TESTIMONY OF

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THE ROLES OF THE SEC AND THE FASB IN ESTABLISHING GAAP

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

I am pleased to appear before you on behalf of the Securities and Exchange Commission to testify concerning the roles of the Securities and Exchange Commission and the Financial Accounting Standards Board in establishing generally accepted accounting principles, and questions that have arisen with respect to the relevancy of generally accepted accounting principles in today's business environment.

I know that all of the Members of this Subcommittee have worked diligently over the past few months, and I would like to commend the leadership shown by you, Mr. Chairman, and Ranking Member Kanjorski, as well as Chairman Oxley and Ranking Member LaFalce of the full Committee, in exploring these important issues and working to maintain investor confidence. The recent House action on H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, was a significant achievement, and this Committee should be commended for the informative hearings and debate leading up to the bill's passage by the House of Representatives. I would also like to add that the SEC has appreciated the opportunity to work with you and your staffs, and we look forward to continuing that cooperation.

Recent events and press articles have raised questions about the transparency of the accounting and disclosure practices of some companies. More specifically, the announcement of the need to restate and subsequent implosion of Enron, the indictment of Arthur Andersen, the bankruptcy of Global Crossing and other recent SEC enforcement actions, among other events, have shaken investors' confidence in the quality of the financial information they are receiving and on which they are basing their investment decisions.[1]

While our financial reporting system in the U.S. continues to be the best in the world, certain aspects of the system can and should be improved. In particular, the Commission believes that the process for setting financial accounting standards must be enhanced so that changes to accounting standards can be implemented more quickly, be more responsive to market changes, and provide more transparent information to investors.

The SEC has a unique position in the financial reporting process. The Commission not only has authority under the securities laws of the United States to set accounting standards to be followed by public companies but also the power to enforce those standards. Practically since its inception, the Commission has looked to the private sector for leadership in establishing and improving the accounting methods used to prepare financial statements.[2] The body currently performing that function is the Financial Accounting Standards Board, or the FASB. As a result, the FASB has the power to set, but not enforce, accounting standards to be used by public companies. With this context in mind, I would like to share with the Subcommittee the SEC's insights into the standard-setting process and the needed reforms to continue to support our capital markets.

[1] Any information relating to ongoing investigations is nonpublic and accordingly my statement will be confined to the public record.
[2] See Accounting Series Release (ASR) No. 4 (April 1938) and ASR No. 150 (December 1973).

The SEC's Role in Financial Reporting

The SEC is on the front line of financial reporting and often is among the first to identify emerging issues and areas of accounting that need attention. Issues needing attention often can be attributed to new and unique transactions that arise in the marketplace, but they also may arise from the authoritative literature.

The SEC staff frequently learns of these issues when companies engage us in a dialogue as to the appropriate financial reporting answer in advance of an event or transaction, commonly referred to as "pre-clearing" an accounting question. While these pre-clearance questions usually relate to single transactions, trends tend to develop surrounding certain issues. When they do, the staff refers these issues to the FASB and its interpretative bodies for guidance. For example, the SEC has urged the FASB to provide consolidation guidance concerning special purpose entities.

The staff also gains insights from the selective review process performed by the Division of Corporation Finance and actions taken by the Division of Enforcement. For example, the SEC staff asked the FASB to add revenue recognition to its agenda because approximately one-half of restatements and one-half of all enforcement actions relate to revenue recognition.

Other major FASB projects that have been completed or that were added to the Board's agenda were done so at the request of the then current Chief Accountant of the SEC because of problems the SEC observed in practice. These projects include business combinations, because of issues related to the pooling-of-interests method of accounting, and accounting for financial instruments at fair value, which the SEC staff referred to the FASB because of transparency issues related to derivatives, investments and loans. We have a responsibility to refer such issues to the FASB, and the FASB has a responsibility to address the issues we refer to them in a timely manner.

