TESTIMONY OF

SCOTT A. TAUB, ACTING CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING

FOSTERING ACCURACY AND TRANSPARENCY IN FINANCIAL REPORTING

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

Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission ("SEC" or "Commission") concerning the Commission's ongoing efforts to improve the transparency, accuracy and utility of financial disclosures. My name is Scott A. Taub and I am the Acting Chief Accountant for the SEC. With help from the approximately 55 others in my office, I serve as the primary adviser to the Commission on matters of accounting and auditing policy and the application of financial reporting and auditing standards.

Transparency in Financial Reporting

Although the past few years have seen unprecedented change in the financial reporting environment in this country, the SEC's goal in this area remains the same—to make public companies provide information that allows capital market participants to understand each company's operations, cash flow, and financial position and to make informed investment decisions. In order for that to occur, the information that is presented in financial reports must be clear and informative, or, as accountants use the term, "transparent." Transparent financial reporting is essential to informed investment decisions by investors and lending decisions by creditors, and to other users of financial statements. It provides investors a comprehensible basis for decision making, and enables them to evaluate management's effectiveness and identify areas requiring further attention.

Recently, in accordance with the Sarbanes-Oxley Act,[1] my office and others at the SEC released a report that directly looked at the transparency of financial information.[2] The Off-Balance Sheet Report notes that achieving transparency in financial reporting depends on the efforts of many parties. Preparers of financial information must be committed to issuing financial reports to communicate with investors, rather than focusing solely on complying with rules and standards. The legal system must operate in a way that rewards and encourages the use of unbiased, professional judgment. Investors and other users of financial information must be willing to make an attempt to understand the information presented to them, rather than simply looking to one figure, such as earnings per share, to make investment decisions. And regulators must formulate a disclosure regime that requires the disclosure of necessary and appropriate information without overburdening preparers and investors.

Of course, financial reporting is also heavily reliant on the standards that govern the preparation of financial statements. These standards create the "language" of financial statements. In the United States, the body of accounting requirements has long been referred to as Generally Accepted Accounting Principles, or "GAAP."[3] While the SEC has the statutory authority to set GAAP to be used in reports of public companies, the Commission has, almost from its inception, looked to the private sector to take the lead in carrying out this responsibility. GAAP has been developed and revised gradually over the 70 years that the SEC has been in existence.

Over time, principles and standards have been developed to account for many types of transactions and situations. New transactions and changes in business have been followed by changes in GAAP in an attempt to ensure consistent and transparent

[1] The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204.

[2] Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers at 99 (June 15, 2005) ("Off-Balance Sheet Report").

[3] Reference to GAAP herein is to U.S. GAAP.

reporting. Improvements in technology and computing power have brought new tools that can allow for different types of measurements and different presentation formats. All the while, many competing pressures have affected the way GAAP has developed. And although, individually, each step in the development of GAAP has been logical, the result is a large and complicated body of literature. I'd like to highlight a few of those pressures and provide some thoughts as to how they have increased the complexity of GAAP.

Causes of Financial Complexity

Over the years, there have been several groups that have set accounting standards, including the Financial Accounting Standards Board ("FASB"), the Emerging Issues Task Force, the SEC, and the American Institute of Certified Public Accountants. Each of these groups has looked at standard-setting in slightly different ways and with slightly different missions. At times, the standard-setters have concentrated on broad standards that seek to specify principles covering a large scope of transactions. At other times, the focus has been on prescribing the accounting for a particular new transaction or to stamp out perceived abuses of existing standards. As a result, we have standards that range from the broad to the specific, and in some areas inconsistent methods of accounting have evolved for transactions that are quite similar economically.

The proliferation of guidance, particularly guidance that covers specific transactions, has been fostered by the fear market participants have of being second guessed—by plaintiffs, by regulators, and by other gatekeepers. The desire of those involved in the reporting process to avoid being judged in hindsight has created a demand for detailed rules, bright lines and safe harbors. Those detailed rules, bright lines, and exceptions in the standards and in subsequent interpretations and rulings have often overwhelmed the basic principles that underlie many of the accounting standards. Rather than easing implementation and promoting greater consistency in reporting as intended, detailed rules and bright lines instead may reinforce a focus on blind adherence without due regard to the principles those rules are intended to support.

