TESTIMONY OF

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BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT

SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

AT A HEARING ON

FOSTERING ACCURACY AND TRANSPARENCY

IN FINANCIAL REPORTING

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

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

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

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

The Complexity Conundrum

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

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

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

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

Four Potential Solutions To Reducing Complexity

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

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

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

1. Conceptual Framework Must Take Priority

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

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

Function of the Conceptual Framework

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

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

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

Example of Complexity: Fair Market Values that are Neither “Fair” nor “Market”

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

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

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

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

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

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

Practicability, Understandability, and Auditability Count

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

Standards that are overly complex or involve imputation of entity specific numbers which the proposed FASB standard requires to be characterized as "fair values" can only severely stress the system when it comes to auditability. Active and continuous consultation with preparers, auditors, and users of financial statements, as well as the SEC and PCAOB on the matter of auditability of proposed standards under development is key, since the SEC and PCAOB ultimately investigate and take enforcement actions against what they may view as fraudulent financial reporting.

2. The Role of the Regulators

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

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

Importantly, we also note the Chamber's report on SEC Enforcement considered the issue of accounting complexity and second-guessing many times throughout the report. Although the Chamber's report is directed at the SEC, we believe this substantiates the point I made earlier, that the standard setters should not ignore issues of auditability, nor should they ignore a "reasonableness" test of how their standards will be understood and applied in the real world by preparers and users of financial statements.

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

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

<u>"Accuracy" Means Reasonable Not Absolute Assurance</u>

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

<u>3. The Litigious Environment</u>

The need to assure auditability of accounting standards is important not only to the auditors that sign audit opinions, and CEOs and CFOs that certify the financial statements, but also to the board members that sign the Annual Report or 10-K. A major force in their concern is due to the tremendous threat of liability in today's litigious environment.

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

Congress Needs To Stem The Tide Of Litigation

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

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

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

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

Conclusion

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

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

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

financial executives international

March 14, 2006

Mr. Robert H. Herz, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856

Dear Bob:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") is writing to request that the Board re-expose the proposed standard on *Fair Value Measurements* for public comment. FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is the financial reporting technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

CCR responded to the Staff Draft on November 16, 2005, to explain our significant concerns with the application of a marketplace participants ("MP") approach to fair value – a concept that we believe has the potential to assign values to nonfinancial assets and liabilities that do not faithfully represent the economics of the underlying transactions. Those concerns do not appear to have been addressed in the Board's subsequent deliberations. We also are concerned about how constituents should apply the fair value measurement guidance in the subsequent accounting in circumstances in which the MP approach gives rise to higher fair values (consistent with highest and best use) than existing valuation methods.

CCR also observes that the composition of the levels in the hierarchy have changed multiple times over the course of Board's redeliberations and that the principle of the highest and best use of an asset described in paragraphs 11, 12, and 31 in the Staff Draft is very different than the valuation premise described in paragraphs 13, B6, and B7 of the June 2004 ED. While we understand that this was discussed at a public meeting, we do not think that there was sufficient due process performed to obtain views of constituents on this very significant change.

During our liaison call on February 27th, members of CCR's FASB subcommittee were asked for views on the establishment of a valuation resource group to assist with implementation of the fair value measurements standard. While this appears responsive, in part, to some of the concerns expressed above, we believe that such activities should be performed before the standard is finalized. This would obviate subsequent amendments to the new standard and would avoid the circumstance of companies having to revise their initial application of the guidance in light of subsequent interpretations by such a group.

Given the uncertainties and concerns expressed above and the fact that the IASB is continuing to work through similar issues on its own version of the standard, we believe that it is in the best interests of all constituents for the Board to issue a revised exposure draft of the proposed standard on Fair Value Measurements. We appreciate the opportunity to express our views on this matter.

Sincerely,

Lawrence J. Salva

Lawrence J. Salva
Chair, Committee on Corporate Reporting
Financial Executives International

cc: Robert J. DeSantis, FAF President