Testimony of Robert H. Herz
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Before the Subcommittee on Commerce, Trade and Consumer Protection
of the Committee on Energy and Commerce
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Full Text of Testimony

Chairman Stearns, Ranking Member Schakowsky, and the Members of the Subcommittee, thank you for the invitation to appear today to review with you the actions and activities of the Financial Accounting Standards Board's ("FASB" or "Board") since the bankruptcies of Enron Corp. ("Enron") and WorldCom, Inc. ("WorldCom"). I have brief prepared remarks, and I would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

***The FASB*[1]**

The FASB is an independent private-sector organization. We are not part of the federal government. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the capital markets and the United States ("US") economy because investors and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[2] is fundamental to our mission because our work is technical in nature, designed to provide investors and the capital markets with the most accurate possible ruler to measure and report upon the underlying economic transactions of business enterprises. Like investors, Congress and other policy makers need an independent FASB and, thus, an accurately designed ruler, to obtain the financial information necessary to properly assess and implement the public policies they favor.

[1] See Attachment 1 for information about the Financial Accounting Standards Board.
[2] See Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109.

While bending the ruler to favor a particular outcome may seem attractive to some in the short run, in the long run a bent ruler (or a biased accounting standard) is harmful to investors, the capital markets, and the economy.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For almost thirty years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC, together with the private-sector Financial Accounting Foundation ("FAF"),[3] maintains active oversight of the FASB's activities.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public enterprises, ultimately with the SEC.

Events of the Past Year

Clearly, the events of the past year, including the high-profile bankruptcies of Enron Corp. ("Enron") and WorldCom, Inc. ("WorldCom"), have shaken confidence in our reporting system and in our capital markets. While most of the problems seem to stem from outright violations of rules and fraud by greedy and unscrupulous executives, apparent audit and corporate governance failures, structuring of sham transactions by

[3] See Attachment 1 for information about the Financial Accounting Foundation.

investment bankers, and research analysts' conflicts, those problems also have prompted broader questions about virtually every aspect of our financial reporting system, including financial accounting and reporting standards and accounting standard setting.

I think those questions are appropriate and are healthy, and, quite frankly, I think they were overdue. As with crises in other areas of business or life, this crisis prompts reflection, introspection, a better understanding, and then rebuilding, change, and renewal. So it must be with our financial reporting system.

Throughout my own career as an accountant, I have believed passionately in the importance of accounting and good financial reporting to the overall soundness of our capital markets. Thus, I think a major lesson and an indelible reminder from this crisis is that sound financial reporting is indeed very key to the health and vitality of our capital markets, our economy, and to society as a whole. It matters!

Reporting is a bit like the air we breathe—as long as it's clean, we kind of take it for granted. But reporting that is bad, misleading, and fraudulent is like dirty air. It pollutes and clouds—it threatens the health of all those around it and makes people want to stay away from the polluted area.

So, while I certainly applaud the many market, structural, and legal reforms that are under way, I am convinced that lasting change and improvement will only come if *all* of us who have a role in the reporting system and in the capital markets rededicate ourselves to the basic proposition that sound, honest, and transparent financial accounting and reporting really matters. Just like the air, it is a public good and we must be committed to keeping it clean.

We also must regard financial reporting as an exercise in good communication—good communication about performance, financial condition, prospects, and uncertainties—and not as, on one hand, an exercise in mere compliance and, on the other hand, an opportunity to spin or to paint a far too pretty picture that is more flattering and appealing than the underlying reality.

Financial reporting as an exercise in good communication also means reporting that meets the needs of investors and other key users of financial statements, that is operational, and that faithfully reflects the underlying business and economic realities. It means reporting that satisfies the key qualitative characteristics described in the FASB's Conceptual Framework—relevance, reliability, neutrality, timeliness, and understandability. And, finally in an era of continuing globalization of business and capital markets, I think financial reporting as an exercise in good communication means reporting that is comparable across borders.

FASB Activities

All of us in the financial accounting and reporting supply chain have a vital role to play. So, what are we at the FASB doing to fulfill our mission and to play our important role in helping improve financial reporting and restore investor confidence? The answer is many things—in regard to specific technical areas, in terms of our own operations, and in terms of the whole structure and direction of accounting standard setting in this country.

Technical Activities[4]

On the technical front, over a year ago before the bankruptcies of Enron and WorldCom, the FASB had a number of important projects under way relating, for example, to the application of the purchase method of accounting, accounting for restructuring costs, reporting on financial performance, improving disclosures about the fair value of financial instruments, and developing new disclosures about intangibles. While some of those projects now have been completed and others continue, we have also significantly modified our agenda and priorities in direct response to issues that have come to light since the Enron and WorldCom bankruptcies. These issues include the accounting for special-purpose entities ("SPEs"), guarantees, distinguishing between liabilities and equity, energy trading contracts, stock-based compensation, and the broad area of revenue recognition. Let me touch briefly on each of those items.