Another factor is the way markets look at financial information. For example, the market's focus on short term performance and its rewards for predictability and consistency have sometimes resulted in management aspiring to reduce volatility in the income statement and to manage earnings. Management's desire to reduce volatility has led to exceptions from key principles in some pronouncements that may not in all cases reflect economic reality. Perceived abuses in terms of earnings management have led in some instances to standards that are prescriptive and are based on hard rules and bright lines, in order to limit the potential that earnings management can be accomplished within the rules. The way the rules are written and the resulting financial statements are used, of course, affects all companies that are trying to report transparent information to investors.

At present, GAAP has developed to include over 2,000 separate pronouncements issued in various forms by numerous bodies. A single accounting judgment can require reference to multiple accounting pronouncements, any one of which could itself be dozens, or in a few cases, hundreds of pages. The sometimes complex maze that is the U.S. financial reporting system reflects the intricacies of today's business transactions and the depth of our reporting system. It also manifests the diverse perspectives of participants in the markets—direct participants (*e.g.*, companies and investors), regulators, gatekeepers (*e.g.*, attorneys, accountants and auditors), and independent standard setters. Although those differing perspectives contribute to the depth and strength of the United States market in many ways, they also have, as I have described, contributed to some of the problems in the system, including its complexity.

Many now are concerned with the increase in costs and effort that this complexity has added to financial reporting, and contend that this complexity is a root cause of many restatements. Complex standards can also stand in the way of attempts by financial statement users to understand the effects of transactions and events. In addition, companies' application of detailed and complicated standards has sometimes been used to hide information from investors, rather than to disclose it. Not surprisingly, users of financial statements—including investors, creditors, regulators, and policymakers—are looking for more balanced, comparable and understandable financial reporting. And preparers and auditors are looking for standards that are easier to understand and implement. As a result, the SEC has been encouraging a major national effort to find ways to simplify financial reporting.

The Consequences of Complex Financial Reporting Requirements

The consequences of the intricacies of our financial reporting system affect all market participants. A complex financial reporting system may pose challenges for preparers seeking to determine the proper accounting for transactions and events. We have possibly seen some effects of that complexity in the increasing number of restatements of financial reports by public companies in the last few years that have followed the incorrect application of accounting standards.[4]

For auditors, complex standards can make it difficult to determine the evidence necessary to support management's conclusions. Both preparers and auditors have expressed increasing concerns over the high costs associated with using and understanding the current myriad of standards and rules—costs of training, costs of implementation and application, and costs of inadvertent misapplication of those standards and rules.

Users of financial statements may find it difficult to compare and contrast financial results of different entities because of the analytical complexity associated with determining whether or how exceptions to, or limitations on the application of, certain accounting standards apply to those entities. Such a reporting system may allow for substantially similar items to be accounted for differently and may permit multiple accounting treatments for some substantially similar transactions.

Another consequence of complex financial reporting requirements is that some companies may put the cart before the horse, i.e., structure transactions so that the accounting drives the transaction rather than the reverse. Bright lines and detailed rules in our existing financial reporting system may present an opportunity for management to structure transactions to produce financial reporting that reflects more positively on the company than the underlying transactions warrant.[5]

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[4] Companies with U.S.-listed securities filed 1,295 financial restatements in 2005, nearly double those filed in 2004. Glass Lewis & Co., Restatement Trend Alert (Mar. 2, 2006).

[5] See Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers at 99 (June 15, 2005) ("Off-Balance Sheet Report").

The current system is believed by many to have engendered a "check-the-box" approach to accounting, auditing, and reporting by preparers and auditors that reduces professional judgment and, for complex issues, necessitates the involvement of technical experts to ensure compliance. Many believe that a move to a more principles-based or objectives-oriented system is essential to create a less complex and more transparent system. The success of any such approach, however, is dependent on the ability and willingness of preparers, audit committees, boards, auditors, and others to exercise sound professional judgment in preparing and reviewing companies' financial reports that focus on effective communications with investors rather than treating financial reporting as merely a compliance exercise. Today, exceptions are overtaking many rules, and bright lines are eliminating judgment. This trend seems to be motivated in part by increasing fears of being second-guessed through litigation. A move to a more principles-based approach will require a different world view (or market view) than that currently in existence.

