the presentation of a corporation's financial condi-

tion—although in a legal—but in the most advantageous manner possible, to present to the markets and to potential investors the most optimistic perspective of the corporation's operating condition.

It has resulted, I believe, in the more disturbing disclosures made later in the decade, where there was intentional manipulation of the financials to mislead the markets and investors.

Although those were the exceptions and not the rule, clearly the incentives are now in place, I believe, to cause the CFO, the CEO, and others, to report, as best they can, a clearly optimistic view of the corporation's condition.

I think now it's time to hear from those in the market, and those who regulate markets, as to whether there is a shared view that there is a better way to do this.

Specifically, the FDIC has recently concluded a pilot program with about 300 insured financial depositories implementing, to my knowledge, the first broad-based use of extensible business reporting language, XBRL. Although now poised to move forward at some point to require all financial entities to report in similar fashion, that action has not yet been taken.

Although there are some individual corporations who have, on their own, begun to file in a manner very similar to an XBRL-like system, there is not yet an industry or SEC view that we are ready to move to replace the quarterly earnings with something of this nature.

I would hope that, in a very broad perspective, in looking from the 50,000-foot level down, perhaps, that we could consider moving away from the retrospective, rules-based reporting, which tells you, perhaps, if you're smart, where the corporation was about 4 months ago, as opposed to a more forward-looking view—without liability attaching—of where the corporation might be at the moment, and more importantly, where it might be going.

My best example to support that perspective is if one was in the business of manufacturing widgets, and under the current system you showed the sale of $100 million worth in the last quarter under the current reporting system, but in current time, real time, your customer satisfaction surveys were indicating that 90 percent of the customers didn't like your widget. As an investor, which would you rather know?

I think disclosure of real-time material facts in user-friendly form could be a very helpful thing in comparative analysis by investors.

And finally, the reason why this is so essential to Members of Congress is that over half of all Americans now, through the workplace, through direct investment, or in some fashion, are invested in our markets. They are a source of an inordinate amount of capital. And we have the obligation to make sure that the working families of this country, who rely on the information given to make investment decisions, are getting accurate information that can be relied on.

And I think this discussion will help us determine whether the current system does that, or whether there is potential for modifications that would be helpful to all who share an interest in this very vibrant marketplace.

With that, did you have a statement, Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman. Mr. Chairman, I, like you, am so excited about this hearing today because of the content that we are going to get into, and I know that you called me at 2:30 in the morning and you couldn't sleep because of the—

Chairman BAKER. Calm down, you're going to be okay.

Mr. KANJORSKI. But quite frankly, I want to congratulate you for calling the hearing. We look forward to this. This is an important issue, we can do an awful lot with it.

I have had the occasion to meet with some of the witnesses in the last several weeks, and I know how dedicated they are to fostering accuracy and transparency.

So, I congratulate Mr. Chairman on the hearing. Thank you.

Chairman BAKER. I thank the gentleman. Mr. Shays?

Mr. SHAYS. Mr. Chairman, I have an introduction. Should I wait later, and do that?

Chairman BAKER. Yes, sir. I think at the appropriate time, yes. Mr. Frank, did you have a statement?

Mr. FRANK. Thank you, Mr. Chairman. I am particularly glad we're having this hearing, because I think it is a chance for us to talk about some things that were done well, and to focus on how to build on what has been done well, and improve it.

The question of the Sarbanes-Oxley bill is obviously an important one for people, especially since next year we will be Sarbanes-Oxley-less in both houses. And the two guardians of that effort will no longer be with us. But their handiwork will be.

And there has been some criticism of it. I think it is in everybody's interest to focus on improvement in that, rather than to talk about any substantial cut-back. And I welcome the participation of the people to whom I think we are ready to entrust the responsibility of some refinement.

And I think we could make it clear—and I would want to say now—as the entities we are dealing with look at Sarbanes-Oxley, I hope they will be willing to make some appropriate adjustments—not exemptions, but adjustments—in how this applies, particularly in part, based on size, and I hope—we would tell them that if there were any things that they thought made sense, that they thought they might like statutory authority to do, they should ask us. I think there would be a great willingness to give them the statutory authority, rather than to make changes in the text of the law, but to give the administrators the flexibility that ought to be necessary with something of this complexity.

I also want to say, Mr. Chairman—maybe it's a little too early, I don't think so—I know one of the great hypocrisies in life is when people say, "I don't like to say, I told you so." In my experience, everyone likes to say, "I told you so." I should add, with my birthday 2 days away, that I find it to be one of the few pleasures that improves with age. I can do it unaided, there are no negative consequences, and you just do it, even as you get older.

And I guess I have a riddle that I ask people: "What does same sex marriage in Massachusetts have in common with the expensing of stock options by corporations?" And the answer is, "A big hoohah that resulted in nothing." That is, in both cases, we had people predicting all sorts of adverse consequences for something which turns out, in practice, to have had virtually none of those consequences.

Now, my hope is, with regard to the expensing of stock options, that now that I think it is accepted as a fait accompli, we will get cooperation in improving the method by which we value them.

I agree, there were legitimate concerns about the methodology. I think one of the problems was that people who were opposed to it in principle understandably didn't want to collaborate in improving it. And that's not a bad attitude. We all take that position. If we don't think something should happen, we are not going to work to make it better. But now that it's clear that it's not going away—and I think the absence of adverse reaction helps with that—I hope, again, we will all work together.

And it's obviously in the expertise of the people before us, that joint responsibility among the three, to help and solicit the input from the companies that are affected, so we can make this work better with even more smoothness.

The final point I just want to raise is—and I appreciate what's been done by the SEC, and I look forward to a collaborative effort again on the question of executive compensation.

And I want to repeat what I have said before. The question of what appears to me to be excessive executive compensation is not simply a matter of envy—although that certainly is not an absent factor in politics, as many know, including our former long-time colleague who know chairs the PCAOB—but I think it has significant negative social consequences.

First of all, you cannot look at the increased resistance to America's involvement in the global economy, the adoption of labor-saving information technology, and pro-productivity devices, and disconnect it from the unhappiness many people feel about what they think is excessive inequality. And excessive inequality has two sides to it: no real wage increase for the average worker; and what appears to me and many others to be excessive compensation on the other side.

And I would simply add again, for people who think this is just a matter of envy, in the study done by Lucian Bebchuk and others at Harvard—and it has not been contested—the percentage of the after-tax profits of the 1,500 largest corporations, according to him, that in 2003 went to compensation for the top, I think, 3 executives, was 10.3 percent of the profits. That's a macro-economically significant statistic, and it has almost certainly increased since then, because if you look at the table, it had increased from—it had doubled from, like, 1995 to 2003. So we are talking maybe 11 or 12 percent of after-tax profits. That's real money that can be used.

So, I look forward to further work, and I think the SEC has taken a good first step. I don't think—there was no significant support—and I will finish in 30 seconds, Mr. Chairman—for us setting salaries. What I think we need to do is to increase the public notion of this, the transparency, and then also work together so there is a mechanism for the owners of these companies, the stock holders, first to get the information, and secondly, to decide on it.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman. Mr. Davis, did you have a statement?

Mr. DAVIS. Thank you, Mr. Chairman. I want to thank Chairman Oxley and Ranking Member Frank for their support of this issue.

Thank you, Chairman Baker, and Ranking Member Kanjorski, for holding this hearing on such an important and relevant topic.

Thank you also to the members of the panels for coming here today. I appreciate your willingness to discuss this issue about reducing the complexity and many of the arcane regulations designed for a different era and a different economy, regarding financial reporting.

We have enjoyed a great working relationship from the committee with the SEC, with the Financial Accounting Standards Board, and also with the Public Company Accounting Oversight Board. I know the chairpersons and representatives of these organizations have been very forthcoming and willing to testify on Capitol Hill.

Yesterday I introduced H.R. 5024, the Promoting Transparency in Financial Reporting Act of 2006, with Mr. Scott and with Mr. Israel as original co-sponsors. This bill will require annual testimony for the next 5 years before the committee by the respective chairmen or their senior appointed designee of the SEC, FASB, and the PCAOB, relating to their efforts to reduce complexity in financial reporting.

I appreciate the efforts of these organizations thus far to reduce complexity, and Chairman Cox and Chairman Herz's public statements of support for such efforts.

I want to emphasize the importance that the members of the Capital Markets Subcommittee and the Full Committee leadership have placed on the issue, and I want to ensure, through this bill, that we are continually updated on the progress that is being made. This will keep members up to date, and also serve as a reminder to the agencies that promoting transparency and simplicity must be a top priority.

In the post-Enron financial era, transparent reporting has become an important aspect of promoting a healthy corporate environment. Financially stable corporations are essential for expanding the U.S. business sector, promoting investor confidence, and strengthening the economy.

As a former small business owner, and a consultant, I know, firsthand, the difficulties that are faced during time-consuming, costly processes of accounting, financial disclosure, and especially the compliance in section 404, with the Sarbanes-Oxley bill. What we want to see, ultimately, is a financial reporting system that is simple, that focuses on value-adding processes, simplifying compliance, which in turn will simplify a transparency, speed the processing for businesses and for the Federal Government, and reduce cost, in the long run.

Some of these efforts should include reassessing complex and outdated accounting standards, moving from rules-based to principle-based accounting standards, and promoting the use of plain English in disclosures, improving the ability of the average investor to read and understand accounting and auditing literature, and encouraging the use and acceptance of extensible business reporting language.

I would make a parenthetical statement on the side, as somebody who has done a lot of work in manufacturing in the high-technology arena. Many of the manufacturing, production, and competi-

tive processes that we need to compete in the global economy are not compatible with the prior generation's forms of financial accounting. And what I saw many companies have to do was use a state-of-the-art production system, and import it into a prior generation's accounting system for compliance with the Federal Government. And hopefully, we can see that simplified.

In closing, I would encourage all members of the Capital Markets Subcommittee to co-sponsor H.R. 5024, and join me in making this a priority. I want to say thank you again to Chairman Baker and Ranking Member Kanjorski, and thank you to the members of the panels for joining us today. We look forward to hearing your thoughts on the progress made thus far, and the plan for the future.

I yield back the remainder of my time. Thank you.

Chairman BAKER. I thank the gentleman. Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Mr. Chairman. I thank you and Ranking Member Kanjorski for calling this Congressional hearing on fostering accuracy and transparency in financial reporting.

I am looking forward to hearing the presentations by the Hon. Willis Gradison, as well as the Hon. Robert Herz, and Mr. Scott Taub.

I think that this issue is something that is very important to the State of Texas. We have had so many working families lose the savings that they had, and I think that it is our responsibility in this committee to have the oversight in public company accounting. And I believe that your presentations will be very important to us, and I look forward to hearing them. I yield back, Mr. Chairman.

Chairman BAKER. I thank the gentleman. Chairman Oxley?

The CHAIRMAN. Thank you, Mr. Chairman. Sorry for being tardy, but I was busy bragging on the House Floor about the Republican victory over the Democrats in the basketball game last night—

Chairman BAKER. I thought you were going to be talking about LSU in the final four, but that's okay.

The CHAIRMAN. Well, I will leave that up to you. But this game was all about bragging rights, so I took advantage of it in my one minute. I—probably because the gentleman from North Carolina didn't play for the other side. I don't know what ever happened with that. Does my friend from Massachusetts seek a—

Mr. FRANK. Well, I just say to the gentleman, enjoy the gym while you can.

[Laughter]

The CHAIRMAN. Well, I joined my friend from Massachusetts and voted against that terrible rule.

Welcome to all of our distinguished witnesses. We are here today to review the status of our public company financial reporting system. For over 70 years, public companies have been filing their financial statements with the SEC. Congress mandated these filings so that the investing public would understand the financial condition of public companies. And these statements and the explanations accompanying these statements are at the heart of investor disclosure.

It is critical for investors making decisions about where to put their money, that these statements are readable, accessible, and meaningful. Although we have been—we have seen some bad ac-

tors purposely and fraudulently deviate from accounting standards, the complexity of these standards can also be a factor in undermining compliance in well-intentioned companies.

I commend the FASB and the SEC for working towards reducing that complexity. I know we have had discussions ongoing on that very issue.

One approach to clarifying financial statements that the SEC and FASB are encouraging is the adoption of a principles-based—also called an objectives-oriented—accounting system. Far too often, we have seen companies engineer transactions to circumvent bright-line accounting rules, making any purpose behind these rules meaningless.

Under the Sarbanes-Oxley Act, we asked the SEC to study the adoption of a principles-based system, and the SEC concluded in its report that such an approach should ultimately result in more meaningful and informative financial statements. However, this movement towards principles-based accounting requires more than just the efforts of our regulators.

I encourage public companies, auditors, attorneys, and the securities industry to join in this initiative. There must be a concerted effort on the part of all market participants to move away from rules-based accounting and auditing standards to a principles-based financial reporting system.

I look forward to hearing from our witnesses on how we can most quickly and successfully adopt such a system.

I would also like to commend the U.S. Chamber of Commerce for encouraging its public company members to cease issuing quarterly earnings guidance. It is too tempting, once that guidance is issued, for a company to manage its business to meet those short-term earnings numbers, rather than to manage its business for the long-term health of the company.

This may lead to poor decisionmaking, but also sometimes to earnings manipulation. For the continued vitality of our capital markets, management and investors need to focus on long-term company health. One way, perhaps, to distance ourselves from relying on these quarterly earnings forecasts is to make progress toward real-time disclosure.

Again, I must commend the SEC under the leadership of Chairman Cox, for promoting a new way to more easily digest and analyze financial information through interactive data, or an eXtensible business reporting language, XBRL. Interactive data will allow investors to quickly download relevant financial information into their own software applications for analysis. No longer will time and money be spent on entering financial data into spreadsheets.

I look forward to hearing from our witnesses how they believe that XBRL will revolutionize the reporting and analysis of financial information.

I would also like to thank our colleague and the chairman of the subcommittee, Chairman Baker, for holding this timely hearing. Chairman Baker has, once again, taken the lead in improving financial reporting for investors. He took an interest in XBRL years ago, when few understood its benefits, and thought it was probably

some kind of a new car. And even fewer knew what it stood for, at that time.

I again welcome our distinguished witnesses today, our former colleague, Bill Gradison, from the Buckeye State, and Mr. Herz, Bob Herz, who has been an outstanding leader at FASB. And I want to also welcome the acting Chief Accountant at the SEC, Scott Taub, for his efforts on our behalf.

And with that, Mr. Chairman, I yield back.

Chairman BAKER. I thank the gentleman for his leadership on this matter. Mr. Miller, did you have a statement? Mr. Scott?

Mr. SCOTT. Yes, I thank you very much, Mr. Chairman. I want to thank you, Chairman Baker, and Ranking Member Kanjorski, for your leadership on this, and also Ranking Member Frank. And certainly Chairman Oxley, for the overall leadership in guiding our committee to this.

This is an important issue to so many, particularly small business owners. As a small business owner myself, I know the issues that we are faced with. One of the biggest complaints that we get in the financial service industry itself, a lot of the smaller companies, it's so complex, it's difficult, it has sprung up a cottage industry of professional explainers that they have to spend extra money going to, which costs them dearly.

And it is incumbent upon us to create more clear and accurate financial reporting. And I am very proud to join with my distinguished colleague from Kentucky, Mr. Davis, in working on a bill, Republicans and Democrats working together on a bill in a very strong bipartisan way that will require that the SEC and FASB and PCAOB provide an annual report to the Financial Services Committee. This will help us to keep our finger on the pulse, and be able to foresee problems as they develop.

This is an ongoing situation as business continues to grow. We want to make sure that our markets maintain vibrancy. We want to make sure that they maintain liquidity, and we want to lessen the complexity of financial statements, while at the same time increase the usefulness of the information gathered.

We have to also ensure that our reporting system does not lead to an overly hostile legal environment. And that is another complaint that we are getting, where auditors and accountants are afraid to provide information beyond, say, a rigid check-box system. More information is helpful for our investors.

But at the same time, we should ensure that information is reported in a way that is accurate. And I am sure all of you and the panelists agree that clear regulation of the markets will help keep our economy and our financial system strong. We have several reform models going forward, and many of you are advocating those.

We look forward to hearing your testimony on this very, very important matter. And I yield back the balance of my time, Mr. Chairman.

Chairman BAKER. I thank the gentleman. Mr. Castle, did you have a statement? Mr. Cleaver?

Mr. CLEAVER. Thank you, Mr. Chairman. I am not a member of this subcommittee, so I appreciate the opportunity to be here.

The—I have been paying close attention to the Enron trial, and one of the most amazing things that I am hearing from people—

and perhaps it's not anything unique to Kansas City, Missouri; it's probably nationwide—and that is that there is still a great deal of concern out in the real world about whether or not we are continuing to get reliable and accurate information from the Herculean corporations like Arthur Andersen and MCI WorldCom, and other companies.

So, I am here, in particular, to hear Mr. Gradison's statement, because I think for most of us, particularly on this committee, who celebrate the fact that Sarbanes-Oxley came from this committee, that we ought to be in a position to go back home and say that there are real efforts being made to reduce the likelihood of this happening again.

So, thank you, Chairman Baker, for the opportunity to be here, and to speak.

Chairman BAKER. I thank the gentleman. There being no additional members with opening statements, I want to express to my first panel my surprise at the number of members who are participating this morning, and that we have members not on the committee attending. So it's perhaps surprising to you that there is such intense interest among the members on this subject.

And we are particularly grateful to have the regulatory panel we have here today, starting first with our distinguished former member, Hon. Willis Gradison, who served with distinguished service for many years here, and now serves in his capacity as acting chair of the Public Company Accounting Oversight Board.

I know you are familiar with our customs, but for everyone, the formality is if you would proceed as you like, attempting to keep your remarks to 5 minutes, and your formal statement will be made part of the record. And we welcome you here. Please proceed, Mr. Gradison.

STATEMENT OF WILLIS GRADISON, ACTING CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Mr. GRADISON. Thank you, Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee and of the Full Committee. I am pleased to appear today to testify on accuracy, transparency, and complexity in financial reporting.

My remarks address the auditor's role in evaluating public companys' application of accounting and financial disclosure standards and rules. I will also discuss PCAOB's experience in establishing and monitoring the implementation of auditing and related professional practice standards, as they relate to audit quality.

The Sarbanes-Oxley Act directed PCAOB to establish an auditor oversight program in order to protect the public interest. PCAOB is also responsible for setting public company auditing standards. And PCAOB is responsible for evaluating auditor application of these standards, to promote high-quality audits, audits that focus on preventing financial reporting failures that we saw in companies ranging from A to Z—Adelphia to ZZZZ Best.

There has been a great deal of discussion about whether principles-based standards result in more accurate, reliable, and understandable financial statements than do prescriptive rules-based standards. True, principles-based standards allow more flexibility

and professional judgement, but they can also lead to undesirable variability in results.

On the other hand, rules-oriented standards may promote complexity, by encouraging companies to engineer transactions to achieve particular financial statement results.

PCAOB has received many requests for specificity and for exceptions to existing auditing standards. We are mindful that granting these requests could result in overly prescriptive standards, rather than providing a framework for the exercise of appropriate, professional judgement.

In my view, overly prescriptive auditing standards can actually weaken audit quality if they encourage auditors to focus on technical compliance, rather than the use of professional judgement. Merely completing a checklist of required procedures may not give the auditor the basis on which to form an opinion. Judgement is essential to the auditor's formation of an opinion.

To facilitate a smooth implementation of our auditing standards, the board and its staff have periodically issued guidance, giving careful attention to avoid detailed, rules-based or exceptions-laden approaches.

In addition, PCAOB can see, firsthand, how auditors are implementing auditing standards through our inspections program. When PCAOB inspectors find significant auditing deficiencies, we invite the firm to comment. This comment process not only helps us to verify or modify our own assessments, but also helps firms to identify the causes of sub-standard audit work.

Our inspectors discuss the relevant issues with firm representatives, ranging from the engagement team leader to the chief executive of the firm. Perhaps, more than anything else we do, it is our discussions with the firms that drive them to improve audit quality.

In addition, the board is committed to educating and seeking input, not just from auditors, but also from preparers, investors, regulators, academics, and other users of financial statements on how to improve audit quality, and thereby protect investors.

Whether through speeches or forums on auditing in the small business environment, or special reports summarizing inspection findings, PCAOB seeks to promote high-quality audits through its communication opportunities, only in cases involving more serious violations as the board relies on its various disciplinary tools.

The debate over accuracy, transparency, and complexity in financial reporting has enhanced public companies', auditors', investors', and regulators' awareness of the challenges our financial reporting system faces. In my view, this is the beginning of a collaborative effort to find solutions to these challenges, including finding the right balance between principles-based and rules-based standards.

I very much look forward to participating in the continuing dialogue, and want to thank you once again for the opportunity to address these very important issues.

[The prepared statement of Mr. Gradison can be found on page 64 of the appendix.]

Chairman BAKER. Thank you very much, sir. For the purpose of introduction of our next witness, I call Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman. I am very pleased to introduce our FASB chairman, Robert Herz. And just to say, parenthetically, that being on the Financial Services Committee for someone in the fourth Congressional District is like being on the Agricultural Committee from Iowa. I have lots of opportunities to introduce people, but Mr. Herz, I take tremendous pride in the work that you do, the work that FASB does.

Being from the fourth Congressional District, I know you live across the Hudson River in New Jersey, and that is still something that you need to think about.

[Laughter]

Mr. SHAYS. But your facilities in Norwalk, and what you people do, is terrific. And I congratulate you for a distinguished career as a senior partner with PricewaterhouseCoopers, as an author, and as an active participant in so many accounting industry organizations.

I thank you for your good work. I appreciate you being here today, and all of us look forward to your testimony.

Chairman BAKER. Please proceed, sir. But I might add, if Mr. Shays has gotten you into the relocation business, there are some really good buys down our way right now, so—

[Laughter]

Chairman BAKER. Please proceed.

STATEMENT OF ROBERT H. HERZ, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Mr. HERZ. Well, thank you, Congressman Shays, for that very, very kind introduction. Thank you for your long-standing support of our organization and our efforts. And thank you, Chairman Baker and Ranking Member Kanjorski, for inviting me here to participate in this very timely and important hearing.

I think the enactment of the Sarbanes-Oxley Act, and the subsequent related actions by the SEC, the PCAOB, and by the FASB, as well as many reforms within the business community, have strengthened financial reporting and increased public confidence in reported financial information.

However, we at the FASB, and we believe many others, think that there is much more work to be done to continue to improve financial reporting.

In our opinion, the complexity that pervades the reporting system, as evidenced by the volume and detail of standards, rules, and regulations, now poses a major challenge to maintaining and enhancing the accuracy and transparency of financial information reported to investors, creditors, and to the capital markets.

We are concerned that complexity has engendered a form over substance approach to accounting, auditing, and reporting, sapping professionalism and increasingly necessitating the involvement of technical experts to ensure compliance.

Complexity has also added to the growing cost and effort involved in financial reporting, and is a contributing factor to the unacceptably high number of restatements of financial reports by public enterprises.

Moreover, and perhaps most importantly, it results in analytical complexity for investors and others seeking to use financial information in their economic decisions.

While some of the complexity is a natural consequence of reporting on diverse and complicated business transactions, I think there are many other sources of complexity in our system, including: the focus and emphasis on short-term earnings; the often conflicting perspectives and agendas of different market participants; an evolutionary approach to standard-setting that has resulted in non-conceptually-based compromises at times and inconsistencies over time; regular demands for detailed rules, bright lines, and exceptions, driven in part by the fear of being second-guessed, and in part by those seeking special treatments and exemptions; continuing use of accounting-motivated structuring in an effort to obtain form over substance results; and resistance to change, and slowness in embracing and implementing new technologies and reporting models.

The FASB has recently undertaken a number of measures aimed at reducing complexity and improving relevance and transparency of financial reporting. First, we have been systematically readdressing specific accounting standards that are overly complex, are rules-based, and do not result in reporting that properly reflects the underlying economic activity.

Major areas that we are currently readdressing include revenue recognition and accounting for pensions and other post-employment benefits.

We also recently issued two new standards, and we have other active projects on our agenda, designed to improve and simplify the accounting for derivatives and other financial instruments.

Second, we have undertaken a very major project to develop and maintain a comprehensive and integrated codification of all the existing accounting literature. That will result in an easily retrievable single electronically based source for all of U.S. generally accepted accounting principles.

Third, we have been pursuing several activities directed towards the development of more principles-based, or objectives-oriented accounting standards, including a major project to strengthen our existing conceptual framework, that should provide a more solid and consistent foundation for the development of objectives-oriented standards in the future.

Consistent with our commitment to international convergence of accounting standards, this project, like many of our other current major projects, is being conducted jointly with the International Accounting Standards Board, whose standards are in use in some 100 countries around the world.

Finally, while the development in the United States of XBRL has been under the direction of the XBRL consortium, the FASB has been working with the consortium, the SEC, and others, to further the use of XBRL and other evolving technologies in financial reporting.

Now, as important as all those measures are, unfortunately, in my view, when taken alone, they are unlikely to significantly reduce the complexity that burdens the U.S. financial reporting system. In our view, that will require concerted and coordinated action

by all key parties in the reporting system to address the structural, cultural, and behavioral forces that generate complexity and impede transparent reporting.

Recently, we have been discussing the issues surrounding complexity with the SEC, with the PCAOB, and with many other interested parties. As part of those discussions, we have begun exploring the kinds of steps that might be necessary to identify the issues that lead to complexity, and to develop proposed solutions and recommendations.

We believe that an initiative involving all key parties would be the most effective means to bring about broad-based improvements aimed at both reducing complexity and increasing the accuracy and transparency of financial reporting. While such an effort would not be easy, and would take time, we believe it is one of national importance.

We look forward to continuing to work closely with the SEC, the PCAOB, this subcommittee, and all other interested parties, to ensure that U.S. financial reporting meets the needs of investors, creditors, and our capital markets. Thank you again, Mr. Chairman, and I will now yield to Mr. Taub.

[The prepared statement of Mr. Herz can be found on page 72 of the appendix.]

Chairman BAKER. Thank you for your comments and your participation here today.

And it's my pleasure to introduce Mr. Scott Taub, acting Chief Accountant, Securities and Exchange Commission. Welcome, sir.

STATEMENT OF SCOTT A. TAUB, ACTING CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION

Mr. TAUB. Thank you. Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee and the Full Committee, thank you for the opportunity to testify today on behalf of the SEC. My name is Scott Taub, and I currently serve as the acting Chief Accountant for the Commission. With help from the approximately 55 others in my office, I serve as the primary advisor to the Commission on matters of accounting and auditing policy, and the application of financial reporting and auditing standards.

The past few years have seen unprecedented change in the financial reporting environment, but the SEC's goal in this area remains the same: full disclosure by public companies of information that allows investors to understand companys' operations and financial position, and to make informed investment decisions. For that to occur, the information that is presented in financial reports must be clear and informative, or as accountants use the term, "transparent."

Recently, in accordance with the Sarbanes-Oxley Act, the SEC staff released a report commonly called the Off-Balance Sheet Report, that notes that achieving transparency depends on the efforts of many parties. Preparers of financial information must focus on communicating with investors, rather than just complying with rules. The legal system must operate in a way that rewards and encourages the use of unbiased professional judgement, and preparers and auditors must be willing to make those judgements.

Investors must be willing to make an attempt to understand the information presented to them, rather than simply looking to one figure, like earnings per share, in their analysis. And regulators must formulate a disclosure regime that requires disclosure of important information, without overburdening preparers or investors.

Of course, good financial reporting also depends on strong accounting standards. U.S. GAAP represents a comprehensive set of standards, and is respected around the world. And development of GAAP has always appropriately focused on promoting transparent reporting. However, various factors have resulted in GAAP becoming a large and complicated body of literature.

One of those factors that is highly visible today is the fear that market participants have of being second-guessed. This fear has helped create a demand for detailed rules, bright lines, and safe harbors that can overwhelm the basic principles that underlie accounting standards.

Pressure on GAAP also comes from the way the market looks at financial information, such as its emphasis on short-term performance, and its rewards for predictability and consistency. These pressures have sometimes led to overly prescriptive rules, different accounting for economically similar transactions, and the inclusion in standards of exceptions from key principles.

Many now are concerned that complexity is harming the quality of financial reporting, while simultaneously adding to its costs. Some contend that this complexity is a root cause of restatements, while others note that detailed and complicated standards can be used to hide information, rather than disclose it. Complex standards can also stand in the way of attempts by users to understand the effects of transactions and events.

However, it is important that we do not simply look to the standard-setters to resolve the problems of complexity. The state of our financial reporting system is the cumulative product of pressure from many constituencies, and considered and coordinated action by all market participants is essential in order to move forward.

Commission staff have been talking with many different parties about the need for such an effort, and we find widespread agreement amongst those in many different roles. We believe, therefore, that the time is right to encourage and foster a broad effort to address complexity and improve transparency.

Also important is to make sure that the information that is provided can be used effectively. Today, through the use of interactive data, we can see the possibility for information filed on electronic reports to literally come to life.

The best known and most advanced method for using interactive data is XBRL. XBRL uses identifying computer codes to tag data in financial reports, so that each piece of data carries a broad range of information about itself, such as whether it is a monetary item or percentage, an asset or liability, revenue or expense, and how the item is calculated.

For the preparers of financial reports, interactive data could streamline the collection and reporting of financial information to the SEC and the public. And the use of interactive data in Commission filings could provide consumers of data real-time access to data in an instantly usable format. Those consumers, including an-

alysts, investors, and others, could determine for themselves what data is important to them, and generate different types of analyses and reports with a minimum amount of effort.

In recognition of the potential of data-tagging technology, the Commission established a program that allows registrants to voluntarily submit financial information in an XBRL format. The goal of the program is to allow preparers, users, and the SEC to better understand the issues surrounding XBRL, and evaluate its benefits.

Approximately a dozen companies have submitted filings under the voluntary program, and Commission staff is currently working to increase the number of companies that participate in the program.

In addition, beginning in June and continuing through the remainder of this year, the Commission will host a series of roundtables focused on the implementation of XBRL. Discussion will include: assessing what investors and analysts are looking for; finding ways to accelerate the development and use of software tools to permit the use of interactive data; and how best to design the requirements for company disclosures to take maximum advantage of the technology.

As you can see, I believe that projects that reduce the complexity in reporting, and make financial information more user-friendly, have the potential to benefit investors and reporting companies, alike. The Commission, FASB, and PCAOB are all committed to the effort.

However, we cannot fulfill the potential without the assistance of and input from investors, members of managements and audit committees, accountants, lawyers, analysts, and many other participants in the American securities markets. We, of course, will also highly value the views of Congress and other regulators and standard-setters.

On behalf of the Commission, and myself, thank you for holding this hearing and highlighting these significant issues in such a timely manner. I look forward to answering any questions.

[The prepared statement of Mr. Taub can be found on page 208 of the appendix.]

Chairman BAKER. Thank you, sir, for your comments this morning. Mr. Taub, I will start with you. It is my understanding that perhaps later this morning, the SEC may announce formally—I would call it a pilot program for the utilization of interactive data/XBRL.

Are you in a position to be able to comment further about the scope or intention of that activity?

Mr. TAUB. I can, a little bit. We have been working to increase the number of companies that take advantage of the XBRL voluntary program, and we announced a couple of months ago that, for companies that were willing to file using an XBRL format for a year, we would be willing to give them expedited review status, such that if their filing was going to be reviewed, it would move to the front of the line, essentially.

We have had a number of companies that have taken us up on the offer, and we do have an announcement planned for any minute now, as far as I know, that indicates the companies that

have volunteered to participate. I think we have somewhere between 15 and 20 companies that have indicated a willingness to participate in the program, and we look forward to their input.

Chairman BAKER. Do you see this as—if successfully implemented, is this a step leading toward more broad-based disclosure, using interactive data, or is this sort of a, "Let's wait and see how this thing turns out," at this point?

Mr. TAUB. At this point, we are certainly in an evaluation stage. I think many of us at the SEC certainly believe that there are huge potential benefits of this, and hope to see it rolled out broadly.

But there are certainly a number of hurdles and obstacles to broad implementation of this kind of reporting, and that's the reason we're hosting roundtables, to try to explore ways to get over some of those obstacles, and to make improvements in areas that are needed in order to make it such that we can roll it out much more broadly.

Chairman BAKER. Thank you very much. Mr. Herz, in your comment—I take great interest in FASB's views.

The purpose of disclosure is to give the market an accurate picture of financial condition as of the date of preparation. With the current system, we manage that picture to be a 90-day snapshot. Some have suggested that if we move to a sort of real-time material fact disclosure, some of the more sophisticated financial enterprises, as of close of business 5:00, they know their position, internationally, where they are.

If we assume that a company, in the first month of the next reporting period, lost its major customer, obviously a material fact to future viability. Today, that team has 68 days left to manage how they're going to make that disclosure.

If you only require disclosure of material fact—and I know the next question is, "Well, what constitutes material fact," but assuming we can arrive at that—is it not advisable in the complex world we now face, with the extraordinary amount of data that is provided, to move to almost a daily snapshot to get out of this spike and trough mentality that seems to have substantial economic effect on capital markets without any real meaningful value to anyone, other than sharp speculators?

Is that something, in concept, that a FASB principle could support, or what is it that we're in pursuit of? If it's to minimize complexity, what is the net principle around which the reorganization should center?

Mr. HERZ. Well, thank you for that question. And I will answer partly, from my FASB role, but also partly from my prior involvement in some of these issues related to real-time reporting, and richer reporting of other key performance data, non-financial data, as you say, material information.

I think, probably just a factual matter first—I might refer to—check with Scott—but there are some things that are material events that the SEC does require on what they call an 8K. And I think those are within, generally, 5 days now, which may include, for example, the loss of a major customer. But it's not a comprehensive reporting, as you are envisioning on a daily basis of financial position, and changes in that financial position on a daily basis.

I certainly believe that is the kind of world we want to move towards. I am not certain at this point whether the infrastructure has developed in order to do that. I think we would have to think about all the components of that infrastructure, including to what extent that ought to be attested to or not attested to, what periodicity that ought to have, what level of detail, you know, which components of that, should it be a full integrated set of financial statements on a daily basis, or not, or whatever.

But there are clearly, evolving over time, more and more information that goes out to the market, both from companies and from other people following companies and people who follow industry trends, who follow weekly car sales, you know, all sorts of book-to-build ratios, that kind of thing. And that, to me, certainly seems to be the future that we ought to be trying to evolve towards.

But getting there, and the infrastructure needed to support that, I think are—still require some thought and development.

Chairman BAKER. I thank the gentleman. My time has expired. Mr. Kanjorski?

Mr. KANJORSKI. I feel a little perplexed, because I was going to suggest what would be the advantage for the American economy if we ended the quarterly reporting, and went to the yearly reporting, so we didn't have this tremendous effect on Wall Street, just by not considering some of the plans and conditions a company has laid in place to accommodate. It seems we're accounting for that quarterly release all the time.

You would like to go on a 24/7 schedule? Wouldn't that cause a great fluctuation in the marketplace?

Mr. HERZ. Well, I think we have to decide as to, really, whether or not—you know, how the market wants to operate, in terms of investment in securities, and people changing investments in securities.

If the market continues to operate the way it does now—and I'm not making a normative judgement, one way or the other, on that—I would see the path one of more frequent reporting. But it's kind of like if you have a game, you want to have the play-by-play as it goes along. Right now, what we seem to have is, in the quarterly earnings guidance, it's kind of saying, "Here is where I'm going to end up at the end of the quarter," rather than, I think as Chairman Baker is suggesting today, "Where am I," and then people do kind of a Kabuki dance around that expected number.

Mr. KANJORSKI. I am just curious as to whether or not you think that would affect the long-term—the difference between long-term planning of corporations and investments, or responding to the immediate play-by-play situation, for purposes of the effect on the market.

Isn't that part of the criticism in our system today, that we are, unlike Japan in many ways, that they plan for long-term investments, and long-term considerations, and as a result, they sometimes, at the end of the day, may beat us on the field, when you take the whole game, as opposed to the play-by-play?

Mr. HERZ. Well, certainly that is a consideration, I mean, I think ultimately you would want to design a system where the short-term reported results are consistent with the long-term, people understanding what the long-term strategy is, and what the bench-

marks towards that are, being able to evaluate progress towards that.

Mr. KANJORSKI. I guess, being a politician, I am sensitive to the 24/7 news cycle, and not at all certain that that has helped in national policy. It seems that everybody has a headache every day as a result of everything, as opposed to sitting back and having it given to you in a comprehensive way, with potential solutions for problems, as opposed to just hearing problems.

I haven't given a lot of thought, but day-to-day accounting, that would be interesting. I should imagine that those people have nothing else to do in life, but sit and read those statements every day would find that enjoyable, but I suspect that a good portion of their lives would be taken up with that endeavor. That's interesting.

Do you have any thought on whether or not we could go back to the yearly reporting, final reports, as opposed to these games we play that everybody—it seems to indicate in Enron and so many of the other companies, they were trying to beat the analysts on Wall Street. And as a result, they were finding clever mechanisms to use to do that. And I think we even have that in Fannie Mae. There was too much of a concentration on anticipating what the earnings figure would be, and they wanted to make adjustments to miss that.

Mr. HERZ. I think that is part of the issue, continues to be part of the issue. People make a projection for what the end of the quarter results are going to be, or the annual result is going to be, and then at least—and this experience is a little bit dated, from when I was in practice, but I—people tell me this still happens—that if you don't make the numbers based on just the business flow, then you try next to alter the business flow. You may try and accelerate sales, and the like.

If that still doesn't work, some people have tried to find ways to—through accounting, either aggressive or stepping over the line—to try and make those numbers for the quarter. But it's like trying to predict the outcome of a basketball game, you know, once the first ball is dribbled.

Mr. KANJORSKI. Mr. Gradison, did you have a comment on that?

Mr. GRADISON. Thank you. I think, in many respects, we have to start by focusing on the investors. Who are they? What are their interests? Are they short-term or long-term? And then, what kind of information are they looking for?

One thing that has struck me in the years that I have been involved in this—and I used to be in the investment business in an earlier life—has been what I perceive to be a shift towards investors in major companies having a very short-term focus.

The turnover rate of holdings, for example, of investment companies is much higher today, as I read the numbers, than it was many years ago. And so, I think that the reaction of reporting companies has to be thought of in terms of what—not just what the market in general wants, but who is holding their shares, what are their interests, and are they long-term or short-term?

The only other point I would make is that—and I think this is just reinforcing a point already made—is the distinction between financial information, which is reported quarterly, and other very important information, which may not be strictly financial: "Did

you lose"—"Did the customers like the widgets," as Chairman Baker said.

And I think that while the auditors—who are the folks that we oversee—are, by their very nature of their work and responsibilities, focused on the financial reporting—and that's very important—there are other things which, in many cases, will be every bit as important, sometimes more important, that bear upon the reaction of the markets, and the desire of—the desires of investors, with regard to what kind of things they want to know about.

Chairman BAKER. The gentleman's time has expired. Mr. Shays?

Mr. SHAYS. Thank you. I would like to pursue this issue a little more in depth. And it's my understanding that the Chamber is basically recommending the elimination of the forecast, and particularly the quarterly, earnings. And it does relate to this whole issue of whether the marketplace gets manipulated because of it.

So, I would like to know your opinion about the Chamber's view. And then I would like to ask why investors seem to look so much at the superficial. Because it seems to me, anyone who is investing a lot of money would probe deeper, and understand what is actually happening. Why don't we start with you, Mr. Taub?

Mr. TAUB. Thank you for the question. I think it is an excellent one.

To me, as I look at what happens in the market, it isn't necessarily the mere fact that there was an earnings forecast that is the problem, it is what happens after that, the management of the numbers to then meet that forecast.

At the SEC, we have long been on an effort to stamp out so-called earnings management that happens around those numbers.

Mr. SHAYS. Let me just interrupt you. Is it difficult for the investor to know that it is being manipulated, or is it relatively self-evident?

Mr. TAUB. I think that it all depends, frankly, on the sophistication of the way that the management is done. Certainly, we have tried to require disclosures, as has the FASB, to give people information that will at least let them evaluate what is happening with these numbers.

But it is something that really is—many people say you can't legislate ethics, and that is a problem—

Mr. SHAYS. Let me ask Mr.—I'm sorry, I have such little time, here. Mr. Herz, the answer to the question?

Mr. HERZ. Well, I guess, it's a free country, so people can give whatever forecasts they—

Mr. SHAYS. I would like to know what you think of the recommendation of the Chamber.

Mr. HERZ. Well, I agree with that recommendation, personally. Of course, we at the FASB do not—that's not our role, per se.

Mr. SHAYS. Okay.

Mr. HERZ. But I personally agree with that, from what I have seen are some problems around that whole process.

Mr. SHAYS. Then explain to me why the investor can't see through the manipulation.

Mr. HERZ. Well, the—

Mr. SHAYS. Or whether you think they actually can.

Mr. HERZ. The investors—I think investors who keep enough of a tune on the company may be able to.

For example, there are various ways you can manage earnings in a "legal" way. Like I said, accelerate sales, cut expenses. But you're kind of robbing from Peter to pay Paul in the—

Mr. SHAYS. We are doing that. But is it evident to the investor?