SPEs[5]

This issue of the accounting for SPEs was very much brought into the spotlight through the Enron debacle. While, as we all know, Enron violated the so-called 3 percent rule and, therefore, did not comply with the existing accounting requirements for SPEs, the whole episode clearly called into question the appropriateness of that rule (which, by the way, did not come from an FASB standard but rather was contained in an SEC staff

[4] See Attachment 2 for a listing and information about the FASB's technical plan and activities.
[5] See Attachment 2 for information about the project on Consolidation of Variable Interest Entities (formerly know as Consolidation of SPEs).

discussion in a Q&A supplement to an issue of the FASB's Emerging Issues Task Force Issue ["EITF"]).[6]

We completed our public deliberations on this issue and issued new requirements in January 2003.[7] The subject was a challenging one, for SPEs cover a wide variety of structures and arrangements ranging from those used and controlled by a single sponsor in order to obtain off-balance-sheet financing (in the extreme version the Enron-like structures that allegedly involved sham or dummy corporations set up for the sole purpose of shifting assets and financing off the books and for self-dealing) to large multiparty vehicles created to diversify risks and issue market-based securities to a variety of interested investors. And, in between those extremes we found SPEs that are used for a variety of securitizations, leases, and other purposes. Thus, you can understand that developing a single, consistent model for when those entities should be consolidated by someone else was challenging. However, we believe the new requirements reflect a workable model under which enterprises with investments or other relationships with an SPE would carefully need to assess their involvement in order to determine whether, in our words, they are the "primary beneficiary" of that SPE and, therefore, would need to consolidate it.

[6] See Emerging Issues Task Force Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions;" see Attachment 1 for information about the EITF, see Attachment 3 for a listing of current members of the EITF.
[7] See FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (January 2003); see Attachment 4 for News Release, "FASB Issues Guidance to Improve Financial Reporting for SPEs, Off-Balance Sheet Structures and Similar Entities" (January 17, 2003); see Attachment 5 for Jackie Spinner, "FASB Tightens Rules on Special Purpose Entities," WashingtonPost.com (January 17, 2003); and Deepa Babington, "Tougher Rules on Enron-Type Deals Approved," Reuters (January 15, 2003).

The approach sets out a framework for making those assessments, and although judgment is required, we expect that by using this model, many, but certainly not all, of the SPEs that currently are not consolidated by anyone would in the future be consolidated. The new requirements also significantly improve the disclosures related to the use of, and involvement with, SPEs.

Guarantees

Closely related to the issue of the accounting for SPEs was an issue relating to the existence of differing practices surrounding the accounting and disclosure (or lack thereof) by enterprises, like Enron, that guarantee the debt and other obligations of SPEs or other enterprises.

We completed our public deliberations on this issue last fall and issued new requirements in November 2002.[8] The new requirements provide that all enterprises recognize a liability at fair value for the obligations they undertake when issuing a guarantee and that those enterprises make additional disclosures.

We believe the new requirements will result in a more representationally faithful depiction of enterprises' liabilities and improved transparency of enterprises' obligations and liquidity risks related to the guarantees they issue.

Liabilities and Equity[9]

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[8] See FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (November 2002); see Attachment 4 for News Release, "FASB Issues Accounting Guidance to Improve Disclosure Requirements for Guarantees" (November 25, 2002); see Attachment 5 for Jackie Spinner, "Rules on Guarantees Tightened, Accounting Board Requires Companies to Report Use," WashingtonPost.com (November 26, 2002).
[9] See Attachment 2 for information about the project on Liabilities and Equity.

It is our understanding that Enron, like many other enterprises, entered into complex financial instruments, some of which embodied obligations that must or could be settled by issuing a variable number of shares of stock. Although in substance some of those instruments were debt obligations, Enron allegedly classified and reported those instruments as equity. The result was that Enron's financial reports allegedly contained a smaller amount of debt than in reality actually existed. Moreover, because an instrument classified as equity receives a different reporting treatment than an instrument classified as debt, Enron was allegedly able to avoid reporting economic losses on those instruments.

The Board has nearly completed its deliberations on certain aspects of this issue and plans to issue new requirements by the end of this month. The new requirements will provide that certain financial instruments shall be classified and accounted for as a liability consistent with their economic substance. The Board believes that the new requirements will result in financial reports that are more representationally faithful. Also because the financial reports will present a more complete and accurate depiction of an enterprise's liabilities and equity, they will assist users of those reports in assessing the future cash flows and equity share issuances of that enterprise.

