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:

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.

* * *

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.*

3/06

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.

[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 "<u>a consequence of scope exceptions is increased complexity and the need for more rules</u>" (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

[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.

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

(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.

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 6

"Truth in Testimony" Disclosure Form

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee **on Financial** Services require the disclosure of the following information. A copy of this form should **be attached** to your written testimony.

1. Name: Robert H. Herz

2. Organization or organizations you are representing:
Financial Accounting Standards Board

3. Business Address and telephone number:
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
(203) 956-5267

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2004 related to the subject on which you have been invited to testify?

☐ Yes ☒ No

5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2004 related to the subject on which you have been invited to testify?

☐ Yes ☒ No

6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:
Robert Herz

Please attach a copy of this form to your written testimony.