Current Initiatives

In the past few years there have been a number of major projects related to the future of accounting standards that have highlighted the need to reduce complexity. In addition to The Off-Balance Sheet Report, these projects include the FASB's 2002 Proposal on a Principles-Based Approach to U.S. Standard Setting and the SEC Staff's 2003 study of principles-based or objectives-oriented accounting standards[6] which was prepared pursuant to the Sarbanes-Oxley Act.

FASB Chairman Herz will no doubt testify about some of the efforts that the Board is currently undertaking to reduce complexity. For example, the FASB has been systematically readdressing specific accounting standards, including several that were identified in the staff's Off-Balance Sheet Report as needing improvement. More significant perhaps to making GAAP easier to apply is the FASB's effort to codify GAAP into a comprehensive and integrated collection of all existing accounting literature organized by subject matter. The FASB has also undertaken a major project to strengthen its existing conceptual framework in order to provide a more solid and

[6] Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (July 25, 2003).

consistent foundation for the development of objectives-oriented standards in the future. All of these efforts by the FASB should indeed yield significant dividends in terms of improved reporting and reduced complexity.

However, it is important that we do not simply look to the FASB to resolve the current problems of complexity. The complexity that has crept into our system is the cumulative product of pressure from different market constituencies. As such, we believe that concerted and coordinated action by all market participants is essential to the successful reduction in the complexities of our financial reporting structure. The effort will be a long one, but it is an effort worth making in order to ensure our capital markets remain strong and vibrant. Commission staff have been talking with many different parties about the need for such an effort, and we find widespread agreement among those in many different roles within the marketplace. We believe therefore that the time is right to encourage and foster a broad effort to address complexity, and we commend the Subcommittee for making transparency of financial reporting a subject of this hearing.

Using Interactive Data To Provide Investors More User-Friendly Financial Information

While improving the transparency of financial information remains a constant focus of the Commission and its staff, it is equally important to make sure that the information that is provided can be used effectively. The Commission and its staff therefore have been evaluating ways in which technology can be used to improve the use of reported information.

For most of its history, the Commission has required the filing of disclosure documents—first, in the form of paper reports; and beginning in the 1980s, in electronic form on EDGAR (Electronic Data Gathering, Analysis, and Retrieval system). Electronic filing represented a major step forward in terms of improving access to information, as it allows anyone with internet access to view the reports of any company in which he or she is interested. Until now, however, the data contained in those reports was quite static and although easier to retrieve than the old paper filing system, only marginally more user-friendly. Since the Commission transitioned to EDGAR, technological advances have occurred that provide tremendous tools for market participants in the reporting and use of financial data in the SEC's mandated disclosures.

Today, through the use of interactive data, we can see the possibility for information that is filed in electronic reports to come to life. By "tagging" each piece of data that currently resides on those forms, that data becomes portable and can be moved to wherever the user chooses to take it, together with any other data the user deems significant to the investment decision. From the perspective of a financial statement user, interactive data will be a giant step toward making the financial data more understandable, useful, and user-friendly. The best known and most advanced method for using interactive data in financial reporting is eXtensible Business Reporting Language ("XBRL").

What Is Interactive Data and XBRL?

With the advent of the Internet came the opportunity for the electronic exchange of data between businesses and the Internet. Extensible Markup Language ("XML") became the standard for that communication. XBRL, like Financial Information eXchange Markup Language ("FIXML") for transaction-specific data, and Market Data Definition Language ("MDDL) for exchanging market information regarding financial instruments, is an XML-based standard. It is designed specifically to communicate business and financial reporting information.

XBRL is an open electronic standard that provides a format for tagging financial information and allows users to extract, exchange, analyze and display financial information. XBRL was developed and continues to be supported by XBRL International, a collaborative consortium of approximately 400 organizations representing many elements of the financial reporting community, including preparers, public accounting firms, software companies, filing agents, data aggregators, stock exchanges, regulators, financial services companies, and industry associations.