Energy Trading Contracts

Existing accounting requirements permitted Enron and certain other energy enterprises to report gains on certain energy trading contracts on a gross (rather than a net) basis.[10] This practice resulted in some enterprises reporting a significantly greater amount of revenues than entities with a similar volume of transactions. In addition, it is our understanding that Enron and certain other energy enterprises used a form of mark-to-market ("MTM") accounting for certain long-dated energy trading contracts that resulted in the recognition of gains at the date the contracts were entered into. Those gains were allegedly reported, and net income inflated, even when there were no quoted market prices or other current market transactions supporting the amount of gain recognized. In October 2002, the EITF and FASB staff addressed those practices.[11]

The EITF decided to preclude MTM accounting for certain energy trading contracts. The EITF also decided to require that gains on certain energy trading contracts be shown net (rather than gross) in the financial reports. At the same time, the FASB staff observed that no enterprise, including energy trading enterprises, should recognize an upfront gain at the inception of entering into certain financial contracts, including certain energy trading contracts, unless the fair value of those contracts are obtained from a quoted market price in an active market or are otherwise evidenced by observable market transactions or data. The Board believes that the EITF consensus and the FASB staff observation will improve the transparency of the reporting of certain financial and energy trading contracts.

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[10] See EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities."
[11] See EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities."

The Board also has a current project on its agenda to improve the existing accounting requirements for measuring and disclosing the fair value of essentially all financial instruments.[12] That project will provide additional guidance on how to measure instruments whose fair value cannot be easily measured by quoted market prices or current market transactions with similar terms and counterparties.

Stock-Based Compensation[13]

In 2001, our international counterpart, the International Accounting Standards Board ("IASB") took up the subject of the accounting for stock-based compensation. It needed to do so, not only because of the growing use of equity-based compensation in other parts of the world, but also because there was no existing literature in the international standards on this topic.

After a year of thorough deliberations by the IASB, like the FASB almost 10 years ago, it proposed that the appropriate accounting for stock options is to measure compensation for the fair value of the options at the date granted and to recognize the cost over the period the option vests.[14] And, also like the FASB, the IASB proposed that the best way to measure the fair value at grant date is to use established option-pricing models and then make certain adjustments for the unique features of employee stock options. However, the IASB's particular set of adjustments and allocation methods are somewhat different from those under the preferable fair value approach developed by the FASB.

[12] See Attachment 2 for information about the project on Disclosures about Fair Value.
[13] See Attachment 2 for information about the other technical activities on Share-Based Payments.
[14] See IASB Proposed IFRS, *Share-based Payment* (November 2002); see FASB Statement No. 123, *Accounting for Stock-Based Compensation* (October 1995).

There also are some other potentially important differences between the IASB's proposal and the FASB's approach. Nevertheless, the fundamental conclusions are the same.

Over the past year in the wake of the Enron and WorldCom bankruptcies, the FASB has received numerous requests that we mandate expense treatment for all stock-based compensation. Initially, most of those requests came from individual investors, institutional investors, and analysts as well as certain Members of Congress. We also have received requests from some of the more than 170 enterprises that in recent months have announced their intention to switch to the preferable fair value approach.[15] Some of those enterprises also have requested that the FASB change or supplement the transition requirements under the existing standard, whereby enterprises voluntarily adopting the preferable fair value approach must do so prospectively; that is, only for new grants of options. Those enterprises indicated that they do not like the "ramp up" effect that the existing standard would have had on their reported compensation expense and, thus, the dampening effect it would have had on the trend of their earnings over the next few years. As you can imagine, we also have received many letters and other input from those that oppose mandatory expense recognition. And, we have received suggestions about improved valuation techniques and expanded disclosures.

Our objectives on this issue are simple—to come up with sound accounting and informative disclosures and, hopefully, do it in a way that achieves international convergence in this important area. As a first step, we have tried to deal with the transition issue in rapid fashion. To that end, in December 2002, we issued a new standard that allows enterprises that are voluntarily changing to the preferable fair value approach to effect the change as currently required, on a prospective basis only for new stock options granted, and only if the enterprises make the switch before the end of 2003, or to make the change for all unvested stock options outstanding, or to restate all periods presented.[16] However, the new standard also recognizes that by allowing choices in transition methods, we also are potentially creating some comparability concerns. Therefore, the new standard also requires clearer and more prominent disclosures about the cost of employee stock-based compensation and the related pro forma effects on reported earnings and earnings per share. The requirements also increase the frequency of key disclosures from annually to quarterly.