Mr. HERZ. I think the investor who follows the company may be able to do it. I think the investor who—if the company is transparent in its disclosure, for example in its quarterly MDTA disclosure, those kinds of things are supposed to be talked about.

Mr. SHAYS. Okay.

Mr. HERZ. If the company is just plain violating rules, that may not be found out until there is an audit, or until the SEC finds it out.

Mr. SHAYS. Or it may never be found out. Mr. Gradison, any opinion?

Mr. GRADISON. I think it's very hard for the investors to tell. For one thing, as more disclosure takes place, and you could see it in the annual reports and in the proxy statements; they're getting thicker and thicker—there is more and more information out there. But then the question arises, how many folks are really analyzing that?

And there is a real question, how many public companies, out of the 15,000 or whatever public companies, really have sponsorship in the sense of analysts professionally analyzing these things as they come out? I don't mean to minimize the number, but it certainly is not 15,000.

And so, for the average investor, trying to sort through these numbers is, in my opinion, well nigh impossible.

Mr. SHAYS. Okay. Let me close with you, Mr. Herz, and just have you speak briefly about what you're trying to do to codify all existing accounting literature to reduce this complexity. In the short time that I have left, could you just talk a little about it?

Mr. HERZ. Yes. I need probably about a 2-minute history lesson here, that what we call generally accepted accounting principles is, as Scott mentioned, something like over 2,000 separate pronouncements that emanated from many different bodies—not just the FASB and predecessors, but the AICPA in different forms, task forces, the SEC in various forms, over a long period of time.

And they were written in different ways to different depths, different levels of coverage. And we are now taking all of that and resorting it by topic in a structured way, so that it will now be almost like chapters. It will be electronic, but you will have a chapter on inventory accounting, and it will have a standard structure with all the other chapters, so people will know exactly what the sum total of GAAP is in that area.

And by doing that, we also feel we will probably come across certain conflicts between different—

Mr. SHAYS. Right.

Mr. HERZ.—pronouncements, which we will have to resolve.

Mr. SHAYS. Great. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. The gentleman's time is expired. Mr. Frank?

Mr. FRANK. Thank you. I was listening to my colleague, and I was intrigued by this Chamber position. I think it makes a great

deal of sense. Of course, the problem is that people will be in a competitive situation, and no one company will want to—or two companies do it.

I am wondering whether we might not institute a situation where, yes, companies are free to do that, but inaccuracy could lead to a suspension of the right. That is, we might say, "If you have a pattern of inaccuracy and you have to restate at some point," you might give the SEC the authority to say, "Well, we are going to suspend that." I think that's something to be examined.

But let me ask related to that, to what extent does the linkage between the compensation of the two or three top executives in the company add to the problem of the inaccuracy here? Mr. Gradison?

Mr. GRADISON. Well, I have to focus—will focus, of course, on the role of the auditors in this regard, because that's what we do. And the role of the auditor with regard to disclosure of compensation basically comes down to whether that information is disclosed in the 10K's and the financial reporting, or whether it is disclosed separately through the proxy statement.

If it is in the financial statements, then the auditors have a responsibility to read these disclosures and to consider whether they are consistent with the auditors' knowledge that was gained during the financial statement audit.

If, on the other hand, they are in the proxy statement—

Mr. FRANK. Who decides now where they are? The company? Well, let me put it this way. Should we require, then, that they be in the financial statement so they can get that kind of scrutiny?

Mr. GRADISON. I would imagine that would be up to the SEC to make that determination.

Mr. FRANK. Well, sometimes they let us make decisions too, Bill. [Laughter]

Mr. GRADISON. We certainly follow any decisions you make, sir.

Mr. FRANK. Right. But what about from the—given what you say, that where they are determines whether or not they are auditable. Would it make sense, in your judgement, for us to put them in a place where we—that would be audited?

Mr. GRADISON. Yes, it would.

Mr. FRANK. All right. Let me go back—and I just want to follow up on what my colleague from Connecticut said—on the question of stock options, because this is—we're talking about accuracy, and I think, in the years I've been here, the biggest single dispute over accuracy really was over how you reported stock options. Is that still—is undoing that decision in—still on the table, or is that now an accepted fact?

Let me go down the list. Mr. Taub, start with you.

Mr. TAUB. I guess, to my mind, it isn't on the table. There is certainly nothing that I am aware of that the FASB is currently considering, as far as potentially undoing—

Mr. FRANK. Let me ask Mr. Herz. Are you aware of any effort to overturn that decision?

Mr. TAUB. Not that I am aware of.

Mr. FRANK. Yes. Mr. Herz?

Mr. HERZ. No. We still get some grumblings from certain folks, but everybody is doing it now, and—

Mr. FRANK. All right. Mr. Gradison?

Mr. GRADISON. The question this year for auditors, as they finish up their work, is whether they find problems in terms of simply the calculations, the application—

Mr. FRANK. Right. I think that's important, and I think—I would hope we could all move on to the next phase. This is now one of those questions that has, for now, been settled and I think settled forever. But I would hope that it would now be a genuine collaborative effort of the three of your operations and the private sector to refine that.

Before I go on to my next question, Mr. Taub, in his absence—would you just convey to your chairman my appreciation of the very decisive way in which he acted when subpoenas were issued to journalists? I think that what Mr. Cox did in that case was a very good demonstration of the appreciation of a free press.

And I just wanted to say publicly that I—you know, it's not easy. I understand. And he is the chairman, and he has staff to work with, and these are not people who did something malicious. It was not easy to do what he did, and I appreciate that he did it.

Let me just ask, finally, with regard to executive compensation, what's the status of the SEC's current proposal to make it more transparent?

Mr. TAUB. We issued proposals in January of this year. The comment period extends another 10 days or so, it expires on the 10th of April. So, we are, of course, actively seeking comments.

I am sure the Commission will seriously consider all of the comments that are received. The release that came out when we proposed the rules indicates that we hope to have the rules in place for the 2007 proxy season, and I believe that certainly is still the hope. And we will actively be considering this issue on—

Mr. FRANK. All right. Let me finish up. I appreciate that. I hope you will move forward with them. I think there is a great deal of support for it.

Beyond that, it would then lead to another issue that had come up under the previous chairman, and I think it may come up again, and that is once that information is out there, I think it will—some people will not be surprised; some of it may be new.

The question, then, of the accountability of the board of directors to the stockholders will again be on the table. Because some people have said, "Well, what's the point of giving us that information, we the stockholders, if we have directors who are immune if we don't like it? And if our votes as stockholders are essentially about as useful in electing directors as the voters of Belarus in electing a new president, then you have given us ice in the winter. You have given us information which we are unable to use."

So, I hope that we will then take the logical next step—and again, I think this is totally consistent with a free market, this advances a free market, none of this involves any government restriction on what corporations can do. What we are talking about is, I think, recapturing some of the power for the stockholders that has been taken away from them.

So, I think the transparency, I hope, will go forward. But I hope it will then be given some muscle by improving the ability of the stockholders to act vis a vis the board of directors if they don't like what they see.

Chairman BAKER. I want to make clear that, as one of the proponents of not expensing in the last Congress, that I am very interested in that accounting assessment and real world implementation consequences, and don't want the chapter to be closed, and not acknowledge the gentleman's concern about it being a resolved issue.

It is resolved, but absent the knowledge that it actually is working without adverse economic consequences, and absent that, I certainly concur with the gentleman's agreement. But I want to reserve, as one engaged in this effort on the other side, that should there be a showing that there is a concern, then we need to come back and talk about it some more.

The gentleman—I would be happy to yield, yes, the gentleman from—

Mr. FRANK. If the gentleman would yield, I would concur with the philosophy we all know about, that it ain't over until it's over. So—

Chairman BAKER. That's the kind of music I like to hear. I thank the gentleman. Mr. Scott, I believe, is next. Excuse me, Mr. Cleaver, you were actually next in line. Did you have—

Mr. CLEAVER. I have no questions.

Chairman BAKER. Mr. Scott?

Mr. SCOTT. Yes, thank you very much, Mr. Chairman. I would like to ask my first series of questions about what we refer to as XBRL, in our efforts to make this more simple and less complex. I think it refers to extensible business reporting language. And I hope we—I hope this technology will help us in that regard.

But let me ask you first of all, Mr. Herz, and each of you, if you could respond to this, would the cost of implementing XBRL be prohibitive for some issuers?

Mr. TAUB. I will give you a few things that we have found out from our voluntary program. We have had about a dozen companies that have participated.

In general, their response has been that the cost was perhaps slightly more than negligible, but certainly not to the point where it would be prohibitive. A couple of large companies have indicated an all-in cost, dollar-wise, of something in the $25,000 range, and time-wise, once an employee is trained on how XBRL is used, it's 6 to 8 hours each time a report needs to be prepared.

Mr. SCOTT. Mr. Taub, given the fact that while we are on C-SPAN, and I don't question the fact that our ratings are sky-high, and everybody is watching across America, but let's assume that there are some people who are very much interested in this hearing. Could you just give a brief explanation of what we are talking about, when we refer to XBRL?

Mr. TAUB. What XBRL does is, through a glossary that's known as a taxonomy in technology circles, it assigns a definition, as it were, to each piece of information. And that definition would carry with it information, then, about the item that is tagged with that definition, such that what happens is a user of financial information, rather than pouring through a bunch of reports to pull, let's say, revenue data from a number of companies, can instead use a piece of software that would go out and find that data for whichever companies the user wanted. So, it greatly reduces the time needed to collate data and do analysis.

Mr. SCOTT. As you know, several of us—this whole committee, as a matter of fact, and certainly the bill that Mr. Davis and I are putting forward—our aim is to simplify and make it clearer. But can the taxonomies of XBRL be effectively used by a wide variety of issuers?

Mr. TAUB. That's an excellent question. And indeed, the issues with regards to taxonomies are amongst the things that we plan to discuss at the public roundtables that we have. There has been a lot of discussion about how to improve the existing taxonomies, and how to design industry-specific taxonomies, to make sure that all companies will have taxonomies they can use.

Mr. SCOTT. Okay. Would you like to comment on that, Mr. Herz? I have a couple of more points and my time—the chairman moves with an iron fist here, so if you could be brief and answer that, I have a couple of more questions, too.

Mr. HERZ. Well, I agree with what Scott said. I think one of the things that needs to be focused on is the taxonomy development, which is, as I understand at this point, not complete in certain areas. And that may be a partial barrier to further expanding the use of XBRL into the SEC's fine voluntary filer program. I think there is some effort needed to take it to the next level.

Mr. SCOTT. Okay. Now, let me ask the gentleman this question. Will efforts, these efforts to simplify financial reporting, be conducted in conjunction with international standard-setters?

Mr. HERZ. Yes, that's also an excellent question. And certainly, I am a big proponent of that being done. We have a real opportunity, to the extent that the simplification would result in kind of a revised way of reporting, and even a revised architecture of reporting, to make that international, almost like, you know, the old hard-wire and telecom going to cellular. You leap-frog a whole generation, and you can make it by building it in, you can make it international.

We work very closely with the International Accounting Standards Board to come up with common accounting standards and financial reporting standards. To the extent that we do that, XBRLizing those, the same data definitions would apply commonly.

Mr. SCOTT. My time is about to run out, but I do want this final question, because auditors are very concerned about this.

Are auditors at too much risk for being sued over their best attempts at meeting the reporting requirements?

Mr. GRADISON. I think, Congressman, that the question of liability hangs over the work of auditors every minute of the day. The responsibilities of auditors, at bottom, are based upon principles that involve the exercise of professional judgement, and the exercise of professional skepticism.

Auditors have to decide, case by case, the scope, extent, testing, and timing of testing of major categories. These are judgement calls. And there are legitimate reasons for them to be concerned that, after the fact, they may face serious financial risks if they miss something.

So, I think we have to recognize that is a fact of life, and would, frankly, strike me as a subject that you all might want to take a look at quite separately from some of the other things that we are talking about today.

Mr. SCOTT. Yes, absolutely. If I may, while the chairman is talking there, let me proceed for a second.

[Laughter]

Mr. SCOTT. What would you recommend that we could do to lessen the liability of the auditors?

Mr. GRADISON. I don't have any specific answer to give to you right now. I do think that it is an entirely proper question, especially since our role is providing oversight of the auditors under the general supervision of the SEC.

And I think that it would be entirely appropriate if you wanted to, perhaps in a different context, for us to think together about that issue. It is an extremely important question. It is related not just to the workings of the court and the liability issues alone, but also to the form of organization of the accounting firms which operate in the former partnerships, or limited partnerships. And that is not unrelated to the question that you are asking about.

In many instances, these organizations are fundamentally self-insured for their very major risks, because of the uncertain nature of claims that might be brought against them, as well as the historical experiences of the Arthur Andersens of this world.

Mr. SCOTT. Yes. So they are at risk. We need to take a look at it. Let me ask you one question about FASB, before I—

Chairman BAKER. And this will be your last one. I finally—

Mr. SCOTT. This will be my last one. Thank you, Mr. Chairman. I appreciate it. As you know, I am very interested in this issue here.

But Mr. Herz, you are with FASB. Do you believe that FASB, or any other standard setter, can gain the cooperation of the private sector to make the necessary changes in our reporting system?

Mr. HERZ. I believe so. I think that from my discussions with many parties—some of whom you will hear from in the second panel—and from discussions with my colleagues in the SEC and the PCAOB as well, that I think that the time is right to sit back and get together and think about, you know, where the system is at, and where it is going, and make the kind of improvements that would both reduce complexity and improve the usefulness and transparency of reporting.

So, I am definitely a guy with the half—the glass half full on that subject.

Mr. SCOTT. Thank you, Mr. Chairman, for your kindness and generosity.

Chairman BAKER. Yes, sir. And Ms. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Mr. Gradison, I just would like to—for you to discuss how complying with Sarbanes-Oxley, in particular, section 404, requires substantial resources, both in terms of personnel and costs.

While large companies can more easily absorb these compliance costs through existing resources and professional staff and budget, many of the smaller cap companies, however, do not have resources to comply with this act, and must hire outside attorneys and accountants.

Can you tell me how significant these complying costs have been in deterring private companies from going public and causing smaller companies to go private?

Mr. GRADISON. There is no question that in the first round of the application of section 404, which occurred last spring, the costs were far higher than any estimates that I was certainly aware of. It was the first time out.

On May the 10th of this year, the SEC and the PCAOB will be hearing from more than 50, I imagine, witnesses or panelists in a day-long session to find out what happened the second time around, with regard to costs.

We did receive encouraging comments a year ago, in April, when the previous roundtable was held, that costs were going to come down, costs that are borne internally within the companies, the cost of consultation from outside, and the auditing costs. And you know, we will see.

The PCAOB has not been satisfied, was not satisfied with the first round. And this was made clear by guidance which was issued on May the 16th of last year, as well as our November 30th report.

Our inspectors are going to be going into the field in just a few weeks, and they are going to be using a very different approach in reviewing the work done by auditors with regard to section 404 than was used by our inspectors last year. All of our people are going to be trained in looking at this. It will be part of an integrated audit, integrated with the review of the financial statements, whereas last year, we did it in a separate manner.

We are going to be expecting the firms to use a top-down risk-based approach to focus on the significant accounts. But in particular, we are using a word which isn't—doesn't have a lot of history in the auditing literature, and that is, "efficiency." We are looking for evidences of efficiency by the auditors, which may relate to your question.

I think in May there will be a lot more information than is available now to help answer your very appropriate question. COSO is working on a new framework, or revised framework, that may be helpful to smaller enterprises. The GAO is completing a report mandated by Senators Enzi and Snowe, with regard to the impact of Sarbanes-Oxley on small business. The SEC's advisory group will be coming in with a report.

And so, while there is certainly information out there —frankly, on both sides—about the effectiveness, we will have a much more complete picture of that very, very soon, and look forward to sharing those results with you.

Ms. VELAZQUEZ. I would like to discuss the SEC advisory committee on smaller public companies' proposed recommendations to provide relief for small companies.

The foundation of the proposal is a new definition for smaller public companies. It defines smaller public companies as those comprising the lowest 6 percent of total U.S. equity market capitalization. Do you believe that this proposed definition fairly represents the universe of small companies, public companies? Mr. Gradison and Mr. Taub?

Mr. GRADISON. Well, I will have to pass the ball to—

Ms. VELAZQUEZ. Sure.

Mr. GRADISON.—Scott Taub on this, simply because that group was created by the SEC, and the specific recommendations to

which you refer, as I understand them, would be entirely within the purview of the SEC, rather than the PCAOB.

Mr. TAUB. Thank you for the question. We are watching very carefully, and eagerly awaiting the recommendations of the advisory committee. Certainly at this point, the draft recommendations do include the types of delineations that you have suggested.

One of the things that one needs to think about if we were to use those kinds of delineations is what does it mean. Okay, a company is deemed a smaller public company, then the next step is what is different in the reporting framework about being a smaller public company, rather than an accelerated or larger company. And indeed, the committee's draft recommendations would include a number of suggestions for differences that would apply to the smaller public companies.

It's probably inappropriate for me to start commenting on recommendations that, indeed themselves, have not yet been finalized. So let me just say that we are eagerly awaiting those recommendations. And although there is no set time table for considering them, I would suggest that we will be doing so on a timely basis.

Ms. VELAZQUEZ. Thank you.

Mr. GRADISON. Perhaps I could add just a word, and that is that our intention with regard to the standard that was already issued, and is now in effect, was in no way that it should be a one-size-fits-all approach. Rather, that it should take into account the size and complexity of the enterprise.

And speaking for myself, I am totally open to the possibility of revisions in the standard, if it appears that they are necessary in order to accomplish that goal. We have had the goal in mind all along. Now, whether we did it right is a matter to be determined.

Ms. VELAZQUEZ. Mr.—yes, okay. Thank you very much, Mr. Chairman.

Chairman BAKER. I appreciate the gentlelady yielding back. Ms. Wasserman-Schultz, did you have a question?

Ms. WASSERMAN-SCHULTZ. Thank you, Mr. Chairman. If—the question I had relates to the impact that financial reporting standards has on the private market pension system, and if you all could comment on what the long-term, or systemic impact you think that there is on the private market pension system, as it relates to financial reporting.

Mr. HERZ. Well, thanks for that question. We are, I think, this Friday going to issue a proposal that would essentially put on sponsors' balance sheets the net under or over-funded position of their defined benefit pension plans, and post-benefit retirement plans. And that's the first phase of a more comprehensive project to relook at the accounting for those kinds of plans.

Now, our mission, of course, is to improve the financial information that goes to investors in the markets. And certainly, we have gotten a lot of commentary, not only from investors, but many other people—and the SEC, in their off-balance sheet study—that this is an area where the existing accounting is in need of significant improvements. So this is our step towards that, our first step towards that.

I have heard all sorts of—you know, as I have talked about this with groups—potential, you know, impacts. One, of course, is the

better information that the investors, the creditors, and the employees will better be able to see the extent of the underfunding, and how that affects the sponsor's financial position, whether they actually seem to be in a position to carry out those promises that they have made.

There has been a movement for many years, long before we even took up this project away from defined benefit pension plans. The kind of statistics that I have been told is that when ERISA was put in in the early 1970's, something like over 40 percent of the covered work force was covered by members in a defined benefit pension plan. That is now down to something like 15 percent.

And of that 15 percent, a majority of those are plans to incorporate or replace the more traditional defined benefit arrangement with what's called a cash balance plan, which is closer to the defined contribution plan. So there are—the defined benefit plans have already been shrinking a lot.

Clearly, with the increased transparency, we have seen this in other areas, when you make things more transparent and the accounting better, it often does have behavioral reactions and reactions by the companies. Some companies may decide to terminate plans or freeze benefits, and the like. But we will have to see.

Ms. WASSERMAN-SCHULTZ. Could you comment on whether you think there are negative incentives in the underlying accounting standards that affect the situation?

Mr. HERZ. Yes. And obviously, we have—in being advised by many parties about the existing accounting standards, and pointing to some of its flaws, some have pointed to behavioral issues related to the existing accounting standards.

One of the aspects of the existing accounting standard is that it does what's called a lot of smoothing over time, and part of that smoothing involves an estimation over a long period of time of an assumed rate of return on the plan assets.

And that rate of return, the way the mechanics of the existing pension accounting work is that—let's say you had $1 billion in plan assets, big company, and you assume a long-term rate of return of 8 percent, based upon your 60 to 40 equity to fixed income mix. The accounting says you can, immediately for that year, accrue income of $80 million. Yet the performance of the plan might be negative that year. Say it goes down by $100 million, the plan assets, the market goes down, the interest rates go up and the bonds decrease in value. That difference of $180 million then gets spread over a long period of time.

So, some people believe that that long-term rate of return mechanism and assumption drives people to over-investing in what, you know, riskier investments, rather than match-funding the liability, for example.

Now, our purpose is not to change, you know, directly, that behavior. But when you change the accounting, behavior does change.

Ms. WASSERMAN-SCHULTZ. And lastly, not to prolong this, Mr. Chairman, but I don't know whether you have mentioned this; what can be done to resolve some of these issues?

Mr. HERZ. Well, of course, there are many things going on. Our function is to try and improve the accounting. We—as I said, our first step is to actually put on the balance sheet, pretty squarely,

the company's position with regard to those plans, how underfunded are they. You know, generally in most cases, they are underfunded.

The bigger question is what to do in the earnings statement, and that will be phase two of our project. Do you eliminate all of that smoothing, and just let the change in the year-to-year value of both the assets and the obligations flow through earnings? Do you get rid of the assumed rate of return assumption? But that will require a lot of study.

Now, of course, there are other things going on, including bills here in Congress that I understand are in conference right now, to hopefully put some more health into the underlying system to increase the funding and the like, and encourage employers to get to a better position, vis a vis the plans.

Ms. WASSERMAN-SCHULTZ. Mr. Chairman, I see that my time has expired. However, I would be remiss if I did not close, before I yield back, by saying, "Go Gators."

Chairman BAKER. I can overlook that remark. Thank you.

[Laughter]

Chairman BAKER. There being no other members with questions, I want to thank you for your participation. I would like just to make one observation that I think needs to be made, and hasn't been part of the hearing to date, in that there is another advantage of this XBRL business on the other end of the pipe from the corporations.

Today, the casual investor, interested in an investment potential, will be delivered a large envelope full of very complicated material that, frankly, most people just put back down. They will call their broker, perhaps. They will talk to a friend. But that data doesn't translate to any ability to compare that corporation's performance to anyone else.

What I believe the advantage XBRL will offer is the ability of a person who is using a laptop, who is using a MacIntosh, who is using an IBM, whatever they are using, it's an interpreter between whatever system the corporation may be using, the computer system, when they enter it. It then will sort it out, so if it needs to go to the regulator, it goes to the regulator. If it's in the public domain, it's in the public domain.

But when I sit down at my coffee table with my laptop, I can get access to information to compare Corporation A—let's assume it's an auto company—with all other auto companies in that sector, or, with a specific auto company. I can compare Chrysler with GM and get comparability.

So, I think the biggest net gain, besides reducing cost to corporations, ultimately, in data preparation, is to empower the individual investor to get accurate, closer to real-time information that enables that person to make a more informed decision, perhaps as well as nothing else has been able to do that in the past.

And that's my sales pitch to the committee about why XBRL ultimately offers some advantage. And if you choose to comment, fine. None required. But I think that's a point that had not been made in the hearing to date, and I think it important.

The fact that we now have a vote pending, I want to thank this panel for your participation—you have been very helpful—and an-

nounce to our second panel that we will recess briefly to make the vote and come back so that the members of the second panel may attend to necessary things while we are gone. We should be absent no more than 10, 15 minutes, and we will return. I understand it's just one vote. The committee stands in recess.

[Recess]

Chairman BAKER. I want to thank the members of the panel for their participation here today. As you have noted, despite expectations, there has been a lot of member interest in this topic, and we certainly appreciate your market perspectives in how we should move forward, if we should move forward with any modifications to the current reporting methodologies.

To that end, I want to recognize Mr. David Hirschmann, who is the Senior Vice President, U.S. Chamber of Commerce. And please, proceed as you wish, sir.

STATEMENT OF DAVID HIRSCHMANN, SENIOR VICE PRESIDENT, U.S. CHAMBER OF COMMERCE

Mr. HIRSCHMANN. Mr. Chairman, thank you very much. I am, as you mentioned, David Hirschmann, senior vice president at the Chamber, the world's largest business federation, representing more than 3 million businesses.

I am here today to share our views on how to improve auditing and accounting procedures, and ensure the viability of the auditing profession, which we think is threatened, and encourage a greater focus on long-term performance measures to help investors, companies, and the economy.

First, I will—let me address the widespread practice of projecting a company's future earnings as a way to inform and guide investors. In fact, this practice is inherently flawed. Earnings guidance is a precise measurement, down to a penny or two per share, based on educated accrual estimates about the value of income, expenses, liabilities, assets, such as pensions, oil reserves, and bad debt, just to name a few.

It used to be that companies were encouraged to manage these earnings. They would have a few honest, legitimate, acorns in the basement, as the saying goes, to support 1 or 2 cents of earnings per share for a rainy day. As one former auditing executive put it, "Analysts viewed any CEO who couldn't legitimately legally manage earnings within a penny or two to meet forecasts as not being in touch with what was happening at the company."

But in the current accounting environment, there are no acorns. And anyone who tries to create them is asking for trouble. Quarterly earnings guidance misrepresents a company's true financial strength, and puts pressure on executives to meet quarterly expectations. Companies often sacrifice creating long-term value, if it means missing quarterly projections. And that is a disservice to the company and to investors.

Instead of issuing earnings guidance, companies should better communicate their strategies and objectives, and come up with alternative benchmarks that will show real progress towards meeting those goals. More communication, and not less, between companies in the investor community is needed. And that is why the Securi-

ties and Exchange Commission should re-examine regulation, Fair Disclosure Regulation, FD.

This regulation, passed with legitimate intention of leveling the information playing field, so that a favorite analyst or investor would not receive better or more timely information. Unfortunately, in part due to the way this rule has been enforced at the SEC, it has the unintended consequence of restricting and reducing communication.

We also support efforts by Chairman Cox to move to clearer and easier forms of electronic communication between companies and investors. XBRL is one example, and proves the capability of the market to assess information and reward those companies that are doing well.

XBRL, which has been championed by AICPA and others, will help everyone better assess financial statements. But the smart money will still take the time to carefully understand industry factors and long-term strategy.

Let me move to the second area, which is the area of fair-value accounting. The concept of developing well-reasoned estimates for certain intangible assets and liabilities, and including them on the corporate balance sheets. There are, no doubt, limitless things that could be both estimated in companies, and added to the financial statements. And many of them would be well consistent with GAAP.

However, we can't lose sight of the fact that they are estimates. The move towards fair-value accounting should be tempered by a thorough examination of the implications, both to business and investors, of adding another imprecise estimate to the financial statements.

In multiple arenas, companies are being required to develop systems for assigning and estimating values to such items, and thereafter continually reassessing and revaluing those items. These educated guesses generate additional risk for companies and their auditors.

If someone thinks the guess is wrong, the company will be sued. When the company relooks at the guess, any significant change will create volatility in the financial statements, creating both stock price and generating more lawsuits.

Fair value accounting also puts great pressure on the auditing profession to certify the appropriateness of these value estimates. These estimates are purely hypothetical, and not at all indicative of the true cash flow that a company expects to receive or incur.

The U.S. Chamber will be asking both FASB and the International Accounting Standards Board to recognize their efforts to create a perception of accounting precision which may have potentially significant consequences for both companies and investors. While the push towards fair-value accounting may be theoretically pure, and even desirable in some cases, the costs may end up being much greater than the benefits.

Finally, the business community has great concerns about the future of the auditing profession. In the post-Sarbanes-Oxley litigation and regulatory environment, auditing firms are under attack from several different parties. Much of this criticism results from erroneous perception that there is precision of financial reporting.

Also, there is pressure on auditors to do more when conducting audits. This has resulted in higher audit fees for their clients. Even as the auditing costs have increased, however, clients are receiving less overall advice and support from their auditors, because of auditors' legitimate fear of litigation, or being second-guessed, or having questions raised by the SEC and the PCAOB about their independence.

The cumulative result of all of this is the very real potential in the near term for further concentration of the auditing profession. There are now only four major firms serving a large majority of the listed and actively traded public companies in the United States. Further contraction of this profession would threaten its viability, and could shake public confidence in our capital markets.

The Chamber has issued a number of recommendations for fortifying the auditing profession. First, the profession should become insurable against catastrophic litigation. Second, the PCAOB standards should be further clarified. And third, we need an expansion and greater competition among the big four accounting firms.

In the interest of time, I will not go into detail to all—in all our recommendations. But I have provided them to the committee as an attachment to the formal statement, which I know will be included in the record.

In conclusion, Mr. Chairman, the United States Chamber of Commerce is fully committed to highly accessible, transparent capital markets, and we will leverage our full resources to ensure accounting and auditing practices that are necessary for achieving this goal. Thank you very much for the opportunity to speak today.

[The prepared statement of Mr. Hirschmann can be found on page 149 of the appendix.]

Chairman BAKER. Thank you very much for your statement, sir.

Our next witness is Mr. Marc E. Lackritz, president of Securities Industry Association. Welcome, sir.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman, and thank you very much for the invitation to testify today. SIA, and our over 600-member firms, share your interest in improving the clarity and the relevance of financial information, and we applaud you for holding this very timely hearing.

As financial intermediaries, Mr. Chairman, our livelihood depends on the quality, consistency, and reliability of financial information. Indeed, our capital markets are the envy of the world, precisely because the quality of information has continued to evolve and improve. We are eager to work with your subcommittee, other Members of Congress, regulators, and all interested parties, to further improve the quality of financial information.

Our markets have thrived largely because of investors' ability to obtain, digest, and appropriately price securities derived from information about companies and the economy. Three factors allow information to flow fully, efficiently, and fairly.

First, companies have powerful motives to disclose information. Certainty, clarity, and comparability in the disclosure of financial information lowers the cost of capital.

Second, the Federal securities laws have long buttressed the efficient flow of information to the markets, especially by punishing the dissemination of deliberately false information.

And third, our markets have excelled in embracing advances in technology, from the telegraph to the Internet. This has enormously enhanced the capabilities of market participants to receive and absorb information in their trading decisions.

Now, none of this would be possible, Mr. Chairman, without the public's trust and confidence that all market participants adhere to stringent rules, vigorously and fairly applied. A key element of public trust is access to reliable and timely information, both by the public directly, and by investment advisors, mutual fund, pension, and 401(k) plan managers who manage trillions of dollars of savings.

At a time when nearly 57 million American households, or more than half of all U.S. households, own stock, directly or indirectly, the securities industry is committed to ensuring that individual investors can achieve their financial goals, such as planning for a child's education, or for a comfortable retirement. With 76 million baby boomers hurtling toward retirement, we recognize that the quality of information must be paramount.

Current information in the marketplace comes from three basic sources: regulated disclosures, voluntary issuer guidance, and research analysts' reports. In total, all this information comprises a comprehensive and effective disclosure regime.

Although we believe the SEC's current financial disclosure regime works exceptionally well to provide the highest quality information to investors, we do support the SEC and, Mr. Chairman, your recent technology initiatives such as the use of XML tag data, to make it easier for investors to compare companies.

We do not believe, however, that it is necessary to mandate any additional disclosure of financial information at this time. High quality accounting standards are absolutely critical to ensuring that financial reporting results in clear, timely, and relevant disclosure to users of financial statements.

We believe accounting standards can be improved in three ways. First, by using fair value to measure all financial instruments. Secondly, by simplifying standards. And third, by converging differing national standards. SIA believes that using fair value forces firms to confront adverse market movements at an early stage, and gives investors an earlier warning of developing problems.

We also agree with regulators that disclosures that provide insight into an entity's risk position and exposures, could enhance regulatory and market discipline. Similarly, accounting standard setters, regulators in the private sector, have all recognized the benefits that would result from a more principles-based approach to accounting.

Principles-based accounting standards are more consistent and comparable, and will allow investors to more easily analyze and compare investment choices, and make fully informed decisions. In addition, such improvements in global accounting standards will facilitate the seamless flow of capital across national borders, as well as reduce the costs of providing relevant information to investors.

In addition to the SEC-mandated quarterly reporting, many corporate issuers voluntarily provide periodic earnings guidance. Guidance is not mandated by statute or regulation. But most companies choose to provide this information in response to market demands.

Recently, several large U.S. issuers have discontinued the practice of issuing earnings guidance, in favor of issuing more detailed performance information. We believe the decision to issue earnings guidance should rest with the issuer, and should not be mandated by law or regulation.

The current system of financial disclosure has served investors, issuers, and the securities industry extraordinarily well. We believe that the greater use of fair value accounting, and the simplification and convergence of accounting standards would further assist issuers in providing better quality information to investors.

We look forward to working with you, Mr. Chairman, and the committee and the Congress, as well as investors, issuers, accountants, and regulators, to further improve the quality, consistency, and clarity of information, so that we can maintain the global preeminence of the U.S. capital markets. Thank you very much.

[The prepared statement of Mr. Lackritz can be found on page 154 of the appendix.]

Chairman BAKER. Our next panelist is Colleen Cunningham, president of Financial Executives International. Welcome.

STATEMENT OF COLLEEN CUNNINGHAM, PRESIDENT, FINANCIAL EXECUTIVES INTERNATIONAL

Ms. CUNNINGHAM. Thank you, Mr. Chairman, for this opportunity to appear before you today. My name is Colleen Cunningham and I am the president and CEO of Financial Executives International. FEI is the leading organization of about 15,000 members, which includes CFO's, treasurers, controllers, and other senior financial executives.

FEI members represent the preparer community. That is, the senior financial executives responsible for the preparation of financial statements. Importantly, we're also users of financial statements relying on financial statements of other companies in our investment and credit decisions.

In both roles as a preparer and user, we applaud the goal of today's hearing. I am pleased to share FEI's views with you today on the important issue of fostering accuracy and transparency in financial reporting.

The complexity and technical demands of accounting standards have increased considerably in recent years to the point where many otherwise capable accountants are no longer confident that they can apply the new requirements without outside assistance from subject matter experts. This is happening at a time when, in the United States financial reporting environment, there is heightened sensitivity and attention given to accounting and financial reporting.

FEI believes that undue complexity harms, rather than enhances, the ability of users of financial statements to understand the information provided by financial reporting. Simple, easy-to-understand standards should be our mutual goal.

FEI concurs with the views of the leaders of the SEC, the FASB, the PCAOB, and all interested—that all interested parties must come together to address what I like to call the complexity conundrum. We applaud the FASB's current projects on simplification and codification, and the conceptual framework. They should go a long way towards enabling preparers, auditors, and users of financial statements to find applicable accounting literature.

However, when the rules themselves are unduly complex, they impede the ability of preparers to provide accurate and transparent financial reporting. No doubt, the growing complexity of business transactions adds to the challenge of developing appropriate accounting standards.

We're currently operating in an environment where companies are second-guessed by their auditors, perhaps third- and fourth-guessed by various regulators, such as the SEC and PCAOB, and then maybe fourth or fifth-guessed by the plaintiff's bar. Is it any wonder there are constant requests for bright lines and interpretations by auditors and preparers to seek additional guidance to ensure that they are doing the right thing?

Additionally, overly theoretical standards can result in financial reporting of questionable accuracy, and create a significant cost burden with little benefit to investors. Even simple, principles-based standards can create undue complexity in their implementation.

For example, a simple principle—record everything at fair value—may be incredibly complex to apply, and imprecise, particularly when there is no ready market for the underlying transaction. This operational complexity cannot be ignored as principles-based standards are created.

I would like to quickly highlight four potential solutions to this complexity conundrum, which are discussed in greater detail in my written testimony.

Number one, the need for FASB to prioritize its conceptual framework and codification project, and follow with principles-based rulemaking, which must be practical in application, and understandable by preparers, users, and auditors, and result in information that is auditable. While this will be helpful going forward, existing standards would also need to be addressed in the context of a new conceptual framework.

Number two, the need for regulators to avoid second-guessing reasonable interpretations of standards, and avoid issuing informal guidance for significant matters that could lead to a large number of restatements.

Number three, the need for Congress to assist in correcting today's litigious environment.

And number four, the need for preparers, auditors, and users of financial statements to be part of the solution, by educating themselves about changing accounting and auditing standards, participating actively in the standard-setting process, and making recommendations for simplifications and transparency in accounting standards in their financial reports.

In conclusion, FEI believes that it is feasible to reduce the complexity of financial reporting standards, and make them easier and less costly to find, understand, remember, and implement. But to

do so will require a concerted effort among all financial reporting stakeholders, many of whom are here today.

I support the SEC's encouragement of studying the use of interactive data, such as XBRL, and the benefits it can provide. However, I urge a note of caution, that technology is not a panacea, and that transparency provided through electronic links, or the old-fashioned way, through non-linkable disclosure, will not reduce the operational complexity imposed on preparers to develop the numbers provided in financial reports. Nor will such transparency improve the understandability of underlying numbers to investors.

The creation of a special committee with wide representation from all constituencies to address the full breadth of the complexity conundrum can help us arrive at practicable solutions that will reduce the level of complexity with respect to existing standards, and at the same time, maximize the utility of financial reporting to investors. Everyone has a role to play in this effort to reduce complexity, and FEI is ready to be part of it.

That concludes my remarks. I want to thank the chairman and the members of the subcommittee for inviting us to participate in today's hearings.

[The prepared statement of Ms. Cunningham can be found on page 53 of the appendix.]

Chairman BAKER. Thank you very much. Next, I welcome Barry Melancon, president of the American Institute of Certified Public Accountants. Please proceed, sir.

STATEMENT OF BARRY MELANCON, PRESIDENT, THE AMERICAN INSTITUTE FOR CERTIFIED PUBLIC ACCOUNTANTS

Mr. MELANCON. Thank you, Mr. Chairman, and members of the subcommittee. My name is Barry Melancon, and I am president and CEO of the American Institute of Certified Public Accountants.

On behalf of the 330,000 members of the AICPA, I truly appreciate the opportunity to present testimony to this subcommittee about increased accuracy, accessibility, and transparency in corporate, financial, and other business information, including non-financial information, that is useful to investors and other users in making decisions.

I request that my written statement and its exhibit be made a part of the official record of this hearing.

The existing financial reporting model provides a solid foundation. Today, the nature of modern corporations, how they are managed, and the evolving performance indicators that senior executives routinely use, however, underscored the need for an expanded reporting model.

Third party research shows that for many companies, only 25 percent of an entity's market value can be attributed to accounting book value, with the remaining 75 percent based on value drivers, such as strategy, distribution channels, product innovation, people, and customer loyalty.

Research also tells us that only about one-third of the value drivers generally associated with industry sectors are published in formal filings.

As you, as chairman of this subcommittee, has said, if U.S. markets are to remain on top in an increasingly competitive global

marketplace, we need to move away from the complex and cumbersome, and explore technological and other methods of enhancing the clarity, accuracy, and efficiency of our accounting system.

We agree with this position, and have been actively working for more than a decade to draw meaningful progress toward a more relevant, reliable, understandable, timely reporting model.

In 1993, the AICPA's special committee on financial reporting—which is better known as the Jenkins Committee, named after its chairman, former FASB chairman, Ed Jenkins—published a report dealing with improving business reporting. We have undertaken many other activities since the Jenkins Committee, which led to the AICPA establishing the enhanced business reporting consortium, a market-driven collaborative effort involving corporations, investors, the accounting profession, and other key participants in the corporate reporting supply chain.

The consortium aims to achieve the right mix of fully disclosed high-quality information made possible not only by adding critical information that is not currently disclosed, but also by advocating for improvement in the consistency and relevancy of existing disclosures. The consortium is on the cutting edge of developing internationally recognized voluntary framework for the disclosure of key business information, in addition to traditional financial statements.

We believe that transparency can be further enhanced through a stronger focus on the quality, not quantity, of reported information.

In addition, the enhanced business reporting consortium's reporting simplification task force, made up of accountants in business and industry and public practice and FASB staff, and observers from SEC staff members, who provide valuable input, intends to make thoughtful recommendations for simplifying existing disclosure requirements based on research findings.

I was happy to hear this morning the considerable discussion on XBRL. The AICPA charted the XBRL international consortium in 2000 to foster the global growth and adoption of XBRL, extensible business reporting language, which we started in 1998. XBRL is a language for the electronic communication of business and financial data. It is the technology that enables more efficient and effective financial and non-financial business reporting. My written testimony contains details on how XBRL operates, and exactly what it is capable of doing.

Today, investors, lenders, and other users of the information, need to make decisions much faster and more often, based on what may happen in the future, rather than what has occurred in the past.

I am pleased to say that this is no longer just a dream. Coupled with enabling technologies like the Internet and XBRL, enhanced business reporting will provide users the breadth of information they require, at the speed that they need to be successful in today's economy.

We believe that the benefits will include reduced uncertainty, lower market volatility, and a decline in the over-emphasis on quarterly earnings. With richer information, investors can be encouraged to take a longer-term view.

Your efforts to stimulate meaningful dialogue about enhancing transparency and reducing complexity will contribute significantly to creating a reporting model that meets today's market needs. We likewise believe that involving more market participants in the development and adoption of enhanced business reporting and XBRL will contribute to providing investors with a financial reporting system that is transparent and more reliable.