The hallmark of the XML-based standards, including XBRL, is their interactive capacity. Instead of treating financial information as a block of text, as in a standard internet page or a printed document, XBRL uses unique identifying computer codes to "tag" different kinds of data in financial reports. For example, specific items in a financial statement, such as net income or total assets, can be tagged. Each piece of data then carries a broad range of information about itself, such as whether it is a monetary item, percentage or fraction; whether it is an asset, liability, expense, etc.; how it relates to other pieces of data, and how it is calculated. Because every number in a report or financial statement is individually identified both qualitatively and quantitatively, that data can be viewed and used independently from the forms on which they appear. The “tagging” of the data turns financial reports that have previously been static into live, interactive documents that can be retrieved through computer searches in a real-time automated fashion.

<u>Historical Uses of Interactive Data at the SEC</u>

In 1984, the EDGAR pilot program required registrants to include tagged data in document headers to assist in accurately organizing filings. These tagged headers used Standard Generalized Markup Language (“SGML”) to segregate data about the filing and the registrant from the underlying text. Later, the Commission required electronic filers to furnish Financial Data Schedules as exhibits to their filings containing financial statements. The Schedules required registrants to provide and tag a specified set of financial information essentially identical to certain items included in registrants' financial statements. Ultimately this requirement was eliminated due to issues over the reliability and usefulness of the data in the Financial Data Schedules.

The Commission’s initiative with data tagging continued with the EDGAR modernization project in 1999 when the Commission began to accept filings submitted to EDGAR using HTML, a widely accepted standard for tagging data and text to present information on the Internet. In order to continue and expand on the benefits provided by tagged data, the EDGAR system changed document header tagging from SGML to XML in May 2000. Since then, the Commission has increased the use of XML for internal processing as well as for the document headers filed on EDGAR and beneficial ownership reports filed under section 16(a) of the Securities Exchange Act of 1934.

The acceptance of the XML family of languages as a standard, including XBRL, has resulted in greater reliability, functionality, and support, making widespread use of data tagging more feasible. As the Internet has gained acceptance in the last 20 years, society’s expectations of the timeliness, accuracy, accessibility, and portability of data have shifted. The time therefore seems ripe for a review of the existing technological reporting framework.

The Benefits of Interactive Data

The potential long-term benefits of using interactive data include cost savings, more reliable and accurate data, and better access to data. From the Commission's internal operating perspective, interactive data could potentially eliminate the need for many of the different types of reports it now receives. Use of interactive data could help the SEC assemble, validate and review the reported data more efficiently and effectively than in the past.

For preparers of financial reports, interactive data could streamline and accelerate the collection and reporting of financial information to the SEC and the public. The use of interactive data and XBRL could create a more direct communication channel with investors and analysts because the data could be tagged directly by the company. Further down the road, the potential also exists for preparers and their boards of directors to use computer-tagged data for real-time operational information.

Consumers of data, including analysts and individual investors, would be able to access and use that data more easily and effectively. Under the current system, locating specific data may require a cumbersome search. This is because today's key word searches of text are based on the occurrences of certain words or phrases without any information about the context of those phrases. Searches for common terms in a financial report can return many results with varying relevance to the information the user is actually seeking.

Like the search for data, data comparison can be burdensome. Today, the process of evaluating the data contained in filings with the SEC typically begins with either the manual re-keying of the data or computer assisted translation from EDGAR filings into a more interactive format. The potential pitfalls of this system are many. The process may be inefficient and cumbersome and often is subject to human error. Judgment must be applied by the user to the data without the full insight of the company that prepared the data. And finally, it is costly, as the data must either be re-entered or purchased as data feeds in a computer readable format.

By contrast, the use of interactive data in Commission filings could provide real-time access to data in an instantly consumable format. The consumers of data can determine for themselves what data is important to them. Different types of analyses and reports can be generated using varying subsets of the data with minimum effort and by viewing data in a variety of ways.

Current Initiatives

In recognition of the new advances in data tagging technologies, the potential benefits to preparers and consumers of the data, and the technological expectations of the market, the Commission has taken several steps toward assessing the potential use of XBRL.