Our next step will be to consider whether we should further change the US requirements relating to the accounting for employee stock-based compensation, including whether we should mandate the fair value approach for all stock-based compensation. Again, if we are to make such a change, we would like to do so in a way that achieves as much international convergence as possible. Therefore, as the IASB released its exposure draft in November 2002 on this subject, we issued an Invitation to Comment that explains in

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[15] See Pat McConnell, Janet Pegg, and Dane Mott, "Companies That Currently Expense or Intend to Expense Stock Options Using the Fair Value Method*,"* Bear Stearns (February 21, 2003).
[16] See FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure* (December 2002); see Attachment 4 for News Release, "FASB Amends Transition Guidance for Stock Options and Provides Improved Disclosures" (December 31, 2002).

detail the similarities and differences between the IASB proposal and the fair value approach under existing US standards and that solicits comments on those differences.[17] We also have been taking this opportunity to gather input on potential ways to improve the consistency of the valuation of stock options and, as some have suggested, on whether there are additional disclosures that might be particularly informative.

Based on the comment letters received in response to the Invitation to Comment and other input we are gathering, we plan to soon be in a position to deliberate and decide, at a public meeting, whether the Board should add a project to its agenda to pursue further improvements to the accounting and reporting standards for stock-based, including whether we should mandate the preferable fair value approach.

Any decisions on changes to the accounting and reporting requirements for stock-based compensation would be subject to the FASB's open and thorough due process procedures, which include public meetings and the issuance of a proposal for public comment. Moreover, prior to making any final decisions on any new requirements, the FASB would consider, at public meetings, all of the input received in response to a proposal. The Board would not issue any new requirements until it has carefully considered the views of all constituents.

Other major national standards setters around the world are going through a similar exercise on this whole subject, so that hopefully we can at some point in the future decide

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[17] See FASB Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123,* Accounting for Stock-Based Compensation, *and Its Related Interpretations, and IASB Proposed IFRS,* Share-based Payment (November 2002); see Attachment 4 for News Release, "FASB Issues Invitation to Comment That Compares IASB's and FASB's Accounting for Stock-Based Compensation" (November 18, 2002).

on a common approach. But, again, the overriding goal is not just international convergence but sound accounting and informative disclosure.

For the FASB, it is not, on the one hand, about arguments that expensing stock options would have negative impacts on capital formation or employee ownership of enterprises and, on the other hand, about forcing enterprises to expense stock options in order to promote better corporate governance and curb abuses of excessive executive compensation. Consistent with our overall public policy and mission, it simply is about getting to the right accounting that best reflects the underlying economics of the transaction.

Revenue Recognition

Revenue recognition is an area of continuing financial accounting and reporting problems and regular SEC enforcement actions. The existing accounting requirements, of which there are plenty, can be found in a variety of sources emanating from a number of different bodies. That guidance has been developed, to a large degree, in an ad hoc fashion over the last 40 years. There is FASB literature, there are EITF consensuses, and there are Statements of Position and Industry Accounting and Auditing Guides issued by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants ("AcSEC"). There are also SEC Staff Accounting Bulletins and SEC Staff Announcements. It is no wonder, therefore, that there are a variety of different and sometimes apparently inconsistent models for recognizing revenue.

As a short-term solution to some of the recurring issues in this area, the EITF issued new requirements in November 2002 relating to revenue arrangements with multiple deliverables.[18] Those requirements should improve the comparability and transparency of the reporting of revenue arising from the delivery or performance of multiple products, services, or rights to use assets. Examples of these common, but previously inconsistently accounted for, transactions include the sale of a cellular telephone with the related telephone service, or the sale of medical equipment with related installation service.

As a longer-term solution, we have added to the FASB's agenda a major project addressing this whole area.[19] Our overall objective is to develop, jointly with the IASB, a coherent, conceptually consistent model for revenue recognition that would replace much of the existing literature and that would serve as a principles-based source for developing future accounting guidance as new types of transactions emerge in the marketplace. We are attacking the subject from both a top-down approach of trying to develop a conceptually consistent set of principles and a bottom-up approach through cataloguing, comparing, and contrasting all the many different current methods for revenue recognition.

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[18] See EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables."

[19] See Attachment 2 for information about the project on Revenue Recognition; see Attachment 4 for News Release, "FASB Adds Revenue Recognition Project to Its Agenda" (May 20, 2002).