The AICPA wants the promise of enhanced business reporting and XBRL to be realized as quickly as possible. We are looking forward to working with this subcommittee, the SEC, FASB, corporate America, the investment community, and public accountants to make this happen. I will be happy to answer any questions that the members of the subcommittee may have.

[The prepared statement of Mr. Melancon can be found on page 166 of the appendix.]

Mrs. BIGGERT. [presiding] As you can see, I am not Mr. Baker any more, but I am happy to be here. Next, we have Ms. Rebecca McEnally, director of capital markets, Policy Center for Financial Markets Integrity, the CFA Institute. You are recognized for 5 minutes. Thank you.

STATEMENT OF REBECCA MCENALLY, DIRECTOR OF CAPITAL MARKETS POLICY, CENTER FOR FINANCIAL MARKETS INTEGRITY, CFA INSTITUTE

Ms. MCENALLY. Thank you. I am happy to be here today, Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee. I am Rebecca McEnally, director of capital markets policy for the CFA Institute Center for Financial Market Integrity, and we do appreciate this opportunity to testify.

The Center was established to promote the highest standards of ethics, integrity, and professional excellence in the global investment community. It shares this goal with its parent, CFA Institute, which is a non-profit organization of more than 81,000 investment professionals in 126 countries.

CFA Institute is widely recognized as the organization that administers the chartered financial analyst examination, and awards the CFA charter, a designation that I share with nearly 68,000 professionals worldwide.

High quality financial information is critical to the work of our members and other investors. So, for more than 3 decades, members of CFA Institute have been actively involved in the public debate about how best to improve financial reporting standards and disclosures.

The corporate reporting scandals and bankruptcies over the past few years have underscored how crucial clear, accurate, and complete financial reporting is to the health and wellbeing of capital markets. The U.S. standard setters, principally the FASB and SEC, as well as the IASB, have made good progress in improving the clarity and accuracy of financial reporting.

But they would agree with us that a vast amount remains to be done. To help propel their efforts forward, the center recently released its White Paper, a comprehensive business reporting model which was developed by our global panel of experts. The paper outlines 12 principles that we believe would greatly increase the clar-

ity, accuracy, and completeness of financial reporting. My written statement summarizes these principles, but I will highlight a few of them here.

First, we believe that financial statements should be prepared from the perspective of the common stock owner, the last residual claimant on the company's resources. Share owners can't properly evaluate a company's potential risks and returns unless the statements completely and accurately reflect both the assets available to the company, and the claims of all others that must be settled before those of the common share owners.

In this regard, financial instruments, pensions, and leases were listed as items requiring attention in the SEC's report, which was submitted to the House Financial Services Committee in June of last year. These need to be fully reflected in the financial statements, and not hidden in the footnotes. These items are at the top of our own list, as well, and we're pleased that the FASB is moving forward on them.

A second principle is that items in the financial statement should be measured at fair value. The reason for this is a simple one. The only information that is useful for financial decision-making, including investment decisions, is fair value information. And because the financial statements are investors' major source of information, items in these statements should be measured at fair value.

Doing so would remove one significant source of complexity in financial reporting, that which derives from the mixture of both historical cost and fair value measurements.

For example, if all the financial instruments were to be measured at fair value, as we have argued for some time, there would no longer be the need for highly complex hedge accounting for those positions that are hedged. Neither would there be an accounting mismatch that could lead to unintended consequences. We were pleased to learn that the FASB and IASB last October reaffirmed their commitments to fair value reporting for all financial instruments, and are working jointly to resolve the remaining issues.

A third principle is that all changes in assets and liabilities should be recorded in a single new financial statement, which we call the statement of changes in net assets, available to common share owners. This statement would build upon and expand the reporting in the current statement.

A current hot topic of discussion is whether company managers should provide quarterly earnings forecasts to analysts, investors, and the markets. Two weeks ago, we asked our global membership if this practice should be discontinued. And we were not surprised to learn that three quarters of those responding said, yes, it should be stopped.

For those who answered yes, we also asked if companies should provide additional information on the fundamental longer-term drivers of the business, and 95 percent said yes.

We conclude from these results that our members find little value in the current earnings guessing game, but they would value clear and timely information on the basic economic factors that affect the company.

I commend the subcommittee for your leadership in addressing investors' concerns about the accuracy and transparency in financial reporting. I appreciate this opportunity to provide the views of CFA Institute, and I look forward to responding to any questions you may have. Thank you.

[The prepared statement of Ms. McEnally can be found on page 183 of the appendix.]

Mrs. BIGGERT. Thank you very much. I will now recognize myself, since there is nobody else here.

First of all, Mr. Melancon, AICPA's consortium has been a leader in promoting the use of XBRL. Where do you see the XBRL development going in the next few years?

And, second of all, do you see a more systematic adoption of XBRL leading to real-time financial reporting?

Mr. MELANCON. Well, XBRL is an enabler. I think you have to look at XBRL in concert with what are we reporting, and that's why I would say an enhanced business reporting to get away from just an earnings number, but key economic value drivers of a business.

I think that programs such as the FDIC's use of XBRL for call report filing shows the use of and the efficiency of using XBRL. I think that will continue and grow. I think the SEC, and certainly Chairman Cox, have been tremendous supporters of it. They have a voluntary program now. And I think that it's important to find, in various components of government, incentives to encourage people to use this on a voluntary basis. And I think companies, in fact, will do so.

Clearly, more work needs to be done. It has come an incredibly long way in a relatively short period of time. And 1998, I would dare say that very few people would even know what XBRL was, and today it's being adopted throughout the world, and certainly in many corners of the U.S. regulatory process, as well.

I think also that there is work to be done in the area of taxonomy development. And it takes the involvement of all of the people in the supply chain area. And it will also be used in areas that are not related, necessarily, to the topic of this hearing, which is more on the financial and GAAP basis. But, for instance, the IRS is involved in it, for the use of compliance work in that area, making things more efficient from their own enforcement perspective.

So, a lot of work to be done in areas such as taxonomy development, but tremendous progress, as well.

Mrs. BIGGERT. Are there any other challenges that companies will face in implementing XBRL?

Mr. MELANCON. I think it was reported by Scott Taub at the earlier panel that, at least in the pilot, the companies that have been using it from an SEC perspective have found the cost—I think his term was, "slightly more than negligible."

I think that it really is a notion of a wider knowledge of it. I think the building of the taxonomies, I think, clearly, the leadership of members of this committee, of Chairman Baker, and of Chairman Cox at the SEC, helped to make it much more accessible, much more known. And therefore, I think that bully pulpit is a very important aspect to getting it adopted and being widely known.

Mrs. BIGGERT. All right, thank you. Then, Mr. Hirschmann, the Chamber has been at the forefront of convincing public companies to cease issuing quarterly earnings guidance. And as you stated in your testimony, this practice of issuing these quarterly earnings guidance is detrimental to the long-term health of our capital markets.

Some of our largest public companies have agreed, and have stopped issuing such guidance. Would you elaborate a little bit on the Chamber's initiative?

Mr. HIRSCHMANN. Thank you. We think all parties have a responsibility here. Companies have a responsibility to step forward and stop issuing earnings guidance. We are using our bully pulpit at the Chamber to create some room for them to do so.

We believe the SEC has a role to play in making it easier for companies to communicate with investors, by reforming Regulation FD. We believe the analyst community has a responsibility by focusing on longer-term growth opportunities in companies. And we're looking at long-term performance, and we know that the better analysts already do. So, I think there is a role for everybody in the financial system to achieve this.

Companies—fully a quarter of the larger companies—have already stopped issuing earnings guidance. Those that have, have found it greatly advantageous. The real challenge is with smaller companies, who fear that they will lose coverage by the analyst community, and that that is the one way they can get their story out.

Efforts like what AICPA is leading on, enhanced business reporting, provides them a better way to get their story out, certainly much better than simply focusing on short-term earnings guidance, which is really a fool's game.

Mrs. BIGGERT. Do you—well, and this is for the rest of the panel, too—do you think that managers, in doing the quarterly earnings guidance, sometimes make business decisions that may not be in the best long-term interest of the company, by having to do that every quarter? Mr. Lackritz?

Mr. LACKRITZ. Well, I think we have to remember that there is going to be—we need a balance here that's going to work in the marketplace.

You know, on the one hand, we get concerned about issuers and demands on the issuers, but we have to remember there are 57 million households out there that own securities, directly or indirectly. And they need good information on which to base decisions.

So, on the one hand, if we're concerned about a short-term mentality because of quarterly reporting, the answer is not to eliminate quarterly reporting and make it longer in between periods. I mean, it would almost be like saying, "Let's not have the sun rise every day, because it creates too short a day."

I mean, the answer really is to encourage better, more frequent reporting of quality, you know, high-quality, comparable, consistent information. And I think we have to make sure to keep investors in this equation, because the marketplace really functions most effectively and allocates limited capital most effectively with the highest quality information.

Mrs. BIGGERT. Okay, thank you. Ms. Cunningham?

Ms. CUNNINGHAM. Sure. I think a lot of what has been said already. I think more communication of strategy, vision, enhanced business reporting model, and operating metrics, rather than reporting a number, will go a long way towards enhancing transparency and accuracy.

And I do think, though, that, you know, companies, in a lot of instances, particularly the smaller companies, do feel trapped in that if they don't provide it, they won't get the coverage. Therefore, they take a hit on their stock price there.

I think investors really need to recalibrate their current short-term focus as well, to one that's more focused on the long term.

Mrs. BIGGERT. Thank you. Mr. Melancon?

Mr. MELANCON. I would agree, that the focus on a single number is problematic. And the disclosure and finding ways to cost effectively do that, hopefully through the use of technology, on some key drivers of the company, what senior management looks to, that can be fully disclosed and give investors, those millions of households, a peek into the company as to what's important.

I think by moving away from a single number, we actually reduce some volatility, but at the same time, help people focus on a longer term. And that is absolutely important. And I think that, you know, let's go along with our notion that it is not necessarily more—not necessarily a volume of information, but a mount of digestible, accurate information that people can use to make good decisions.

Mrs. BIGGERT. Ms. McEnally?

Ms. MCENALLY. Thank you. I think we need to make a very clear distinction here between giving earnings guidance and the quarterly reporting that is essential to the valuation of investments.

Investors require not only clear, accurate, and complete financial information, but they have to have timely information. Otherwise, markets can't be efficient, and investors can't do what they have to do to properly allocate their capital.

So, I would not want there to be any confusion at all between the issue of earnings guidance and the requirement for clear, complete, quarterly information.

Mrs. BIGGERT. Thank you. Then Mr. Lackritz, could you explain why principle-based accounting standards would assist investors in analyzing investment choices between countries with different regulatory regimes and different accounting standards?

Mr. LACKRITZ. Sure. I think the key here is that we need to move toward converged—or at least comparable—kinds of standards, because that's going to facilitate the seamless flow of capital.

If you have principles-based accounting standards, it will make it easier to converge those standards from differing jurisdictions, number one. Number two, it will provide more opportunity for CFOs and companies to use their judgement, which of course, everybody is running away from now, because of the potential liability that everybody has.

And I think we have seen the results of some of the problems by not having converged accounting standards today. I mean, 6 years ago, $9 out of $10 raised in initial public offerings was raised in the United States. Last year, of the top 10 initial public offerings,

none of them were listed in the United States, and 23 out of the top 25 initial public offerings were not listed in the United States.

One of the reasons for that is the liability system here. A second reason is the costs that are being imposed by some of the regulations that have evolved. And the third reason, I think, is because accounting standards are not converged.

So, by moving to principles-based accounting standards, that will really facilitate the flow of capital across borders, and also reduce the cost of providing information to investors, as well.

Mrs. BIGGERT. Okay. Do any other panelists have thoughts on this issue?

[No response.]

Mrs. BIGGERT. Then I would like to insert into the record a statement of Merrill Lynch regarding earnings guidance, and a speech of Paul Schott Stevens, the president of the Investment Company Institute, given last week, regarding ICI's interest in XBRL. Without objection.

Mrs. BIGGERT. And with that, the Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. So, without objection, the record—hearing record—will remain open for 30 days, for members to submit written questions to the witnesses, and to place their responses in the record.

And with that, I would like to thank all of you so much for your excellent testimony, and I know it's a long day, and—to sit, and with two panels, but we really appreciate your help in our deliberations on this issue.

So, with that, the hearing is adjourned.

[Whereupon, at 12:34 p.m., the subcommittee was adjourned.]

A P P E N D I X

March 29, 2006

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Fostering Accuracy and Transparency in Financial Reporting
March 29, 2006

Good morning. We are here today to review the status of our public company financial reporting system. For over 70 years, public companies have been filing their financial statements with the Securities and Exchange Commission. Congress mandated these filings so that the investing public would understand the financial condition of public companies. These statements and the explanations accompanying these statements are at the heart of investor disclosure. It is critical for investors making decisions about where to put their money that these statements are readable, accessible, and meaningful.

Although we have seen some bad actors purposely and fraudulently deviate from accounting standards, the complexity of these standards can also be a factor in undermining compliance in well-intentioned companies. I commend the Financial Accounting Standards Board and the SEC for working towards reducing this complexity.

One approach to clarifying financial statements that the SEC and FASB are encouraging is the adoption of a principles-based, also called an objectives-oriented accounting system. Far too often, we have seen companies engineer transactions to circumvent bright-line accounting rules, making any purpose behind these rules meaningless. Under the Sarbanes-Oxley Act, we asked the SEC to study the adoption of a principles-based system, and the SEC concluded in its report that such an "approach should ultimately result in more meaningful and informative financial statements."

However, this movement towards principles-based accounting needs more than just the efforts of our regulators. I encourage public companies, auditors, lawyers, and the securities industry to join in this initiative. There must be a concerted effort on the part of all market participants to move away from rules-based accounting and auditing standards to a principles-based financial reporting system. I look forward to hearing from our witnesses how we can most quickly and successfully adopt such a system.

I also would like to commend the U.S. Chamber of Commerce for encouraging its public company members to cease issuing quarterly earnings guidance. It is too tempting, once that guidance is issued, for a company to manage its business to meet those short-term earnings numbers rather than manage its business for the long-term health of the company. This may lead to poor decision making, but also sometimes to earnings manipulation. For the continued vitality of our capital markets, management and investors need to focus on long-term company health.

One way, perhaps, to distance ourselves from relying on these quarterly earnings forecasts, is to make progress toward real-time disclosure. Again, I must commend the SEC, under the leadership of Chairman Cox, for promoting a new way to more easily digest and analyze financial information—through interactive data, or eXtensible Business Reporting Language (XBRL). Interactive data will allow investors to quickly download relevant financial information into their own software applications for analysis. No longer will time and money be spent on entering financial data into spreadsheets. I look forward to hearing from our witnesses how they believe XBRL will revolutionize the reporting and analysis of financial information.

I would like to thank my colleague from Louisiana, Chairman Baker, for holding this timely hearing. Chairman Baker has once again taken the lead in improving financial reporting for investors. He took an interest in XBRL years ago, when few understood its benefits, and even fewer knew what it stood for.

Thank you again. I look forward to hearing from our two distinguished panels of witnesses on these important issues. I yield back.

STATEMENT OF THE HONORABLE
Wm. Lacy Clay
Before
The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"Fostering Accuracy and Transparency in Financial Reporting?"

March 28, 2006

Good morning Chairman Baker, Ranking Member Kanjorski, Members of the Committee and witnesses.

Thank you for holding this hearing, Mr. Chairman. I also want to thank the SEC, the FASB and PCAOB for their spirit of cooperation in working together to "increasing the transparency of reported financial information and decreasing the complexity while doing so." This level of cooperation is not the norm in Washington, DC and should be applauded.

Mr. Chairman, over a hundred million Americans have investments in our markets. The confidence of these investors is paramount to the continued viability of the markets. This confidence is buoyed by the accuracy, reliability and transparency of our financial reporting.

We are world leaders in the quality of financial information and the timely disposition of that information. We must remain in this position while also being careful to limit the complexity so that transparency is not compromised. We must also be careful that our accounting standards are high, but not redundant so as to increase the cost of already expensive requirements.

I agree with Acting Chairman Gradison of the Public Company Accounting Oversight Board when he says that we need a combination of both "principles-based accounting" and "rules based accounting" as a system of rules without principles in unworkable.

I look forward to hearing the testimonies and the responses to questions.

Opening Statement, Capital Markets Subcommittee Hearing
Tuesday, March 29, 2006
TWO – THREE MINUTES

Thank you Chairman Baker and Ranking Member Kanjorski for holding this hearing on such an important and relevant topic. Thank you also to the members of the panels. I appreciate your willingness to come here today to discuss the issue with the Committee, and I look forward to hearing testimony on what each of your organizations has been doing to reduce the complexity of financial reporting.

The Financial Services Committee has enjoyed a great working relationship with the Securities and Exchange Commission, the Financial Accounting Standards Board and the Public Company Accounting Oversight Board, and the chairpersons and representatives of these organizations are always willing to come to the Hill to testify.

Yesterday, I introduced H.R. 5024, the Promoting Transparency in Financial Reporting Act of 2006 with Mr. Scott and Mr. Israel as original cosponsors. This bill will require annual testimony for the next five years before the Committee by the respective chairmen (or their designee) of the SEC, FASB and PCAOB relating to their efforts to reduce the complexity in financial reporting.

I appreciate the efforts of these organizations thus far to reduce complexity, and Chairman Cox and Chairman Herz' public statements of support for such efforts. I want to emphasize the importance that the Members of the Capital Markets Subcommittee, and the Committee leadership, have placed on the issue, and I want to ensure through this bill that we are continually updated on the progress that is being made. This will keep Members up-to-date, and will also serve as a reminder to the SEC, FASB and PCAOB that promoting transparency MUST be a top priority.

In the post-Enron financial era, transparent reporting has become an important aspect of promoting a healthy corporate environment. Financially-stable corporations are essential for expanding the U.S. business sector, promoting investor confidence and strengthening the economy.

As a former small business owner, I know firsthand the difficulties faced during the time-consuming and costly processes of accounting and financial disclosure. Unfortunately, financial reporting remains an arduous task with too many opportunities for error and manipulation. Reassessing outdated accounting standards and improving the ability of the average investor to understand and utilize financial literature is essential to the livelihood of American business and protection of American investors.

Some of these efforts should include reassessing complex and outdated accounting standards, moving from rules-based to principles-based accounting standards, promoting the use of plain English in disclosures, improving the ability of the average investor to read and understand accounting and auditing literature and encouraging the use and acceptance of extensible business reporting language (XBRL).

In closing, I would encourage all members of the Capital Markets Subcommittee to cosponsor H.R. 5024, and join me in making this a priority.

Thank you again to Chairman Baker and Ranking Member Kanjorski, and thank you to the members of the panels for joining us today. I look forward to hearing your thoughts on the progress made thus far, and the plan for the future. I yield back the remainder of my time.

Statement of
Candace Browning
SVP, Head of Global Securities Research & Economics
Merrill Lynch & Co., Inc.

Submitted to the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

Hearing entitled
"Fostering Accuracy and Transparency in Financial Reporting"
March 29, 2006

Mr. Chairman and Members of the Subcommittee, I am pleased to submit a statement regarding the issue of earnings guidance, addressed at your hearing entitled "Fostering Accuracy and Transparency in Financial Reporting."

My name is Candace Browning, and I am the Head of Global Securities Research & Economics for Merrill Lynch. Prior to being named to that position in 2003, I was a U.S. airlines analyst for 18 years. During much of this time there was no such thing as quarterly earnings guidance. The role of the analyst was then, and remains today, to provide investors insight into companies and industries that results in sensible and profitable long-term allocations of capital.

Whether evaluating the merits of a new business model in an initial public offering or identifying excess capital that should be reaped for shareholders' benefit, the analyst's role in the capital formation process remains critical to transparent capital markets. Projecting a company's future earnings and tracking shorter-term quarterly performance is important, but in recent years that focus on quarterly earnings has overshadowed the rest of the job.

Quarterly earnings can be tweaked by cutting back on expenses such as advertising and technology investments or accelerating the recognition of revenue. Managing to this short-term orientation presents obvious drawbacks, as highlighted by the US Chamber of Commerce and a recent McKinsey study. (Both argue that quarterly earning guidance fails to reduce short term volatility and can inappropriately create an illusion of stability.) However, the ancillary effects and unintended consequences of quarterly earnings guidance are arguably more damaging and unrecognized.

By providing specific earnings guidance, a company dictates both the measurement stick and the expected outcome. The measurement stick is typically a certain level of earnings – which may or may not be appropriate. And guidance is typically given without regard to important non-operating items such as write-offs or restructuring charges, which should be included because they reflect management's prior decisions regarding allocation of capital. The company's goal is to encourage the market's acceptance of its self-defined measurement stick and then beat the resulting

consensus, thus proving that it is earning higher-than-expected returns and so worthy of further allocation of investor capital.
This process creates an echo chamber that drowns out investor debate and distills what should be a complex message about a company's operations and performance into a single number – dictated by the company itself.

At Merrill Lynch, analysts are advised not only to discount heavily and to question earnings guidance, but also to analyse what the guidance – and the way it is constructed – says about the management. For example, analysts who follow companies with high operating leverage and little visibility into actual earnings per share know that the reason they give guidance is to ensure that they are able to beat that guidance. At one investor conference recently a spokesman stated proudly that his company either "met" or "beat" their guidance in 56 of the last 59 quarters. That this metric is carefully tracked shows that beating the guidance is what is important, and that the guidance is clearly not accurate and should be heavily discounted. Where cyclical companies with high operating leverage provide guidance, an analyst should question not only the figures, but also the management's wisdom in providing guidance at all.

But breaking free from company guidance is a tall order. An earnings forecast that contradicts management is highly provocative. Analysts who disagree with companies are sometimes derided publicly and subject to retaliation, such as being excluded from asking questions. Even Thomson First Call presumes that company guidance is correct and asks analysts to confirm their estimates if they fall outside it. For all these reasons, forecasts that contradict companies' management guidance do not happen as often as they should.

Merrill Lynch believes it would be in the best interests of investors if companies dropped quarterly earnings guidance. Market participants need to see it for what it is – a rough assessment of one indicator of a company's well-being. Earnings guidance dictates an outcome and discourages debate. Worst of all, this one number cannot possibly convey the subtle forces that shape a wise capital allocation decision and ultimately investors are let down.

None of this means a company should stop providing the marketplace with the financial data needed to make a determination regarding its future expected performance, particularly if it is aware of an adverse development that will dramatically affect its results. Information on long-term goals or targets such as reducing costs, increasing market share, growing capacity and improving return on equity are all examples of healthy objectives that should be communicated to investors. Running a company is a complex task; the dialogue between analysts and companies should reflect that.

I would also like to inform you that Merrill Lynch & Co., Inc. does not provide quarterly earnings guidance.

Thank you for the opportunity to present Merrill Lynch's views on an issue of significant interest to the investor community. I applaud your efforts in seeking more accurate financial insights regarding company performance.

TESTIMONY OF

COLLEEN S. CUNNINGHAM

PRESIDENT AND CHIEF EXECUTIVE OFFICER

FINANCIAL EXECUTIVES INTERNATIONAL

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT

SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

AT A HEARING ON

FOSTERING ACCURACY AND TRANSPARENCY

IN FINANCIAL REPORTING

MARCH 29, 2006

Thank you Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee for this opportunity to appear before you today.

My name is Colleen Cunningham and I am the President and Chief Executive Officer of Financial Executives International (FEI). FEI is the leading international organization of 15,000 members including CFOs, Treasurers, Controllers, tax executives and other senior financial executives.

FEI members represent the preparer community, that is, the senior financial executives responsible for the preparation of financial statements. Importantly, we are also users of financial statements, relying on financial statements of other companies in our investment and credit decisions. In both roles, as a preparer and user of financial statements, we support the goal of this hearing, to foster accuracy and transparency in financial reporting.

I am pleased to have the opportunity to share our views with you today on the important issue of **fostering accuracy and transparency in financial reporting**. The complexity and technical demands of accounting standards have increased considerably in recent years, to the point where many otherwise capable accountants are not confident that they can apply the new requirements without outside assistance from subject matter experts. This is happening at a time when, in the United States financial reporting environment, there is heightened sensitivity and attention given to accounting and financial reporting. FEI believes undue **complexity** harms, rather than enhances, the ability of users of financial statements to understand the information provided by financial reporting. Simple, easy to understand standards should be our mutual goal.

The Complexity Conundrum

FEI concurs with the view of the leaders of the SEC, FASB, and PCAOB that all interested parties must come together to address complexity.

We applaud the FASB's current project on simplification and codification. This should go a long way towards enabling preparers, auditors and users of financial statements to find applicable accounting literature. However, when the rules themselves for how to report transactions are unduly complex, they impede the ability of preparers to provide accurate and transparent financial reporting.

No doubt, the growing complexity of business transactions adds to the challenge of trying to develop accounting standards. Additionally, the current litigious environment creates the need for preparers and their auditors to seek additional guidance to ensure that they are "doing the right thing".

The underlying environment causing the constant requests for "bright lines" and interpretations by auditors and preparers needs to be addressed. Additionally, overly theoretical and complex standards can result in financial reporting of questionable accuracy and can create a significant cost burden, with little benefit to investors.

Four Potential Solutions To Reducing Complexity

In the remainder of my remarks, I will outline four potential solutions to the "complexity conundrum". They are:

1. the need for FASB to prioritize its conceptual framework and codification projects, and follow with principles-based rulemaking, which must be practicable in application, understandable by preparers, users and auditors, and result in information that is "auditable."

2. the need for regulators to avoid second-guessing reasonable interpretations of standards, and avoid issuing "informal guidance" instead of formal rulemakings for significant matters that could lead to a large number of restatements,
3. the need for Congress to assist in correcting today's litigious environment, and
4. the need for preparers, auditors and users of financial statements to be part of the solution by educating themselves about changing accounting and auditing standards, participating actively in the standard-setting process, and making recommendations for simplifications in accounting standards and their own financial reports (or those of companies they audit or invest in) to improve financial reporting, making it more useful and understandable to investors.

1. Conceptual Framework Must Take Priority

I applaud the FASB, and the International Accounting Standards Board (IASB), for their dual efforts to communicate the importance of the current conceptual framework project, and we look forward to reviewing and commenting on upcoming proposals associated with it.

We would urge FASB to apply a *"concepts-first"* approach to accounting standards setting, followed by the principles.

Function of the Conceptual Framework

The reason why *"concepts- first"* is so critical to standard-setting, is because the role of the Conceptual Framework, as designed by FASB in its formative years, was to provide a consistent theoretical foundation upon which to build meaningful standards.

FASB is currently preparing to release, as part of its convergence project with the IASB, proposed revisions and improvements to the concepts relating to the "Objectives of Financial Reporting" (currently contained in FASB's "CON 1") and "Qualitative Characteristics of Financial Reporting" (currently contained in FASB's "CON 2"). CON 1 and CON 2 have not been without controversy, but formed the basis on which Generally Accepted Accounting Principles or GAAP has developed over the past quarter century. By and large, the early concepts statements have proven to be a strong and worthy foundation upon which to construct standards. However, the critical nature of issues currently being debated in proposed changes to the conceptual framework, such as who the "users" of financial reporting are, what the "objective" of financial reporting should be, and the need for accounting standards to meet certain qualitative thresholds such as reliability, relevance, usefulness and understandability, are key. Recently issued accounting standards are not always reflective of the current conceptual framework, but rather rely on changes to the conceptual framework that have not yet been proposed, let alone finalized as "generally accepted." FEI has voiced its concern about this "cart-before-the-horse" approach of standard-setting numerous times. We do wish to note FASB has opened its doors, telephone lines and meetings to us and we applaud FASB for providing opportunities for the preparer community and other constituents to voice their views.

Following is an example of a current, proposed FASB standard which we believe imposes a great deal of complexity, will result in information of dubious value for investors, and poses significant questions as to its conceptual underpinnings.

Example of Complexity: Fair Market Values that are Neither "Fair" nor "Market"

FEI's Committee on Corporate Reporting (CCR) recently wrote the FASB asking FASB to reexpose the Exposure Draft of its proposed Fair Value Measurement standard (see March 14, 2006 letter of FEI's CCR to FASB, attached). We made this request in part since the latest changes being proposed by FASB are significant and may not be well understood, and also due to significant changes in the proposed standard versus two previous versions of the proposed standard that were publicly available (i.e., the 2004 "Exposure Draft" and 2005 "Working Draft" of the Fair Value Measurement standard). We appreciate FASB's consideration of our and others requests, although we hope they will reconsider their recent decision not to reexpose the document for public comment.

We support FASB's decision to extend the effective date of the proposed Fair Value Measurement standard to 2008, allowing more time to understand and implement it. However, we believe recent past experience has shown that important implementation guidance and even interpretive guidance has followed issuance of standards, and it is not in the public interest to force companies to "change gears" in the midst of their implementation. FASB has stated a desire to form a Valuation Resource Group in support of this standard, and FEI would be pleased to be a part of that group.

In terms of complexity, accuracy, and transparency of financial reporting, we are very concerned that FASB's proposed Fair Value Measurement standard will only exacerbate complexity, with little benefit to, or indeed may actually detract from, the understandability and usefulness of the resultant reported information.

It may be helpful to give some context as to the FASB's proposed Fair Value Measurement "hierarchy". "Level 1" in the hierarchy would generally include widely available, publicly quoted market values for financial instruments traded in active, liquid markets. That is easy to understand and not a concern. Our most serious concern is with what FASB currently describes as "Level 3" in the proposed Fair Value Measurement hierarchy, which describes how companies would apply a complex, artificial construct designed to mirror a "market participants" approach to imputing market values, even when no active market exists for a financial instrument (or nonfinancial instrument, if fair value were to be required by another standard, and this standard used as a reference point for computing fair value).

Following the complex requirements for determining Level 3 fair values in particular will not only come with significant cost, but result in numbers of highly questionable meaning and reliability. The use of such numbers will not always benefit, and could potentially mislead, investors, and increase the likelihood of second-guessing by regulators and the plaintiff's bar.

Thus, the example of FASB's proposed Fair Value Measurement standard reminds us of the need to put the concepts first.

Practicability, Understandability, and Auditability Count

While a set of "principles" can make sense to standard-setters theoretically, they must also meet the test of being practicable in implementation, and understandable by preparers and users in the real world. Auditability is also particularly important.

Standards that are overly complex or involve imputation of entity specific numbers which the proposed FASB standard requires to be characterized as "fair values" can only severely

stress the system when it comes to auditability. Active and continuous consultation with preparers, auditors, and users of financial statements, as well as the SEC and PCAOB on the matter of auditability of proposed standards under development is key, since the SEC and PCAOB ultimately investigate and take enforcement actions against what they may view as fraudulent financial reporting.

2. The Role of the Regulators

Although the litigation explosion is something we urge Congress to address as described in Recommendation 3 below, there are important actions the regulators can also take to help stem the tide of litigation and the related desire for rules-based standards. Specifically, regulators need to limit second guessing of professional judgments by corporate management, particularly judgments that have been confirmed by the professional judgment of outside auditors and outside legal counsel.

In this regard, we note the detrimental effect of the "should have known" standard that is described in the recent report of the U.S. Chamber of Commerce, regarding SEC Enforcement. We share the Chamber's concern in this regard, and believe the SEC should give serious consideration to the Chamber's recommendations, including recommendations to reduce the undue pressure on companies to waive attorney client privilege and other pressures to "cooperate" that unduly weaken companies' ability to do a thorough investigation and avoid harming employees unreasonably in an effort to appear to cooperate.

Importantly, we also note the Chamber's report on SEC Enforcement considered the issue of accounting complexity and second-guessing many times throughout the report. Although the Chamber's report is directed at the SEC, we believe this substantiates the point I made

earlier, that the standard setters should not ignore issues of auditability, nor should they ignore a "reasonableness" test of how their standards will be understood and applied in the real world by preparers and users of financial statements.

Although I support the SEC's encouragement of studying the use of interactive data such as XBRL and the benefits it can provide, I urge one note of caution: that interactive data is not a "panacea" in that transparency provided through electronic links or the old fashioned way through non-linkable disclosure will not reduce the "operational" complexity imposed on preparers and auditors to develop the numbers provided in financial reports, nor will such transparency improve the understandability of the underlying numbers to investors.

The PCAOB plays an important role in reducing complexity as well. And that is by avoiding unreasonable second-guessing in its inspections of audit firms, with respect to interpretations of GAAP by management, which were previously opined on by outside auditors and outside legal counsel.

"Accuracy" Means Reasonable Not Absolute Assurance

To win the war on complexity, both the PCAOB and SEC will need to maintain a disciplined approach, to assist all other constituents in the financial reporting process, in reducing the "expectation gap" of the public – i.e., that information provided by financial reporting provides reasonable estimates of numbers – and that auditors' opinions provide reasonable – but not "absolute" assurance.

3. The Litigious Environment

The need to assure auditability of accounting standards is important not only to the auditors that sign audit opinions, and CEOs and CFOs that certify the financial statements, but also to

the board members that sign the Annual Report or 10-K. A major force in their concern is due to the tremendous threat of liability in today's litigious environment.

The threat to the very existence of the major accounting firms was noted in a recent study by the U.S. Chamber of Commerce, and the threat to board service by qualified people due to their desire to avoid tremendous litigation exposure is also a factor that should be considered since board service is a key component of corporate governance in the interest of fostering accurate and transparent financial reporting.

Congress Needs To Stem The Tide Of Litigation

It has been noted that companies sometimes request a high level of specificity in accounting standards, to avoid being "trapped" by litigation based on a different interpretation of a broad principled based standard The litigation issue is in large part outside the standard setters and regulators jurisdiction, so it will require Congressional action to stem the tide of litigation that can threaten the survival of audit firms, public companies, shareholders, officers, directors, and employees.

4. Preparers, Auditors and Users Need To Be Part Of The Solution

By being part of the solution, preparers, auditors and users of financial statements can take the initiative to educate themselves, and foster the accuracy and transparency of financial reporting, by improving their ability to keep up with new developments in terms of how businesses operate, new products and transactions, new technology, and new accounting standards and reporting requirements.

FEI members participate in the standard setting process through PCAOB's Standing Advisory Group, the SEC's Advisory Committee on Smaller Public Companies, and the advisory councils of both the FASB and the IASB. Our Technical Committees constantly share feedback with regulators and standard setters through meetings and responding to requests to serve on roundtables, advisory committees and respond via comment letters to share insights and provide constructive recommendations for consideration. Additionally, preparers can, and should, take initiatives in improving financial reporting without waiting for a rule.

Conclusion

We believe that it is feasible to reduce the complexity of financial reporting by making accounting standards easier and less costly to find, understand, remember and implement. But, to do so will require a concerted effort among all financial reporting stakeholders and leadership many of whom are here today.

The creation of a special committee with wide representation to address complexity can help us arrive at practicable solutions to combating complexity that maximizes the utility of financial reporting to investors. Everyone has a role to play in this effort to reduce complexity, and FEI is ready to be a part of it.

That concludes my remarks. I want to thank the Chairman and the members of the Subcommittee for inviting FEI to participate in today's hearings.

TESTIMONY OF

Bill Gradison
Acting Chairman

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

MARCH 29, 2006

PCAOB
Public Company Accounting Oversight Board

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

I am pleased to appear today before the House Financial Services Capital Markets Subcommittee to testify on accuracy, transparency, and complexity in financial reporting. As Acting Chairman of the Public Company Accounting Oversight Board, I will address the auditor's role and experience in evaluating public companies' application of accounting and financial disclosure standards and rules. I will also discuss PCAOB's experience in establishing and monitoring the implementation of auditing and related professional practice standards.

The Sarbanes-Oxley Act of 2002 (the "Act") directed PCAOB to establish a continuous program of auditor oversight in order to achieve the Act's stated goal of protecting the public interest "in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."[1] Among the responsibilities the Act assigned to PCAOB is the responsibility for establishing auditing and related professional practice standards for auditors of public companies. In addition, PCAOB is responsible for evaluating auditor application of those standards to promote high quality audits -- audits that focus on preventing the kinds of financial reporting failures that we saw in companies ranging from Adelphia to ZZZZ Best. In performing standard-setting and other tasks, we are overseen by the Securities and Exchange Commission, whose Acting Chief Accountant, Scott Taub, I am pleased to join here before you today.

Accuracy, Transparency, and Complexity in Financial Reporting

In addition to the role of the independent auditor, the accuracy, transparency, and complexity of public company financial statements are affected by a number of factors. These include the nature of the public company's business, its controls over the preparation of financial statements, applicable accounting standards and disclosure requirements, and the quality and integrity of its management.

The Financial Accounting Standards Board and the SEC are responsible for the establishment and oversight of the application of accounting standards and disclosure rules governing the preparation and presentation of public company financial statements. And, of course, corporate management is responsible for preparing and presenting those statements. The manner in which independent audits are conducted affects both the actual and perceived reliability and relevancy of a public company's financial statements. When an auditor concludes that financial statements do <u>not</u> fairly portray a company's financial

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[1] Sarbanes-Oxley Act, Section 101(a).

results in conformity with applicable accounting standards, the auditor has several options: He or she may request changes to the financial statement amounts or disclosures, may modify his or her opinion on those financial statements to indicate the nature of misstatements or omissions and the extent to which the financial statements depart from a fair presentation, or the auditor may withdraw from the audit engagement without expressing an opinion.

Auditors thus play an integral role in evaluating public companies' application of accounting standards and disclosure rules and are therefore in a key position to influence, and hopefully increase, public confidence in the accuracy and reliability of the resulting financial statements.

In recent years, there has been a great deal of discussion about whether principles-based accounting standards more effectively result in understandable financial statements that better reflect the underlying financial picture of a company than do more prescriptive and more technical "rules-based" accounting standards.

The terms "principles-based" and "rules-based" typically are used to refer to the two ends of a spectrum of specificity. On one end of that spectrum are principles-based standards that contain comparatively fewer details and prescriptions and, on the other end are rules-based standards that are highly prescriptive in their requirements, and leave fewer decisions to professional judgment. Principles-based standards necessarily leave, at least in the first instance, the determination of whether the principles in the standards are fairly implemented to the judgment of public companies and their external auditors. But here's the rub – in order for a system of general principles to work, the judgment used to apply those principles cannot be based on whatever the company and its auditor *say* is fair, but rather on what informed financial statement users would *believe* is fair.

I firmly believe that a system of rules without principles is unworkable, though I expect the debate over the right balance between the two will never go away. That debate is not only healthy and timely, it is at the heart of the issue before us – complexity, transparency, and accuracy. Let me explain.

Principles-based standards have the seductive appeal of allowing more flexibility and professional judgment in dealing with different situations but, precisely because of that characteristic, they are likely to lead to increased variability in results, even when applied by conscientious corporate managers and checked by competent independent auditors. As a matter of fact, it was this debate over the variability of acceptable accounting outcomes for similar fact situations that led to the formation of the Financial Accounting Standards Board.

Public company managers have a natural desire to be successful and to be perceived as successful by the investing public. This can result in significant tension, especially when applying broad principles in preparing financial

statements. That tension is greater when the company's results fail to match up to manager or investor expectations. Public companies often see a conflict between short-term incentives and long-term objectives. On the one hand, management may face a short-term incentive to present the company's results in a misleading fashion that might be rationalized as permitted by applicable accounting principles. On the other hand, the company faces the long-term objective to maintain investors' confidence by ensuring that the company's results are accurate, reliable, understandable, and useful to investors.

Some company managers have been known to challenge their auditors to "show me where the accounting standards say I can't do this." Many accounting standards were created, or modified, in order to provide a definitive answer to that question. (Many of you will recognize this as a process not dissimilar to that which gave us a substantial portion of our tax code.) When auditors succumb to the pressure of managers' desire to present an unduly rosy picture, it can lead to financial statements that fail to clearly present the company's results – much less being capable of comparison to other investment opportunities – by using complexity and non-disclosure to obscure, rather than transparency to reveal the true results. The Act's reforms, especially those related to the SEC's reviews of corporate disclosures and PCAOB's inspections of audits, go directly to reducing the incidence of this result and, with continual oversight, may permit more reliance on principles-based standards going forward. To date, however, this tension has significantly limited the benefits of principles-based accounting standards.

Another impediment to more reliance on principles-based standards is the relentless pressure put on standards-setters to make exceptions to the principles, usually to suit parochial interests of particular industries or groups of companies, or auditors seeking a safe harbor from liability exposure. The more exceptions standards-setters grant, of course, the more rules-based standards inevitably become. Rules-oriented standards *themselves* may promote complexity by encouraging companies and their financial service providers to engineer transactions that exploit existing rules to achieve particular financial statement results such as removing debt from a balance sheet. New rules may then be required to prevent abuses of these loopholes in existing standards. It can become a vicious circle.

Complexity in Auditing

Although the debate over complexity in financial reporting has largely focused on transparency of financial statement presentations, many have argued that the auditors' approach to their own work should be simplified. Indeed, as the standards-setter for audits of public companies, PCAOB has received many requests for specificity and for exceptions. The Board is mindful of the risk that acceding to these requests could result in auditing standards that are overly prescriptive rather than providing a framework that serves as the foundation for the exercise of professional judgment. In my view, overly prescriptive auditing

can weaken audit quality if it encourages auditors to focus on technical compliance rather than professional judgment.