Some of the issues the SEC staff encounters do not require a fundamental change to existing accounting or completion of a major project by the FASB. In these situations, we may refer an issue to the Emerging Issues Task Force, or EITF,[3] for interpretation. In this manner, timely and appropriate guidance can be provided to preparers and auditors before inappropriate practices become ingrained.

In light of the SEC's unique role, it is critical that the SEC work closely with the FASB, particularly as it relate to the FASB's agenda. In addition, the SEC has the ultimate responsibility to ensure that the FASB deals with issues referred to it by the SEC. The cooperative effort between the public and private sectors has given the United States the best financial reporting system in the world, and the Commission is intent on making it even better.

Importance of Transparent Financial Reporting to the Capital Markets

Now I would like to discuss more fully the importance of transparent financial reporting to our capital markets.

A primary goal of the federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure. Transparency in financial reporting – that is, the extent to which financial information about a company is visible and understandable to investors and other market participants – is central to meeting this goal. Transparency:

- Enables investors, creditors, and the market to evaluate an entity;
- Increases confidence in the fairness of our markets; and
- Is fundamental to corporate governance because it enables boards of directors to evaluate management's effectiveness, and to take early

[3] The EITF is a committee of accounting practitioners that assists the FASB in providing timely guidance on emerging issues and the implementation of existing standards. If the EITF reaches a consensus solution to an emerging or implementation issue, Commission or FASB action may not be considered necessary. The SEC Chief Accountant participates as an observer at EITF meetings.

corrective actions, when necessary, to address deterioration in the financial condition of companies.

Therefore, it is critical that all public companies provide transparent disclosures that result in an understandable, comprehensive and reliable portrayal of their financial condition and performance.

To this end, the SEC mandates certain content and disclosures in SEC filings, such as audited financial statements and Management's Discussion and Analysis. A company's financial statements form the core of its required SEC filings and greatly influence the content of the mandated disclosures included elsewhere in the documents. Thus, audited financial statements, and the standards that underlie them, play a fundamental role in making our markets the most efficient, liquid, and resilient in the world.

U.S. Accounting Standard-Setting Process

The Securities Act of 1933 and the Securities Exchange Act of 1934 each clearly state the authority of the Commission to prescribe the methods to be followed in the preparation of accounts and the form and content of financial statements to be filed under the Acts.[4] In meeting this statutory responsibility effectively, in recognition of the expertise, energy and resources of the accounting profession, and without abdicating its responsibilities, the Commission, for over 60 years, has looked to the private sector for leadership in establishing and improving accounting standards. The quality of our accounting standards and our capital markets can be attributed in large part to the private sector standard-setting process, as overseen by the SEC.

The primary private sector standard setter is the FASB, which was established in 1972. An oversight body appoints the members of the FASB. This oversight body, the

[4] See, e.g., section 19(a) of the Securities Act of 1933, 15USC 77s(a), and section 13(b)(1) of the Securities Exchange Act of 1934, 15 USC 78m(b)(1).

Financial Accounting Foundation, or FAF, is comprised of investors, business people, and accountants. The FASB's standards are designated as the primary level of generally accepted accounting principles, or GAAP, which is the framework for accounting. The FASB's standards set forth recognition, measurement, and disclosure principles to be used in preparing financial statements.

Concerns About the FASB

Historically, the determinations by the FASB and its predecessors generally have been regarded, by the Commission, as being responsive to the needs of investors. Lately, however, concerns have arisen that the FASB is not being as responsive as it should be. Even before the recent events, the SEC staff called upon the FASB to work with us to address concerns about timeliness, transparency, and complexity. Specifically, we asked the FASB to address the following concerns:

- The current standard-setting process is too cumbersome and slow.
- Much of the recent FASB guidance is rule based and focuses on a check-the-box mentality that inhibits transparency.
- Much of the recent FASB guidance is too complex.