Operational and Structural Activities

Before joining the FASB, I spoke with many, many constituents, current and former FASB members and senior staff, the FAF Trustees, members of our Financial Accounting Standards Advisory Council, many Members of Congress, officials at the US General Accounting Office, the US Department of the Treasury, the Federal Reserve System, the SEC and other regulators, and many others familiar with the FASB and financial reporting to discuss their views on the subject of accounting standards and accounting standard setting. As you can imagine, there were a variety of perspectives and, in some cases, significant differences in views. For example, many in the corporate community feel that the FASB has not been sufficiently responsive to their concerns about disclosure overload, operationality and cost-benefit, and particular accounting approaches that, in their view, do not properly reflect the operating realities of their enterprises.

Users and some Members of Congress, however, seem to feel the opposite. Rightly or wrongly, they feel that the FASB and the SEC have been overly accommodative to the corporate community and have permitted too many exceptions in standards and rules and too much flexibility that have enabled off-balance-sheet financing, inadequate disclosure, and form over substance transactions to proliferate. Implicit in those beliefs is a view that standard setters have been too focused on the views and needs of preparers and auditors and must be more attune to the needs of investors and other users of financial information.

On the positive side, just about everyone I spoke with agrees that the FASB should be independent. But some Members of Congress and some users emphasize that independence more in terms of freedom from undue influence from the corporate and audit communities. Others, including many users and Members of Congress, are fearful that the FASB might effectively become an arm of the federal government and subject to all the attendant political pressures. In that regard, I think that the Act strikes an appropriate balance. While providing for mandatory funding of the FASB, it also clearly emphasizes that such funding is not intended to federalize the organization or to put it in a position that would subject it to political pressures, including improper influence or control by the SEC. Time will tell whether that balance is achieved in practice.

Most people seem to believe that international convergence of accounting standards across the major capital markets of the world is a highly desirable goal, and many also support a move toward a more principles-based system. They feel that our standards have become too complex and too detailed with too many rules emanating from too many bodies. However, many I spoke with are considerably skeptical about whether a principles-based approach could work in this country. Finally, many were critical that the FASB has been too slow in identifying and dealing with emerging problem areas. They stress that the FASB, as the independent and primary accounting standard setter in this country, needs to take more responsibility and control of the overall situation.

In order to address these issues, challenges, and opportunities, in July 2002, we launched a series of wide-ranging reviews covering such matters as our approach to standard setting, including our agenda setting and project management processes and whether developing a more principles-based approach to standard setting would help reduce the level of detail and complexity in US standards; evaluating what we can do to more actively foster international convergence; seeking ways to increase the level of investor and key user involvement in all our activities; and addressing other internal organizational issues relating to human resources, internal processes, and constituent relations. Moreover, as part of those reviews we considered whether modifications in the current structure of US accounting standard setting, including the roles, composition, and processes of the EITF and the AcSEC, would improve the overall quality and effectiveness of the system. While the Board and our senior staff have been spearheading these reviews, we have been actively seeking advice from a variety of other parties.

In January 2003, we presented a comprehensive report of our findings and recommendations to the FAF Trustees. We already have begun implementing certain improvements to internal processes as they were identified. Also recommendations related to broader matters such as implementing a principles-based approach or significantly changing the structure of US standard setting are continuing to be discussed with the FAF Trustees and key constituents, including the SEC.

Some of the key aspects of our review, findings, and recommendations relate to improving our speed and timeliness, increasing the involvement of investors and other users in our activities, the topic of a principles-based accounting system, and international convergence, and how all of these things impact the structure and direction of US accounting standard setting.

Improving Speed and Timeliness

With regards to improving speed and timeliness, the FAF Trustees took an important step last year and approved a change in our voting requirements. Our Rules of Procedure now require only a four to three vote of the Board, rather than the previous five to two vote to issue both proposals and final standards.[20]

Additionally, last year we implemented a reorganization of our senior staff to enhance the focus and accountability of our staff activities. Among other actions, this involved splitting the responsibilities of the single Director of Research and Technical Activities into three different roles, with one director focusing on major Board projects, another focusing on the EITF and other implementation activities, and a third focusing on internal processes, human resources, and special projects.

Moreover, we are conducting a thorough process mapping of all our procedures in order to identify and to hopefully eliminate those that are redundant or do not add value, while at the same time not compromising our thorough and open due process. One of our Board members has been actively involved with this effort with the assistance of an outside process-reengineering consultant.

In addition, FASB weekly public meetings are now much longer than in the past—we are addressing more subjects and larger chunks of subjects at each meeting. We strongly believe that by spending more time together as a Board, we will increase both the

[20] See Attachment 4 for News Release, "Financial Accounting Foundation Changes Financial Accounting Standards Board's Voting to Increase Efficiency" (April 24, 2002).

efficiency and the effectiveness of our work. In addition, our many meetings with constituent groups are now focused more closely on the identification of emerging problem areas and trends.