For these reasons, I believe auditing standards have been and remain relatively principles-based. Fundamentally, auditors must gather sufficient evidence to provide a proper basis for an opinion that states that:

> *In our opinion*, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.[2]

Accordingly, auditing standards require that auditors exercise professional judgment at all stages of an audit – from planning to actually performing an audit. Merely completing a checklist of all required procedures does not give the auditor the basis on which to form an opinion because judgment is essential to the auditor's formation of this opinion.

Auditing Internal Controls over Financial Reporting

PCAOB's best known standard – Auditing Standard No. 2, which establishes the framework for an integrated audit of internal control over financial reporting in conjunction with an audit of the financial statements themselves – is an example of a principles-based standard. That is, although Auditing Standard No. 2 is lengthy, a closer look at the standard exposes its true principles-based nature. Importantly, the text of the standard establishes a conceptual framework that relies heavily on auditor judgment for implementation. For example, the standard requires an auditor to exercise substantial judgment in identifying significant accounts, determining materiality, assessing the risk of misstatement, and evaluating the significance of identified deficiencies.

We have all heard anecdotes about the challenges public companies faced in the first year of implementing the internal control requirements of the Act and the SEC's rules. Among those challenges have been the difficulties auditors themselves faced in exercising their judgment on how best to implement Auditing Standard No. 2. PCAOB has attempted to mitigate those difficulties and to encourage thoughtful use of judgment in two ways: offering implementation guidance and monitoring the implementation of PCAOB auditing standards.

Implementation Guidance

First, to facilitate a smooth implementation of PCAOB auditing standards, the Board and its staff have periodically issued implementation guidance, giving careful attention to avoid detailed, rules-based or exceptions-laden approaches.

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[2] See AU § 508.08 (emphasis added).

For example, soon after the Board adopted Auditing Standard No. 2 on March 9, 2004, and it was approved by the SEC as required by the Act, on June 17, 2004,[3] the Board's staff issued a series of questions and answers over the course of several months to assist auditors in the implementation of Auditing Standard No. 2. These Q&As stemmed directly from early questions from auditors and their audit clients.

In addition, on May 16, 2005, the Board issued a policy statement regarding the implementation of the standard, accompanied by additional staff Q&As.[4] Both documents addressed how auditors can make the internal control audit more effective and efficient, and they provided specific guidance on integrating the audits, using a top-down approach, using the work of others, assessing risk, as well as other topics. Finally, on November 30, 2005, the Board issued a Report on the Initial Implementation of Auditing Standard No. 2, in which the Board clarified certain questions about the definitions of terms used in the standard, as well as ways to make the integration of the audits of internal control and the financial statements more efficient.[5]

The Board continues to monitor implementation of Auditing Standard No. 2 in order to help auditors make their internal control audits as effective and efficient as possible. In that regard, we have recently announced that, together with the SEC, the Board will host a day-long roundtable discussion among corporate managers, auditors, investors, and others about the second-year implementation of our internal control standard. We want to know where it is working and where it is not. Only in this way can PCAOB help auditors and companies share best practices.

Monitoring Implementation of PCAOB Auditing Standards

This leads me to the second method by which the Board influences the application of its auditing standards. Through its inspections program, PCAOB has the opportunity and mandate to see how auditors are implementing auditing

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[3] See SEC Release No. 34-49884 (June 17, 2004), Order Approving Proposed Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2").

[4] See PCAOB Release No. 2005-009, Policy Statement Regarding Implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (May 16, 2005) (available at http://www.pcaobus.org/ Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx).

[5] See PCAOB Release No. 2005-023, Report on the Initial Implementation of Auditing Standard No. 2 (Nov. 30, 2005) (available at http://www.pcaobus.org/Rules/Docket_014/2005-11-30_Release_2005-023.pdf).

standards. Our inspections and standards-setting functions are in a continual feedback loop, so to speak. In my view, Congress showed great wisdom in structuring the Board in this fashion. This structure gives us the opportunity to explore both more broadly and in more depth what we hear anecdotally.

Let me share with you an example of using our inspections process to ensure the effective implementation of our auditing standards. Specifically, in its May 16, 2005 Policy Statement, the Board indicated its intention to use its 2005 inspections to evaluate how efficiently and effectively firms conducted the first round of audits under Auditing Standard No. 2.[6] During the summer and fall of 2005, the Board deployed a team of specially-trained inspectors to review the largest accounting firms' internal control audit methodologies, as well as components of selected internal control audits performed under Auditing Standard No. 2.

In order to allow audit firms to react as quickly as possible, PCAOB inspectors conveyed their feedback on the internal control audit methodologies and conduct of audits to the leaderships of the firms on a real-time basis. Importantly, the PCAOB inspectors' focus was not on technical compliance, but rather on making sure auditors adequately assessed and addressed the areas of greatest risk of material weaknesses in internal control. By acting in such ways, the Board hopes to preserve the principles-based approach in this and other standards and to foster sound judgment in auditing rather than an unthinking focus on technical compliance.

Additional Avenues to Promote Audit Quality

In addition to standard-setting, guidance, and inspections, we have additional avenues, including enforcement, to promote audit quality. The Board is committed to educating and seeking input not just from auditors, but also from preparers, investors, regulators, academics, and other users of financial statements, on how to improve audit quality and thereby improve the accuracy, reliability, and transparency of financial statements. Whether through speeches, our forums on Auditing in the Small Business Environment, or reports summarizing various inspection findings, PCAOB seeks to promote high audit quality by making the most of its communication opportunities.

* * *

Mr. Chairman, I have described how the desire for specificity and exceptions from application of standards can foster unnecessary complexity, and reduced comparability and transparency, in financial reporting. I have also described the efforts of PCAOB to encourage a principles-based approach to auditing, and specifically to the auditing of internal control over financial reporting.

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[6] See PCAOB Release No. 2005-009, supra n. 5, at 13-14.

The debate over accuracy, transparency, and complexity in financial reporting has enhanced public companies', auditors', investors', and regulators' awareness of the challenges our financial reporting system faces. In my view, this is the beginning of a collaborative effort to find solutions to these challenges, including the right balance between principles-based and rules-based standards. I very much look forward to the continuing dialogue.

Thank you for the opportunity to address these important issues. I welcome any questions you may have.

Testimony of

Robert H. Herz

Chairman

Financial Accounting Standards Board

before the

Capital Markets, Insurance and Government Sponsored Enterprises

Subcommittee

of the

Committee on Financial Services

March 29, 2006

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Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Capital Markets, Insurance and Government Sponsored Enterprises
Subcommittee
of the
Committee on Financial Services
March 29, 2006

Prepared Statement

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

Good morning. I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). I want to thank you for inviting me to participate at this very important and timely hearing.

I have brief prepared remarks and would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

The enactment by Congress of the Sarbanes-Oxley Act of 2002, and subsequent related actions by the United States ("US") Securities and Exchange Commission ("SEC"), the Public Company Accounting Oversight Board ("PCAOB"), and the FASB, as well as various reforms within the business community, have strengthened the financial reporting system and increased public confidence in reported financial information. However, despite the benefits of those important reforms, we at the FASB, and many others, believe that there is much more work to be done to improve US financial reporting.

In our opinion, the complexity that pervades the reporting system—as evidenced by the volume and detail of accounting, auditing, and reporting standards, rules, and regulations—poses a major challenge to maintaining and enhancing the accuracy and transparency of financial information reported to investors, creditors, and the capital markets. We are concerned that complexity has engendered a form-over-substance approach to accounting, auditing, and reporting, sapping professionalism and increasingly necessitating the involvement of technical experts to ensure compliance.

The complexity has also added to the growing costs and effort involved in financial reporting and is a contributing factor to the unacceptably high number of restatements of financial reports by public enterprises. Moreover, it results in analytical complexity for investors and others seeking to use financial information in their economic decisions.

While some of the complexity is a natural consequence of reporting on diverse and complicated business transactions, there are many other sources of complexity, including:

- The continuing focus and emphasis on short-term earnings,
- The often conflicting perspectives and agendas of market participants,
- An evolutionary approach to standard setting that has resulted in nonconceptually based compromises and inconsistencies over time,
- Regular demands for detailed rules, bright lines, and exceptions driven in part by the fear of being second-guessed by regulators, enforcers, and the trial bar and in part by those seeking special treatments and exemptions,
- Continuing use of accounting-motivated structuring in an effort to obtain form-over-substance results, and

- Resistance to change and slowness in embracing and implementing new technologies and reporting models.

The FASB has recently undertaken a number of measures aimed at reducing complexity and improving the relevance and transparency of financial reporting.

First, the FASB has been systematically readdressing specific accounting standards that are overly complex, are rules-based, and do not result in reporting that properly reflects the underlying economic activity. Major areas the Board is currently readdressing include revenue recognition and accounting for pensions and other postemployment benefits. The Board also recently issued two new standards, and has other active projects on its agenda, designed to improve and simplify the accounting for derivatives and other financial instruments.

Second, the FASB has undertaken a major project to develop and maintain a comprehensive and integrated codification of all existing accounting literature. This project will result in an easily retrievable single electronic-based source for all US generally accepted accounting principles.

Third, the FASB has been actively pursuing several activities directed toward the development of more principles-based or objectives-oriented accounting standards, including a major project to strengthen our existing conceptual framework. That project will provide a more solid and consistent foundation for the development of more objectives-oriented standards in the future. Consistent with our commitment to international convergence of accounting standards, this project, like many of our current projects, is being conducted jointly with the International Accounting Standards Board, whose standards are in use in some 100 countries around the world.

Finally, while the development in the US of eXtensible Business Reporting Language ("XBRL") has been under the direction of the XBRL Consortium, the FASB has been working with the Consortium and others to further the use of XBRL and other evolving technologies in financial reporting.

As important as all of those measures are, unfortunately, when taken alone, they are unlikely to significantly reduce the complexity that burdens the US financial reporting system. In our view, that will require concerted and coordinated action by all key parties in the reporting system to address the structural, cultural, and behavioral forces that generate complexity and impede transparent reporting.

Recently, we have been discussing issues surrounding complexity with the SEC, the PCAOB, and many other interested parties. As part of those discussions, we have begun exploring the kinds of steps and actions that might be necessary to identify the issues that lead to complexity and to develop proposed solutions and recommendations.

We believe that an initiative involving all key parties would be the most effective means to bring about broad-based improvements to the US financial reporting system aimed at both reducing complexity and increasing the accuracy and transparency of financial

reporting. While such an effort would not be easy and would take time, we believe it is one of national importance.

We look forward to continuing to work closely with the SEC, the PCAOB, this Subcommittee, and all other interested parties to ensure that the US financial reporting system meets the needs of investors, creditors, and our capital markets.

Thank you again, Mr. Chairman. I look forward to the opportunity to respond to any questions.

Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Capital Markets, Insurance and Government Sponsored Enterprises
Subcommittee
of the
Committee on Financial Services
March 29, 2006

Full Text of Testimony

Chairman Baker, Ranking Member Kanjorski, and other Members of the Subcommittee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB.

My testimony includes a brief overview of (1) the FASB, including the importance of the Board's independence and public due process, (2) the Board's view on the current state of the United States ("US") financial reporting system, (3) measures that the FASB has undertaken to reduce complexity and improve the relevance and transparency of financial reporting, and (4) why we believe further broad-based improvements in the US financial reporting system are necessary.

The FASB

The FASB is an independent private-sector organization.[1] We are not part of the federal government. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises, including small businesses and not-for-profit organizations.[2] Those standards are essential to the efficient functioning and operation of the capital markets and the US economy because creditors, investors, and other consumers of financial reports rely heavily on sound, honest, and unbiased financial information to make rational credit, investment, and other resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002 ("SOX"),[3] is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report information about their economic activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises. Like creditors and investors, Congress and other policy makers need an independent FASB to maintain the integrity of the standards in order to obtain the financial information necessary to properly assess and implement the public policies they favor.

The Securities and Exchange Commission ("SEC"), together with the private-sector Financial Accounting Foundation ("FAF"),[4] maintains active oversight of the FASB's activities.

The FASB's Public Due Process in Developing Accounting Standards

Because the actions of the FASB affect so many organizations, its decision-making process must be open, thorough, and as objective as possible. The FASB carefully

[1] "Facts about FASB" (2005), pages 1 and 3 (see Attachment 1).
[2] The FASB's sister operating unit—the Governmental Accounting Standards Board—is responsible for establishing and improving standards of financial accounting and reporting for state and local governmental entities. FASB Rules of Procedure (December 1, 2002), page 56.
[3] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109.
[4] "Facts about FASB," pages 3–4 (see Attachment 1).

considers the views of all interested parties, including users, auditors, preparers, and regulators of financial reports of both public and private enterprises, including small businesses and not-for-profits organizations.

Our Rules of Procedure require an extensive and thorough public due process.[5] That process involves public meetings, public roundtables, field visits, public liaison meetings with interested parties, and exposure of all proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with a wide range of interested parties to obtain their input and to better our understanding of their views. The Board makes final decisions only after carefully considering and analyzing the input of interested parties.

While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides for far more public deliberations of the relevant issues and far greater opportunities for interaction with the Board by interested parties. It also is focused on making technical, rather than policy or legal, judgments. The FASB's Mission Statement and Rules of Procedure require that in making those judgments the Board must balance the often conflicting perspectives of various interested parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of high-quality financial reporting set forth in our conceptual framework.

The FASB and the FAF, in consultation with interested parties, periodically review the FASB's due process procedures to ensure that the process is working efficiently and effectively for users, auditors, preparers, and regulators of financial reports.[6] In recent years, the FASB and the FAF have undertaken a significant number of actions to improve the Board's due process procedures.[7]

The Current State of the US Financial Reporting System

Most everyone agrees that the capital markets in the US remain the deepest and most liquid in the world. The acknowledged success of the US capital markets, and their contribution to the nation's economic vitality, have been due in no small measure to the availability of relevant, reliable, readily understandable, and timely financial information.

The corporate scandals and malfeasance that came to light in the recent past, in part, through hearings held by this Subcommittee, demonstrated the need for reforms to the US financial reporting system and improvements in performance by system participants. The

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[5] "Facts about FASB," pages 6–8 (see Attachment 1).

[6] In connection with the enactment of SOX the SEC performed a review of the FASB's due process and concluded that "the FASB has the capacity . . . and is capable of improving both the accuracy and effectiveness of financial reporting . . ." Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter (April 2003), page 5 of 8.

[7] See Full Text of Testimony of Robert H. Herz, Chairman, Financial Accounting Standards Board, before the Financial Institutions and Consumer Credit Subcommittee of the Committee on Financial Services (April 13, 2005), pages 2–3, reviewing some of the recent actions to improve the FASB's due process procedures.

resulting responses, including the enactment of SOX, and subsequent actions by the FASB, the Public Company Accounting Oversight Board ("PCAOB"), and the SEC, and other reforms within the business community have all strengthened and increased public confidence in the US financial reporting system. For example, the FASB has observed that many of the parties involved in the US financial reporting system today have a much greater focus on the critical importance of high-quality financial accounting and reporting to the health and vitality of our capital markets and our economy than has existed for many years.

Despite these important reforms, we at the FASB, and many others, believe that there is more to be done to improve the US financial reporting system. There continue to be important issues facing the system that either were not addressed at all or were not addressed systematically by the recent reform efforts. Those issues include the need to reduce complexity and improve, as indicated by the title of this hearing, the accuracy and transparency of reported financial information for investors, creditors, and the capital markets.

Complexity of the System

In the more than 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 US generally accepted accounting principles ("GAAP"), generally accepted auditing standards, and SEC rules, regulations, and interpretations governing financial reporting. This complex system of standards, rules, and regulations has long been viewed as a strength of our reporting system and, in part, is a reflection of the complexity inherent in reporting on increasingly diverse and complicated business transactions and arrangements.

We at the FASB, however, and many others, believe that the current volume and detail of accounting, auditing, and reporting standards, rules, and regulations pose a major challenge to maintaining and enhancing the accuracy and transparency of financial reporting to investors, creditors, and the capital markets. We, and many others, 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 enterprises, [8] and is viewed as a contributory factor to the unacceptably high number of restatements of financial reports by public enterprises. For while many restatements are due to intentional misstatements and fraud, others appear to merely reflect unintentional mistakes in implementing and auditing complex accounting and reporting requirements.

[8] In 2004, the FASB established a Small Business Advisory Committee in an effort to obtain more active involvement by the small business community in the development of financial accounting and reporting standards, including providing more input on the costs incurred by smaller companies in implementing FASB standards. FASB News Release, "FASB Establishes Small Business Advisory Committee" (March 18, 2004).

Sources of Complexity

Some of the many powerful forces that we believe generate complexity in the financial reporting system and impede improving the accuracy and transparency of financial reporting include:

- A focus and emphasis on short-term earnings, which may drive behaviors by preparers that are inconsistent with fostering accuracy and transparency in financial reporting;
- A failure to successfully and broadly adopt and apply evolving technologies to the financial reporting system;
- Conflicting perspectives and agendas of the parties that participate in the reporting process;
- General resistance to change;
- An evolutionary approach to standard setting that has resulted in nonconceptually based compromises and inconsistencies over time;
- Gaps in the education and training of accountants and auditors;
- Use of accounting-motivated transactions to enhance reported financial results; and
- Attempts to politicize standard setting and regulation.

We believe that many of those forces engender a culture (1) that results in a constant demand for detailed rules, exceptions, bright lines, and safe harbors; (2) that deters preparers and auditors from exercising professional judgment; and (3) that results in disclosures that while lengthy and dense, all too often are boilerplate, are overly legalistic, and fail to effectively communicate important information.

Measures the FASB Has Taken to Reduce Complexity and Improve the Relevance and Transparency of Financial Reporting

The FASB, with the support of the SEC staff, has in recent years taken a number of measures aimed at addressing the current state of accounting standards in order to reduce the complexity and improve the relevance and transparency of financial reporting and the overall usability of the existing accounting literature.

Projects to Readdress Outdated Standards

First, the FASB has been systematically readdressing specific accounting standards that are overly complex and do not provide the most relevant and comparable financial information. For example, in June 2001, we issued two related standards on improving the accounting for business combinations and goodwill and intangible assets.[9] Those

[9] FASB Statement of Financial Accounting Standards No. 141, *Business Combinations* (June 2001), and FASB Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (June 2001).

standards superseded a standard that (1) was more than 30 years old; (2) permitted economically similar business combinations to be reported under two very different methods, producing dramatically different financial statement results; and (3) generated complex, detailed, and form-driven implementation guidance.[10]

More recently, in December 2004, we issued a standard on improving the accounting for share-based payments.[11] That standard superseded a standard that (1) was more than 30 years old; (2) permitted enterprises to avoid reporting the economic costs of certain share-based payments thereby distorting their reported financial condition and results of operations; and (3) generated complex, detailed, and form-driven implementation guidance.[12]

Other outdated accounting standards that the Board is currently addressing, or plans to address in the future, include standards in the following areas:

- consolidation policy,[13]
- postretirement benefit obligations, including pensions,[14]
- leases,[15]
- liabilities and equity,[16]
- performance reporting,[17] and
- revenue recognition.[18]

In that regard, the Board plans to issue in the next few days a proposal for public comment to improve the accounting for postretirement benefit obligations including pensions. Additionally, in the coming year, we also plan to issue two preliminary documents for public comment on improving the accounting for financial performance reporting for business enterprises, and revenue recognition, respectively.

The Board also has been actively improving and simplifying the accounting for financial instruments.[19] Since January of this year, the Board has issued (1) a final standard that simplifies the financial reporting of certain hybrid financial instruments containing embedded derivatives;[20] (2) a final standard that simplifies efforts to obtain hedge-like

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[10] APB Opinion No. 16, *Business Combinations* (August 1970).
[11] FASB Statement of Financial Accounting Standards No. 123, *Share-Based Payment* (Revised December 2004).
[12] APB Opinion No. 25, *Accounting for Stock Issued to Employees* (October 1972).
[13] "FASB Response to SEC Study on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers" (February 16, 2006), page 4 (see Attachment 2).
[14] *Id.* at pages 3–4.
[15] *Id.* at page 3.
[16] *Id.* at page 5.
[17] *Id.*
[18] The FASB Report, "FASB's Revenue Recognition Project" (December 24, 2002).
[19] "FASB Response to SEC Study on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers," page 5 (see Attachment 2).
[20] FASB Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Instruments* (February 2006).

(offset accounting) for servicing assets and liabilities;[21] and (3) a proposal to reduce both complexity in accounting and volatility in earnings caused by differences in existing accounting rules by providing enterprises with the option to report selected financial assets and liabilities at fair value.[22] In addition, the Board plans to issue a final standard before the end of June that would improve the current guidance for measuring fair value and expand current disclosures about the use of fair value to measure assets and liabilities, including financial instruments.[23]

Many of the aforementioned improvements are being conducted jointly with the International Accounting Standards Board ("IASB"),[24] whose standards are now being used in about 100 countries around the world. Like the FASB, the IASB agrees that the overall objective of financial accounting and reporting standards should be to provide decision-useful information to a wide range of users—investors, employees, lenders, suppliers, customers, governments, and the public—who, unlike management, have to rely on the financial statements as their major source of financial information about an enterprise.[25]

Some of the improvements will undoubtedly be controversial and generate opposition by some parties. We, therefore, appreciate the support of this Subcommittee and all market participants as we pursue these very important and necessary improvements to the relevance and transparency of financial reporting.

Codification and Retrieval Project

Second, the FASB has undertaken a massive project to develop a comprehensive and integrated codification of all existing accounting literature.[26] The project will organize the literature by subject matter and should provide an easily retrievable single source for all US GAAP. In addition, the codification should provide a useful roadmap to identifying those areas in US GAAP that are most in need of simplification and improvement. In 2007, the Board expects to issue a draft of the codification to the public for an extended verification period.

Objectives-Oriented Standard-Setting Activities

Third, the FASB is attempting to stem the proliferation of new pronouncements emanating from multiple sources by consolidating US accounting standard setting under

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[21] FASB Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets* (February 2006).

[22] FASB News Release, "The Financial Accounting Standards Board Issues Proposal to Create a Fair Value Option for Financial Assets and Liabilities" (January 25, 2006).

[23] FASB News Release, "FASB Issues Proposal on Fair Value Measurements" (June 23, 2004).

[24] "A Roadmap for Convergence between IFRSs and US GAAP—2006-2008, Memorandum of Understanding between the FASB and the IASB" (February 27, 2006), pages 2–4.

[25] Revisiting the Concepts, "A New Conceptual Framework Project," FASB and IASB (May 2005), page 3.

[26] The FASB Report, "The FASB's Efforts Toward Simplification" (February 28, 2005), pages 3–4 (see Attachment 3).

its auspices and is developing new standards more consistent with a principles-based or objectives-oriented system.[27] As part of that effort, in late 2002, the FASB reached an agreement with the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants ("AcSEC") that gave the Board more direct control in setting accounting standards. Under that agreement, the AcSEC committed to cease issuing Statements of Position on particular industry accounting topics after a transition period.

In addition, in January 2003, the Board increased its participation in the Emerging Issues Task Force ("EITF") process by adding two Board members to the EITF's Agenda Committee and by requiring that all future EITF consensus decisions be subject to ratification by the Board before they become effective.[28]

More recently, the FASB has been working with representatives at the American Institute of Certified Public Accountants ("AICPA") and others to improve the process the FASB uses to develop standards applicable to private enterprises. The FASB and AICPA currently plan to issue for public comment proposed process improvements later this year.

Finally, the Board has initiated several activities to ensure that new standards are more consistent with an objectives-oriented system. Those activities include improving the format and content of FASB standards, developing broader implementation guidance, minimizing the number of scope exceptions, and fostering the behavioral changes necessary to support objectives-oriented accounting standards.[29]

Conceptual Framework Project

Fourth, and directly related to the FASB's objectives-oriented activities, we have undertaken a major project to strengthen the existing conceptual framework in order to provide a more solid and consistent foundation for the development of objectives-oriented standards in the future.[30] That project, a joint project with the IASB, is essential to the pursuit of an objectives-oriented system, because such a system requires that its standards be based on a framework that is sound, comprehensive, and internally consistent. We plan to issue the first of several proposed improvements to the framework for public comment within the next few weeks.

EXtensible Business Reporting Language and Related Activities

Lastly, the FASB has been active in exploring the financial reporting system implications of eXtensible Business Reporting Language ("XBRL") and other evolving technologies. The application of XBRL to financial reporting is directed by the XBRL Consortium, a

[27] *Id.* at pages 2–3.
[28] *Id.*; "Facts about FASB," page 8 (see Attachment 1).
[29] "FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System" (July 2004), pages 2–7 (see Attachment 4).
[30] Revisiting the Concepts, "A New Conceptual Framework Project," pages 1–2.

group of more than 200 leading accounting, technology, and financial services enterprises and government agencies.

In September 2003, the FASB established an XBRL fellowship position. The role of the FASB XBRL fellow is to further XBRL awareness at the Board and to act as a liaison with the XBRL Consortium. Other recent XBRL activities by the FASB include:

- Participating at the 12th annual XBRL international conference;
- Participating at the Boston XBRL Conference;[31]
- Conducting training sessions for the FASB Board and staff to further increase their understanding of XBRL;
- Continuing development of an extension taxonomy based on FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (revised 2003); and
- Continuing exploration of the possibility of developing a converged taxonomy between FASB and IASB standards.

The FASB and the FAF are also currently exploring other activities that may be undertaken in furtherance of our support of XBRL and other evolving technologies.

Why Further Broad-Based Improvements in the US Financial Reporting System Are Necessary

Important as the aforementioned measures are, we at the FASB believe that, taken alone, those activities are unlikely to achieve the objective of significantly reducing the complexity and improving the accuracy and transparency of the overall financial reporting system. Rather, we, and many others, believe that achieving that objective will require proactively addressing various structural, institutional, cultural, and behavioral factors that have generated complexity and impeded improvements to the accuracy and transparency of financial reporting.[32]

For example, the FASB's effort to move toward more objectives-oriented standards, described earlier, and as noted in our October 2002 proposal on Principles-Based Accounting Standard Setting and as reiterated in our response to the July 2003 SEC staff report on that subject,[33] 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,

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[31] FASB Chairman's Presentation to Boston XBRL Conference (April 26, 2005) (available for viewing at www.fasb.org).

[32] *See, e.g.*, Peter Williams, "Accounting: Tides of Change," *Financial Director* (March 2, 2006); Paul B.W. Miller and Paul R. Bahnson, "Herz is No. 1! (FASB Chair Bob Herz, that is)," *Accounting Today* (December 6, 2005); Jack Ciesielski, "The Complexity Conundrum," *The Analyst's Accounting Observer Weblog* (December 6, 2005) (see Attachment 5).

[33] "FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System," pages 6–7 (see Attachment 4).

counter to the goals of an objectives-oriented system, we have experienced a constant flow of requests for detailed rules, bright lines, and safe harbors. Accordingly, many argue that reforms to the existing legal, regulatory, and enforcement frameworks surrounding financial reporting are prerequisites for any move to a more objectives-oriented system.

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

A variety of solutions have been proposed to reduce complexity and increase transparency within our reporting system. Some, including professional investors and financial analysts, see fair value accounting as a way to simplify accounting standards and improve the accuracy and transparency of financial statements.[34] 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 XBRL and "click-down" approaches to providing information on a customized basis for different users. Others advocate expanding financial reporting to include key financial or nonfinancial performance metrics or indicators. Those and other new approaches could potentially render today's general-purpose financial statements a relic of the past.

Whatever the solution, and there may be many, progress in reducing complexity and improving the accuracy and transparency of reported financial information is, in our view, critical to the continued and long-term health and vitality of our capital markets and economy. Recently, we have been discussing issues surrounding complexity with the SEC, the PCAOB, and many other interested parties. As part of those discussions, we have begun exploring the kinds of steps and actions that might be necessary to begin to identify the issues that lead to complexity and to develop proposed solutions and recommendations.

We believe that an initiative involving all key parties would be the most effective means to bring about broad-based improvements to the US financial reporting system aimed at both reducing complexity and increasing the accuracy and transparency of financial reporting. While such an effort would not be easy and would take time, we believe it is one of national importance.

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[34] *See, e.g.,* CFA Centre for Financial Market Integrity, "A Comprehensive Business Reporting Model: Financial Reporting for Investors," (October 24, 2005 Draft), pages 12–13.

We look forward to continuing to work closely with the SEC, the PCAOB, this Subcommittee, and all other interested parties to ensure that the US financial reporting system meets the needs of investors, creditors, and our capital markets.

Thank you again, Mr. Chairman. I look forward to the opportunity to respond to any questions.

Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Capital Markets, Insurance and Government Sponsored Enterprises
Subcommittee
of the
Committee on Financial Services
March 29, 2006

Attachment 1

FACTS about FASB

FACTS ABOUT FASB 2006

401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116 • www.fasb.org

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting Release No. 1, Section 101 and reaffirmed in its April 2003 Policy Statement) and the American Institute of Certified Public Accountants (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979). Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors and others rely on credible, transparent and comparable financial information.

The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

THE MISSION OF THE FINANCIAL ACCOUNTING STANDARDS BOARD

The mission of the Financial Accounting Standards Board (FASB) is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information.

Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent and understandable financial information. Financial information about the operations and financial position of individual entities also is used by the public in making various other kinds of decisions.

To accomplish its mission, the FASB acts to:

- Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;

- Keep standards current to reflect changes in methods of doing business and changes in the economic environment;

- Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;

- Promote the international convergence of accounting standards concurrent with improving the quality of financial reporting; and

- Improve the common understanding of the nature and purposes of information contained in financial reports.

The FASB develops broad accounting concepts as well as standards for financial reporting. It also provides guidance on implementation of standards. Concepts are useful in guiding the Board in establishing standards and in providing a frame of reference, or conceptual framework, for resolving accounting issues. The framework will help to establish reasonable bounds for judgment in preparing financial information and to increase understanding of, and confidence in, financial information on the part of users of financial reports. It also will help the public to understand the nature and limitations of information supplied by financial reporting.

The Board's work on both concepts and standards is based on research aimed at gaining new insights and ideas. Research is conducted by the FASB staff and others, including foreign national and international accounting standard-setting bodies. The Board's activities are open to public participation and observation under the "due process" mandated by formal Rules of Procedure. The FASB actively solicits the views of its various constituencies on accounting issues.

The Board follows certain precepts in the conduct of its activities. They are:

To be objective in its decision making and to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.

To weigh carefully the views of its constituents in developing concepts and standards. However, the ultimate determinant of concepts and standards must be the Board's judgment, based on research, public input and careful deliberation about the usefulness of the resulting information.

To promulgate standards only when the expected benefits exceed the perceived costs. While reliable, quantitative cost-benefit calculations are seldom possible, the Board strives to determine that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits.

To bring about needed changes in ways that minimize disruption to the continuity of reporting practice. Reasonable effective dates and transition provisions are established when new standards are introduced. The Board considers it desirable that change be evolutionary to the extent that it can be accommodated by the need for relevance, reliability, comparability and consistency.

To review the effects of past decisions and interpret, amend or replace standards in a timely fashion when such action is indicated.

The FASB is committed to following an open, orderly process for standard setting that precludes placing any particular interest above the interests of the many who rely on

financial information. The Board believes that this broad public interest is best served by developing neutral standards that result in accounting for similar transactions and circumstances in a like manner and different transactions and circumstances should be accounted for in a different manner.

AN INDEPENDENT STRUCTURE

Financial Accounting Standards Board (FASB)
The FASB is part of a structure that is independent of all other business and professional organizations. Before the present structure was created, financial accounting and reporting standards were established first by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants (1936–1959) and then by the Accounting Principles Board, also a part of the AICPA (1959–1973). Pronouncements of those predecessor bodies remain in force unless amended or superseded by the FASB.

Financial Accounting Standards Advisory Council (FASAC)
The FASAC has responsibility for consulting with the FASB as to technical issues on the Board's agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces and such other matters as may be requested by the FASB or its Chairman. At present, the Council has more than 30 members who are broadly representative of preparers, auditors and users of financial information.

Financial Accounting Foundation (FAF)
The FAF, which was incorporated to operate exclusively for charitable, educational, scientific and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, is responsible for selecting the members of the FASB and its advisory council, ensuring adequate funding of their activities and exercising general oversight with the exception of the FASB's resolution of technical issues.

Governmental Accounting Standards Board (GASB)
In 1984, the Foundation established the GASB to set standards of financial accounting and reporting for state and local governmental units. As with the FASB, the Foundation is responsible for selecting its members, ensuring adequate funding and exercising general oversight.

Trustees
The Foundation is separate from all other organizations. However, its Board of Trustees is made up of members from constituent organizations having interest in financial reporting. Nominees from constituent organizations are approved by the Trustees. There also are Trustees-at-large who are not nominated by those organizations, but are chosen by the sitting Trustees. The constituent organizations are:

FAF Constituent Organizations

- American Accounting Association
- American Institute of Certified Public Accountants

- CFA Institute
- Financial Executives International
- Government Finance Officers Association
- Institute of Management Accountants
- National Association of State Auditors, Comptrollers and Treasurers
- Securities Industry Association

The members of the FAF Board of Trustees are:

- Robert E. Denham (Chairman of the Board and President, FAF), Senior Partner, Munger, Tolles & Olson LLP;
- Frank C. Minter (Vice President, FAF), Retired Vice President and Chief Financial Officer, AT&T International;
- Douglas R. Ellsworth (Secretary and Treasurer, FAF), Director of Finance, Village of Schaumburg, Illinois;
- W. Steve Albrecht, Associate Dean of the Marriott School of Management and Professor, Brigham Young University;
- Philip D. Ameen, Vice President & Comptroller, General Electric Company;
- Barbara H. Franklin, President and Chief Executive Officer, Barbara Franklin Enterprises;
- William H. Hansell, Executive Director Emeritus, International City/County Management Association;
- Richard D. Johnson, Former Auditor of State, Iowa;
- Edward W. Kelley, Jr., Former Governor, Federal Reserve System;
- Duncan M. McFarland, Former Chairman and Chief Executive Officer, Wellington Management Company;
- Timothy P. Flynn, Chairman and Chief Executive Officer, KPMG LLP;
- Lee N. Price, President and Chief Executive Officer, Price Performance Measurement Systems, Inc.;
- James H. Quigley, Chief Executive Officer, Deloitte & Touche USA LLP;
- Ned V. Regan, University Professor, The City University of New York;
- Rick Anderson, Chairman, Moss Adams LLP; and
- Paul C. Wirth, Global Controller and Chief Accounting Officer, Credit Suisse First Boston.

AN OPEN DECISION-MAKING PROCESS

Actions of the FASB have an impact on many organizations within the Board's large and diverse constituency. It is essential that the Board's decision-making process be evenhanded. Accordingly, the FASB follows an extensive "due process" that is open to public observation and participation. This process was modeled on the Federal Administrative Procedure Act and, in several respects, is more demanding.

HOW TOPICS ARE ADDED TO THE FASB'S TECHNICAL AGENDA

The FASB receives many requests for action on various financial accounting and reporting topics from all segments of its diverse constituency, including the SEC. The auditing profession is sensitive to emerging trends in practice and, consequently, it is a frequent source of requests. Requests for action include both new topics and suggested review or reconsideration of existing pronouncements.

The FASB is alert to trends in financial reporting through observation of published reports, liaison with interested organizations and discussions with the EITF—see page seven. In addition, the staff receives many technical inquiries which may provide evidence that a particular topic, or aspect of an existing pronouncement, has become a problem. The FASB also is alert to changes in the financial reporting environment that may be brought about by new legislation or regulatory decisions.

The Board turns to many other organizations and groups for advice and information on various matters, including its agenda. Among the groups with which liaison is maintained are the Accounting Standards Executive Committee (AcSEC) and Auditing Standards Board of the AICPA, the Public Company Accounting Oversight Board, the International Accounting Standards Board (IASB), and the appropriate committees of such organizations as CFA Institute, Financial Executives International (FEI) and Institute of Management Accountants (IMA). As part of the agenda process, the Board may make available for public comment agenda proposals that concisely describe the scope of potential projects. The Financial Accounting Standards Advisory Council (FASAC) regularly reviews the Board's agenda priorities and consults on all major projects added to the technical agenda. The FASB's User Advisory Council and Small Business Advisory Committee also serve as resources to the Board both in formulating the FASB technical agenda and in advising on specific agenda projects.

After receiving input from the constituency, the Board must make its own decisions regarding its technical agenda. To aid in the decision-making process, the Board has developed a list of factors to which it refers in evaluating proposed topics.

Those factors include consideration of:

- *Pervasiveness of the issue*—the extent to which an issue is troublesome to users, preparers, auditors or others; the extent to which there is diversity of practice; and the likely duration of the issue (i.e., whether transitory or likely to persist);

- *Alternative solutions*—the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability and comparability are likely to be developed;

- *Technical feasibility*—the extent to which a technically sound solution can be developed or whether the project under consideration should await completion of other projects;

- Practical *consequences*—the extent to which an improved accounting solution is likely to be acceptable generally, and the extent to which addressing a particular subject (or not addressing it) might cause others to act, e.g., the SEC or Congress;

- *Convergence possibilities*—the extent to which there is an opportunity to eliminate significant differences in standards or practices between the U.S. and other countries with a resulting improvement in the quality of U.S. standards; the extent to which it is likely that a common solution can be reached; and the extent to which any significant impediments to convergence can be identified;

- *Cooperative opportunities*—the extent to which there is international support by one or more other standard setters for undertaking the project jointly or through other cooperative means with the FASB; and

- *Resources*—the extent to which there are adequate resources and expertise available from the FASB, the IASB or another standard setter to complete the project; and whether the FASB can leverage off the resources of another standard setter in addressing the issue (and perhaps thereby add the project at a relatively low incremental cost).

It is not possible to evaluate the above factors in precisely the same way and to the same extent in every instance, but identification of factors to be considered helps to bring about consistent decisions regarding the Board's technical agenda.

Accessibility of Meetings

The core of the Board's due process is open decision-making meetings and exposure of proposed standards for public comment. All technical decisions are made in meetings (generally held at the FASB's offices) that are open to public observation, although observers do not participate in the discussions. A live broadcast of such meetings is available free of charge on the FASB website. Each meeting broadcast is also archived and available on the FASB website for one week following the meeting. Each public meeting is announced in advance through the FASB *Action Alert.* Decisions reached are also published in *Action Alert.*

The staff presents written material, including analysis and recommendations, to the Board members in advance as the basis for discussion in a Board meeting. The written material is the result of extensive research by the staff, including a detailed review and analysis of all of the significant alternative views for each issue to be discussed at the meeting. The meeting format calls for oral presentation of a summary of the written materials by the staff, followed by Board discussion of each issue presented and questioning of the staff on the points raised. The Board may reach conclusions on one or more of the issues presented. Any conclusions reached are tentative and may be changed at future Board meetings.

Public Exposure of Standards

Each FASB Statement or Interpretation is issued in draft form (Exposure Draft) for public comment. When the Board has reached conclusions on the issues, it directs the staff to prepare a proposed Exposure Draft for consideration by the Board. After further discussion and revisions, Board members vote by written ballot to issue the Exposure Draft. A majority vote of the Board is required to approve a document for issuance as an

Exposure Draft. Alternative views, if any, are explained in the document and posted on the FASB website.

The Exposure Draft sets forth the proposed standards of financial accounting and reporting, the proposed effective date and method of transition, background information, and an explanation of the basis for the Board's conclusions.

At the end of the exposure period, which is determined at the discretion of the Board but should never be less than 30 days, all comment letters and position papers are analyzed by the staff. This is a search for new information and persuasive arguments regarding the issues; it is not intended to be simply a "nose count" of how many support or oppose a given point of view. In addition to studying this analysis, Board members review the comment letters to help them in reaching conclusions.

Further Deliberation of the Board

After the comments have been analyzed and studied, the Board redeliberates the issues. As in earlier stages of the process, all Board meetings are open to public observation. The Board considers comments received on the Exposure Draft, and often incorporates suggested changes in the final document. If substantial modifications appear to be necessary, the Board may decide to issue a revised Exposure Draft for additional public comment. When the Board is satisfied that all reasonable alternatives have been considered adequately, the staff is directed to prepare a draft of a final document for consideration by the Board. A vote is taken on the final document, again by written ballot. A simple majority of four votes is required for adoption of a pronouncement.

Statements of Financial Accounting Standards

The final product of most technical projects is a Statement of Financial Accounting Standards (SFAS). Like the Exposure Draft, the Statement sets forth the actual standards, the effective date and method of transition, background information, a brief summary of research done on the project and the basis for the Board's conclusions, including the reasons for rejecting significant alternative solutions. It also identifies members of the Board voting for and against its issuance and includes reasons for any dissents.

Additional Due Process

For major projects, the Board generally goes significantly beyond the core due process described above. Soon after a major project is placed on the Board's technical agenda, a resource group usually is formed, including preparers, auditors, and users of financial information who are knowledgeable about the subject matter. Experts from other disciplines also may be included. Care is taken to ensure that various points of view on the issues involved are represented.

The resource group provides information and practical insights from constituents' perspectives on FASB agenda projects. The FASB staff seeks information from resource group members as needed throughout the life of a project, for example, as it initially identifies issues to be addressed and as it issues and develops its analysis of possible alternative approaches. Resource group members also are asked to perform external review of drafts of Exposure Drafts and final Statements.