Evolution of Standard-Setting

As we contemplate reform, we need to consider how we got here. So it is important to understand how the current system of standard setting evolved. In its nearly 30-year history, the FASB has undertaken a series of projects to drastically change how financial information is reported to investors and other financial users. These projects, which include consolidation of financial statements and accounting for financial instruments at fair value, represent major conceptual changes in financial reporting. As you might expect, such sweeping change has been very controversial and sapped the resources of the FASB.

As a result, the FASB has not issued comprehensive guidance on issues such as revenue recognition and consolidation of special purpose entities. The FASB's interpretive body, the EITF and the SEC staff have attempted to address some of the issues, but without an underlying principle the result has been disappointing.

The Fair Value Project

An example of the fundamental changes that have taken place in how financial information is reported is the FASB's project on measuring financial instruments at fair value. This project, which has been broken down into discrete pieces, has resulted in several standards concerning measurement and disclosure of financial instruments. Furthermore, it has fundamentally moved the paradigm for the financial reporting of financial instruments away from historical cost.

While certain issues are unresolved, changes this broad and fundamental take time and, necessarily, must be accomplished on a step-by-step basis. One such issue is reliability. Some of the guidance that has been issued has raised questions about the quality of earnings because certain fair value measurements have been estimated using models, and objective inputs to the model are not available. A question that the FASB must address is how to measure fair value when objective evidence does not exist for determining the assumptions from which to estimate fair value using a valuation model. Another open and related question that the FASB must address is the one of recognition of changes in fair value in the income statement. We continue to support the FASB's consideration of these important issues.

Principles Versus Rules

Additionally, over the last few years, certain of FASB's standards have been rule-based, as opposed to principle-based. Rule-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard. This encourages a check-the-box mentality to financial reporting that eliminates judgments from the application of the reporting. Examples of rule-based accounting guidance include the accounting for derivatives, employee stock options, and leasing. And, of course, questions keep coming. Rule-based standards make it more difficult for preparers and auditors to step back and evaluate whether the overall impact is consistent with the objectives of the standard.

An ideal accounting standard is one that is principle-based and requires financial reporting to reflect the economic substance, not the form, of the transaction. FASB Statement Nos. 141, *Business Combinations*, and 142, *Goodwill and Other Intangible Assets*, which were issued in 2001, appear to be steps in the right direction. These standards will serve as a test of the level of specificity needed to strike a balance between rules and principles. Principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues.

A move to principle-based standards will require greater discipline by the corporate community, the accounting profession, private-sector standard-setting bodies, and the SEC staff. A move away from a check-the-box approach to financial reporting means that all constituencies must make concerted efforts to report transactions consistent with the objectives of the standards. While this may mean that not all transactions are recorded in exactly the same manner, it is my belief that similar transactions in this system of principle-based standards will not be reported in materially different ways, preserving comparability. Finally, a critical and important benefit of principles-based standards is that it would mitigate the opportunities to financially engineer around the rules. We have been working with the FASB to change its style to be more principle-based.

Past FASB Achievements

An objective analysis of the FASB's process must take into consideration what it has done well. U.S. GAAP, which is the backbone of our disclosure system, is the most complete and comprehensive set of accounting principles in the world. Some countries do not have any guidance on how to account for financial instruments.

And GAAP continues to be improved. Recently, the FASB completed the first phase of its project on business combinations, which eliminated pooling-of-interests accounting, enhanced disclosure requirements relating to goodwill and intangible assets and moved towards international convergence. Another example of an improvement is SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* The FASB took up this project, which was very controversial at the time, and promulgated a standard that not only improved financial reporting by requiring companies to account for their non-pension postretirement benefits on an accrual rather than a cash basis, but also served to increase corporate awareness of the underlying economics surrounding such postretirement benefits.

Recent Developments

Recently, in an effort to speed up the standard setting process, the FASB has initiated a reorganization of its staff. The primary change is one that divides the Technical Director position into three separate positions, all reporting to the Chairman. Additionally, the FAF has recently appointed a new FASB chairman, effective July 1, 2002 and has instructed him to review, between now and the end of the year, the structure and procedures of the FASB, and to make recommendations to improve efficiency and timeliness.