Increasing Involvement of Users in the FASB's Activities

While the Board has always received significant and valuable input from preparers, auditors, and regulators, over the years we have heard considerably less from investors and users of financial reports about their needs and views. Therefore, in order to obtain more active user involvement, in February 2003, we established the User Advisory Council ("UAC").[21] The UAC includes representatives from mutual fund groups, the major investment and commercial banks, rating agencies, and other groups that represent investors and other key users.[22] We held our first public meeting of the UAC on February 13, 2003. We are pleased about the quality and quantity of input we received at that meeting. We intend to continue to use the UAC as a source of input on FASB agenda decisions and on specific issues within ongoing FASB projects.

We are aware that with all the emphasis on public enterprises, we also need to make sure we are properly focusing on other important constituencies, including private enterprises and not-for-profit entities, and have dedicated staff resources to those particular areas.

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[21] See Attachment 4 for News Release, "FASB Establishes User Advisory Council and Plans First Council Meeting on February 13" (February 6, 2003).
[22] See Attachment 6 for a listing of members of the User Advisory Council.

Principles-Based Standards[23]

Many have expressed concerns that accounting standards have become too detailed and too complex. Some say it has become increasingly difficult for both preparers and auditors to stay current in order to comply with an ever-expanding set of rules. Further, there are concerns that this detail and complexity has fostered a "check the box" mentality and has encouraged financial and accounting engineering to structure transactions around the rules to attain form over substance results. And, we have been told that many of our existing accounting standards include numerous exceptions, including exceptions to accommodate the concerns of particular constituents, exceptions intended to limit the volatility in reported income, and exceptions to mitigate the effects of transitioning to new accounting standards. Many of those criticisms are valid. Let us also remember, however, that the standards we currently have are largely a product of what constituents have asked for over the last 10 to 15 years in the context of the overall financial reporting, capital markets, regulatory and legal systems in this country and that those standards and rules emanated not only from the FASB but also from the EITF, the AcSEC, and the SEC.

Over the years, constituents have argued that their particular "special" circumstances require exceptions to the standards, and enterprises and auditors, fearful of second-guessing by the SEC and the trial bar, have sought bright-lines, clarity, and detailed implementation rules. Accordingly, any attempt to address those criticisms by moving to

[23] See Attachment 2 for information about the other technical activities on Simplification and Codification.

more principles-based accounting standards not only must address how the FASB might accomplish this but also must address the wider issues in the system.

As previously noted, our series of reviews at the FASB have specifically included the subject of principles-based accounting standards, and the Act requires that the SEC evaluate the feasibility of implementing such an approach in the US.[24] Therefore, we have been working closely with the SEC staff in this area, and in October 2002 we issued for public comment a proposal on this whole subject.[25] In December 2002, we held a public roundtable meeting with respondents to discuss various aspects of the proposal.

The proposal seeks to better define what we mean by principles-based standards, including the format, style, content, and level of detail in the standards, and whether we need some form of an overriding standard similar to what is included in the international literature, which is intended to guide the preparation and presentation of financial reports.

While I think that some have tended to exaggerate the differences between what they see as the US rules-based approach and the more general or principles-based approach in other parts of the world, I also feel that there are some real differences. To me it is a matter of where you start, where you stop, and what is your home base.

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[24] See Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Section 108(d).
[25] See FASB Proposal, *Principles-Based Approach to U.S. Standard Setting* (October 21, 2002); see Attachment 4 for News Release, "FASB Issues Proposal for a Principles-Based Approach to U.S. Accounting Standard Setting" (October 21, 2002); see Attachment 5 for Floyd Norris, "New Set of Rules in the Works for Accounting," *The New York Times* (October 22, 2002).

Under a principles-based approach, one starts by laying out the key objectives of good reporting in the particular subject area and then provides guidance explaining the objective and relating it to some common examples. While rules are sometimes unavoidable, the intent is not to try to provide specific guidance or rules for every possible situation. Rather, if in doubt, the reader is directed back to the principles. And there are few, if any, exceptions to the principles.

The proposal also touches on the implications of moving to a principles-based approach on the role, approach, and processes of the EITF and the AcSEC and on the FASB's own implementation activities. Finally and very importantly, it examines the implications for the behavior and actions of other parties in the financial reporting system, because successful implementation of a principles-based approach would require some major changes in ingrained behavior by virtually all constituents.