During development of a standard, usually prior to issuance of an Exposure Draft, the Board may choose to conduct field visits for the purpose of assessing the costs and benefits or operationality of the proposed standard.

During the comment period, the Board also may conduct field tests of the provisions of the Exposure Draft, if necessary.

After the discussion document or an Exposure Draft is issued for public comment, the Board often holds public roundtable meetings with interested constituents. Those meetings provide an opportunity for the Board and staff to ask questions about information and viewpoints offered by constituents who participated in the comment process. Observers are welcome at all roundtable meetings.

Statements of Concepts

In addition to Statements of Financial Accounting Standards, the FASB also issues Statements of Concepts. Statements of Concepts do not establish new standards or require any change in the application of existing accounting principles; instead, they are intended to provide the Board and constituents with a foundation for setting standards and concepts useful as tools for solving problems. The framework defined in the Statements of Concepts helps the Board identify the right questions to ask in structuring technical projects and contributes to a consistent approach over time. Because of their long-range importance, Statements of Concepts are developed under the same extensive due process the FASB follows in developing Statements of Financial Accounting Standards on major topics.

Other Documents

In addition to broad issues of financial accounting and reporting, the Board considers narrower issues related to implementation of existing standards and other problems arising in practice. Depending on their nature, application and implementation problems may be dealt with by the Board in Statements or Interpretations or by the staff in FASB Staff Positions. All of those are subject to discussion at public Board meetings and to exposure for comment.

Emerging Issues Task Force (EITF)

The EITF was formed in 1984 in response to the recommendations of the FASB's task force on timely financial reporting guidance and an FASB Invitation to Comment on those recommendations. EITF members are drawn primarily from public accounting firms but also include representatives of large companies and users of financial statements. The Chief Accountant of the Securities and Exchange Commission attends EITF meetings regularly as an observer with the privilege of the floor. Lawrence W. Smith, FASB Director, Technical Application and Implementation Activities, also serves as Chairman of the EITF.

Composition of the EITF is designed to include persons in a position to be aware of emerging issues before they become widespread and before divergent practices regarding them become entrenched. Therefore, if the group can reach a consensus on an issue, usually that consensus is taken by the FASB as an indication that no Board action is needed. A consensus is defined as an agreement, provided that no more than three of the fourteen voting members object. Consensus positions of the EITF are considered part of GAAP. If consensus is not possible, it may be an indication that action by the FASB is necessary.

The EITF meets at least four times a year. Meetings are open to the public and, generally, are attended by substantial numbers of observers; meetings are also broadcast on the FASB website. Because interest in the EITF is high, the FASB has separate subscription plans for keeping up-to-date on the issues. EITF materials are available free of charge on the FASB website.

Availability of Publications
To encourage public comment, Exposure Drafts and other discussion documents are distributed primarily through the FASB website.

Statements of Standards, Statements of Concepts and Interpretations also are distributed broadly when published through FASB subscription plans and may be purchased separately by placing an order at the FASB website. Those documents are also available free of charge on the FASB website.

The FASB strives to keep the public informed of developments on its projects through a monthly newsletter, *The FASB Report,* and a weekly notice, *Action Alert,* which provides notice of upcoming Board meetings and their agendas with brief summaries of actions taken at previous meetings. *Action Alert* is available by e-mail subscription at the FASB website.

FASB Website
The FASB website includes general information about the Board and its activities, information on upcoming public meetings, announcements of Board actions, summaries and status of all active technical agenda projects, minutes of Board meetings, comment letters, the technical plan for FASB projects, and information about the Financial Accounting Foundation, as well as information on how to order publications online, by phone or mail.

The website can be accessed at www.fasb.org.

The Public Record
Transcripts of public hearings, letters of comment and position papers, research reports and other relevant materials on projects leading to issuance of pronouncements become part of the Board's public record. The public records on all projects are available for inspection in the public reference room at FASB offices in Norwalk, Connecticut. Copies of public records also may be purchased at prices that vary according to the volume of material that has to be copied by accessing the FASB website at www.fasb.org or by contacting Records Retention at (203) 847-0700, ext. 270, for more information.

ADDITIONAL INFORMATION

General Information
For further information about the FASB, including Board meeting schedules, access the FASB website at www.fasb.org, call or write Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116, telephone (203) 847-0700 or via e-mail at director@fasb.org.

To Order Publications
Statements, Interpretations, Exposure Drafts and other documents published by the FASB may be obtained by placing an order on the FASB website at www.fasb.org or by contacting the FASB Order Department at 1-800-748-0659, weekdays 9:00 a.m. to 5:00 p.m. EST.

Public Roundtable Meetings and Comment Letters
For information about submitting written comments on documents or about public roundtable meetings, access the FASB website at www.fasb.org or contact the FASB Project Administration Department at (203) 847-0700, ext. 389.

Public Reference Room and Files
The FASB maintains a public reference room open during office hours, Monday through Friday. The public reference room contains all FASB publications, comment letters on documents and transcripts of public hearings. Copies of this material may be obtained for a specified charge by accessing the FASB website at www.fasb.org or by contacting Records Retention at (203) 847-0700, ext. 270, for an appointment.

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To order additional copies of *FACTS about FASB* without charge, contact Public Relations at (203) 847-0700, ext. 479, or fax a request to (203) 849-9714.

MEMBERS OF THE FASB

The seven members of the FASB serve full time and are required to sever all connections with the firms or institutions they served prior to joining the Board. While collectively they represent diverse backgrounds, they also must possess "knowledge of accounting, finance and business, and a concern for the public interest in matters of financial accounting and reporting."

Board members are appointed for five-year terms and are eligible for reappointment to one additional five-year term. Expiration dates (at June 30) of current terms are indicated in captions beneath the members' photographs.

Robert H. Herz *was appointed FASB Chairman, effective July 1, 2002.*
He was a Senior Partner with PricewaterhouseCoopers, its North America Theater Leader of Professional, Technical, Risk & Quality and a member of the firm's Global and U.S. Boards. He also served as a part-time member of the IASB.

He joined Price Waterhouse upon graduating from the University of Manchester in England with a B.A. degree in economics. He later joined Coopers & Lybrand as its Senior Technical Partner and later held a similar position with PricewaterhouseCoopers.

He has authored numerous publications and chaired the AICPA SEC Regulations Committee, the Transnational Auditors Committee of the International Federation of Accountants and was a member of the EITF.

G. Michael Crooch *was a Partner with Arthur Andersen and Director of the firm's International Professional Standards Group before joining the FASB on July 1, 2000. Mr. Crooch was the American Institute of Certified Public Accountants' (AICPA) delegate to the International Accounting Standards Committee (IASC) and served on the IASC's Executive Committee. He also served on the Institute's Accounting Standards Executive Committee, including three years as the Committee Chairman. He earned bachelor's and*

master's degrees from Oklahoma State University and a Ph.D. from Michigan State University.

Katherine Schipper *was appointed to the FASB, effective September 2001. Prior to joining the FASB, she was the L. Palmer Fox Professor of Business Administration at Duke University's Fuqua School of Business. She has served the American Accounting Association (AAA) as President and as Director of Research. She was a member of the FASB's Advisory Council (FASAC) from 1996 to 1999. Ms. Schipper holds a B.A. degree from the University of Dayton and M.B.A., M.A. and Ph.D. degrees from the University of Chicago.*

Leslie F. Seidman *was named to the FASB, effective July 1, 2003. Prior to joining the Board, she managed her own financial reporting consulting firm. Among the previous posts she held were Vice President at J.P. Morgan & Company, where she was responsible for establishing accounting policies, and Assistant Director of Implementation and Practice Issues at the FASB. She started her career as an auditor at Arthur Young & Company. She earned a B.A. degree from Colgate University and an M.S. degree from New York University.*

Donald M. Young *was appointed to the Financial Accounting Standards Board (FASB), effective January 1, 2005. Prior to joining the FASB, Mr. Young managed his own firm providing consulting and research services for technology and private equity clients. Previous to that he was Managing Director at PaineWebber/UBS and held senior positions at several investment banking firms. He is a member of CFA Institute. He received a bachelor's degree from the University of Michigan and earned an M.B.A. degree from Harvard Business School.*

Edward W. Trott *was appointed as a member of the FASB, effective October 1, 1999. Since 1992, he headed the Accounting Group of KPMG's Department of Professional Practice. Before joining the Board, he was a member of the FASB's Emerging Issues Task Force, the Financial Reporting Committee of the Institute of Management Accountants, the FASB's Advisory Council and the Accounting Standards Executive Committee and Auditing Standards Board of the AICPA. He holds a bachelor's degree from the University of North Carolina and an M.B.A. degree from the University of Texas.*

George J. Batavick *was named a member of the FASB, effective August 1, 2003. He was previously Comptroller of Texaco Inc. where he had company-wide responsibility for strategy and policy matters covering all aspects of accounting and financial reporting. Prior to this post, he held a number of key positions, including Deputy Comptroller and Director of Internal Auditing. Before joining Texaco, he was with Getty Oil Company. He began his career at Arthur Andersen. He is a graduate of St. Joseph's University in Philadelphia where he earned a B.S. degree.*

FASB Staff

The Board is assisted by a staff of approximately 68 professionals drawn from public accounting, industry, academe and government, plus support personnel. The staff works directly with the Board and task forces, conducts research, participates in public hearings, analyzes oral and written comments received from the public and prepares recommendations and drafts of documents for consideration by the Board.

FASB Fellows are an integral part of the research and technical activities staff. The Fellowship program provides the Board the benefit of current experience in industry, academe and public accounting and offers the Fellows first-hand experience in the accounting standard-setting process. Fellows take a leave of absence from their firms or universities and serve as project managers or consultants on a variety of projects.

Suzanne Q. Bielstein *is Director, Major Projects and Technical Activities for the FASB. Previously, she served in various capacities at the FASB, including Assistant Director of Technical Research and Project Manager on the business combinations and combinations for not-for-profit organizations. Prior to joining the FASB in early 1999, she spent five years with Caradon plc in two different roles—Vice President of Planning, North America, and Vice President and Corporate Controller of Clarke American Checks, Inc. (a subsidiary of Caradon). Before joining Caradon, Ms. Bielstein was an Audit Partner at KPMG in Boston. Ms. Bielstein earned a B.B.A. degree in accounting from the University of Notre Dame.*

Linda A. MacDonald*, who has been a member of the FASB staff since 1996, was named Director, Planning, Development and Support Activities in 2006. Previously, Ms. MacDonald was a Project Manager on the Board's projects on fair value measurements, asset impairment and disposal activities (FASB Statements No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, and No. 146, Accounting for Costs Associated with Exit or Disposal Activities), and principles-based approach to U.S. standard setting (FASB proposal. Ms. MacDonald is a former member of the Technical Standards Subcommittee of the AICPA Ethics Committee. She earned a B.A. degree in economics and management from Albion College and a M.B.A. in finance from American University.*

Lawrence W. Smith *was named Director, Technical Application and Implementation Activities of the FASB in August 2002. Prior to assuming this post, he was a Partner with KPMG for 14 years, headquartered most recently in Stamford, Connecticut. From 1992–1996, Mr. Smith served as a Partner in KPMG's Department of Professional Practice in New York. During his 25-year tenure with KPMG, he served as Engagement Partner and SEC Reviewing Partner on a number of international Fortune 1000 clients. He is a past member of the Technical Standards Subcommittee of the Professional Ethics Committee of the AICPA. Mr. Smith received an M.S. degree in accounting from Northeastern University.*

Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Capital Markets, Insurance and Government Sponsored Enterprises
Subcommittee
of the
Committee on Financial Services
March 29, 2006

Attachment 2

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

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.

Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Capital Markets, Insurance and Government Sponsored Enterprises
Subcommittee
of the
Committee on Financial Services
March 29, 2006

Attachment 3

The FASB Report, "The FASB's Efforts Toward Simplification"

*THE **FASB** REPORT*
No. 265 / February 28, 2005
(The FASB Report No. 380)

The FASB's Efforts Toward Simplification

By Lawrence W. Smith

Just imagine you are the CFO of a medium-sized company, and a business unit sent you a contract for a fairly sizable sales transaction. The terms of the transaction have some peculiarities that cause you to check the accounting literature because you want to be sure to record the transaction correctly. You enter fasb.org into your internet browser, click on the "GAAP" icon, click on "revenue," and there you are—everything you always wanted to know about revenue accounting. You read the overview, scroll down to the section on "recognition," then check the section on "measurement," and finally check the disclosure requirements summarized in the section on "disclosure." You scan the implementation issues that follow the basic requirements. You note there are few exceptions related to the requirements for this transaction; therefore, you feel comfortable with your understanding of how to record the transaction. Nevertheless, your curiosity gets to you, so you click on the icon "conceptual basis" and read the fundamental Concepts Statements leading to the prescribed accounting. Okay, you now know how to record the transaction and you are confident you can explain the accounting to your CEO as well as why that accounting makes sense.

We at the FASB understand that an active imagination would be required today to dream up that scenario; however, we are hopeful that in the not-too-distant future that scenario will be much closer to reality.

Bob Herz, FASB chairman, believes there are three fundamental considerations the FASB must keep in mind in its standard-setting activities: improvement in financial reporting, simplification of the accounting literature and the standard-setting process, and international convergence. This article explains what the FASB has done over the past two-and-one-half years to address simplification and what it has planned for the future. But first let us look at the challenges posed by the current state of affairs.

Bob Herz, FASB chairman, believes there are three fundamental considerations the FASB must keep in mind in its standard-setting activities: improvement in financial reporting, simplification of the accounting literature and the standard-setting process, and international convergence.

Consider the revenue transaction discussed above. The first question would be where to start looking. Revenue recognition is addressed in 180 different pieces of accounting

literature. Some are pronouncements created by the FASB, some by the Accounting Principles Board (APB), yet others by the Accounting Standards Executive Committee of the AICPA (AcSEC), the Emerging Issues Task Force (EITF), and let us not forget about the Securities and Exchange Commission (SEC). The fact is that current U.S. "GAAP" comprises of over 2,000 "pronouncements" issued by these different organizations in a variety of forms: FASB Statements, Technical Bulletins, Interpretations, and staff implementation guides (Q&As); APB Opinions and Accounting Interpretations; AcSEC Statements of Position (SOPs) and Technical Practice Aids; SEC Staff Accounting Bulletins, and so forth.

Who Sets Accounting Standards?

Over the last two years there have been three fundamental changes in how accounting standards are set or, more specifically, by whom they are set. The first fundamental change is a relatively subtle one. Over the last 10 years the prominence of the role played by the SEC in setting accounting standards has varied over time, with some "administrations" taking a very active role, and others taking more of an oversight role. One need only review the number and source of EITF "D Topics" addressed over that time period to understand different administrations' philosophies about oversight of the FASB.

Over the last two years there have been three fundamental changes in how accounting standards are set or, more specifically, by whom they are set.

The Sarbanes-Oxley Act of 2002 required the SEC to designate an organization(s) as having the authority to promulgate accounting standards for public companies in the United States, which it did in April 2003 when it reaffirmed the FASB as the designated private-sector standard setter for public companies. We have established a working protocol with the SEC for its staff to first refer issues it identifies that may have accounting standard-setting implications to the FASB for consideration, with the understanding that the SEC staff reserves the right to exercise its legislative authority to deal with any issues it identifies.

The second fundamental change in standard setting began in the fall of 2002 when the FASB and the AICPA agreed that, after a transition period, the AICPA and AcSEC would no longer issue authoritative accounting guidance. Previously, SOPs and Industry Accounting and Audit Guides "cleared" by the FASB were level B under the GAAP hierarchy. Going forward (except for transition projects), the Board will not be asked to clear any AICPA or AcSEC documents; consequently, any such documents will fall under level D in the current GAAP hierarchy.

And third, beginning in 2003, the operation of the EITF was fundamentally changed. In an effort to provide greater direction to the EITF in terms of the issues addressed by that group, two Board members were added to the EITF Agenda Committee. The FASB also

took greater direct ownership of GAAP established by the EITF by requiring that consensus positions be ratified by the Board.

The objective of those changes was to simplify the accounting standard-setting process by eliminating the various organizations that might potentially deal with an accounting issue and giving constituents the ability to do "one-stop shopping" at the FASB. In so doing, we also looked at how we issue accounting guidance and acknowledged that we had contributed to the complexity of GAAP by issuing accounting guidance in a variety of forms. For example, our arsenal of guidance included Statements, Interpretations, Technical Bulletins, "D-Topic announcements," staff implementation guides (Q&As), Derivatives Implementation Guidance Issues, *Action Alert* announcements, and *The FASB Report* articles.

We might have added to that confusion in 2002 (although hopefully only temporarily) by instituting a new form of guidance, FASB Staff Positions (FSPs). The original reason for introducing FSPs was to eliminate further use of many of the tools in our arsenal of guidance. Another reason was to have a means to solicit constituent comments on proposed staff guidance, which had not been the practice with some of the prior forms of guidance.

Observers of our process may have noticed that the use of FSPs has evolved rapidly over their short history such that they are not only being used to provide interpretive guidance, but also to make minor amendments to existing standards. I would like to take this opportunity to point out that the due process used to issue an FSP is the same as the due process used to issue a new standard. Thus, it really does not matter whether something gets issued as an FASB Statement or an FSP on Topic "X." Regardless of the form of the final guidance, the FASB staff will study the issue, the Board will deliberate the issue and expose it for public comment, the staff will analyze the comments, and the Board will redeliberate the issue before the guidance is finalized. Our ultimate vision for simplification of standard setting is one process and one form of guidance.

The GAAP Hierarchy and the Codification Project

While the FASB is charged with setting accounting standards, the authoritative guidance on what constitutes generally accepted accounting principles and the relative authority of those principles (i.e., the GAAP hierarchy) resides in the auditing literature. After concentrating standard setting with the FASB, it became obvious to the FASB (and the SEC) that the GAAP hierarchy should be embedded in the accounting literature, not the auditing literature. The FASB is in the process of preparing an Exposure Draft of a standard that will move the GAAP hierarchy into the accounting literature. The FASB has discussed this with representatives of both the AICPA and the Public Company Accounting Oversight Board (PCAOB), who have agreed to take actions necessary to effectively acknowledge the GAAP hierarchy once it becomes a part of the accounting literature.

The Board decided to adopt the GAAP hierarchy in the same fundamental form as it now exists in the auditing literature. However, the Exposure Draft will include the Board's

vision of the future GAAP hierarchy—only two levels, authoritative and nonauthoritative. Users of GAAP will no longer have to worry about what literature trumps other literature. In fact, there will be only one set of "authoritative" literature, which we are currently referring to as the Codification.

During the summer of 2004, the trustees of the Financial Accounting Foundation approved the largest project ever addressed by the FASB. Prior to obtaining that approval, we had cleared with both the AICPA and the SEC the right to use in the Codification their literature that is currently part of GAAP. The Codification will be a compilation of existing U.S. GAAP, organized by accounting topic, regardless of its source (i.e., FASB Statement, EITF consensus, AcSEC SOP, etc.). There will be a standard structure to the Codification, such that users will quickly know what subsections address the specific aspects of a topic (e.g., recognition, measurement, disclosure, implementation guidance, etc.).1

. . . the trustees of the Financial Accounting Foundation approved the largest project ever addressed by the FASB. . . . The Codification will be a compilation of existing U.S. GAAP, organized by accounting topic, regardless of its source. . . .

While the Codification will present existing GAAP differently, its purpose is not to change the requirements of GAAP. Nevertheless, as the various sources of literature are put together to prepare the Codification, inconsistencies in accounting requirements will be identified and resolved by the Board. Constituents will have an opportunity to comment on the resolution of identified inconsistencies, as well as other aspects of the Codification, during an extended "verification process." The verification process will begin once a sufficient portion of the Codification has been completed. The Codification is a multiple-year project whose time is long overdue.

Principles-Based Standards

The last and perhaps most challenging aspect of our journey to simplification of accounting standards relates to the topic of "principles-based" standards, or "objectives oriented" (the term the SEC used in its report to Congress on the topic). I am not going to recap here all that has been said for and against principles-based standards. Quite frankly, its time for some action, not words. The problem is that while it may appear that this action is totally within the control of the FASB as the promulgator of accounting standards, in reality, it is not. To understand why it is not within the control of the FASB, just read some comment letters we receive relative to a particular issue, or sit in a meeting with some constituents from a specific industry asking to be excluded from the scope of a standard, or talk to some auditors that are seeking specific guidance on the application of a standard, or talk to a regulatory body, or, worse yet, just listen to a plaintiff's attorney argue that your interpretation of what was intended by a particular "principle" was wrong and that the financial statements you issued or audited were not in conformity with GAAP.

Perhaps the most challenging aspect of our journey to simplification of accounting standards relates to the topic of "principles-based" standards.

A number of factors will influence how successful the Board is in moving toward principles-based standards, and that success will be subject to each individual's interpretation of what is meant by "principles based." The goal, in my mind, should be that there are few scope exceptions, few bright lines, and understandable objectives upon which reasonable people can exercise judgment that will not be the subject of second guessing by auditors, regulators, and the plaintiffs' bar supported by good implementation guidance. Our hope is that the other forces that influence the financial reporting system will allow us to move toward that goal.

Summary

We often hear from constituents that they believe U.S. GAAP has become too complex and too voluminous. My purpose in writing this article is to demonstrate that the FASB is concerned about the proliferation of and complexity of accounting standards. Unfortunately, we cannot control the increasing complexity of commercial arrangements. However, we can influence (1) the complexity of the standard-setting process and of the standards themselves; (2) the organization of the variety of standards, rules, and guidance that constitute what we now refer to as GAAP; and (3) how modifications are made to that guidance to reflect current thinking on the appropriate accounting for commercial arrangements. As described in this article, we have initiated some significant steps toward simplifying both the process and the organization of GAAP. We appreciate the support we have received thus far in our move toward simplification, and we ask for your continued input and support as we move forward.

[1] Private enterprises should note that while SEC literature will be included in the Codification, it will be included as a separate subsection within each topic to distinguish it from other GAAP requirements.

Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Capital Markets, Insurance and Government Sponsored Enterprises
Subcommittee
of the
Committee on Financial Services
March 29, 2006

Attachment 4

FASB Response to SEC Study on Adoption of a Principles-Based Accounting System

FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System

July 2004

Introduction

In July 2003, the staff of the Securities and Exchange Commission (SEC) submitted to Congress its *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* (the Study). The Study includes the following recommendations to the Financial Accounting Standards Board (FASB or Board):

1. The FASB should issue objectives-oriented standards.
2. The FASB should address deficiencies in the conceptual framework.
3. The FASB should be the only organization setting authoritative accounting guidance in the United States.
4. The FASB should continue its convergence efforts.
5. The FASB should work to redefine the GAAP hierarchy.
6. The FASB should increase access to authoritative literature.
7. The FASB should perform a comprehensive review of its literature to identify standards that are more rules-based and adopt a transition plan to change those standards.

The Board welcomes the SEC's Study and agrees with the recommendations. Indeed, a number of those recommendations relate to initiatives the Board had under way at the time the Study was issued.[35] The Board is committed to continuously improving its standard-setting process. The Board's specific responses to the recommendations in the Study are described in the following sections of this paper.

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[35] In October 2002, the Board issued a proposal, *Principles-Based Approach to US Standard Setting* (the Proposal). That Proposal was issued in response to concerns about the quality and transparency of financial reporting resulting from the increasing level of detail and complexity in the standards. In March 2003, the Board discussed the comments received on the Proposal (including input from the SEC staff) and decided to pursue a number of initiatives aimed at improving the quality of FASB standards as well as the standard-setting process.

Objectives-Oriented Standards

In the Study, the SEC staff recommends that "those involved in the standard-setting process more consistently develop standards on a principles-based or objectives-oriented basis" (page 4).[36] According to the Study (page 4), an objectives-oriented standard would have the following characteristics:

- Be based on an improved and consistently applied conceptual framework;
- Clearly state the accounting objective of the standard;
- Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis;[1]
- Minimize exceptions from the standard;
- Avoid use of percentage tests ("bright-lines") that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard.

[1] In doing so, however, standard setters must avoid the temptation to provide too much detail (that is, avoid trying to answer virtually every possible question within the standard itself) such that the detail obscures or overrides the objective underlying the standard. [Footnote in original.]

The "objectives-oriented" approach to setting standards described above (and expanded upon in the Study) is similar to the principles-based approach described in the Board's Proposal. After discussing the comments received on its Proposal, the Board agreed that its conceptual framework needs to be improved. This is because an internally consistent and complete conceptual framework is critical to a standard-setting approach that places more emphasis on the underlying principles that are based on that framework. Pages 8 and 9 of this paper further describe the Board's activities related to the conceptual framework; the following sections address the other characteristics of an objectives-oriented approach addressed in the Study.

Format and Content of Standards

The Board agrees with the Study's recommendation to improve the format and content of its standards. In particular, The Board agrees that the objective and underlying principles

[36] All page numbers refer to the Study (except where noted otherwise).

of a standard should be clearly articulated and prominently placed in FASB standards. In response to comments received on its Proposal, the Board agreed that although its existing standards are based on concepts and principles, the understandability of its standards could be improved by writing its standards in ways that (a) clearly state the accounting objective(s), (b) clearly articulate the underlying principles, and (c) improve the explanation of the rationale behind those principles and how they relate to the conceptual framework.

The Board is working on developing a format for its standards that will encompass the attributes of an objectives-oriented standard described in the Study, for example, describing the underlying objective of the standard in the introductory paragraphs, using bold type to set off the principles,[37] and providing a glossary for defined terms.

In addition, the Board is working with a consultant to identify changes in the organization and exposition of its standards that will increase the understandability of those standards. Accounting standards by their nature will include many specific technical terms; however, the Board believes it can do a better job simplifying the language used in its standards to describe how to account for complex transactions. In addition, the Board will strive to apply other effective writing techniques to enhance constituents' understanding of FASB standards.

When discussing proposed accounting standards or specific provisions of a standard, many of the Board's constituents comment on whether a standard is "operational." Because that term can mean different things to different people, the Board decided to define the term *operational* for its purposes. The Board uses the term *operational* to mean the following:

- A provision/standard is comprehensible by a reader who has a reasonable level of knowledge and sophistication,
- The information needed to apply the provision/standard is currently available or can be created, and

[37] The Board is considering using the black letter/gray letter style of the International Accounting Standards Board (IASB) and will use that style in its business combinations Exposure Draft. The Board intends to request constituent input on that style and will address the advantages and disadvantages of using that style in all FASB standards at a later date.

- The provision/standard can be applied in the manner in which it was intended.

The Board believes that if its standards are more understandable, they also will be more operational.

Implementation Guidance

As noted in the Board's Proposal, an approach to setting standards that places more emphasis on principles will not eliminate the need to provide interpretive and implementation guidance for applying those standards. Thus, the Board agrees that some amount of implementation guidance is needed in objectives-oriented standards in order for entities to apply those standards in a consistent manner. The Board uses the term *implementation guidance* to refer to all of the guidance necessary to explain and operationalize the principles (that is, the explanatory text in the standards section, the definitions in the glossary, and guidance and examples included in one or more appendices that help an entity apply the provisions in the standards section).

The Board believes that the amount of necessary guidance will vary depending on the nature and complexity of the arrangements that are the subject of the standard. The Board believes that there should be enough guidance such that a principle is understandable, operational, and capable of being applied consistently in similar situations. Judgment is required to decide how much guidance is needed to achieve those objectives, without providing so much guidance that the overall standard combined with its implementation guidance becomes a collection of detailed rules. Therefore, the amount and nature of implementation guidance will vary from standard to standard.

The Board believes that its primary focus should be providing broadly applicable implementation guidance, not providing guidance on relatively narrow and less pervasive issues, including, for example, issues that are specific to certain entities or industries. When developing that implementation guidance, the Board plans to apply the same guidelines that underpin objectives-oriented standards. For example, rather than consisting of a list of rules or bright lines, the implementation guidance would explain or expand on the principle(s) or objectives in the standard.

The Board intends to continue to include examples in its proposed and final standards. The Board will attempt to make examples as realistic as possible and have them relate to common transactions and events. Because examples help to illustrate the application and intent of the underlying principles in a standard, the Board believes examples should be viewed as additional guidance in applying and understanding the standards—not as rules that should be followed.

The Board also believes that it has a responsibility to provide interpretive guidance when a given standard is being misread or misapplied. That guidance generally will be provided in the form of Emerging Issues Task Force (EITF) consensuses or FASB Staff Positions, both of which are subject to Board approval. As the Board moves toward adopting a more objectives-oriented approach to setting its standards, the EITF and the FASB staff will adopt a similar approach in developing interpretive guidance that is consistent with the underlying principles of the relevant standard. The Board acknowledges that the SEC will continue to provide guidance as it deems necessary. In addition, other participants in the financial reporting system will continue to provide nonauthoritative forms of guidance.

Scope Exceptions

The Study appropriately points out that ". . . one of the factors that creates increased complexity and a tendency towards a rules-based approach to standard setting is the existence of scope exceptions in a standard" and that "a consequence of scope exceptions is increased complexity and the need for more rules" (page 31, emphasis in original). The Study states the following:

> In reality, establishing the proper scope of the standard is one of the more difficult challenges. The scope of a standard could range from very broad to very narrow. If the scope is too broad, the standard setter would be unable to provide sufficient guidance for the standard to be meaningful and useful to preparers and auditors. This is apt to generate a proliferation of exceptions. However, if the scope of the standard is too narrow, it would not have sufficient applicability to justify the time and effort of the standard setter, and may not capture all transactions with similar economic substance. [Page 31; footnotes omitted.]

An objective of having few, if any, scope exceptions in its standards was an important aspect of the Board's Proposal. Thus, the Board agrees that accounting standards with

few, if any, exceptions to the principles will increase the extent to which similar transactions and events are accounted for similarly. This will thereby enhance comparability and reduce the level of detail and complexity that arises from exceptions. The Board acknowledges that it needs to be diligent in making rational and consistent scope decisions and that scope decisions that provide for fewer exceptions are desirable.

As the Board moves to an objectives-oriented approach to setting standards that minimizes the number of scope exceptions, it will need to address existing (legacy) scope exceptions, particularly those that result from specialized industry needs. The Study refers to the possible need for legacy scope exceptions and states that ". . . standard setters should judiciously determine when it is appropriate to allow a legacy exception to its objectives-oriented standards" (pages 35 and 36). As noted in the Study, the Board "will need to weigh the costs resulting from lack of comparability with the benefits of certain companies not having to undergo a change in accounting policy" (page 36).

Behavioral Changes

The Study discusses the importance of and need for preparers and auditors to exercise appropriate professional judgment in applying accounting standards based on the stated objectives and principles and consistent with the economic substance of transactions and events. The Study also correctly, in the Board's view, points out that detailed rules, bright lines, exceptions, and treatment alternatives can act as a barrier to achievement of these objectives. In addition, the Study points out that while detailed rules and bright lines may increase the perceived consistency and comparability of financial information, they can result in "false comparability" and reporting based on form rather than substance. The Board agrees with all of those observations.

The Study also states, however, that a move toward more objectives-oriented standards will require shifts in attitude, behavior, and expertise of preparers and auditors. The Board believes that it may take several years or more for such attitudes and behavioral changes to take root. One reason for that belief is that preparers continue to request scope exceptions, scope exemptions, and treatment alternatives and to oppose changes that would eliminate existing scope exceptions and treatment alternatives. In addition, the Board's recent experience suggests that many preparers and auditors have become

less willing to exercise professional judgment in areas involving accounting estimates, uncertainties, and inherent subjectivity. Instead, they have been requesting detailed rules and bright lines in an apparent effort to reduce the need for the exercise of judgment in inherently subjective areas. Increased accountability for the accuracy of financial information under the new requirements related to the Sarbanes-Oxley Act coupled with a fear of "second guessing" by enforcement agencies and the trial bar are frequently cited as reasons for this behavior.

The Board supports the conclusions of the Study regarding the importance of and need for the exercise of professional judgment in applying accounting standards and for limiting scope exceptions and treatment alternatives. Further, the Board is committed to working with the SEC, the Public Company Accounting Oversight Board (PCAOB), and constituents to foster the behavioral changes necessary to support the type of objectives-oriented accounting standards envisaged in the Study.

Asset-Liability View

The Study states that ". . . the revenue/expense view is inappropriate for use in standard-setting—particularly in an objectives-oriented regime" (page 30) and that ". . . the FASB should maintain the asset/liability view in continuing its move to an objectives-oriented standard setting regime" (page 42). As noted in the Study, FASB Concepts Statement No. 6, *Elements of Financial Statements*, gives priority (conceptual primacy) to the definitions of assets and liabilities by defining the other elements (equity, revenues, expenses, gains, and losses) in terms of changes in assets and liabilities. The Board agrees with the view expressed in the Study that analyzing the assets and liabilities and the changes in assets and liabilities in a given arrangement is the most appropriate approach to setting financial reporting standards and intends to continue to apply the asset-liability view in its standard-setting projects. The Board notes that application of the asset-liability view is not inconsistent with, and can accommodate, the development of financial reporting standards for aggregation, classification, and display of information about the components of enterprise performance.

Conceptual Framework

As noted in the Study, the FASB uses its conceptual framework in the process of developing accounting standards. The Board agrees with the Study's assertion that ". . . having a clear, consistent conceptual framework is a necessary step in facilitating a move towards a more objectives-oriented regime" (page 41). The Study states (page 42) that the FASB should make the following efforts at improving its conceptual framework as it moves toward a more objectives-oriented approach to setting standards:

1. More clearly articulate how the trade-offs among relevance, reliability, and comparability should be made,
2. Eliminate the inconsistencies between the discussion of the earnings process (found in SFAC No. 5) and the definition[s] of the elements of financial statements (found in SFAC No. 6), and
3. Establish a paradigm for selecting from among possible measurement attributes.

The Board is addressing certain necessary changes to its Concepts Statements in three of its current agenda projects. Specifically, the Revenue Recognition project is addressing the inconsistencies between earnings process and elements definitions. The Liabilities and Equity project is reconsidering the distinction between liabilities and equity and aspects of the liabilities definition. As part of the longer-term objectives of its Fair Value Measurement project, the Board will consider how the qualitative characteristics of relevance and reliability should be applied in selecting an appropriate measurement attribute. Those current projects address the first two recommendations for improving the conceptual framework (refer to items 1–3 above). As for the third recommendation, the Canadian Accounting Standards Board (AcSB), on behalf of the IASB and its liaison standard-setting partners, is currently undertaking a research project: measurement objectives—concepts. The FASB staff is following that research project closely and participating in it as appropriate. The purpose of the research is to identify the most appropriate measurement basis (or set of bases) for measuring assets and liabilities when accounting standards require initial recognition or remeasurement.

Most recently, the Board agreed to undertake a "conceptual framework improvements" project with a goal of making its conceptual framework clear, complete, and internally

consistent. At their joint meeting in April 2004, the IASB and the FASB agreed that such a project should be undertaken jointly, that is, that the Boards would work together to develop a single, complete, and internally consistent conceptual framework that would be used by both Boards. In undertaking that project, the FASB would complete and refine its existing framework rather than comprehensively reconsider all components of that framework. The Boards plan to identify and initially focus on troublesome unresolved issues that continue to reappear in different standard-setting projects and in a variety of different guises (crosscutting issues). The Boards believe that resolution of such "crosscutting" conceptual issues will enable more efficient development of consistent, converged, high-quality standards-level guidance. The following are examples of crosscutting issues:

- The term *probable*, which appears in the FASB's assets and liabilities definitions (but not in its recognition criteria)
- The liabilities definition
- The accounting for contractual rights and obligations
- The "unit of account," which involves both aggregation (including linkage) and disaggregation.

Once the crosscutting issues have been identified, those issues would be prioritized, with one of the determinants being how often and how soon those issues are likely to arise in standards-level projects. Another determinant would relate to interdependencies among the crosscutting issues, with higher priority being assigned to issues on which the resolution of other crosscutting issues depends. Still another determinant would involve issues that would foster convergence of the FASB's and IASB's frameworks.

Another aspect of the conceptual framework that the Board is considering enhancing relates to disclosures in the financial statements. The AcSB, on behalf of the IASB and FASB, is conducting basic research relating to a disclosure framework that would be part of the overall conceptual framework activity described above. Such a disclosure framework would provide a conceptual underpinning for making decisions about presentation and disclosure requirements for new accounting standards.

One U.S. Standard Setter

The Study states "under an objectives-oriented regime, there cannot be a proliferation of standard setters" (page 48) and clarifies that there "would be one standard setter (FASB)" (page 9). In late 2002, the FASB reached an agreement with the Accounting Standards Executive Committee (AcSEC) of the AICPA that gave the Board more direct control in setting standards. Following a transition period that should end in 2004, AcSEC will cease issuing Statements of Position, but continue to issue Audit and Accounting (A&A) Guides. The FASB staff will continue to review A&A Guides as well as changes to the current Guides. However, the Board will no longer clear the issuance of A&A Guides. A primary purpose of the staff review of the Guides will be to ensure that the Guides are not establishing interpretive authoritative guidance that should be provided by the FASB.

In January 2003, the Board increased its participation in the EITF's process by adding two Board members to the EITF's Agenda Committee and by requiring that all future EITF consensus decisions be subject to ratification by the FASB before they become effective. As a result of those actions, the FASB is the only designated standard setter in the United States.[38]

International Convergence

The Study states that ". . . a continuing shift by the FASB towards a more objectives-oriented regime should facilitate the convergence process" (page 44). The FASB is committed to working with the IASB and others toward the goal of producing a single set of high-quality accounting standards that can be used both domestically and internationally to support healthy global capital markets.

As noted previously, the FASB recently agreed to undertake a project with the IASB to develop a common conceptual framework. The FASB also is involved in several joint

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[38] While the SEC has the ultimate statutory responsibility for the financial reporting system and will continue its oversight role with respect to the FASB, the SEC staff generally looks first to the FASB to address and resolve issues relating to accounting standards, referring matters it believes need to be addressed to the Board with the expectation that wherever possible, the Board, the EITF, or the FASB staff will provide the necessary guidance.

projects with the IASB. Joint projects involve sharing staff resources, making every effort to contemporaneously issue for public comment Exposure Drafts and other due process documents, and promulgating similar accounting standards. Currently, the FASB and IASB are conducting joint projects to address Revenue Recognition, Business Combinations (purchase method procedures), and Reporting Financial Performance.

The two Boards also are pursuing a joint short-term convergence project that is expected to result in a number of standards that will achieve convergence in specified targeted areas. The scope of that short-term convergence project is limited to those differences between U.S. GAAP and International Financial Reporting Standards (IFRS) in which convergence around a high-quality solution appears achievable in the short term. Because of the nature of the differences, it is expected that a high-quality solution can usually be achieved by selecting between existing U.S. GAAP and IFRS. The topics currently being addressed by the FASB in its segment of the short-term convergence project include accounting changes and error corrections, earnings per share, exchanges of productive assets, income taxes, and inventory costs.

In addition, as noted in the Study the FASB and IASB have committed to coordinating their agendas whenever possible. At their joint meeting in April 2004, the Boards agreed that in principle, any significant accounting standard would be developed cooperatively with the objective of issuing the same or similar standard concurrently in the United States and in those jurisdictions that apply IFRS.[39] Consistent with that, the Boards agreed to consider expanding the current joint agenda projects to include the FASB's liabilities and equity project and its project on criteria for liability extinguishment as well as the IASB's project on accounting for insurance contracts. In addition, after discussing a number of potential major projects that might be added to the joint agenda, the Boards agreed on three projects that should be considered for admission to the joint agenda as resources become available (employee benefits, leasing, and intangible assets). The Boards also agreed to evaluate opportunities for further convergence or improvements to

[39] To facilitate issuance of same or similar standards, the FASB will be working with the IASB in its efforts to develop a more objectives-oriented format for its standards (as described on page 3 of this paper).

financial reporting through one or more shorter-term projects related to financial instruments.

GAAP Hierarchy

The Study notes that because the conceptual framework is intended primarily to aid the FASB in its deliberations, the existing GAAP hierarchy places industry practice above the FASB's conceptual framework. The Study states that ". . . when the FASB completes its efforts to improve the conceptual framework, that body of literature should serve not only as a guide for the FASB in its subsequent deliberations, but also as a guide for accounting professionals as they attempt to resolve difficult issues in practice for which there is not clear guidance in the literature. The direct use of the conceptual framework by preparers and auditors to complement standards should permit standard setters to draft more succinct standards than they otherwise could" (page 45).

Members of the Board and staff have met with representatives of the PCAOB and the AICPA to discuss possible changes to the GAAP hierarchy. The Board agrees with the suggestion in the Study that the various levels of the GAAP hierarchy be eliminated and that the conceptual framework be given greater prominence. The Board plans to issue a document for public comment that will propose moving the GAAP hierarchy into the FASB literature. That proposal also will address the Board's long-term goal of creating two basic levels of literature: authoritative and nonauthoritative. Since that goal cannot be achieved until the long-term codification and simplification initiative described below is completed, the Board must develop an interim way to grandfather the existing GAAP hierarchy. The Board also must develop processes and procedures for reviewing the A&A Guides and changes that must be made to those Guides and to other literature that has been developed by standard setters other than the FASB (for example, AcSEC).