The FAF also has changed the FASB voting process to require a simple majority vote for the issuance of an accounting standard. Previously, a supermajority of the seven-member board was required. Critics of the supermajority requirement have commented that the need for five votes has resulted in a lack of accounting guidance in certain controversial or complex areas, as the FASB was unable to gather a sufficient number of votes. In addition, critics also comment that in an effort to obtain five votes, the FASB has compromised on certain aspects of a standard. We are encouraged by these recent actions and hope that they will lead to more timely and improved guidance. We applaud the FASB and the FAF for their efforts.

International Convergence

In this day and age, one cannot talk about standard setting in the United States without discussing international convergence. On the international front, capital markets of the world are increasingly interdependent while technology is making borders disappear. This trend has been accelerated by the European Commission's proposed regulation that would generally require all listed EU companies to apply international accounting standards for their 2005 consolidated financial statements. In light of this, there is a critical need to focus on the convergence of U.S. GAAP and international accounting standards.

While convergence can have a variety of different meanings, it has generally assumed that, ultimately, all standard setters should agree on a single, high-quality accounting answer. In the long-term, this definition of convergence is a laudable one to which all should aspire. However, there is an immeasurable need for the FASB and the International Accounting Standards Board, or IASB, to converge the high-level principles in their standards in the short-term, rather than the long-term, and so, much more needs to be done. We recognize there is a joint IASB/FASB project on accounting for business combinations. In order to achieve convergence in the short-term, however, the FASB and the IASB have to work together more closely than they have to date. To this end, the SEC has encouraged both the IASB and the FASB to re-examine their agendas in order to speed up their short-term convergence efforts.

The Public Accountability Board

Now I would like to briefly address another critical and related part of the financial reporting process, which is the oversight of the accounting profession. Auditing is a critical component in the financial reporting process. It provides credibility to the financial statements and comfort to investors. Accordingly, the Commission is exploring ways to strengthen the system of overseeing the work of the accountants that perform audits of public companies. This oversight is not presently, nor is it contemplated to be, under the umbrella of the FASB.

The oversight or "peer-review" system that has been used in the U.S. since 1977 has been questioned as to its effectiveness in ensuring high-quality audits. As a result, the Commission expects to soon make a proposal for a different system. The proposed system would include the concept of a Public Accountability Board or PAB. The PAB would direct periodic reviews of accounting firms' quality controls for their accounting and auditing practices and also would discipline auditors for incompetent and unethical conduct.

There are several important aspects of the PAB that I want to mention. First, our proposal would call for the PAB to work as a complement to the enforcement efforts of the Commission and focus on ethical and competence requirements rather than existing statutory and regulatory requirements. We have seen success of such a two-tier system of regulation, specifically within the securities industry. The proposed system is aptly designed to handle behavior that is unethical or incompetent.

Second, the PAB would be an organization that is dominated by members that are unaffiliated with the accounting profession. Because there is a public benefit to having some expertise of the accounting profession, the PAB should have a minority of representation from that industry.

Lastly, the source of funding of the PAB is one that must be secure and independent. Our proposal would include a system where involuntary fees would be imposed upon those who benefit from financial statements audits, whose quality would be overseen by the PAB. Those subject to the involuntary fees would include, but not be limited to, the accounting firms that perform such audits.

Conclusion

In summary, let me state that we have the deepest and most liquid capital markets in the world largely because of the high quality of our financial reporting system. However, even though our system is the best at present, there is room for improvement. Recent events have been a catalyst for reform and the work related to implementing the needed reforms I have discussed today has begun. While it is imperative that the criticisms of the accounting standards-setting process be addressed, we should not abandon the system that has allowed us to achieve what we have to date. Instead we must take the opportunity to make fundamental improvements to standard setting and oversight. Thank you for your interest in having scheduled this hearing today and inviting me to participate. I am pleased to answer any questions that the Subcommittee members may have.