In short, the proposal requires preparers, auditors, audit committees, and boards to be willing to exercise professional judgment and to resist the urge to seek specific answers to and rulings on every implementation issue and to view accounting and reporting as an exercise in good communication and not just compliance. It also requires investment bankers and the accountants and lawyers that work with them to stop trying to invent ways to create products and structures to loophole standards, and it also necessitates that the SEC staff temper demands for bright lines to facilitate their review and enforcement activities. Finally, it also would likely require some changes to the legal and litigation framework surrounding financial reporting and auditing.

Having been an auditor both in the US and in the United Kingdom and a standard setter both in the US and at the IASB, I believe that there are many potential advantages to a more principles-based approach if properly implemented, including:

- Allowing (some might say forcing enterprises and auditors) to exercise professional judgment thereby enhancing professionalism in both the reporting and auditing of financial statements;

- Having accounting standards that are easier to understand and that focus more on economic substance;

- Reducing the opportunities for form over substance structuring and arbitraging of rules because there would be fewer exceptions to the principles and fewer potentially conflicting rules;

- Helping avoid the potential double jeopardy that preparers and auditors could face in situations where compliance with detailed rules may not be sufficient to avoid enforcement and litigation if the substance is lacking; and

- Making it easier to converge with the IASB standards and other major national standards that already use more of the principles-based approach.

On the flip side, however, there are some important potential disadvantages. Many point to Enron, WorldCom, and recent events in the US and say that enterprises and auditors cannot be trusted to properly exercise professional judgments. Others express concerns that comparability could be reduced both because different good-faith judgments about the appropriate accounting treatment can occur on similar facts and because the generality of standards leaves more room for different interpretations by preparers and accommodations by auditors. And, it may be harder to properly enforce a principles-based system. It also would likely require more disclosures in financial reports explaining how an enterprise implemented the particular principles.

In the end, I believe whether or not implementing a more principles-based system is worth the effort will depend on whether it results in financial reporting that is more useful, more understandable, and more trustworthy to investors and other users. I personally favor such an approach, but I do not discount the hurdles in properly implementing it in this country.

In the coming weeks, we plan to discuss at public Board meetings the input received in response to the proposal and decide what additional actions, if any, the FASB should pursue in this area. We also plan to continue to work closely with the SEC as it responds to the Act's requirement to study and report on the potential adoption by the US of a principles-based accounting system.

International Convergence[26]

A more principles-based approach could help in the drive for international convergence between the US and other parts of the world. Clearly, the growth of cross-border investing and capital flows and a growing endorsement of international standards in many parts of the world mean that, on the one hand, the US cannot go it alone in terms of development of accounting standards and, on the other hand, the development of international standards across the major capital markets of the world requires that the US be a very active participant in the process, for there can be no truly international accounting standards if the largest capital market in the world, the US, is not part of their development. Accordingly, we have been dedicating significant resources at various levels to this effort, including developing procedures and protocols used not only by the FASB but also by the IASB and other major national standards setters in working together. In addition, we are working with the IASB on several major joint projects, including, as mentioned earlier, revenue recognition, business combinations, and reporting on financial performance. We also are closely monitoring the progress of the IASB on other key projects.

In October 2002, we reached agreed with the IASB to use our best-efforts to align our agendas and, very importantly, to undertake a specific project (with the help and support of the SEC staff) aimed at accelerating the convergence process by trying to eliminate or narrow some of the areas of difference between existing US and international standards.[27] Because there are literally hundreds of differences between US and international standards, realistically, this effort will still be ongoing, well beyond 2005 when Europe adopts international standards en masse. But we need to set this process in motion now, so we can make achieve greater progress in this important area going forward.

For the FASB, this is a major area of activity that is logistically challenging and that necessitates increases in both our staff and monetary resources, but we need to do it. I

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[26] See Attachment 2 for information about the project on International Convergence.

[27] See Attachment 4 for News Release, "FASB and IASB Agree to Work Together toward Convergence of Global Accounting Standards" (October 29, 2002); and SEC Press Release, "Actions by FASB, IASB Praised" (October 29, 2002).

think the trick is to do it in a way that does not significantly delay or dilute our efforts to improve US standards and that, by working with our international colleagues, results in better standards that can be applied both here and across the major capital markets of the world. And, while most people seem to support international convergence, we all recognize that it will not be easy to achieve because by definition it will involve choices between existing standards; and thus, changes to both US and international standards are inevitable.

Improving the Structure of US Accounting Standard Setting

As indicated earlier, many of our constituents are concerned not only with the volume and complexity of US standards, but also with rules coming from many different bodies. Indeed, it is true that over the past 25 or so years we have had something of a four-legged stool in this country in terms of accounting standard setting.

There has been the FASB as the primary standard setter. There also has been the AcSEC as a senior standard setter. And although the AcSEC was tasked generally with addressing particular industry matters, it also from time to time got into developing standards on much broader topics.