Access to Authoritative Literature

The Study notes that "one of the concerns and sources of frustration that accounting professionals have expressed is the lack of a single, searchable database containing all of the authoritative guidance" (page 48, footnote omitted). The Study states (page 49) that it

is "reasonable and appropriate that the FASB should have the responsibility for developing and maintaining" such a database. Citing the funding mechanism for the FASB put in place by the Sarbanes-Oxley Act, the Study states that ". . . the long-run goal should be for the FASB's documents to be freely available" (page 49).

The Board agrees that a comprehensive searchable database is very desirable and recently hired a consultant to study the issues that must be resolved if the Board was to undertake a project to organize the accounting literature by subject area into a single authoritative, electronically searchable source. The Board acknowledges that development of such a database would require the resolution of numerous conceptual, financial, and logistical issues over a number of years. The FASB staff discussed a potential codification project with the SEC staff in June 2004. This potential project will also need to be discussed with and approved by the Trustees of the Financial Accounting Foundation (FAF). The Board also agrees that free access to a comprehensive database would be highly desirable and notes that its recent funding from the mandated accounting support fees might make this possible. However, any final decision about whether the potential database would be made freely available lies with the FAF Trustees.

In the meantime, the FASB is trying to improve its products in the following ways:

a. Making FASB standards and Concepts Statements freely available for downloading at the FASB website (completed).
b. Expanding the *Current Text* (which includes FARS) to include FASB Staff Positions, implementation guidance from staff question-and-answer documents, and references to AICPA literature, thereby improving the retrievability of those pieces of implementation guidance (completed).
c. Making the current Financial Accounting Research System (FARS) system web-based and increasing the frequency of updates (in process).
d. Issuing the *Original Pronouncements* in an "as amended" format (in process).

In addition, constituents are able to listen to public Board meetings free of charge via audio webcast and have access to project summaries on the website, which are updated after every Board meeting.

Comprehensive Review of Literature

Pages 9 and 62 include a table of recommended action items. One of those action items is for the FASB to perform a "comprehensive review of current standards to identify and address those that are rules-based." As noted on page 41, the Board recently went through a process of identifying and prioritizing potential future projects. The goal of that comprehensive review was to develop a longer-term coordinated technical agenda with the IASB (refer to page 11 of this paper). The Board does not plan to undertake a separate project to identify rules-based standards and replace them with objectives-oriented standards. However, it will consider whether existing literature is rules-based in making future agenda decisions, as well as the existing agenda criteria that pertain to improving financial reporting and achieving convergence. The FASB believes the areas needing more attention are those areas that either have no guidance or have guidance that is not functional, not those areas that have existing rules-based standards that are functional.

Conclusion

The Board hopes that this paper is responsive to the recommendations outlined in the Study. As noted in the Study, many of the recommended actions are already under way. The Board appreciates the ongoing dialogue with the staff of the SEC in working toward the common goal of ensuring that the U.S. financial reporting system is the best in the world and thereby increasing investor confidence in that system.

Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Capital Markets, Insurance and Government Sponsored Enterprises
Subcommittee
of the
Committee on Financial Services
March 29, 2006

Attachment 5

Recent Articles about the FASB's Initiative to Reduce Complexity in the Financial Reporting System

Recent Articles About the FASB's Initiative to Reduce Complexity in the Financial Reporting System

1. Williams, Peter, "Accounting: Tides of Change," *Financial Director* (UK), March 2, 2006

2. "Regulators Call for More Transparency, Less Complexity," *Accounting Web.com,* December 12, 2005

3. Ciesielski, Jack, "The Complexity Conundrum," *The Analyst Accounting Observer*, December 6, 2005

4. Hughes, Siobhan, "Update: FASB Chmn Calls for Less Complexity in Accounting, *Dow Jones News Service,* December 6, 2005

5. Miller, Paul B. W. and Bahnson, Paul R., "Herz is No.1! (FASB Chair Bob Herz, that is)," *Accounting Today,* December 6, 2005

Accounting: Tides of change

The complexity of financial reports undermines the transparency they were supposed to uphold

Peter Williams, Financial Director 02 Mar 2006

One of the time honoured complaints about financial reporting is the increase in complexity and the related decrease in transparency. While many have noted that those twin evils undermine the usefulness of financial information to capital markets, doing anything about it seems about as likely as turning back the tide.

But Bob Hertz, chairman of the US Financial Accounting Standards Board (FASB), has decided to take on the role of King Canute. He is calling for structural, institutional, cultural and behavioural changes to the system of financial reporting. The truth is that the detail and volume of accounting, auditing and reporting undermines the quality and transparency of financial reporting that it was designed to support.

Standard-setters now see that the current system has engendered a check-box, form-over-substance approach to accounting, auditing and reporting by financial directors, auditors and regulators. Professionalism and judgement have gradually drained away leaving financial reporting to the technical expert, ensuring minute compliance. The retreat of professionalism and the reliance on detailed rules increases the opportunity to structure form-over-substance arrangements in a bid to get the accounting answer you want. This approach also leads to ignorance and genuine confusion among those producing financial reports.

The US has seen a number of financial reporting restatements. While some are due to fraud and lack of due care, many reflect unintentional mistakes in implementing and auditing complex accounting and reporting requirements. Financial directors face two types of complexity: "what to do" and "how to". It is no longer simple to work out which standards, rules or regulations apply in a particular circumstance, and even when you've decided that, there is still the problem of finding the answer. Increasingly, reporting is relying on accounting estimates and fair measurements which, in turn, rely on complex data gathering and processing exercises.

Investors are increasingly unclear about what was done in preparing the financial statements and to what extent various treatments properly reflect the underlying business and economic realities.

This complexity arose for many reasons. Financial reporting is a mirror held up to business; the transactions are becoming more sophisticated and so the accounting reflects that. But it is more than that. Complexity has arisen as a result of conflicting perspectives and agendas of those involved in the reporting process, resistance to change, outdated legacy accounting standards, an approach to standard setting that produces compromises, exceptions, quick fixes and inconsistencies. The system is the rope in a tug of war between politicians, regulators and the profession. All three have shown themselves capable of putting self-interest above the greater good.

There is also the cultural aspect. We might all say that we want to be allowed to exercise judgement, but when faced with the threat of that judgement being

challenged by a regulator, or a court, or even a disapproving audit committee then the temptation is to reach for the comfort of a rule set out in black and white.

What does reduced complexity look like? For users it could mean more financial reporting that is relevant, understandable and faithful to the underlying business it is representing. Some see fair value accounting as a way to achieve those goals. As the International Accounting Standards Board (IASB) has recently reaffirmed, it and FASB are looking at fair values as a key way to improve measurement. But others believe it introduces unacceptable subjectivity, misleading volatility and additional complexity. In other words, what may be better for users would not simplify life for FDs and auditors. We could all produce accounting rules that were simple for FDs to adhere to and easy to audit, but would convey nothing.

Some suggest that the holistic general purpose financial statement has had its day. In its stead the future of financial reporting lies in technologies such as XRBL driving information tailored to the needs of individual users at that time. Others are still calling for an expansion of the role of the reporting model to systematically cover non-financial performance indicators, risk and rewards and forward looking information, while others crave for a retreat from information and disclosure overload.

It is no accident that Hertz is starting a "cut complexity" bandwagon at this time. If US GAAP is to merge with international GAAP it would be better if fit-for-purpose systems came together instead of two which were based on a 19th century capitalist system, rather than the realities of the 21st century globalised economy. The fact that there is a call for such fundamental reforms to the financial reporting system is hugely encouraging. Others, especially the European Union, need to participate. Hertz calls the status quo neither acceptable nor sustainable. But how progress will be made and how long it will take is unknown.

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Regulators Call for More Transparency, Less Complexity

The Securities and Exchange Commission (SEC) is seeking help from the accounting industry to simplify the rules that may be partly to blame for the corporate scandals of recent years, the SEC chairman said Monday.

The SEC, working with the Public Company Accounting Oversight Board (PCAOB) and the Financial Accounting Standards Board (FASB), is undergoing a "major national effort to make accounting less complex," said SEC Chairman Christopher Cox, at the American Institute of Certified Public Accountants' (AICPA) annual meeting in Washington, D.C. "The accounting scandals that our nation and the world have now mostly weathered were made possible in part by the sheer complexity of the rules.," Cox said. "Criminal conduct could be concealed in a thicket of detail."

He outlined what is being done: "First, FASB, with our support, is reassessing specific standards in major areas where rules fail to provide transparent information. Second, FASB is trying to codify all of the existing literature, in order to establish a single source for all GAAP material. And third, in order to do that, FASB is trying to contain the proliferation of new pronouncements from multiple sources."

Another pressing matter faces the industry, he said: the market domination of the Big Four, which audit 80 percent of all the public companies in the U.S.

Cox said: "Is this intense concentration in the market for large public company auditing services good for America? If you believe, as I do, that genuine competition is essential to the proper functioning of any market, then the answer is no."

Cox said the SEC may consider rewriting the rules to eliminate barriers that keep smaller firms away from auditing large companies.

Cox feels these initiatives will require more help from accountants. "These improvements will help you better serve the public, and your clients. And they'll let you focus your efforts on what really matters."

FASB Chairman Robert H. Herz, who addressed the conference Tuesday, echoed the concerns Cox had expressed about the complexity of the rules and the need to improve transparency.

Herz said thousands of pronouncements now make up U.S. generally accepted accounting and auditing standards, SEC rules, interpretations, regulations and other guidance.

"Many, including some members of the FASB, believe that the current system has engendered a check-the-box, 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."

Transparency suffers because it is so difficult to understand the financial statements and to make comparisons between companies, he said.

Herz feels it's time to stop observing the problem and start solving it. Herz suggested a thorough analysis of the factors that cause complexity and impede transparency before looking at possible solutions. "I believe the status quo is neither accceptable nor sustainable."

AccountingWEB.com Dec-12-2005

The Analyst's Accounting Observer (AAO) Weblog is a periodic blog by Jack Ciesielski, dealing with accounting topics in the news.

To contact Jack, please send email to jciesielski@accountingobserver.com.

12/6/2005

The Complexity Conundrum

Filed under:

- General

— Jack Ciesielski @ 11:38 pm

How do you get complexity out of financial reporting without adding more at the same time?

Let me state the obvious: our financial reporting system is shoulder-deep in complexity. Chalk it up to any number of reasons: business operations are more complex than ever, taking place in a multitude of time zones and currencies, with derivative financial instruments employeed to decrease earnings volatility while raising convoluted accounting issues. Analysts and investors demand more financial information in an ever-more urgent time frame - and sometimes ignore what they receive, asking for adjustments to help them arrive at a pro forma earnings figure, for example. That adds more complexity to the pile.

I'm attending the AICPA's SEC/PCAOB Current Developments Conference in Washington DC, and "complexity" has been one of the recurring themes. It was evident in Chairman Cox's videotaped speech on Monday. He outlined his remedy for complexity:

"First, FASB, with our support, is reassessing specific standards in major areas where rules fail to provide transparent information. Second, FASB is trying to codify all of the existing literature, in order to establish a single source for all GAAP material. And third, in order to do that, FASB is trying to contain the proliferation of new pronouncements from multiple sources."

Notice that FASB is the key player in each of Chairman Cox's planned steps. The first step is already moving forward with the FASB's re-examination of pension accounting. (Because leases were mentioned as a candidate for improvement in the SEC's off-balance sheet report, don't be surprised if this isn't added to the FASB agenda next.) The second step, FASB's codification project, is a longer term effort at reducing complexity; don't expect much of it to be completed before decade's end. And the third step has already been acted upon: no longer does the AICPA issue accounting standards for public companies.The FASB is now the only U.S. standard setter.

What does the FASB have to say about the complexity problem it's been charged with fixing?

I had the pleasure of introducing FASB Chairman Robert Herz to the audience at the conference; his speech centered on complexity, and I think it's well worth reading for a good summary of how things got to the current state of complexity. Let me offer a few highlights - starting with what "reducing complexity" really means to different parties.

To many preparers, reducing complexity seems to imply accounting and reporting that is easier to do. Similarly, for many auditors it would seem to imply accounting and reporting that is easier to audit. But for many users, it seems to mean making reported financial information more understandable and more useful, which includes making it more relevant and more representationally faithful of the underlying economics, objectives which, of course, may not translate into accounting and reporting that is easier to do or easier to audit.

One man's complexity reduction is another man's fog, so to speak. Ridding complexity from the financial reporting system is going to be an exercise in compromise.

On how we got into this situation:
"... there are also a number of other powerful forces that have and continue to generate complexity in the reporting system and impede improving financial reporting. Among these forces are the conflicting perspectives and agendas of the participants in the reporting process; resistance to change; outdated rules-based legacy accounting standards that fail to report the economic effects of transactions and events; an evolutionary approach to standard setting that can result in non-conceptually based compromises, exceptions, and inconsistencies in standards over time; a continuing focus and emphasis on short-term earnings; gaps in the education and training of accountants; anti-abuse rules to try to curb the continuing use of accounting-motivated transactions to burnish reported financial results; attempts to politicize standard-setting and regulation; and a palpable fear of the potential consequences of being second-guessed by regulators, enforcers, and the trial bar. And in our culture. many of these forces create a constant demand for detailed rules, exceptions, bright lines, and safe harbors; deter preparers, auditors, audit committees and boards from exercising professional judgment; and result in disclosures that while lengthy and dense, all too often are boilerplate, overly legalistic, and fail to effectively communicate important information.

I think he covered all the bases. One more excerpt:

"So, while I and others within the financial reporting community have been vocal about the need to reduce complexity and improve transparency of financial reporting, I believe it is time to stop observing the problem and start thinking about how to solve these issues. For I am concerned that failure to take action will inevitably lead to more complexity, less transparency, and potentially less relevance of reported financial information. Accordingly, we have been discussing with the SEC and the PCAOB the kinds of steps

and actions that would be needed to begin to seriously focus on and address these issues".

Everybody talks about complexity. Maybe someone is finally going to do something about it, but it will take more than just the FASB to finish it. I agree with Bob: there has to be a cultural change in many of the players on the financial reporting stage, but cultures don't change overnight.

Comments are closed.

UPDATE: FASB Chmn Calls For Less Complexity In Accounting

263 words
6 December 2005
18:10
Dow Jones News Service
English
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(Adds reaction in fourth and fifth paragraphs and background in sixth paragraph.)

By Siobhan Hughes
Of DOW JONES NEWSWIRES

WASHINGTON (Dow Jones)--Financial Accounting Standards Board Chairman Robert Herz said Tuesday that financial accounting standards are too complicated and must be simplified.

"I feel pretty strongly that the time has come for collective action to address these issues," Herz said in remarks to the American Institute of Certified Public Accountants.

He said that one of the candidates for simplification is a standard for accounting for leases. "I think we will likely take it on," Herz said in response to a question from the audience. "Clearly, that is a prime candidate for the issue of reduced complexity."

The remarks broke little new ground, but stood out for some observers because of their sense of urgency and the emphasis on bringing the Securities and Exchange Commission, the Public Company Accounting Oversight Board, and others into the process.

"I think he was in his own way telling people that now is the time we really, really have to get things moving," said Raymond Beier, a senior partner at PricewaterhouseCoopers. "I think there's a strong implication that he's brokering a process among the key stakeholders to bring greater clarity, more transparency, more understandability into financial reporting."

The **FASB** chief's speech came one day after Securities and Exchange Commission Chairman Christopher Cox called for more straightforward accounting rules.

-By Siobhan Hughes, Dow Jones Newswires; 202-862-6654; Siobhan.Hughes@dowjones.com [12-06-05 1810ET]

Herz is No. 1! (FASB chair Bob Herz, that is)

By Paul B.W. Miller and Paul R. Bahnson

On Dec. 6, 2005, Financial Accounting Standards Board Chairman Robert Herz addressed the American Institute of CPAs National Conference on Current Securities and Exchange Commission and Public Company Accounting Oversight Board Reporting Developments in Washington.

The chair traditionally speaks at this venue, but often the remarks are only perfunctory. This time, though, Herz showed his leadership by calling on capital market participants to lay aside their self-interest and work together to achieve "progress ... in improving the quality and transparency of financial reporting."

In addition, he said, "I also believe that we need to reduce the complexity of our reporting system." (The entire text can be found at www.fasb.org/herz _aicpa_12-06-05.pdf.)

The heart of the matter

These and other comments hit proverbial nails on the head. This statement from near the end of the speech especially reverberates: "I feel pretty strongly that the time has come for collective action to address these issues. And while I recognize that such an effort could result in significant changes to our reporting system, including institutional and structural changes, some of which could impact FASB, from where I sit, I believe the status quo is neither acceptable nor sustainable. Our reporting system, while probably the best in the world, is too complex and is capable of providing more transparent, more understandable and more useful information to investors and the capital markets."

We want to analyze his key points:

* His strong feelings. Herz is now a seasoned standard-setter, having seen firsthand the swift opposition that arises whenever proposals threaten to disrupt the status quo. Nevertheless, he offers up bold plans for progressive action. Why would he do so unless he feels strongly that something must be done, and done now? With his expressed vision and demonstrated commitment to progress, we think the world should count on him to do what he says.

* Collective action. His point is one that we've often made - nothing is likely to happen if the profession sits on its hands, waiting to be told what to do. Passive acceptance of mediocrity and begrudging compliance with meager change simply will not cut it. For those who wish to live in the past, well, get out of the way. This train is leaving the station.

* Significant changes. For those who like it the way it is and want nothing more than tweaks, look out, because Herz's goal is to bring major change to the system, even at a cost to the institution he leads. This comment shows extraordinary courage in the face of temptation to not rock the boat.

* The status quo. The next phrase ought to be dynamite for those who go to work each day without thinking about the quality of their output. Herz has proclaimed first that the status quo is unacceptable because it isn't producing high-quality and transparent financial statements.

He then goes further by proclaiming that the status quo isn't sustainable. By that, we think he means that the profession has to deliver financial statements that have real value because they're useful. We also think he means that accountants no longer have the political power to prevent change.

* What's wrong. Herz hits the right button by saying that accounting is too complex to get the job done. But he's not complaining that accounting practice is too hard; rather, he is lamenting that financial statements are so arcane that they don't actually communicate truth. Simplifying those messages likely means that it might become harder to be an accountant, especially in terms of creating and learning new techniques. And, yes, it will mean taking new risks to earn new rewards.

* The goal. The final phrase states Herz's goal for the reform process. Note that he doesn't want to make it easier for managers to manage their financial image and he doesn't want to make auditing safer for auditors either. He's also not looking to make it simpler for FASB.

As we have advocated for a long time, the test of any change will be two-fold: First, if current practice doesn't produce transparent, understandable and useful information for users and the markets, then it must be replaced. Second, it must be replaced only by new practices that do provide that information.

We think everyone can be sure that Chairman Herz is not just flapping his gums on these points. He is dead serious about building a coalition of change agents who share this vision, and he wants as many to come along as possible.

How is he going to do that? We found his words to be carefully crafted, but nonetheless right on point. In his speech's second paragraph, for example, he says that there are "a number of fundamental structural, institutional, cultural and behavioral forces that we believe have and continue to generate complexity in the system and that impede transparent reporting."

If it had been us, we would have been more direct and called them "political" forces that have, on one hand, strongly resisted any change in the status quo, and just as strongly tried to undermine any efforts to develop new practices, despite the fact that the aura of the precision and reliability of generally accepted accounting principles crumbled and disappeared before their eyes.

Again, Herz is calling it like it is. The problem lies with the people involved in financial reporting, not with the technology. The people need to re-orient themselves, or be replaced, so that today's amazing technology can be fully applied to fulfill the responsibility of providing transparent, useful and timely information to the markets.

What's happening?

Herz goes on to explain that FASB, with encouragement from the SEC, has already launched three initiatives to get the ball rolling. The first is a plan to "systematically re-address accounting standards in major areas for which the existing complex and outdated rules fail to provide relevant and transparent financial information." For example, pension accounting is back on the agenda, and the goal is clear - to get more information out of the footnotes and into the financial statements.

The second is a massive effort to restructure the authoritative literature so that everyone - preparers, auditors and users - can access and apply it. And the third is the board's major project to recast the Conceptual Framework to "provide a more solid and consistent foundation for the development of principles-based standards in the future."

He also makes it clear that he intends to press on, even against strong opposition. Here's what he said: "Over the last few years, counter to the goals of a principles-based system, at FASB we have experienced a constant flow of requests for detailed rules, bright lines and safe harbors from preparers and auditors."

There you have it, a forthright acknowledgement that managers and CPAs have not advanced users' interests in the past, thus setting the stage for Herz's call for a new future orientation.

The road ahead

Bob closed his talk with this pragmatic observation: "By acting together in the public interest, we can ensure that we continue to honor and fulfill [our] longstanding commitment to high-quality financial reporting. Given the many structural, institutional, cultural and behavioral issues facing the system, the effort to reduce complexity and improve transparency will not be easy and will take time, but I hope you agree that it is one of national importance and one that deserves the support of all of us."

While we applaud his vision, we have a different take on the future. There is no doubt that standard-setters and regulators can influence practice; however, we think the greatest impetus for transparent financial reporting will come from preparers and auditors who finally figure out that voluntarily telling the truth, the whole truth, and nothing but the truth in their statements will bring huge rewards through lower capital costs and the higher security prices that they so eagerly seek.

But until that paradigm rules the day, the lead will have to be taken by people like Bob Herz, who is No. 1 in our eyes.

Paul B.W. Miller is a professor at the University of Colorado at Colorado Springs, and Paul R. Bahnson is a professor at Boise State University. The authors' views are not necessarily those of their institutions. Reach them at paulandpaul@qfr.biz.

March 14, 2006

Mr. Robert H. Herz, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856

Dear Bob:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") is writing to request that the Board re-expose the proposed standard on *Fair Value Measurements* for public comment. FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is the financial reporting technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

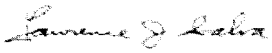
CCR responded to the Staff Draft on November 16, 2005, to explain our significant concerns with the application of a marketplace participants ("MP") approach to fair value – a concept that we believe has the potential to assign values to nonfinancial assets and liabilities that do not faithfully represent the economics of the underlying transactions. Those concerns do not appear to have been addressed in the Board's subsequent deliberations. We also are concerned about how constituents should apply the fair value measurement guidance in the subsequent accounting in circumstances in which the MP approach gives rise to higher fair values (consistent with highest and best use) than existing valuation methods.

CCR also observes that the composition of the levels in the hierarchy have changed multiple times over the course of Board's redeliberations and that the principle of the highest and best use of an asset described in paragraphs 11, 12, and 31 in the Staff Draft is very different than the valuation premise described in paragraphs 13, B6, and B7 of the June 2004 ED. While we understand that this was discussed at a public meeting, we do not think that there was sufficient due process performed to obtain views of constituents on this very significant change.

During our liaison call on February 27th, members of CCR's FASB subcommittee were asked for views on the establishment of a valuation resource group to assist with implementation of the fair value measurements standard. While this appears responsive, in part, to some of the concerns expressed above, we believe that such activities should be performed before the standard is finalized. This would obviate subsequent amendments to the new standard and would avoid the circumstance of companies having to revise their initial application of the guidance in light of subsequent interpretations by such a group.

Given the uncertainties and concerns expressed above and the fact that the IASB is continuing to work through similar issues on its own version of the standard, we believe that it is in the best interests of all constituents for the Board to issue a revised exposure draft of the proposed standard on Fair Value Measurements. We appreciate the opportunity to express our views on this matter.

Sincerely,



Lawrence J. Salva
Chair, Committee on Corporate Reporting
Financial Executives International

cc: Robert J. DeSantis, FAF President

Statement of the U.S. Chamber of Commerce

ON: "FOSTERING ACCURACY AND TRANSPARENCY IN FINANCIAL REPORTING"

TO: HOUSE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES

BY: DAVID HIRSCHMANN, SENIOR VICE PRESIDENT, U.S. CHAMBER OF COMMERCE

DATE: MARCH 29, 2006

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

Testimony before the House Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Fostering Accuracy and Transparency in Financial Reporting"

Testimony by David Hirschmann
Senior Vice President, U.S. Chamber of Commerce

March 29, 2006

Good afternoon, Mr. Chairman, members of the subcommittee. My name is David Hirschmann and I am Senior Vice President at the United States Chamber of Commerce, the largest business federation in the world, representing more than 3 million businesses.

I'm here today to present the business community's views on how to improve auditing and accounting practices, insure the viability of the auditing profession, and encourage a greater focus on long-term performance measures to help investors, companies, and the economy.

First, allow me to address the widespread practice of projecting a company's future earnings as a way to inform and guide investors.

In fact, this practice is inherently flawed. Earnings guidance is a precise measurement—down to a penny or two per share—based on subjective forecasts of accrual accounting information that is itself quite subjective in many respects.

Guidance is issued based on forecasted financial statements that principally contain only educated estimates about the value of income, expenses, liabilities and assets, such as pensions, oil reserves, and bad debt, to name just a few.

It used to be that companies were encouraged to "manage" earnings—they would have a few honest, legitimate, acorns in the basement, as the saying goes, to support one or two cents of earnings on a rainy day. As one former auditing executive put it, analysts viewed any CEO who couldn't legitimately, legally manage earnings within a penny or two to meet forecasts as not being in touch with what was happening at a company. But in the current accounting environment, there are no acorns, and anyone who tries to create them is asking for trouble.

Quarterly earnings guidance misrepresents a company's true financial strength and puts pressure on executives to meet quarterly expectations. Companies often sacrifice creating long-term value if it means missing quarterly projections—and that is a disservice to the company and its investors.

Instead of issuing earnings guidance, companies should better communicate their strategies and objectives and come up with alternative benchmarks that will show progress toward meeting their goals.

More communication—not less—between the companies and the investor community is needed, and that is why the Securities and Exchange Commission (SEC) should reexamine Regulation Fair Disclosure (Reg FD). This regulation was passed with the legitimate intention of leveling the information playing field so that a favored analyst or investor would not receive better or more timely information. Unfortunately, in part due to the way this rule has been enforced, it has had the unintended consequence of restricting and reducing communication.

We also support efforts by Chairman Cox to move to clearer and easier forms of electronic communication between companies and investors. Good companies have the advantage when there is an open and level playing field for information. Initiatives like eXtensible Business Reporting Language (XBRL) improve the capability of the market to assess information and reward those companies that are doing well. If we have one note of caution, it is that while numbers are obviously important, analysts and investors should not focus only on numbers and ignore the underlying business fundamentals. XBRL will help everyone to better assess financial statements, but the smart money will still take the time to carefully understand industry factors and long-term strategy.

Let me move to a related area that is of great concern to the business community, and that's the issue of fair value accounting—the concept of developing well-reasoned estimates for certain intangible assets and liabilities and including them on the corporate balance sheets.

There are no doubt, limitless things that could be both estimated and added to financial statements. And, many of them would be consistent with Generally Accepted Accounting Principles (GAAP). However, we can't lose sight of the fact that they are estimates. The move toward fair value accounting should be tempered by a thorough examination of the implications to both business and investors of adding another imprecise estimate to the financial statements.

All investors want to understand the value of items on a company's balance sheet. That is easy when an asset or liability has a readily determinable market value. The problem arises with intangibles and other items for which there really is no market value.

The traditional historical cost approach to financial reporting can lead to out-of-date valuations of certain assets, but it at least had the virtue of being objective and stable. That allows investors and analysts to assess operational trends over time.

The concern is the continuing push by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to move away from historic values for hard-to-value assets and liabilities. In multiple arenas, companies are being required to develop systems for assigning estimated values to such items—and, thereafter, continually reassess and revalue these items.

These educated guesses then generate risk for companies and their auditors. If someone thinks the guess is wrong, the company will be sued. When the company relooks at the guess, any significant change will create volatility in the financial statements—hurting the stock price and generating more lawsuits. Fair value accounting also puts great pressure on the auditing industry to certify the appropriateness of value estimates.

It is also highly questionable whether investors and other users of financial statements would find fair value estimates of certain assets and liabilities useful in making their own forecasts about a company's future cash flows. These estimates are purely hypothetical and not at all indicative of the cash flows that a company actually expects to receive or incur.

In the end, it is not at all clear that this well-intentioned attempt to give investors better information will do anything other than make financial statements less precise and meaningful for investors.

The world of accounting regulation does not get much attention. However, we have already seen the impact of adding estimates of the value of unvested stock options on the way in which companies, particularly emerging companies, offer stock incentives to rank and file employees.

Now, FASB is considering adding additional fair value estimates to the financial statements on a range of issues to including business combinations and asset retirement obligations.

It would also have a major impact on real world business transactions and operations. For instance, an acquisition or merger that might make good business sense might never come about if all of the future costs of integrating the companies are added to financial statements in the year the merger is completed.

The U.S. Chamber will be asking FASB and the IASB, as they further explore the feasibility and desirability of expanding the application of fair value accounting concepts, to recognize that their efforts may create a perception of accounting precision which may have potentially significant consequences for companies and investors. While the push towards fair value auditing may be theoretically pure, the costs may end up being much greater than the benefits.

Finally, the business community has great concerns about the future of the auditing profession.

In the post-Sarbanes-Oxley litigation and regulatory enforcement environment, auditing firms are under attack from several different parties. Much of this criticism results from the erroneous perception of precision in financial reporting.

Also, there is pressure on auditors to "do more" when conducting audits, and this has resulted in higher auditing fees for their clients. Even as their auditing costs have increased, clients are receiving less overall advice and support from their auditors because of auditors' fear of litigation or raise questions from the SEC or PCAOB about their independence.

The environment has become even more volatile because accounting principles remain in flux—as I've already talked about—as business transactions become more complex.

The cumulative result of all of this is the very real potential for further concentration in the auditing profession. There are now only four major firms serving a large majority of the listed and actively traded public companies in the United States. Further contraction in this profession would threaten its viability and could shake public confidence in our capital markets.

The Chamber has issued three recommendations for fortifying the auditing profession. First, the profession should become insurable against catastrophic litigation. Second, PCAOB standards should be clarified. And, third, we need expansion of and greater competition among the Big Four accounting firms.

For reasons of time, I will not go into detail on how we propose implementing these three goals, but I have provided to the committee the Chamber's auditing white paper, released earlier this year and would ask that full recommendations be included in the record of this hearing along with this statement.

In conclusion, the United States Chamber of Commerce is fully committed to highly accessible and transparent capital markets, and we will leverage the full resources of the organization to ensure accounting and auditing practices that are necessary for achieving that goal.

Thank you for the opportunity to speak today and I look forward to your questions.

TESTIMONY OF
MARC E. LACKRITZ
PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
U.S. HOUSE OF REPRESENTATIVES

MARCH 29, 2006

I. Introduction

Mr. Chairman and members of the Subcommittee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] SIA and our more than 600 member firms share your interest in improving the clarity and relevance of financial information, and we applaud you for holding this timely hearing. As financial intermediaries,[2] our livelihood depends on the quality, consistency, and reliability of financial information. Indeed, the U.S. capital markets are the envy of the world precisely *because* the quality of information has continued to evolve and improve. We are eager to work with your subcommittee, other members of Congress, regulators, and all interested parties to further improve the quality of financial information.

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[1] The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. Our primary mission is to build and maintain public trust and confidence in the securities markets. Our members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

[2] Although we are financial intermediaries, our members are also issuers and publicly held companies. Our testimony, however, focuses on investors and their perspective on financial information.

II. Overview

Our liquid, transparent, and dynamic capital markets function to allocate a scarce resource – capital – to its most efficient use. These vibrant markets provide issuers the opportunities to raise capital – to establish or expand their businesses or help finance public projects – and give investors the opportunities to put their capital to work. Our markets have thrived largely because of investors' ability to obtain, digest, and appropriately price securities derived from information about companies and the economy. Without that information, the entire price discovery function of the markets would collapse. And without the markets to act as signaling mechanisms for capital allocation, our entire economy would become as moribund and flat as those of state-run economies.

Three factors allow information to flow fully, efficiently, and fairly. First, companies have powerful motives to disclose information. Certainty, clarity, and comparability in the disclosure of financial information lowers the cost of capital. Second, the federal securities laws have long buttressed the efficient flow of information to the markets, especially by punishing the dissemination of deliberately false information. Third, our markets have excelled at embracing advances in technology, from the telegraph to the Internet. This has enormously enhanced the capabilities of market participants to receive and absorb information in their trading decisions.

None of this would be possible however, without the public's trust and confidence that all market participants adhere to stringent rules, vigorously and fairly applied. Because of that trust, billions of shares trade hands every day, and manufacturers, school districts, and hospitals have access to financing in our capital markets. But public trust and confidence also depends on access to reliable and timely information, both by the public directly and by the investment advisers, mutual fund, pension, and 401(k) plan managers who manage trillions of dollars of

savings. At a time when nearly 57 million Americans – or half of all U.S. households – own stock, the securities industry is committed to ensuring that individual investors can achieve their financial goals, such as planning for a child's education or for a comfortable retirement. With 76 million Baby Boomers hurtling toward retirement, we recognize that the quality of information must be paramount.

Securities firms have expended tremendous resources over the last several years to ensure that our greatest asset – the public's trust – is never compromised. Corporate governance, accounting, research, SRO governance, and mutual fund scandals have produced a tsunami of regulation. Our industry's compliance costs nearly doubled over the past three years to an estimated $25.5 billion, mainly because of increased staffing and frequent inquiries from regulators.[3]

Similarly, some of these regulatory requirements have made it more expensive and daunting to list in the U.S. markets, driving foreign issuers away, and causing many others to consider going private.4 New York Stock Exchange CEO John Thain recently testified that in 2000, nine out of every ten dollars raised by foreign companies through new stock offerings were done in the U.S. But last year, none of the top ten initial public offerings (IPOs) measured by global market capitalization was registered in the U.S. markets. In fact, 23 out of the 25 largest IPOs in the world chose to register outside the United States, often in London or the Deutsche

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[3] *The Cost of Compliance in the U.S. Securities Industry, Survey Report*, February 2006, Securities Industry Association, available at http://www.sia.com/surveys/pdf/CostofComplianceSurveyReport.pdf. Broker-dealers have added 8,800 new compliance officers, accountants, auditors, lawyers, paralegals, legal assistants, and accounting and auditing clerks since the passage of Sarbanes-Oxley. Those positions now represent 6.1 percent of all industry jobs, up from 4.6 percent before Sarbanes-Oxley. During this same period, the industry shed 63,000 net positions.

[4] A 2005 Foley & Lardner, LLC study found that the average cost of being public in 2004 increased 33 percent over 2003 for a company with annual revenue under $1 billion, with audit fees accounting for the largest out-of-pocket cost increases (Foley & Lardner, LLC, *The Cost of Being Public in the Era of Sarbanes-Oxley* (June 16, 2005), at http://www.foley.com/files/tbl_s31Publications/FileUpload137/2777/2005%20Cost%20of%20Being%20Public%20Final.pdf).

Bourse. Going forward, we must carefully consider how proposed regulation and legislation will affect the competitiveness of our markets, as well as how we can maintain our global leadership across the world.

III. Role of Financial Information in the Marketplace

Today's investors have virtually instantaneous access to volumes of information about issuers, investment choices, and the securities markets due in large part to technological advances and the ubiquity of the Internet. In many ways, technology has democratized the securities markets by making the same information available to all investors – not just high net-worth individuals or institutions – at the same time. Investors can review and analyze issuers' filings on a more current basis, quickly compare that information to other issuers' reports, follow market trends, and read analyst reports concerning the company. Investment decisions, however, are only as valuable as the quality of the information they have available to them.

The increasing number of financial restatements by U.S.-listed issuers over the last several years has raised concern about the accuracy of financial statements. In 2005, a study by Glass Lewis found that one in every 12 U.S.-listed public companies restated their financials, up from one in every 23 in 2004.[5] Partially, that increase may be due to the complex nature of ensuring compliance with some accounting standards. In the post-Enron era, executives may be paying closer attention to their company's financial reporting mechanisms and internal controls and are therefore doing a better job of ensuring that errors or interpretive issues are being resolved. As a result, investors are now getting more accurate information than ever before because of increasingly rigorous standards being imposed either internally or externally on issuers.

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[5] Glass, Lewis & Co., LLC, *Getting it Wrong the First Time* (March 2, 2006), available at <http://www.glasslewis.com/downloads/Restatements2005Summary.pdf>.

SIA believes the SEC's current financial disclosure regime works exceptionally well to provide the highest quality information to investors. We do not believe it is necessary to mandate any additional disclosure of financial information, but we urge policymakers to support continued improvements in global accounting standards. Because of varying country-to-country standards, investors cannot easily analyze and compare investment choices, and may not able to make fully informed decisions. SIA therefore supports more consistent, comparable, "principles-based" accounting standards. Such standards will facilitate the seamless flow of capital across national borders as well as reduce the costs of providing relevant information to investors.

IV. Financial Reporting Requirements

A. Regulated Quarterly Disclosures

Current information in the marketplace comes from three basic sources: regulated disclosures, voluntary issuer guidance, and research analyst reports. Regulated disclosures include filing quarterly reports on SEC Form 10-Q,[6] annual reports on Form 10-K, and extraordinary transactions on a current basis on Form 8-K.[7] In total, these reports comprise a comprehensive and effective disclosure regime.

In 1996, the SEC unveiled its EDGAR online filing and disclosure system, thus allowing the public to access and compare corporate reports in a reliable centralized location. The SEC is also assessing the benefits of XML-tagged data, and is offering companies incentives to disclose financial information using the XML-based Extensible Business Reporting Language (XBRL). The goal of using XML-tagged financial reporting data is to provide "greater context for data

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[6] Form 10-Q includes quarterly financial results, management discussion and analysis, and a description of significant events that have occurred within the company during the quarter.

[7] Extraordinary transactions include bankruptcy, death of an officer or director, change in public accountant, etc. Karel Lannoo and Arman Khachaturyan, *The Emerging Framework for Disclosure Regulation in the EU,* Report of a Centre for European Policy Studies (CEPS) Taskforce (2003).

through standard definitions, enabling investors and other marketplace participants to analyze data from different sources and to support automatic exchange of financial information across various software platforms, including web services."[8] XML, if adopted for EDGAR and generalized reporting, will make financial analysis quick, cheaper and better, making it more accessible to the average investor and reducing significantly the cost of doing securities research. These initiatives – in combination with the pertinent information many issuers already provide on their corporate websites – would give investors real-time access to an unprecedented volume of company information.

Some critics of quarterly reports claim that they lead to a short-term, "make your earnings" mentality. They have suggested that quarterly reports should be eliminated so that issuers can focus on the longer-term horizon. Others have called for more real-time accounting reporting. SIA believes that the information contained in quarterly reports has improved the quality of the markets and helped investors. Regulated quarterly reporting is an important mechanism for corporate management to communicate with shareholders regarding issues that affect the company's financial status. We therefore oppose efforts to eliminate the quarterly reporting.

The punishing effects that a late filing can inflict on an issuer further underscore the importance of quarterly reporting. Late filings often indicate conflicts between auditors and management and may signal serious financial trouble for the company.[9]

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[8] SEC Press Release, *SEC Announces Initiative to Assess Benefits of Tagged Data in Commission Filings*, July 22, 2004, available at: http://xml.coverpages.org/SEC-XBRL.html.

[9] For example, in October 2004, Investors Financial Services Corp. decided to delay filing its 10-Q to correct its accounting methods for mortgage-backed securities purchases. The company's share priced plunged 16 percent and the stock price did not recover until three weeks later, after the company had restated three years of financial results. David Henry, *Where's the Quarterly Report*, BusinessWeek Online (Dec. 13, 2004).

B. Accounting Standards

High quality accounting standards are absolutely crucial to ensuring that financial reporting results in clear, timely, and relevant disclosure to users of financial statements. We believe accounting standards can be improved in three ways: by using fair value to measure all financial instruments; by simplifying standards; and, by converging differing national standards.

Fair Value

Though it has some very resolute opponents, accounting standard setters and regulators have generally concluded that all financial instruments should be measured at fair value. The securities industry – which has long-utilized fair value (or mark-to-market) in its daily activities[10] – has worked with the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), and the SEC on developing fair value standards that meet rigorous criteria. Indeed, the forthcoming FASB statement on Fair Value Measurement[11] and the proposed statement on a Fair Value Option[12] are both very significant contributions to improving accounting standards.

As regulators have noted in the context of Basel II,[13] disclosures that provide insight into an entity's risk positions and exposures can enhance regulatory and market discipline.[14] Using

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[10] Fair value is used in structuring and pricing instruments, risk evaluation and monitoring, margining, and in the compensation of our employees.

[11] *FASB Working Draft of Statement of Financial Accounting Standards No. 15X, Fair Value Measurements and the Proposed FASB Staff Position* (Oct. 21, 2005).

[12] *The Fair Value Option for Financial Assets and Financial Liabilities — Including an amendment of FASB Statement No. 115 (Proposed Statement of Financial Accounting Standards)* (Jan. 25, 2006).