On September 27, 2004, the Commission issued proposed rule amendments to allow registrants voluntarily to submit certain financial information in XBRL format as exhibits to their official filings and a companion concept release generally exploring the use of tagged data in Commission filings.[7] These releases sought public comment on the use and usefulness of tagging technologies in general, and specifically XBRL, including comments on the readiness of the technologies, the impact on participants in the financial reporting system, and the Commission's ability to collect and disseminate the data. Feedback on the proposed rule and companion concept release was generally supportive of the Commission's plan to explore the use of interactive data and XBRL.

On February 3, 2005 the Commission adopted final rule amendments establishing the XBRL Voluntary Program, with an effective date of March 16, 2005.[8] As established, under the XBRL Voluntary Program:

- preparers will have an opportunity to test the submission of XBRL documents and provide feedback to the Commission and others regarding the process;
- the investing community will have the opportunity to download XBRL documents and explore their use; and
- the SEC staff can experiment with various mechanisms to process, store, view, and analyze the XBRL-tagged information.

[7] XBRL Voluntary Financial Reporting Program on the Edgar System, Propose Rule Release No. 33-8496 (Sept. 27, 2004); Enhancing Commission Filings Through the Use of Tagged Data, Concept Release No. 33-8497 (Sept. 27, 2004). The summary of comments to the proposed rule can be viewed at http://www.sec.gov/rules/extra/s73504comsum.htm#P91_3018. Comments to the proposed rule and concept statement can be found at http://www.sec.gov/rules/proposed/s73504.shtml and http://www.sec.gov/rules/concept/s73604.shtml, respectively.

[8] XBRL Voluntary Financial Reporting Program on the Edgar System, Final Rule Release No. 33-8529 (Feb. 3, 2005).

To date, approximately a dozen companies have submitted filings under the voluntary program and the Commission is continuing efforts to explore the further use of interactive data and XBRL. The Commission staff is currently working to formalize a voluntary interactive data test group to better understand the issues associated with reporting in this new format. Participants in the test group commit to submit XBRL encoded reports for a period of at least one year and to share feedback about the process and the cost for reporting in XBRL. In exchange for participation in the test group, the Commission staff is offering expedited review of registration statements or annual reports.

Beginning in June and throughout the remainder of 2006, the Commission will host a series of roundtables focused on the implementation of interactive data and XBRL to help provide investors and analysts with better financial information about operating companies and investment companies.[9] Discussion at the roundtables will include assessing what investors and analysts are looking for in the new world of interactive data; how to accelerate the development and use of new software that permits the dissemination of interactive financial data; and how to best design the requirements for company disclosures to take maximum advantage of the potential of interactive data.

Mutual Funds

Given data-tagging technology's potential to improve the quality of disclosure for average investors and empower them to make better investment choices, the mutual fund arena—where over 90 million Americans have invested almost $10 trillion to finance their retirement, children's education, health care, and other basic needs— is an important place to explore the use of data tagging. The Commission's voluntary XBRL program is open to mutual funds and other investment companies.

Even more important for individual fund investors, we are exploring the power of data tagging, the Internet, and other technologies to help average investors sift through the wealth of non-financial mutual fund disclosure that is filed with the Commission and tailor the information to their needs. We are hopeful that technology will enable average investors to engage in better and timelier comparison shopping among mutual funds,

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[9] Commission Announces Roundtable Series on Giving Investors and Analysts Better Financial Data via Internet, Press Release No. 2006-34 (Mar. 9, 2006).

based on investment objectives, costs, performance, risks, and other factors. To that end, the Commission staff has been exploring data tagging with participants in the fund industry and with analysts and other end users of both financial and non-financial fund information. Together, tagging of mutual fund information and Internet availability of that information have the potential to provide mutual fund investors with more personalized information and analysis about their fund choices.

Conclusion

Projects that reduce the complexity in financial reporting and make financial information more user-friendly through interactive data have the long-term potential to benefit investors and companies alike. The Commission, FASB and PCAOB, however, cannot fulfill that potential without the assistance of, and input from, investors, members of managements and audit committees, accountants, lawyers, analysts and the other participants in the American securities markets. We, of course, also will value highly the views of Congress and other regulators and standards setters.

On behalf of the Commission, thank you for holding this hearing and highlighting these significant issues in such a timely manner. I would be happy to answer any questions.