There is also the EITF to address emerging issues and areas in which there appears to be differences in particular interpretations in practice. And, of course, there is always the SEC.

In addition, the standards and rules that make up the US literature have been promulgated in a variety of different forms—FASB Statements, FASB Interpretations, FASB

Technical Bulletins, FASB staff announcements and implementation guides, Accounting Principles Board Opinions, and Accounting Research Bulletins; the AcSEC Statements of Position and Industry Audit and Accounting Guides; EITF consensuses; SEC Staff Accounting Bulletins, Accounting Series Releases, Financial Reporting Releases, and SEC staff speeches and announcements.

In looking at this issue, we believe that many of the concerns about the existing accounting standard-setting structure are valid. We also believe that the FASB, as the primary accounting standard setter, needs to take greater responsibility for addressing this whole situation and, as needed, realigning the structure of US standard setting.

We believe that structural changes are necessary to better control the proliferation and consistency of standards and rules and, in line with the movement toward international convergence, to ensure that as new US standards are developed they do not unnecessarily create new areas of divergence between US standards and international standards. Moreover, if we were to go to a more principles-based approach, it would be important that the work of any other bodies be consistent with that approach and not undermine it.

To their credit, about a year ago the SEC staff indicated that they would try to forbear as much as possible from setting standards either through speeches or staff announcements and even wherever possible via formal accounting releases.

So what have we at the FASB done? First, while we are very appreciative of the valuable contributions by the AcSEC over the years, we have concluded that its role as a second senior-level accounting standard setter should, after a transition period of approximately one year, be discontinued.[28] We also concluded that, in the future, the maintenance and development of any industry-based standards should reside with the FASB.

So, while the American Institute of Certified Public Accountants may choose to continue to issue industry accounting and auditing guides by way of implementation guidance, it will cease issuing Statements of Position that create new accounting standards. Like the AcSEC, we would fully expect to actively use the work of properly constituted industry-based task forces to assist us in our standard-setting efforts.

With regard to the EITF, we believe it continues to serve a very valuable function in helping surface and resolve emerging and troublesome practice issues. But we also think more direct involvement by the FASB in the EITF's agenda, in the course of its deliberations, and in ratifying its final consensuses is in order.[29]

Thus, beginning with the January 2003 EITF Agenda Committee meeting, two FASB Board members became Agenda Committee members. Board members also will more actively participate at all EITF meetings.

In addition, all future EITF consensuses would be subject to FASB Board ratification. In this way, we believe we can continue to obtain the benefits from the EITF while at the same time making sure that its activities and conclusions are consistent with those of the FASB. Finally, we have recently broadened the composition of the EITF to include a user representative to ensure that the user perspective is properly considered in the EITF's deliberations.

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[28] See Attachment 2 for information about the changes to the AICPA Accounting Standards Executive Committee.

Conclusion

The above is a brief summary of some of our many actions and activities at the FASB post-Enron and WorldCom. These actions and activities are designed to better meet the challenges and opportunities that face us and that face the financial reporting system. I hope you will agree that it is not business as usual at the FASB and that we are on the right track.

On the technical front, we have been dealing with some of the problem areas that have been highlighted in the recent scandals, such as SPEs, guarantees, liabilities and equity, energy trading contacts, stock-based compensation, and revenue recognition, while at the same time trying to move the ball forward in terms of the future of financial reporting in such areas as reporting on financial performance and disclosures about intangibles.

We also are working hard to improve the speed, timeliness, and overall effectiveness of our own operations, we are proactively working to bring about international convergence, and together with the SEC we are exploring the feasibility of a more principles-based approach. And, in line with all this, we are revamping the accounting standard-setting structure in this country.

If I had to summarize what we are doing, I think it is all about three things—improvement, simplification, and international convergence. Those are the strategic imperatives that are driving our agenda and that will shape our future standards and, hopefully, the future of US financial reporting.

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[29] See Attachment 2 for information about the changes to the EITF.

The overriding goal must be improvement of the overall financial accounting and reporting system in this country. That is what it is all about—sound, transparent, unbiased information that the system needs to work effectively. All of us who are players in the system must rededicate ourselves to that proposition. We must work together toward that objective, and we must rise above short-term self-interests and recognize that some old ways of doing things need to change. I know that many Members of Congress and the investing public are demanding that we and others take bold and decisive actions, the capital markets expect it, and I believe that our country deserves nothing less.

Thank you again, Mr. Chairman, Ranking Member Schakowsky, and all of the Members of the Subcommittee. I very much appreciate your continuing interest in, and support of, the mission and activities of the FASB.

I would be happy to respond to any questions.