[13] After a number of banking failures earlier in the decade, in 1988 the Bank for International Settlements' ("BIS") Basel Committee on Bank Supervision produced an international model agreement on a set of minimal capital requirements for banks that became known as the Capital Accord. As the markets evolved and financial instruments became more complex, it was recognized that the Accord (now known as Basel I) was inadequate, and work began on a replacement ("Basel II") that would be reflective of the increasing interdependence of financial markets, and that would ensure that the capital requirements for financial institutions were in line with the best current thinking on prudent risk management.

fair value forces firms to confront adverse market movements at an early stage, and investors receive an earlier warning of developing problems. Similarly, fair value forces companies to state what an asset is worth today, rather than what they hope it will be later, which is what we believe users of financial statements prefer. As our economy and capital markets have become more dynamic, the historical cost of an asset may no longer be an adequate basis to make investment decisions.

Simplification

The complexity and sheer volume of current accounting literature has become overwhelming even to the most sophisticated professional. To some degree, that is the necessary consequence of an ever more complex and dynamic economy. However, complexity does create some dangers, including the possibility of "gaming" the system.[15] Both SEC Chairman Christopher Cox and FASB Chairman Robert Herz have recognized the problem and have committed their organizations to tackle the issue.[16] Standard setters, regulators, and the private

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[14] Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, Madrid, Risk Management Trends and the Supervisory Structure, (May 27, 2004).

[15] Fair value also has an important role here. Last June, the SEC released its report and recommendations on off-balance sheet transactions in the wake of the Enron disaster. In discussing transactions entered into for no economic purpose but instead to obtain a desirable accounting treatment, the report noted that "the motivation for the transaction or the structuring could be essentially eliminated if all financial instruments were recorded at fair value." In the securities industry's view, that's a key lesson of that debacle. *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*, p. 110 (June 15, 2005).

[16] FASB Chairman Robert H. Herz Remarks before the 2005 AICPA National Conference on Current SEC and PCAOB Reporting Developments (Dec. 5, 2005); SEC Chairman Christopher Cox Remarks before the 2005 AICPA Conference on Current SEC and PCAOB Reporting Developments (Dec. 5, 2005). Since December, FASB has adopted a series of Statements designed to reduce complexity. *See, FASB Issues Final Standard to Account for Certain Hybrid Financial Instruments – New Standard Provides a Means to Simplify Accounting* (Feb. 16, 2006).

sector have all recognized the benefits that would result from a more "principles-based" approach to accounting.[17]

Achieving that goal, however, will not be easy. As Chairman Cox and Chairman Herz have both observed, issuers and their auditors are justifiably afraid of being second-guessed by juries, regulators, and the media. As a consequence, preparers and their accountants clearly want to reduce their exercise of professional judgment and adopt a "check-the-box" approach to accounting and auditing in the hope that it will minimize their liability. Correcting that tendency will to some degree involve addressing tort reform. Although it is a difficult and complex subject, it must be addressed so that professionals do not have to fear doing their job. We believe this Committee and others in Congress should examine this very important issue.

Convergence

The ever-increasing volume of cross-border transactions attests to the evolution of the capital markets and the erasure of national boundaries. However, historically the various countries of the world have independently evolved their own accounting practices over time. While those differing accounting conventions generally share the same goal of providing investors, analysts, and other users of financial statements with insight into the operations of issuers, "homogenizing" the standards can be difficult. FASB and the IASB, and the SEC and the Council of European Securities Regulators ("CESR") have recognized the importance of accounting convergence.[18] We hope that in the near future a sufficient degree of convergence or comparability will be achieved so as to permit issuers listed in the United States or the European

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[17] For a discussion of how moving to "principles-based" rather than "rules-based" standards can contribute to financial stability, see *Toward Greater Financial Stability: A Private Sector Perspective*; The Report Of The Counterparty Risk Management Policy Group II; pp. 151-153; pp. C-1-C-2 (July 2005).

[18] FASB Press Release, *FASB and IASB Reaffirm Commitment to Enhance Consistency, Comparability and Efficiency in Global Capital Markets* (Feb. 27, 2006).

Union to obtain listings in the other jurisdiction with minimal difficulty. Greater comparability across borders will again help to facilitate the flow of capital by more efficiently allocating scare resources on a global basis.

C. Volunteer efforts by issuers to improve quality of disclosure

In addition to the SEC-mandated quarterly reporting, many corporate issuers voluntarily provide periodic earnings guidance. The *Private Securities Litigation Reform Act of 1995* – which protected issuers from liability for forward-looking statements about projected performance – prompted many companies to issue earnings guidance more widely. Earnings guidance is often the subject of extensive media coverage, speculation, and comparison.

Guidance is not mandated by statute or regulation, but most companies choose to provide this information in response to market demands. A recent survey of executives and directors of companies that issue earnings guidance found that most executives believe that earnings guidance has provided valuable information to the marketplace and has kept performance expectations in check.[19]

Although corporate executives believe that earnings guidance has many benefits – including higher valuations, lower volatility, and improved liquidity[20] – a recent McKinsey study

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[19] *McKinsey Quarterly: Weighing the Pros and Cons of Earnings Guidance: A McKinsey Study* (March 2006). Another McKinsey study notes that in February 2006, Google's share price fell seven percent after failing to meet the lofty expectations for the fourth quarter of 2005, although Google had not issued any earnings guidance. The survey authors noted that some commentators speculated that if Google had released earnings guidance, expectations could have been kept more squarely in check. Peggy Hsieh, et. al., *McKinsey Quarterly: The Misguided Practice of Earnings Guidance* (March 2006) http://www.mckinseyquarterly.com/article_abstract.aspx?ar=1759&L2=5&L3=5.

[20] *McKinsey Quarterly: Weighing the Pros and Cons of Earnings Guidance: A McKinsey Study* (March 2006).

seems to disprove these perceptions. Results showed that frequent earnings guidance does not increase valuations, or have any effect on share price volatility or liquidity.[21]

Several large U.S. issuers have discontinued the practice of issuing earnings guidance in favor of issuing more detailed performance information.[22] Issuers want to focus on long-term goals instead of short-term earnings, and reduce the costs associated with issuing earnings guidance (both the hard costs of management time spent on preparing the guidance as well as the negative effect on the share price when earnings guidance targets are subsequently not met). In fact, when Coca-Cola discontinued releasing earnings guidance in 2002 citing an increased focus on long-term goals, its share price held steady.[23]

SIA agrees that the decision to issue earnings guidance should rest with the issuer. As a policy matter, we should all work to encourage more and better financial information in the marketplace, but the release of earnings guidance should not be mandated by law or regulation.

VI. Conclusion

The current system of financial disclosure has served investors, issuers, and the securities industry extraordinarily well. In addition to mandated disclosures, issuers often voluntarily provide information beyond what is required by the SEC, thus giving investors access to more detailed information about the company. We believe the that greater use of fair value accounting, and the simplification and convergence of accounting standards would further assist issuers in providing better quality information to investors.

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[21] The issuance of corporate earnings guidance does appear to increase trading volumes in the short-term, but this does not have any lasting effect on liquidity. Peggy Hsieh, et. al., *McKinsey Quarterly: The Misguided Practice of Earnings Guidance* (March 2006). The McKinsey study surveyed 4,000 companies with revenues greater than $500 million. The results may differ for smaller companies.

[22] These companies include Citigroup, Coca-Cola, Intel, Motorola, Berkshire Hathaway, Ford, and General Motors. Dan Roberts, *Guidance Falling Out of Favour on Wall St*, Financial Times (Mar. 12, 2006).

[23] Peggy Hsieh, et. al., *McKinsey Quarterly: The Misguided Practice of Earnings Guidance* (March 2006).

Because of the diverse roles we play in the capital markets, we are sympathetic to the concerns of issuers and financial officers that the current system hinders their good-faith efforts and imposes unnecessary costs. We hope we can work together with investors, issuers, accountants, and regulators to improve the quality, consistency, and clarity of information so that we can maintain the global preeminence of the U.S. capital markets.

TESTIMONY OF

Barry Melancon

PRESIDENT AND CEO

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BEFORE THE

CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED

ENTERPRISES SUBCOMMITTEE

OF THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

CONCERNING

FOSTERING ACCURACY AND TRANSPARENCY IN FINANCIAL REPORTING

March 29, 2006

My name is Barry Melancon. I am the President and CEO of the American Institute of Certified Public Accountants. On behalf of the AICPA, which has been representing the accounting profession for almost 120 years, I truly appreciate the opportunity to present testimony to this Subcommittee about increased accuracy, accessibility, and transparency in corporate financial and other business information, including non-financial information that is useful to investors making decisions.

I am here today representing the approximately 330,000 Certified Public Accountants who are members of the AICPA. Approximately 142,000 of our members practice in business and industry in both public and private companies as CFOs, controllers, and internal auditors and accountants. These professionals are integral to companies producing the financial statements and quarterly and annual reports that are currently used by shareholders, lenders, regulators, and others who make investments in, do business with, and provide oversight of corporate America.

An additional 139,000 AICPA members are in public practice. The work that many of them perform, auditing public and private companies, make it possible for investors and other users to have reasonable assurance that the financial information published by management is credible and reliable. That helps to create the confidence capital markets need to make the investment decisions that fuel economic growth.

AICPA is hardly a newcomer to the discussion on business and financial reporting this Subcommittee is having today. To the contrary, in one way or another, AICPA and its members have been at the center of this topic since the need for useful and accessible financial and business information was first understood to be vital.

The existing financial reporting model provides a solid foundation, but the profile of today's companies has changed. The nature of their assets, how they are managed, and the performance indicators that senior executives routinely use underscore the need for a model that focuses not only on financial information, but also on a range of contextual and non-financial information that provides an enriched understanding of company performance, values, strategies and potential. As an example, in the industrial era, the physical assets of the manufacturing company were of significant importance to the users of a company's financial information. Today this continues to be true, but intellectual assets, which are not captured by financial statements and traditional business reporting, can be much more important. For example, an industrial company, while needing intellectual assets to create its products, has an equal need for the tangible assets of its manufacturing plant to be successful. However, the tangible assets of a software company are much less important to its success than the education and caliber of its workforce. Virtually all that the software company needs to be successful is a good intellectual property. We need to find a way to disclose and to communicate these types of corporate assets to users.

In some cases our involvement has been public and formal—like this hearing and the Senate Banking Committee testimony the AICPA presented in July 2000 on financial reporting methods for the 21st century.

In other instances, AICPA and its members have formally researched, discussed, and debated this subject internally.

All of this is part of our jobs and mission as individuals, professionals, and a profession.

Five recent examples of our activities demonstrate how the topic of useful and accessible financial and non-financial business information has been a preoccupation for AICPA and its members.

In 1993, the AICPA Special Committee on Financial Reporting, which is better known as the Jenkins Committee because of its chairman, Edmund L. Jenkins, the former Chairman of FASB, published a report called "Improving Business Reporting - A Customer Focus. Meeting the Information Needs of Investors and Creditors." Although the word wasn't in vogue at the time, that report was one of the first to call for what today we would describe as a broader "bandwidth" of information from public companies. This report was issued with the recommendation of providing greater and more useful information to investors.

Three years later, the AICPA Special Committee on Assurance Services published a report building on the work of the Jenkins Committee.

In 2000, the AICPA Accounting Standards Task Force of the Group of 100 developed an internal report called "Achieving a New Business Reporting Model for the 21st Century," which focused on motivating investors to demand a better reporting model and capital users and regulators to supply it.

Fourth, the AICPA Special Committee on Enhanced Business Reporting, which was active from January 2003 through January 2005, established the *Enhanced Business Reporting Consortium.* The Consortium is on the cutting edge of developing a voluntary framework for the disclosure and presentation of relevant value drivers, financial and non-financial performance measures, and qualitative information around strategy, plans, opportunities, and risks. For example, the framework will

provide best practices guidance for the disclosure of indicators of customer satisfaction and workforce demographics. These are areas that have significant relevance to the financial success of a business and that we all want to know, but that companies generally don't disclose on a regular basis to investors. The consortium is also promoting easing complexity in existing financial reporting requirements and is conducting research to identify the relative usefulness of disclosures to key user groups with the intention of issuing recommendations for simplification.

Fifth, in a similar fashion, the AICPA chartered XBRL International in 2000 to foster the global growth and adoption of "XBRL" - eXtensible Business Reporting Language—that AICPA started in 1998. XBRL is a language for the electronic communication of business and financial data which is revolutionizing business reporting around the world. It provides major benefits in the preparation, analysis and communication of business information. It offers cost savings, greater efficiency and improved accuracy and reliability to all those involved in supplying or using data. XBRL is what makes it possible to use the EBR framework effectively.

The United States has the most efficient capital markets in the world. But, twelve years after it was discussed in depth by the Jenkins Committee, we know that business and technology have progressed and it is time for improved financial and non-financial reporting models that meet the needs of today's markets. Investors require it, the technology exists to provide it, and capital markets will function even more efficiently with it.

The only excuse for not implementing an enhanced business reporting model—inertia—is unacceptable.

Every business student will tell you that information is the key to a free and successful economy. Indeed, the success of U.S. capital markets has always been based on what we today call "transparency," that is, available, highly credible, informative, and reliable financial and non-financial business reporting.

This was true long before the corporate scandals of the recent past once again made it obvious. As the U.S. economy has changed from one that is overwhelmingly based on physical assets to one that is increasingly dependent on intangibles, it has become clear to us, FASB, and the SEC that existing accounting models are not as well-suited to the task of informing investors as they need to be.

In addition, investors and other users of the information want that information provided on a timelier basis than it is today. Quarterly and annual reports, which are useful, primarily provide historical rather than current information. Because of that, they are not as helpful to investors and lenders who need to make decisions much faster than they did in the past

Currently, there is a limited amount of truly up-to-date information that investors use to assess corporate earning capacity. Useful and timely information has always been highly valued but, because of the growth of online reporting and electronic news sources such as Bloomberg and CNBC, the speed of activity and the rapid reporting of external events important to companies and sectors are more important today to users of the information than ever before. Indeed, the risks facing today's corporations are greater if for no other reason than investors react to them faster. That means that investors need or, rather, demand more and better information and they want it delivered far more quickly than has ever been the case.

Coupled with enabling technologies like XBRL, Enhanced Business Reporting will provide users the breadth of information they require at the speed they need to be successful in today's economy. AICPA believes EBR, enabled through XBRL, will make this happen. The technology has been created to allow users of information to access that information on close to a real time basis rather than waiting for a quarterly or annual report and the currently commonplace conference call with the management team. Coupled with the Internet, which allows key financial and non-financial business information to be widely available electronically, XBRL will enable this information to be utilized more effectively. All of this will make capital markets far more efficient.

Most important, EBR will also allow a far richer mix of information to be available to consumers of business information. One of the consistent findings of the groups and task forces that have worked on this issue for the AICPA is that enhanced financial reporting is now necessary.

The EBR Consortium is concentrating on the development of an internationally recognized framework that will establish voluntary guidelines for reporting key business information that falls outside of traditional financial statements. This will allow for more complete, relevant, consistent, and useful disclosures by putting structure around the reporting of this information for companies seeking best practice guidelines. The EBR framework organizes this kind of information into the following four categories:

- Business Landscape: The company's perspective on the business and economic climate as well as other external forces that could affect the entity's business strategy and its ability to achieve success.
- Strategy: This section builds on Business Landscape and communicates not only the business strategy, but also how the organization and the underlying structures support the execution of strategy.
- Competencies and Resources: A description of how the company manages available resources and competencies to execute the company's Strategy. A principal goal of this section is identification and discussion about value drivers-the elements of a company's business that are the sources of its value.
- Performance: This section provides insight into whether the company and its management team have produced results in line with stakeholder expectations. It is critical to explain relationships linking the Business landscape, Strategy and Competencies and Resources. Ultimately, the key performance indicators or narrative about qualitative factors presented in this section will enable stakeholders to better assess sustainable business practices and the quality and variability of a company's cash flows and profitability.

The framework will be customized on an industry by industry basis through a collaborative process involving corporations, investors and other key participants in the corporate reporting supply chain. A series of sample reports illustrating how a company might apply the framework is available at http://www.ebr360.org/ContentPage.aspx?ContentPageId=8.

Investors want more transparency today in the American capital markets, and the EBR framework will play a key role in achieving transparency by enabling

stakeholders to see the potential of a company through the eyes of management. The overarching objective of the EBR Consortium, however, is to achieve the right mix of fully disclosed, high-quality information, made possible not only by adding critical information that is not currently disclosed (the role of the EBR framework), but also by advocating for improvement in the consistency and relevance of existing disclosures. We believe that transparency can be further enhanced through a stronger focus on the quality, not quantity, of reported information, and that there are opportunities for simplification of reporting requirements. Decades of ever-increasing and more complex disclosure requirements have in some cases resulted in disclosures that have marginal usefulness because they are no longer relevant, redundant, or overly complex and hard to understand. The Consortium has established a Reporting Simplification Task Force to conduct research aimed at garnering a better understanding of the relative importance of financial and non-financial disclosures currently provided in an annual report to a wide variety of users. The task force intends to make thoughtful recommendations for the simplification of existing disclosure requirements based on the findings.

EBR and traditional financial reporting delivered electronically, available on demand, and tagged by XBRL technology, when adopted will enable users to answer questions about a company's financial condition at no marginal cost to the company. Users will have current data that, using XBRL, they will be able to mine more efficiently. Users will be able to customize the data they need to conduct the analysis they feel is important in ways that they cannot do today. And with a speed and efficiency that is not available today. Equally as important, the information will be in a format that facilitates analysis and comparison.

In much the same way that pocket calculators and personal computers made it possible for auditors and accountants to do things faster and more efficiently, XBRL and the internet will enable corporate reporting to move seamlessly and painlessly to a level of content that has long been contemplated but never before delivered. Indeed, up to now it has not been deliverable.

XBRL is a true American success story. It was conceived by Charlie Hoffman, a CPA who worked for a small firm in Washington State. He brought it to the AICPA, which has worked hard and invested a great deal to make it a reality.

XBRL is now a global effort that has been adopted as far away as China as well as here in the United States with the recent success of the FDIC Call Report Modernization project based on XBRL and the SEC voluntary filing program.

XBRL is the business reporting equivalent of bar coding. Because of greatly enhanced information and reduced errors, the now ubiquitous codes of thick and thin lines we all see in stores have made product distribution far more efficient and much less costly. Bar coding has saved the grocery industry $17 billion per year because inventory management, pricing, and consumer sentiment are now measured and queried at a far lower cost. It has also increased the grocery industry's capacity to carry substantially more items in its inventory. The AICPA expects the same type of results with XBRL. Attached to my testimony as Exhibit 1 is additional detailed information on what XBRL is and how it functions.

XBRL will do the same for business and financial reporting by making it easier for investors and analysts to find the reported details they are seeking about a company's operations and results and make better use of this information. That is

why it is no wonder that Securities and Exchange Commission Chairman Cox is one of XBRL's biggest supporters. Just last week he told CNBC that XBRL's interactive features and depth of information will make it possible for investors to get the information they need quickly, effortlessly, and at little cost. He also praised United Technologies for voluntarily filing its financial information in XBRL format this year. The AICPA is grateful for Chairman Cox's support and is eager to work with the SEC to make XBRL available and as ubiquitous as those barcodes.

XBRL is only one of several elements that will have to be considered as the evolution towards a reporting model that meets the needs of today's markets continues to become a reality. Others include:

- Engaging markets in the development of a structured framework for enhanced business reporting information on an industry-by-industry basis so that EBR can be used to its full potential.

- Simplifying overly complex reporting. The AICPA actively participates in the Enhanced Business Reporting Consortium Reporting Simplification Task Force, which is currently working to identify the relative usefulness of disclosures to key user groups with the intention of issuing thoughtful recommendations for simplification

- The increasing need for international convergence of reporting and auditing standards

- The need for auditors to provide timely assurance on the information systems used and underlying data elements rather than just summary level assurance on the basic financial statements
- The need for improved safe harbor legislation to protect directors and managers who produce the financial and business reports and the auditors who audit the financial statements where a good faith effort to provide more high-quality and transparent disclosures has been made

Finally, in addition to what has been discussed concerning Enhanced Business Reporting, XBRL and the usefulness of financial and non-financial business information with regard to public companies, it is important that a little more be said about these activities in the private company sector. 99.7 percent of incorporated businesses in the United States are private companies and their impact on the U.S. economy is significant. Because we believe that the needs of users of private company financial statements differ in some ways from the needs of investors and other users of public company financial statements, the AICPA Board, in late 2003, established the Private Company Financial Reporting Task Force whose primary charge was to determine whether or not financial statements of private, for-profit entities, prepared in accordance with generally accepted accounting principles (GAAP), were meeting the needs of those private companies. Partly as a result of that effort, the AICPA is currently conducting an historic effort with FASB that is focused on meeting the financial reporting needs of private company lenders and investors.

All of these issues are important and deserve concerted and thoughtful dialogue. They do not, however, mean that doubts about the value of Enhanced Business

Reporting should exist at this point. To the contrary, EBR is essential to the future of the U.S. economy, the proper functioning of capital markets, and investor confidence. Its promise is extraordinary.

The AICPA wants the promise of EBR and XBRL to be realized as quickly as possible. We are looking forward to working with this Subcommittee, the SEC, corporate America, and public accountants to make this happen.

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EXHIBIT 1

XBRL-US
c/o AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881
Site: www.XBRL.org/us
E-mail: xbrlus@xbrl.org
Tel: 201-938-3920
Fax: 201-938-3329

Transforming Business Reporting

XBRL (eXtensible Business Reporting Language) is a royalty-free, open standard for the tagging of information to improve the quality and transparency of business reporting. XBRL permits the automatic exchange and reliable extraction of business information across all software. XBRL is not a proprietary software product, but an open standard developed by XBRL International Inc., a not-for-profit consortium of over 400 companies and agencies. XBRL is designed to:

- Enhance the usability of business data by eliminating the need to re-key, thereby minimizing the risk of error.
- Make each financial item identifiable to software that understands XML and that conforms to the XBRL 2.1 specification by using a tagging scheme.
- Report all the pertinent context of the data, e.g., whether it is segment data, part of an audited statement, etc.

Taxonomies are dictionaries of business terms and their corresponding tags, e.g., US GAAP taxonomy. Instance refers to an XBRL-enabled document.

Today's Problems: Without XBRL

- It is time-consuming for users to extract business information and organize it for analysis.
- Investors and analysts benchmarking company performance against other companies do so with considerable guesswork, manual intervention and re-keying of data.
- Reporting is based on a rigid reporting calendar rather than event or risk-driven.
- Format limitations cause presenters to reduce the extent of the information that could be delivered.
- Preparers have limited methods to organize information to highlight salient facts.

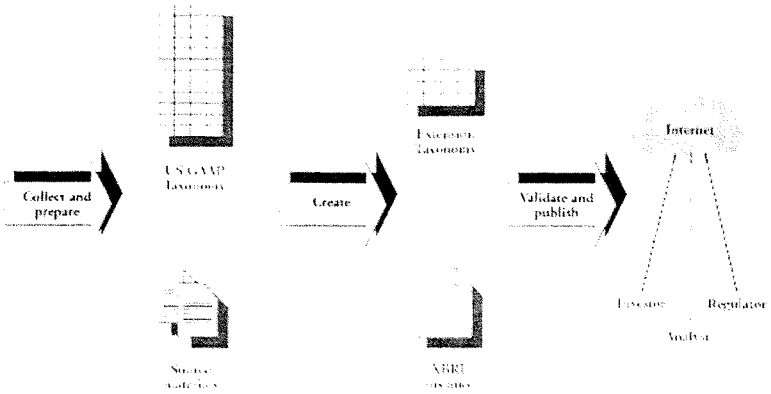
Tomorrow's Benefits: With XBRL

For public companies:

- Reduces workload – publish a single set of tagged results simultaneously through a multitude of channels including interactive Web sites.
- Communicates pertinent information and analysis to investors, analysts and other stakeholders without relying on third parties to interpret and repackage the information.
- Demonstrates tangible commitment to greater transparency for early adopters.
- Improves access to information as users drill down to the data needed, using their own analysis tools (preparer of the results controls the depth of potential drill-down).
- Data can be compared and benchmarked more easily.
- A rich variety of data can be automatically identified and processed, reducing the needs for re-keying or reformatting.

How do companies report in XBRL?

1. Collect and prepare source materials such as historical financial statements:
   a. Determine the scope and amount of detail to put into the XBRL Instance.
   b. Determine which software you want to use and any assistance needed.
2. Create the company extension taxonomy and Instance document using XBRL-enabled software:
   a. Input profile data, such as the name of the company and the period being reported.
   b. Select tags from the US GAAP taxonomy and apply them to the company's financial data.
   c. Designate the appropriate 'meta data' for the tagged information ('contexts' and 'link bases').
3. Validate the Taxonomy Extension and Instance document to ensure they are XBRL compliant.
4. Publish the documents, e.g., post to the corporate Web site, upload to the SEC's EDGAR database, distribute as a link in a news release.



How is financial data converted into XBRL?

Public companies are responsible for the complete and accurate tagging of their financial statements. They can either create the tagged documents themselves or turn to a service provider. The most efficient approach is to obtain the assistance of persons experienced in both US GAAP reporting and in using XBRL. Currently these individuals are mostly found among the XBRL International membership, including the major public accounting firms. Training is often available from a reputable services provider or one of the software vendors offering XBRL tools. For forthcoming training events available through XBRL International, **visit www.xbrl.org/us/events for details.**

What software is available to create XBRL tagged business reports?

The current version of XBRL and the US GAAP taxonomies that contain those tags are currently supported in document creation tools from (in alphabetical order) Allocation Solutions, CoreFiling, Fujitsu, Hitachi, Rivet Software, Semansys, SimpleX and UBmatrix.

Earlier versions of XBRL are supported in tools from Blast Radius, CaseWare IDEA, Oracle, SAP and Microsoft. FDIC regulated banks submitting XBRL reports are able to use products from DBI, FinArch, FRS, IDOM, ITI, Fidelity and Jack Henry Associates. Also, tools for software programmers working in XBRL are available from DecisionSoft and Batavia J2R.

Many vendors are now in the process of developing XBRL-enabled software. Vendors have an opportunity to be listed on the XBRL International Web site. XBRL International itself does not offer software tools.

A current listing of vendors' products and service offerings is available at www.xbrl.org/us/vendors

How will an end user know the reliability of information in an XBRL tagged report?

A user can have a high degree of confidence that an XBRL file obtained from a Web site via a secure Internet protocol is, at the time of obtaining it, the exact file posted by the owner of the Web site. The meaning of the XBRL tags in the file depends on the meaning of those tags at the time the file was created.

A user looking for confirmation that the XBRL document is correct can check to see if the XBRL document is accompanied by the report of an independent auditor. The Public Company Accounting Oversight Board in a May 25, 2005 Staff Q&A recently noted: "...an auditor may be engaged to examine and report on whether the XBRL-Related Documents accurately reflects the information in the corresponding part of the official EDGAR filings. That engagement is an examination under AT section 101 of the PCAOB's interim attestation standards, Attest Engagement ("AT section 101"), as amended."

What level of effort is needed to create an XBRL tagged set of statements?

A preparer that has familiarity with the industry, the proper tools and prior experience tagging in XBRL will be able to complete the tagging job in 2 hours per page, although with more complex reports this estimate could increase by a factor of 3 to 4.

Updating an XBRL file for subsequent periods takes less time. Once the XBRL tools, process, and initial tagging are in place, this investment is reused only requiring updates for new tags and financial reporting elements.

What is the role of XBRL in the corporate reporting supply chain?

Participants in a business information supply chain summarize and exchange information across organizational boundaries.

These participants encompass public and private companies, lenders, investors, regulators, business partners and capital markets. Today, every participant must work with a variety of formats and differing data definitions for the information that they collect, and that they, in turn, must publish in many formats and with different meanings.

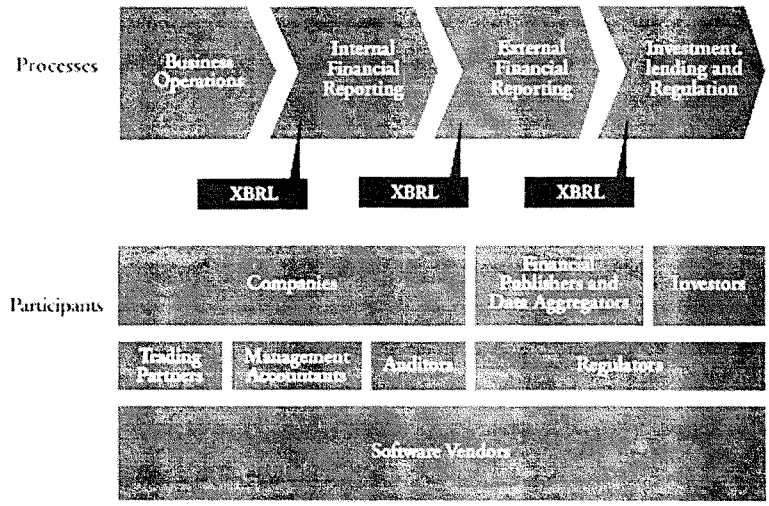
XBRL is a common language to be used across the entire supply chain, from reporting individual business events and operating results inside an organization, to reporting to external stakeholders.

About XBRL-US

XBRL-US is the US based arm of XBRL International Inc., a non-profit consortium of over 400 leading companies, associations and government agencies. XBRL-US is hosted and supported by the American Institute of CPAs, one of the founding members of XBRL International. The XBRL-US Web site contains an up-to-date list of members. Members conduct their work in periodic meetings, conference calls and online. Members benefit from knowledge sharing with leading experts, cross-industry collaboration, awareness of software vendor capabilities and plans and influence on the evolution of XBRL itself.

Joining XBRL-US

Your organization can enjoy these benefits by becoming a member of XBRL-US. Membership in XBRL US includes membership in the international organization. The Web site **www.xbrl.org/us/** join has information on how to join.



Statement of
Rebecca McEnally, CFA Ph.D
Hearing Before the U.S. House of Representatives Committee on Financial Services: Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
"Fostering Accuracy and Transparency in Financial Reporting"
March 29, 2006

Chairman Baker, Ranking Member Kanjorski, and members of the Subcommittee, I am Rebecca McEnally, Director of Capital Markets Policy for the CFA Institute Centre for Financial Market Integrity. The Centre appreciates the opportunity to testify today.

The Centre was established to promote the highest standards of ethics, integrity, and professional excellence in the investment community. It shares this goal with its parent, CFA Institute, which is a non-profit professional membership organization of more than 81,000 members in 126 countries. Our members are engaged in all aspects of the capital markets, including investment advising, portfolio management, financial analysis, and other fiduciary roles. CFA Institute is widely recognized as the organization that administers the CFA examination and awards the CFA Charter, a designation that I share with nearly 68,000 investment professionals worldwide.

High-quality financial information is critical to the work of our members and other investment professionals. So, for more than three decades, CFA Institute members have been actively involved in the public debate about how best to improve financial reporting standards and disclosures. We commend this Subcommittee for your leadership in addressing investors' concerns about the accuracy and transparency of financial reporting.

The corporate reporting scandals and bankruptcies over the past few years underscored how crucial clear, accurate, and complete financial reporting is to the health and well-being of our financial markets. Indeed, these problems reminded us that our markets, currently the strongest in the world, cannot long remain so without such information. Neither can markets survive without investors' trust and confidence that the information upon which they base their investment decisions is accurate, readily understandable, and complete.

The US standard-setters, principally the Financial Accounting Standards Board (FASB) and the Securities Exchange Commission (SEC), as well as the International Accounting Standards Board (IASB), have made progress in the last decade in improving the clarity and accuracy of financial reporting, but they would agree with us that a vast amount remains to be done. To help propel their

efforts forward, the Centre recently released its white paper, *A Comprehensive Business Reporting Model: Financial Reporting for Investors*, developed by our global panel of experts, which outlines 12 principles that we believe would greatly increase the clarity, accuracy and completeness of financial reporting. The complete paper may be found at:
http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2005.n4.4001

I will highlight a few of those principles in this statement. However, I provide a full summary of the twelve principles at the end.

First, we believe that financial statements should be prepared from the perspective of the common shareowner, the last residual claimant on a company's resources. Shareowners cannot properly evaluate a company's potential risks and returns, and value their investments, unless the statements completely and accurately reflect both the assets available to the company and the claims of all others that must be settled before those of the common shareowners.

In this regard, we refer the Subcommittee to the SEC's report submitted to the House Financial Services Committee in June of last year, *Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers.* The items cited in this report as requiring attention are at the top of our current short list, too. We are pleased that the FASB is moving forward on them.

A second principle is that items in the financial statements should be measured at fair value. Under GAAP, the fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, other than in a liquidation. On the other side of the balance sheet, the fair value of a liability is the amount at which that liability could be incurred or settled in a current transaction between willing parties, other than in a liquidation. Quoted market price in an active market is the best evidence of fair value and is used as the basis for measurement.

The reason for this is a simple one: the only information that is useful for financial decision-making, including investment decisions, is fair value information. Hence, because financial statements are investors' major source of information, the items in these statements should be measured at fair value. We would add to this, that if most or all items in the statements are measured at fair value, one significant source of complexity in financial reporting would be removed -- that which derives from the mixture of both historical cost and fair value measurement in the same statements.

For example, if all financial instruments were to be measured at fair value, as we have argued for some time, there would no longer be a need for highly complex hedge accounting for positions in the instruments, nor would there be an "accounting" mismatch that can lead to unintended consequences. We were

pleased to learn that the FASB and IASB last October reaffirmed their commitments to fair value reporting for all financial instruments and are working jointly to resolve the remaining issues.

A third principle is that all changes in assets and liabilities must be recorded in a single, new financial statement which we call the "Statement of Changes in Net Assets Available to Common Shareowners." This statement would build upon and expand the reporting in the current income statement. Put simply, no event or transaction which affects the wealth of investors and other claimants on the company should be allowed to escape complete, clear, accurate, and timely recognition in the statement. This means no deferrals of things that have happened, and no items hiding out of sight of investors and other statement users.

Aside from the recommendations in our paper, I also want to comment on several other needed improvements that would benefit investors.

We strongly support the current standards convergence program of the FASB and the IASB. When the day comes that company managers have a single, globally-applicable set of reporting standards, the costs of statement preparation for the various markets in which they raise capital will be significantly reduced, along with one more source of reporting complexity. Obviously, investors will benefit from the reduction because they will not have to try to transform statements from different reporting regions into a single standard in order to perform their analyses.

A current hot topic of discussion is whether company managers should provide quarterly earnings forecasts to analysts, investors, and the markets in general. We recently asked our global membership in an informal questionnaire if this practice should be discontinued, and we were not surprised to learn that of those responding, three-quarters said "Yes, it should be stopped." We also asked those who said "yes" if companies should "provide additional information on the fundamental, longer-term drivers of the business," and 95 percent said "yes." From these results, we conclude that our members find little value in the current earnings guessing-game, but they would value clear, timely information on the basic economic factors that will affect the company and its prospects.

I mentioned earlier that we could reduce one source of reporting complexity by measuring all items at fair value. We have to face the fact that modern businesses are highly complex, and that they engage in very complex transactions. However, one needless source of complexity is the maze of accounting choices currently available to managers for reporting identical or essentially similar transactions and events. If investors are to understand the underlying economics of transactions in the face of so many choices, managers must provide pages and pages of explanatory notes, detailing which choice was made, why, and how the choice was applied, a waste of good managers' time, and investors' analysis time as well. We are pleased that recent reporting standards have diminished these

choices significantly but we believe that much more needs to be done, especially as older standards come under review and revision.

XBRL, eXtensible Business Reporting Language, has much promise for statement preparers and users alike. However, much remains to be done by way of revising and completing the taxonomy so that it is complete and provides consistent, reliable reporting across all companies and industries. Investors do not merely use the numbers in financial statements. Indeed, those numbers are of little use without the understanding needed to interpret them. Hence, the data, tables and explanatory material in the notes to the statements, the "Management Discussion and Analysis," and the other related explanatory materials must be readily accessible in a tagged cell format. Currently, they are accessible in XBRL only as they are in the non-electronic text filings. Developing a complete tagged cell format will take much time and effort, but must be done if XBRL is to realize its full potential and usefulness to investors.

Again, I commend the members of this Subcommittee for your leadership in addressing investors' concerns about the accuracy and transparency in financial reporting and appreciate the opportunity to provide the views of CFA Institute. I am happy to respond to your questions.

Exhibit 1. Summary of the Comprehensive Business Reporting Model Proposed Principles, Current Practices, and Reasons for the Importance of the Proposed Changes

1. **Principle: The company must be viewed from the perspective of a current investor in the company's common equity.**

Current Practice: Financial reporting standard setters have made significant improvements in financial reporting since the early 1990s. These advances include rules requiring that all derivatives be reported at fair value and that all stock options granted to employees (compensation) be expensed at fair value. But much remains to be done. Many major claims against the company's resources (for example, pension obligations and contingencies) currently escape the balance sheet and income statement and are not fully reported in the notes. Similarly, many revenue-generating assets (for example, receivables, intangibles, and leased assets) are allowed under current rules to escape complete and clear recognition in the financial statements. (See Principle 2)

Reasons for Importance: The current common shareowner (CCS) is the last to receive a share of the company's net assets (that is, assets in excess of liabilities) and earnings. This means that the claims of all others must be fully satisfied before those of the CCS. Consequently, a CCS must have complete and accurate information about all other claims—including potential risk exposures and possible returns—to value his or her own investment. Similarly, a CCS must understand what assets are controlled and used by the company and the implications of these assets for the company's future growth and financial health.

2. **Principle: Fair value information is the only information relevant for financial decision making.**

Current Practice: Since the early 1980s, financial reporting standard setters have tended to base new standards on fair value measurement. The FASB, working on its own behalf and that of the IASB, has developed a new

standard for fair value measurement for assets and liabilities and expects to release the final standard in the second quarter of 2006. The CFA Centre strongly supports these efforts, but the majority of standards comprising the bulk of current GAAP are not based on fair value principles. Much work remains to be done to bring these rules into compliance with the FASB's fair value measurement standard.

Reasons for Importance: Decisions about whether to purchase, sell, or hold investments are based upon the fair values of the investments and expectations about future changes in their fair values. Financial statements based on outdated historical costs are less useful for making such assessments. Fair values, by definition, impound all of the most current assessments about the value of an investment and any future changes in that value.

3. **Principle: Recognition and disclosure must be determined by the relevance of the information to investment decision making and not based upon measurement reliability alone.**

Current Practice: Although recently developed reporting standards have tended to be designed to provide information relevant to financial decision making, many older standards, which form the bulk of current GAAP, were structured more from a concern for practicability (what was easiest to do and most easily verified) rather than from a consideration of what would constitute the most useful information. Indeed, many companies have now instituted financial analysis divisions responsible for developing the sorts of information investors require but are only used by internal managers. The role of the financial analysis team is to develop timely fair value information so that managers will have the information they require to make their own investment decisions, for example, to acquire assets, expand or reduce operations, or divest portions of the operating activities. Although company managers may be reluctant to provide such information to investors, they recognize that the information is critical for the investment decisions that they when acting as investors must make.

The CFA Centre believes that most standard setters subscribe to the idea that GAAP accounting methods must produce decision-relevant information, but much work remains to achieve this objective.

Reasons for Importance: Financial information may be completely reliable if it is easily verifiable according to one or more criteria. But the information may not be relevant for financial decision making. An example is the purchase by a company of a major manufacturing facility 30 years ago for which the bill of sale is available to support the recorded cost. The recorded cost may, therefore, be considered reliable in the conventional sense. Financial decision makers today, however, would find little that is useful or relevant in that number for the decisions they must make today.

4. **Principle: All economic transactions and events should be completely and accurately recognized as they occur in the financial statements.**

Current Practice: Because companies seek to portray themselves in the best light, they sometimes engage in transactions that do not require immediate recognition (such as off-balance-sheet financing). For example, despite amendments of the lease accounting rules by the FASB, many leased assets remain off balance sheet even when the company effectively owns or controls them.

Reasons for Importance: The purpose of financial reporting is to convey the economic position of the company and changes in that position to investors. Reporting methods that omit or fail to reflect the economic essence of events and transactions as they occur do not achieve the purpose of financial reporting.

5. **Principle: Investors' wealth assessments must determine the materiality threshold.**

Current Practice: Despite statements of regulators, including the U.S. SEC, company managers and their auditors tend to apply ad hoc "rules of thumb" when deciding (1) whether certain items are of sufficient size or importance (materiality) to warrant clear, separate reporting and (2) the reporting method to be applied.

For example, some managers and auditors may use as their benchmark 5 percent of a line item, such as net income or total assets or sales. In contrast, we believe that materiality assessments should be based upon whether the item would make a difference to an informed investor. For example, a relatively small amount might change the trend of an expense category. Moreover, related items should be considered in total, rather than individually, to determine materiality.

Reasons for Importance: Financial statements are prepared for those outside the company who need the information and who base their financial decisions upon it (e.g., investors). Consequently, the materiality threshold should be based upon what will affect investors' decisions and not upon preparers' arbitrary assessments. These decisions should be based both on quantitative as well as qualitative factors. For example, even a small amount of fraud committed by company managers would likely be considered to be highly material to investors, who need to assess the integrity of those to whom they have entrusted their assets.

6. Principle: Financial reporting must be neutral.

Current Practice: Reporting standards issued recently tend to honor this principle more faithfully than before. Examples include the recently issued FASB and IASB rules on the expensing of stock options. Many older standards, however, still exist and are applied to major categories of transactions that were heavily influenced by concern about outcomes rather than the imperative to fully report the economic essence of the items.

Reasons for Importance: Reporting of economic transactions and events should not be influenced by the outcomes of the financial reporting or the effects that the reporting may have on one or more interests. For example, in the recent stock options expensing debate, those opposed to expensing argued that expensing stock options as compensation would reduce net income, causing companies that issue stock options to reduce the number of options granted to employees, making

it harder to attract talented employees. The argument was misplaced. All costs of production, including employee compensation, must be reported fairly, completely, and accurately. In the past, concern for outcomes has caused preparers to bring considerable pressure, both directly and indirectly through other political forces, against standard setters to scale back, slow, alter, or abandon standard-setting attempts altogether. One example is the reporting of defined-benefit pension obligations and the cost associated with such plans. The rule as it was initially drafted for reporting such obligations was broadly consistent with fair value recognition. But under the intense pressure of preparers, successive drafts gradually purged all remnants of fair value reporting. Under the final rule, neither the balance sheet nor the income statement reflects the economic position of the plan and changes in that position.

7. **Principle:** **All changes in net assets must be recorded in a single financial statement, the Statement of Changes in Net Assets Available to Common Shareowners.**

Current Practice: Changes in net assets are not reported in a single place but are scattered throughout the financial statements, the income statement, cash flow statement, balance sheet, and statement of changes in shareholders' equity. Moreover, the extensive aggregation and netting in the financial statements make analyses to generate many of these numbers all but impossible.

Reasons for Importance: We believe that all such changes should be reported clearly and understandably and in a single statement. Investors must now expend great effort to locate these changes and make use of them. Indeed, because of the high levels of aggregation and the lack of consistency, investors must resort to a great deal of analysis to try to determine the source and magnitude of many changes, if they are able to do so at all.

8. **Principle:** **The Statement of Changes in Net Assets Available to Common Shareowners should include timely recognition of all changes in fair values of assets and liabilities.**

Current Practice: Relatively few statement items are required to be recorded at fair value with changes recognized currently in net income. Derivative instruments and securities held for trading are notable examples that meet this test. The rules, however, permit gains and losses for some items that currently are recorded at fair value in the balance sheet (for example, available-for-sale securities and cash flow hedges) to be deferred outside of income.

Reasons for Importance: If investors are to be able to evaluate how the value of their investment in a company is increasing or decreasing, they must be able to fully understand how the company's operations and activities are increasing or decreasing the values of the assets they hold and the obligations they have incurred. The clearest measures of a company's wealth-generating or wealth-consuming patterns are changes in the fair values of these assets and obligations.

9. **Principle: The Cash Flow Statement provides information essential to the analysis of a company and should be prepared using the direct method only.**

Current Practice: Only a handful of the thousands of public companies worldwide report cash flows using the direct method.

Reasons for Importance: Ultimately, investors value their investments by forecasting the company's future cash flows and cash flow generating ability. A clear picture of the company's current means of generating cash flows, the patterns of inflows and outflows, and its effectiveness in producing cash is essential to this analysis. The current cash flow statements of most companies do not provide this information.

10. **Principle: Changes affecting each of the financial statements must be reported and explained on a disaggregated basis.**

Current Practice: The financial statements issued by most companies today, from the largest with extensive cross-border operations to very small, narrowly focused startups, tend to be highly summarized and condensed. This is achieved by adding together unlike items to report relatively few line items in the statements, despite the disparate economic attributes of their operations. A

good example is the line item "miscellaneous assets," which is sometimes the largest amount in the balance sheet.

Reasons for Importance: Aggregation of information with different economic attributes, different measurement bases, different trends, and from very different operations results in substantial loss of information. Indeed, the information lost is essential to investors' understanding of a company's financial position, changes in that position, and the implications for valuation of investments.

11. Principle: Individual line items should be reported based upon the nature of the items rather than the function for which they are used.

Current Practice: Information in financial statements, particularly in the income statement but also to a lesser degree in the balance sheet, is aggregated in major functional categories, such as cost of goods sold and selling, general, and administrative activities. This practice began long ago when companies tended to be focused in a single industry or activity and the items aggregated were more nearly homogeneous. Such is not the case today.

Reasons for Importance: The forecasting of individual line items for use in valuation and other decisions requires that they be relatively homogeneous—that is, represent a single economic attribute or an aggregation of very similar attributes. For example, rather than following the current practice of aggregating labor cost, pension costs, raw materials, energy costs, overhead allocations, and the like into cost of goods sold, which mixes items of very different economic characteristics, trends, and measurement bases, the individual categories should be reported. Indeed, investors currently expend much effort to disaggregate such numbers. Because of the limited information available, the calculations require much estimation and result in considerable error, thus affecting the usefulness of the information. Companies reporting under International Accounting Standards are permitted to report expenses based on

either function or nature. So, this is not a new concept.

12. **Principle:** **Disclosures must provide all the additional information investors require to understand the items recognized in the financial statements, their measurement properties, and risk exposures.**

Current Practice: Disclosures vary widely in quality and quantity. Older standards frequently provide for scant required disclosures. Some disclosures, for example, those for defined benefit pension plans (and for stock option expensing prior to the enactment of new standards in this area) have been crafted to make up for inadequate financial reporting in those areas.

Reasons for Importance: If investors are to understand the numbers reported in the financial statements, they must have sufficient supplementary disclosures to evaluate the numbers. Such disclosures can include, for example:

- financial reporting methods used;
- models used for estimation and measurement;
- assumptions used;
- sensitivity analyses of point estimates;
- information about risk exposures; and
- information explaining why changes in important items have occurred, and a host of other important disclosure.

In short, the statements are not interpretable without this information. Disclosures should be regarded as being as important to investors' assessments as the recognition and measurement in the statements.

2006 Mutual Funds and Investment Management Conference

Address by:

Paul Schott Stevens

President

Investment Company Institute

March 20, 2006
Phoenix, Arizona

It's a pleasure to help kick off this 41st annual Mutual Funds and Investment Management Conference, co-sponsored by the Investment Company Institute and the Federal Bar Association.

At last year's conference, we tried some new approaches. We scheduled more concurrent sessions to cover more ground, and repeated some sessions to enable you to choose those that interest you most. We got a lot of positive feedback, so we're following the same general format this year.

I think we have an excellent program, and I want to thank all those involved in organizing it. I'm pleased to note that their efforts have paid off. We have well over 1600 attendees here today – by far the biggest turnout in recent memory.

Of course, another reason for the great turnout may be the Arizona venue. We are honored that one of our keynote speakers is Senator Jon Kyl of this great state. We look forward to his remarks.

We also look forward to hearing tomorrow from Ann Combs, Assistant Secretary of Labor for the Employee Benefits Security Administration.

We have a broad-ranging agenda for the conference.

That should not be surprising. It reflects much of the work the ICI has been doing over the past year on regulatory and operations issues.

We have continued to focus on the mutual fund regulatory reforms projected by the SEC.

For example, we've worked to assist members with the highly labor-intensive processes of implementing the compliance rule and the redemption fee rule.

We've continued to work with our members and many other interested parties to find an effective solution to the late trading problem.

We've sought to ensure that proposed requirements for brokers to inform investors at the point of sale about costs and potential conflicts of interest results in effective disclosure and is consistent with the way in which brokers serve their clients.

We've spearheaded efforts to implement the remaining recommendations of the NASD's mutual fund breakpoint task force.

In other areas, we've continued to engage in the debate on market structure issues, including the adoption and implementation of Regulation NMS and the restructuring of the securities markets themselves.

As always, our work goes beyond the world of securities regulation. We have worked with the Department of Labor on fee disclosure to retirement plan sponsors, developed a model disclosure schedule on third-party fees, and made recommendations on prohibited transaction reform and default investments.

In the tax area, we are working with the IRS and FASB on a great variety of issues. Some of these are issues only lawyers and accountants could love – but all of them are important to our investors.

We are also pursuing an extensive legislative agenda.

We're strongly supporting provisions of tax legislation currently in conference. That includes extending capital gains and dividend tax rate reductions scheduled to expire at the end of 2008, and making permanent retirement and savings provisions scheduled to expire at the end of 2010 – including increased IRA and 401(k) savings limits, "catch up contributions", and Roth 401(k)s.

Finally, we're working to build ever broader bipartisan support for the GROWTH Act – a proposal that would keep more retirement savings invested longer and growing longer by deferring taxation of automatically reinvested capital gain distributions until fund shares are sold.

In addition to our regulatory and legislative work, we have been supporting the important work of the Independent Directors Council. I'd like to congratulate the IDC,

and all those independent fund directors engaged in its work, on a highly productive year. Over the past year, the IDC has:

- published two papers on fair valuation, in conjunction with ICI and ICI Mutual Insurance Company;
- published a "first of its kind" longitudinal study of fund governance practices;
- issued a timely and incisive report on board oversight of multiple funds;
- hosted a very successful spring workshop and fall conference; and
- conducted regular meetings of director "chapters" across the country.

When we take a step back from day-to-day concerns such as these, we can see that policymakers have been focusing on two broad national imperatives that bear directly on mutual funds.

The first is that investing is more important than ever – given the demographic pressures posed by the huge Baby Boom cohort, growing stress for the Social Security system, the reduced availability of defined benefit pension plans, and increasing health costs.

The second is that more Americans than ever are attentive to their financial goals. They want to invest, they want to invest smart, and they want to start early. Policymakers recognize the importance of this investor attitude – and its value.

In that context I want to talk to you about two important propositions.

One, how we can better inform investors – specifically, through far more use of the Internet.

Two, how we can better equip Americans to save for a secure retirement.

Using the Internet to Better Inform Investors

First, let me discuss the Internet, and its enormous potential to provide a breakthrough in communicating effectively with fund shareholders. The first panel session this morning will focus on this topic. It's a big one, and I'm sure I'll leave plenty of ground to cover.

Think about the changes the Internet has brought to bear in our society in a remarkably short period of time. Suddenly, we have a world of information at our disposal, in real time, anytime, and virtually anywhere.

And people aren't just going online to watch NCAA basketball or to check their bid for that classic Pet Rock selling on eBay.

More and more Americans are using the Internet as a prime source of financial information. So many investors are keeping track of share prices via the Internet that the New York Times has decided that next-day stock tables are old news. Last week, the Times announced it will no longer be running the full tables. Instead, it's going to bolster its website with more in-depth data.

As the Times business editor explained: "This recognizes the fact that the vast majority of readers now go online to get financial information because we can serve them better that way."

Certainly the government understands the Internet's value as a vehicle for distributing important financial information. If you work for the federal government – or like me, used to work for the federal government – you may know that the Federal Thrift Savings Plan, the defined contribution plan for federal employees, wants to deliver all quarterly account statements through its website. TSP participants who want to receive their quarterly statement in the mail must now affirmatively request the paper option; otherwise it will be delivered solely online.

The growing reach of the Internet cuts across all demographic lines.

That's especially true among mutual fund investors.

A comprehensive ICI survey last year demonstrates that mutual fund shareholders are very much "logged-on."

We found that nearly 90 percent of mutual fund investors have access to the Internet. About two-thirds of those with Internet access go online at least once a day.

Three quarters of fund investors who go online use the Internet to access their financial and investment accounts. Nearly 60 percent of fund investors who go online use the Internet to obtain investment information.

And our study shows that Internet use also has grown dramatically among all segments of investors – including seniors, those with a high school education or less, and those with household incomes of $50,000 or less.

So it's abundantly clear that the Internet has tremendous potential as a tool of investor information and education. The question is: How can we take the fullest advantage of it to improve the accessibility, utility and quality of the information we provide?

I believe a key benefit of the Internet is that it provides a means for dealing with the conflicting pressures that have continually afflicted fund disclosure. There is a constant push-pull between the need to make fund prospectuses understandable to the average investor – and the demands of detailed disclosure requirements that make most investors less likely to consult disclosure documents.

The dilemma we face is that the more disclosure that regulators mandate, the more difficult it is to make information easy to understand. On the other hand, the more we might try to make the information understandable, the more difficult it would be to include all of the detail that some market participants require.

As we think about the current disclosure system, one thing is clear: One size fits none.

The Internet offers a solution. It's called choice. Investors can get the information they need, in a form they are likely to use. And we can still provide more detailed information to those investors – or other marketplace participants – who want it.

That's one of the significant advantages the Internet offers over paper – we can allow different users to access and analyze the levels and types of data most useful to them. And we can do this without any net loss in the amount of information available. So we avoid the question of either-or, of less versus more. Thanks to the Internet, we can provide both less and more. We can inform millions of average investors more effectively, and put them in control.

But how do we get from here to there?

For a start, we can begin to move forward on providing investors with interactive data. SEC Chairman Christopher Cox has emphasized that this can help put investors "in the driver's seat." The Commission's initiative to advance eXtensible Business Reporting Language, or XBRL, is designed to accomplish this objective – facilitating automated search, retrieval and analysis of tagged data over the Internet.

To date, the SEC's XBRL initiative has focused principally on financial data. But when it comes to mutual fund disclosure, financial statements are not the source of information that is most useful to investors. To allow mutual fund investors to reap the benefits of XBRL, we need a custom-designed taxonomy that goes beyond financial data.

I'm pleased to announce today that the Institute is launching an initiative to develop that broader XBRL taxonomy for mutual fund disclosure. Building on the Commission's efforts, we hope to lay the groundwork for providing interactive mutual fund data that will serve the needs of investors and other interested parties, including the Commission itself. This is a substantial undertaking and we look forward to working with the SEC and a variety of interested groups to make it a reality.

In the meantime, we are encouraging ICI members to participate in the SEC's voluntary XBRL filing program.

XBRL represents an important step. But it must be part of a broader road map that will take us from paper-based disclosure to new and improved approaches.

There's a growing consensus that it's time to make the fullest use of the technology available so that investors have the information they need, all the information they want, in the format that makes it as valuable as possible for them. The Institute looks forward to working with the Commission and all stakeholders to achieve this goal.

Equipping Americans to Save

Effectively informing investors is an important part of a much larger picture – encouraging Americans to save for a secure retirement.

It is important to keep in mind that a secure retirement is the overwhelming savings goal of mutual fund shareholders. In fact, 72 percent of fund shareholders indicate saving for retirement is their primary financial goal.

It's easy to understand why. People are living longer in retirement. And many are getting less and less in the way of health coverage from their former employers. Meanwhile, health care costs are rising.

Retirees will rely on a number of sources for their retirement income: Social Security, employers' retirement plans and individual savings.

Each of these faces challenges.

Social Security faces the long-term challenge of 79 million Baby Boomers who reach 65 between 2011 and 2029.

Only about 60 percent of American workers are offered a chance at retirement plan coverage on the job. Some have retirement plan coverage but only in certain jobs, covering pieces of their careers. Many have plans available to them and do not participate. Many wish they had plans available, but do not.

Among retirement plans, there has been a shift from "defined benefit" pension plans to "defined contribution" plans. Today, defined benefit plans are offered to 22 percent of workers, compared to 53 percent who are offered defined contribution plans.

The growth of defined contribution plans – which include 401(k), 403(b) and 457 plans – has been phenomenal. They have enabled more than 60 million Americans to save more than $3 trillion.

Roughly half of that is invested in mutual funds. Our industry has played an important role in growing savings – taking advantage of scale to offer investors diversification, low costs, abundant information, liquidity, tax and accounting services, and professional asset management.

We also have a proud history of popularizing retirement savings tools. One of the most dramatic examples is the 401(k).

Like many important levers of progress, the modern 401(k) was somewhat of an accident. Originally, Congress intended something much smaller in scope. In 1978, when Congress added section 401(k) to the tax code, it was actually to resolve a longstanding dispute about whether executives could defer taxes on their profit-sharing bonuses.

But there's no holding back the power of a good idea. A number of ingenious individuals at companies, at mutual fund and other financial services firms, and at the IRS took a close look at the provision. They saw the opportunity for a breakthrough in retirement security. They realized it could be a mechanism to allow ordinary workers to save for retirement on a tax-deferred basis. Sometimes, but certainly not always, the unintended consequences are the best.

On November 10, 1981 – what some would call the birthday of the 401(k) – the IRS proposed regulations blessing the deferral of not just profit-sharing bonuses but also wages. Do you know what mutual fund assets were at the end of that year? $241 billion. Industry assets today are 37 times that amount, a compound annual growth rate of more than 16 percent.

Those IRS regulations were the start of something big. They opened the door to a new way to save and invest for retirement for everyday Americans.

But it took a lot of initiative and work to encourage employees to walk through that door. Over the 25 years since it was born, the modern 401(k) is the story of a successful

partnership between mutual fund companies and others in the financial services industry, employers, and the government.

Financial firms, particularly the mutual fund industry, helped employers become plan sponsors and educate their employees about 401(k) plans. We developed the necessary record-keeping systems and helped employers comply with the complex non-discrimination testing required by IRS rules. Financial firms even wrote "off the shelf" plan documents that could be tailored to individual business needs.

But most of all, the fund industry helped companies understand that offering a 401(k) gave employees access to professional asset management.

The past quarter-century has seen rapid growth in defined contribution plans, especially 401(k) plans.

Today, there are 47 million 401(k) plan participants, more than four times as many as there were two decades ago. Their plans hold assets worth more than $2 trillion, fifteen times the $144 billion two decades ago.

Looking back, 25 years ago, how many would have predicted this level of success?

Looking forward, we need to ask: How well will the 401(k) model meet participants' future retirement needs? What might 401(k) plans produce after a full career?

ICI has conducted research on this question, in collaboration with the Employee Benefit Research Institute. Our joint analysis, which takes into account actual worker behavior, makes it clear: under a wide range of projected scenarios workers can save enough through 401(k) plans over a full career to replace, in retirement, a significant portion of their pre-retirement income. Consider participants turning 65 between 2030 and 2039: for more than 60 percent, 401(k) accumulations are projected to replace more than half their salary.

Of course, defined contribution plans are not the whole picture. Social Security must be preserved. IRAs need to be improved as a savings vehicle, especially for individuals not covered at work. Our research indicates that simplification of eligibility rules could enhance participation.

And of course, we also need to encourage people to save outside of retirement plans and IRAs, through measures like the GROWTH Act.

Looking Forward

But I want to focus now on what can be done to strengthen the ability of Americans to build retirement security through 401(k) plans.

What changes are needed so that even more workers can be put on the path of a secure retirement? With Congress even now considering comprehensive pension reform legislation, our representatives have before them a series of fateful choices.

First, they should choose to broaden the saving population.

Many workers eligible for 401(k) plans do not take advantage of the opportunity. One of the best ways to get them onto the savings track would be automatic enrollment: unless the employee opts out, the employer would automatically enroll him or her at a designated contribution rate. The plan might also provide for a periodic increase in the contribution rate.

Research shows that automatic enrollment increases participation rates dramatically, particularly among lower-income workers. The EBRI/ICI model finds that automatic enrollment increases participation among all eligible workers from 66 percent to 92 percent. Among lower income workers, it more than doubles participation – from 42 percent to 91 percent.

Second, Congress should choose to facilitate good investment decisions.

Once employers automatically enroll their employees in the 401(k) plan, there must be a place to put the money. Employers need help in designating default investment options consistent with the savings horizon of their employees. In the current legal environment, many employers are only willing to use very conservative options as their plan's default.

We applaud the ongoing efforts of Congress and the Department of Labor to encourage the use of appropriate default investments.

Employees also need help making good investment decisions. Some employees want investment products to allow individuals to "set it and forget it." Our industry needs to continue to meet that challenge with innovative solutions.

In addition, many workers want and need access to professional advice, and are seeking access to it. Congress needs to modernize the rules regarding who may offer investment advice to workers in a 401(k) plan. With appropriate safeguards, we must widen the circle of financial intermediaries who can provide advice to plan participants.

Third, Congress should reject the notion of lowering savings incentives.

Most workers and savers would be surprised to know that rules on IRAs and defined contributions aren't permanent. The purpose of these provisions was to encourage workers to save more. Isn't that more important than ever?

In 2001, Congress increased contribution limits in both defined contribution plans and IRAs, and made a number of other important changes to the rules governing retirement savings vehicles. Making these changes permanent is crucial to people's ability to save for retirement. For example, if the 2001 legislation sunsets, the IRA limit falls back to $2,000. That would hurt workers across all income groups. And older workers will lose the opportunity to make catch-up contributions, the chance to make up for years when they found it hard to afford to invest in their future. The pension legislation under consideration now provides Congress with a unique opportunity to make these provisions permanent.

Conclusion

Retirement security is one of the most important issues on the national agenda.

Mutual funds are a powerful tool to address individual financial needs, including saving for retirement. Over the past 25 years, mutual fund investing has helped millions of working Americans save for the future. Through a continuing partnership with policymakers, our industry can help inform American investors even better and equip them to save even more effectively for a secure retirement.

Thank you for your attention and do enjoy the conference and beautiful Arizona! It's the home of some of the greatest treasures in America: the Grand Canyon, magnificent mountain ranges, extraordinary desert scenery – and, of course, spring training.

Arizona is also the home of some great leaders in Congress, including our guest today.

TESTIMONY
OF

SCOTT A. TAUB
ACTING CHIEF ACCOUNTANT
OFFICE OF THE CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
FOSTERING ACCURACY AND TRANSPARENCY IN FINANCIAL REPORTING

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MARCH 29, 2006

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

TESTIMONY OF

SCOTT A. TAUB, ACTING CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING

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IN FINANCIAL REPORTING

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services

U.S. House of Representatives

March 29, 2006

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission ("SEC" or "Commission") concerning the Commission's ongoing efforts to improve the transparency, accuracy and utility of financial disclosures. My name is Scott A. Taub and I am the Acting Chief Accountant for the SEC. With help from the approximately 55 others in my office, I serve as the primary adviser to the Commission on matters of accounting and auditing policy and the application of financial reporting and auditing standards.

Transparency in Financial Reporting

Although the past few years have seen unprecedented change in the financial reporting environment in this country, the SEC's goal in this area remains the same—to make public companies provide information that allows capital market participants to understand each company's operations, cash flow, and financial position and to make informed investment decisions. In order for that to occur, the information that is presented in financial reports must be clear and informative, or, as accountants use the term, "transparent." Transparent financial reporting is essential to informed investment

decisions by investors and lending decisions by creditors, and to other users of financial statements. It provides investors a comprehensible basis for decision making, and enables them to evaluate management's effectiveness and identify areas requiring further attention.

Recently, in accordance with the Sarbanes-Oxley Act,[1] my office and others at the SEC released a report that directly looked at the transparency of financial information.[2] The Off-Balance Sheet Report notes that achieving transparency in financial reporting depends on the efforts of many parties. Preparers of financial information must be committed to issuing financial reports to communicate with investors, rather than focusing solely on complying with rules and standards. The legal system must operate in a way that rewards and encourages the use of unbiased, professional judgment. Investors and other users of financial information must be willing to make an attempt to understand the information presented to them, rather than simply looking to one figure, such as earnings per share, to make investment decisions. And regulators must formulate a disclosure regime that requires the disclosure of necessary and appropriate information without overburdening preparers and investors.

Of course, financial reporting is also heavily reliant on the standards that govern the preparation of financial statements. These standards create the "language" of financial statements. In the United States, the body of accounting requirements has long been referred to as Generally Accepted Accounting Principles, or "GAAP."[3] While the SEC has the statutory authority to set GAAP to be used in reports of public companies, the Commission has, almost from its inception, looked to the private sector to take the lead in carrying out this responsibility. GAAP has been developed and revised gradually over the 70 years that the SEC has been in existence.

Over time, principles and standards have been developed to account for many types of transactions and situations. New transactions and changes in business have been followed by changes in GAAP in an attempt to ensure consistent and transparent

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[1] The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204.

[2] 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 at 99 (June 15, 2005) ("Off-Balance Sheet Report").

[3] Reference to GAAP herein is to U.S. GAAP.

reporting. Improvements in technology and computing power have brought new tools that can allow for different types of measurements and different presentation formats. All the while, many competing pressures have affected the way GAAP has developed. And although, individually, each step in the development of GAAP has been logical, the result is a large and complicated body of literature. I'd like to highlight a few of those pressures and provide some thoughts as to how they have increased the complexity of GAAP.

Causes of Financial Complexity

Over the years, there have been several groups that have set accounting standards, including the Financial Accounting Standards Board ("FASB"), the Emerging Issues Task Force, the SEC, and the American Institute of Certified Public Accountants. Each of these groups has looked at standard-setting in slightly different ways and with slightly different missions. At times, the standard-setters have concentrated on broad standards that seek to specify principles covering a large scope of transactions. At other times, the focus has been on prescribing the accounting for a particular new transaction or to stamp out perceived abuses of existing standards. As a result, we have standards that range from the broad to the specific, and in some areas inconsistent methods of accounting have evolved for transactions that are quite similar economically.

The proliferation of guidance, particularly guidance that covers specific transactions, has been fostered by the fear market participants have of being second guessed—by plaintiffs, by regulators, and by other gatekeepers. The desire of those involved in the reporting process to avoid being judged in hindsight has created a demand for detailed rules, bright lines and safe harbors. Those detailed rules, bright lines, and exceptions in the standards and in subsequent interpretations and rulings have often overwhelmed the basic principles that underlie many of the accounting standards. Rather than easing implementation and promoting greater consistency in reporting as intended, detailed rules and bright lines instead may reinforce a focus on blind adherence without due regard to the principles those rules are intended to support.

Another factor is the way markets look at financial information. For example, the market's focus on short term performance and its rewards for predictability and consistency have sometimes resulted in management aspiring to reduce volatility in the

income statement and to manage earnings. Management's desire to reduce volatility has led to exceptions from key principles in some pronouncements that may not in all cases reflect economic reality. Perceived abuses in terms of earnings management have led in some instances to standards that are prescriptive and are based on hard rules and bright lines, in order to limit the potential that earnings management can be accomplished within the rules. The way the rules are written and the resulting financial statements are used, of course, affects all companies that are trying to report transparent information to investors.

At present, GAAP has developed to include over 2,000 separate pronouncements issued in various forms by numerous bodies. A single accounting judgment can require reference to multiple accounting pronouncements, any one of which could itself be dozens, or in a few cases, hundreds of pages. The sometimes complex maze that is the U.S. financial reporting system reflects the intricacies of today's business transactions and the depth of our reporting system. It also manifests the diverse perspectives of participants in the markets—direct participants (*e.g.*, companies and investors), regulators, gatekeepers (*e.g.*, attorneys, accountants and auditors), and independent standard setters. Although those differing perspectives contribute to the depth and strength of the United States market in many ways, they also have, as I have described, contributed to some of the problems in the system, including its complexity.

Many now are concerned with the increase in costs and effort that this complexity has added to financial reporting, and contend that this complexity is a root cause of many restatements. Complex standards can also stand in the way of attempts by financial statement users to understand the effects of transactions and events. In addition, companies' application of detailed and complicated standards has sometimes been used to hide information from investors, rather than to disclose it. Not surprisingly, users of financial statements—including investors, creditors, regulators, and policymakers—are looking for more balanced, comparable and understandable financial reporting. And preparers and auditors are looking for standards that are easier to understand and implement. As a result, the SEC has been encouraging a major national effort to find ways to simplify financial reporting.

The Consequences of Complex Financial Reporting Requirements

The consequences of the intricacies of our financial reporting system affect all market participants. A complex financial reporting system may pose challenges for preparers seeking to determine the proper accounting for transactions and events. We have possibly seen some effects of that complexity in the increasing number of restatements of financial reports by public companies in the last few years that have followed the incorrect application of accounting standards.[4]

For auditors, complex standards can make it difficult to determine the evidence necessary to support management's conclusions. Both preparers and auditors have expressed increasing concerns over the high costs associated with using and understanding the current myriad of standards and rules—costs of training, costs of implementation and application, and costs of inadvertent misapplication of those standards and rules.

Users of financial statements may find it difficult to compare and contrast financial results of different entities because of the analytical complexity associated with determining whether or how exceptions to, or limitations on the application of, certain accounting standards apply to those entities. Such a reporting system may allow for substantially similar items to be accounted for differently and may permit multiple accounting treatments for some substantially similar transactions.

Another consequence of complex financial reporting requirements is that some companies may put the cart before the horse, i.e., structure transactions so that the accounting drives the transaction rather than the reverse. Bright lines and detailed rules in our existing financial reporting system may present an opportunity for management to structure transactions to produce financial reporting that reflects more positively on the company than the underlying transactions warrant.[5]

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[4] Companies with U.S.-listed securities filed 1,295 financial restatements in 2005, nearly double those filed in 2004. Glass Lewis & Co., Restatement Trend Alert (Mar. 2, 2006).

[5] See 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 at 99 (June 15, 2005) ("Off-Balance Sheet Report").

The current system is believed by many to have engendered a "check-the-box" approach to accounting, auditing, and reporting by preparers and auditors that reduces professional judgment and, for complex issues, necessitates the involvement of technical experts to ensure compliance. Many believe that a move to a more principles-based or objectives-oriented system is essential to create a less complex and more transparent system. The success of any such approach, however, is dependent on the ability and willingness of preparers, audit committees, boards, auditors, and others to exercise sound professional judgment in preparing and reviewing companies' financial reports that focus on effective communications with investors rather than treating financial reporting as merely a compliance exercise. Today, exceptions are overtaking many rules, and bright lines are eliminating judgment. This trend seems to be motivated in part by increasing fears of being second-guessed through litigation. A move to a more principles-based approach will require a different world view (or market view) than that currently in existence.

Current Initiatives

In the past few years there have been a number of major projects related to the future of accounting standards that have highlighted the need to reduce complexity. In addition to The Off-Balance Sheet Report, these projects include the FASB's 2002 Proposal on a Principles-Based Approach to U.S. Standard Setting and the SEC Staff's 2003 study of principles-based or objectives-oriented accounting standards[6] which was prepared pursuant to the Sarbanes-Oxley Act.

FASB Chairman Herz will no doubt testify about some of the efforts that the Board is currently undertaking to reduce complexity. For example, the FASB has been systematically readdressing specific accounting standards, including several that were identified in the staff's Off-Balance Sheet Report as needing improvement. More significant perhaps to making GAAP easier to apply is the FASB's effort to codify GAAP into a comprehensive and integrated collection of all existing accounting literature organized by subject matter. The FASB has also undertaken a major project to strengthen its existing conceptual framework in order to provide a more solid and

[6] 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 25, 2003).

consistent foundation for the development of objectives-oriented standards in the future. All of these efforts by the FASB should indeed yield significant dividends in terms of improved reporting and reduced complexity.

However, it is important that we do not simply look to the FASB to resolve the current problems of complexity. The complexity that has crept into our system is the cumulative product of pressure from different market constituencies. As such, we believe that concerted and coordinated action by all market participants is essential to the successful reduction in the complexities of our financial reporting structure. The effort will be a long one, but it is an effort worth making in order to ensure our capital markets remain strong and vibrant. Commission staff have been talking with many different parties about the need for such an effort, and we find widespread agreement among those in many different roles within the marketplace. We believe therefore that the time is right to encourage and foster a broad effort to address complexity, and we commend the Subcommittee for making transparency of financial reporting a subject of this hearing.

Using Interactive Data To Provide Investors More User-Friendly Financial Information

While improving the transparency of financial information remains a constant focus of the Commission and its staff, it is equally important to make sure that the information that is provided can be used effectively. The Commission and its staff therefore have been evaluating ways in which technology can be used to improve the use of reported information.

For most of its history, the Commission has required the filing of disclosure documents—first, in the form of paper reports; and beginning in the 1980s, in electronic form on EDGAR (Electronic Data Gathering, Analysis, and Retrieval system). Electronic filing represented a major step forward in terms of improving access to information, as it allows anyone with internet access to view the reports of any company in which he or she is interested. Until now, however, the data contained in those reports was quite static and although easier to retrieve than the old paper filing system, only marginally more user-friendly. Since the Commission transitioned to EDGAR, technological advances have occurred that provide tremendous tools for market participants in the reporting and use of financial data in the SEC's mandated disclosures.

Today, through the use of interactive data, we can see the possibility for information that is filed in electronic reports to come to life. By "tagging" each piece of data that currently resides on those forms, that data becomes portable and can be moved to wherever the user chooses to take it, together with any other data the user deems significant to the investment decision. From the perspective of a financial statement user, interactive data will be a giant step toward making the financial data more understandable, useful, and user-friendly. The best known and most advanced method for using interactive data in financial reporting is eXtensible Business Reporting Language ("XBRL").

What Is Interactive Data and XBRL?

With the advent of the Internet came the opportunity for the electronic exchange of data between businesses and the Internet. Extensible Markup Language ("XML") became the standard for that communication. XBRL, like Financial Information eXchange Markup Language ("FIXML") for transaction-specific data, and Market Data Definition Language ("MDDL) for exchanging market information regarding financial instruments, is an XML-based standard. It is designed specifically to communicate business and financial reporting information.

XBRL is an open electronic standard that provides a format for tagging financial information and allows users to extract, exchange, analyze and display financial information. XBRL was developed and continues to be supported by XBRL International, a collaborative consortium of approximately 400 organizations representing many elements of the financial reporting community, including preparers, public accounting firms, software companies, filing agents, data aggregators, stock exchanges, regulators, financial services companies, and industry associations.

The hallmark of the XML-based standards, including XBRL, is their interactive capacity. Instead of treating financial information as a block of text, as in a standard internet page or a printed document, XBRL uses unique identifying computer codes to "tag" different kinds of data in financial reports. For example, specific items in a financial statement, such as net income or total assets, can be tagged. Each piece of data then carries a broad range of information about itself, such as whether it is a monetary item, percentage or fraction; whether it is an asset, liability, expense, etc.; how it relates

to other pieces of data, and how it is calculated. Because every number in a report or financial statement is individually identified both qualitatively and quantitatively, that data can be viewed and used independently from the forms on which they appear. The "tagging" of the data turns financial reports that have previously been static into live, interactive documents that can be retrieved through computer searches in a real-time automated fashion.

Historical Uses of Interactive Data at the SEC

In 1984, the EDGAR pilot program required registrants to include tagged data in document headers to assist in accurately organizing filings. These tagged headers used Standard Generalized Markup Language ("SGML") to segregate data about the filing and the registrant from the underlying text. Later, the Commission required electronic filers to furnish Financial Data Schedules as exhibits to their filings containing financial statements. The Schedules required registrants to provide and tag a specified set of financial information essentially identical to certain items included in registrants' financial statements. Ultimately this requirement was eliminated due to issues over the reliability and usefulness of the data in the Financial Data Schedules.

The Commission's initiative with data tagging continued with the EDGAR modernization project in 1999 when the Commission began to accept filings submitted to EDGAR using HTML, a widely accepted standard for tagging data and text to present information on the Internet. In order to continue and expand on the benefits provided by tagged data, the EDGAR system changed document header tagging from SGML to XML in May 2000. Since then, the Commission has increased the use of XML for internal processing as well as for the document headers filed on EDGAR and beneficial ownership reports filed under section 16(a) of the Securities Exchange Act of 1934.

The acceptance of the XML family of languages as a standard, including XBRL, has resulted in greater reliability, functionality, and support, making widespread use of data tagging more feasible. As the Internet has gained acceptance in the last 20 years, society's expectations of the timeliness, accuracy, accessibility, and portability of data have shifted. The time therefore seems ripe for a review of the existing technological reporting framework.

The Benefits of Interactive Data

The potential long-term benefits of using interactive data include cost savings, more reliable and accurate data, and better access to data. From the Commission's internal operating perspective, interactive data could potentially eliminate the need for many of the different types of reports it now receives. Use of interactive data could help the SEC assemble, validate and review the reported data more efficiently and effectively than in the past.

For preparers of financial reports, interactive data could streamline and accelerate the collection and reporting of financial information to the SEC and the public. The use of interactive data and XBRL could create a more direct communication channel with investors and analysts because the data could be tagged directly by the company. Further down the road, the potential also exists for preparers and their boards of directors to use computer-tagged data for real-time operational information.

Consumers of data, including analysts and individual investors, would be able to access and use that data more easily and effectively. Under the current system, locating specific data may require a cumbersome search. This is because today's key word searches of text are based on the occurrences of certain words or phrases without any information about the context of those phrases. Searches for common terms in a financial report can return many results with varying relevance to the information the user is actually seeking.

Like the search for data, data comparison can be burdensome. Today, the process of evaluating the data contained in filings with the SEC typically begins with either the manual re-keying of the data or computer assisted translation from EDGAR filings into a more interactive format. The potential pitfalls of this system are many. The process may be inefficient and cumbersome and often is subject to human error. Judgment must be applied by the user to the data without the full insight of the company that prepared the data. And finally, it is costly, as the data must either be re-entered or purchased as data feeds in a computer readable format.

By contrast, the use of interactive data in Commission filings could provide real-time access to data in an instantly consumable format. The consumers of data can determine for themselves what data is important to them. Different types of analyses and

reports can be generated using varying subsets of the data with minimum effort and by viewing data in a variety of ways.

Current Initiatives

In recognition of the new advances in data tagging technologies, the potential benefits to preparers and consumers of the data, and the technological expectations of the market, the Commission has taken several steps toward assessing the potential use of XBRL.

On September 27, 2004, the Commission issued proposed rule amendments to allow registrants voluntarily to submit certain financial information in XBRL format as exhibits to their official filings and a companion concept release generally exploring the use of tagged data in Commission filings.[7] These releases sought public comment on the use and usefulness of tagging technologies in general, and specifically XBRL, including comments on the readiness of the technologies, the impact on participants in the financial reporting system, and the Commission's ability to collect and disseminate the data. Feedback on the proposed rule and companion concept release was generally supportive of the Commission's plan to explore the use of interactive data and XBRL.

On February 3, 2005 the Commission adopted final rule amendments establishing the XBRL Voluntary Program, with an effective date of March 16, 2005.[8] As established, under the XBRL Voluntary Program:

- preparers will have an opportunity to test the submission of XBRL documents and provide feedback to the Commission and others regarding the process;
- the investing community will have the opportunity to download XBRL documents and explore their use; and
- the SEC staff can experiment with various mechanisms to process, store, view, and analyze the XBRL-tagged information.

[7] XBRL Voluntary Financial Reporting Program on the Edgar System, Propose Rule Release No. 33-8496 (Sept. 27, 2004); Enhancing Commission Filings Through the Use of Tagged Data, Concept Release No. 33-8497 (Sept. 27, 2004). The summary of comments to the proposed rule can be viewed at http://www.sec.gov/rules/extra/s73504comsum.htm#P91_3018. Comments to the proposed rule and concept statement can be found at http://www.sec.gov/rules/proposed/s73504.shtml and http://www.sec.gov/rules/concept/s73604.shtml, respectively.

[8] XBRL Voluntary Financial Reporting Program on the Edgar System, Final Rule Release No. 33-8529 (Feb. 3, 2005).

To date, approximately a dozen companies have submitted filings under the voluntary program and the Commission is continuing efforts to explore the further use of interactive data and XBRL. The Commission staff is currently working to formalize a voluntary interactive data test group to better understand the issues associated with reporting in this new format. Participants in the test group commit to submit XBRL encoded reports for a period of at least one year and to share feedback about the process and the cost for reporting in XBRL. In exchange for participation in the test group, the Commission staff is offering expedited review of registration statements or annual reports.

Beginning in June and throughout the remainder of 2006, the Commission will host a series of roundtables focused on the implementation of interactive data and XBRL to help provide investors and analysts with better financial information about operating companies and investment companies.[9] Discussion at the roundtables will include assessing what investors and analysts are looking for in the new world of interactive data; how to accelerate the development and use of new software that permits the dissemination of interactive financial data; and how to best design the requirements for company disclosures to take maximum advantage of the potential of interactive data.

Mutual Funds

Given data-tagging technology's potential to improve the quality of disclosure for average investors and empower them to make better investment choices, the mutual fund arena—where over 90 million Americans have invested almost $10 trillion to finance their retirement, children's education, health care, and other basic needs— is an important place to explore the use of data tagging. The Commission's voluntary XBRL program is open to mutual funds and other investment companies.

Even more important for individual fund investors, we are exploring the power of data tagging, the Internet, and other technologies to help average investors sift through the wealth of non-financial mutual fund disclosure that is filed with the Commission and tailor the information to their needs. We are hopeful that technology will enable average investors to engage in better and timelier comparison shopping among mutual funds,

[9] Commission Announces Roundtable Series on Giving Investors and Analysts Better Financial Data via Internet, Press Release No. 2006-34 (Mar. 9, 2006).

based on investment objectives, costs, performance, risks, and other factors. To that end, the Commission staff has been exploring data tagging with participants in the fund industry and with analysts and other end users of both financial and non-financial fund information. Together, tagging of mutual fund information and Internet availability of that information have the potential to provide mutual fund investors with more personalized information and analysis about their fund choices.

Conclusion

Projects that reduce the complexity in financial reporting and make financial information more user-friendly through interactive data have the long-term potential to benefit investors and companies alike. The Commission, FASB and PCAOB, however, cannot fulfill that potential without the assistance of, and input from, investors, members of managements and audit committees, accountants, lawyers, analysts and the other participants in the American securities markets. We, of course, also will value highly the views of Congress and other regulators and standards setters.

On behalf of the Commission, thank you for holding this hearing and highlighting these significant issues in such a timely manner. I would be happy to answer any questions.

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