Remarks of Robert H. Herz

Chairman, Financial Accounting Standards Board

2004 AICPA National Conference
on Current SEC and PCAOB Reporting Developments

December 7, 2004

The views expressed are my own and do not represent positions of the Financial Accounting Standards Board.

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Chairman, FASB
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It's always a great pleasure and honor to be a speaker at this terrific conference. My congratulations to the members of the AICPA SEC Regulations Committee and the very hard working members of the AICPA events staff for organizing another successful conference this year.

And my thanks to the members of AcSEC and to the AICPA professional staff for working with us in recent years in sorting out the way forward for private-sector accounting standard setting. It's very much appreciated.

Certainly, these are very challenging, but I also think very interesting times for all of us involved in financial reporting. And particularly so for those of you who are preparers and auditors and have been working very hard to implement the Section 404 requirements.

What I'd like to do is to set forth and briefly discuss what I see as some of the key challenges and cross-currents facing the financial reporting system that we will all need to navigate over the next few years as we endeavor to continue to improve the relevance, reliability, and comparability of financial information, both here and across the major capital markets of the world.

Indeed, I believe we are at a critical juncture and how we collectively and collaboratively address and resolve these issues will in my view be fundamental in determining the kind of reporting system we will have for many years to come.

I'll try to set forth these key challenges in the form of what may seem like rather exaggerated statements.

I know you all recognize that I am doing this to stimulate thought and discussion and that any views I express are not official positions of the FASB nor do they necessarily reflect the views of my fellow FASB Board members.

I've got five statements I hope will highlight some of the important challenges and cross-currents I think we are seeing.

Before I begin with the first statement, I'd like to put my remarks in context of our agenda and activities at the FASB. In particular, by noting that we are pursuing three overall strategic objectives:

1. Improvement of U.S. accounting standards.
2. Simplification of the standards and the supporting literature.
3. International convergence.

The trick, of course, is how best to achieve all of these. Ideally in any major project we would like to accomplish all three objectives. I think that's what we are trying to achieve in joint projects with the IASB, that by working together we hope to come up with not only a common standard, but one that is also higher quality and that hopefully from the U.S. perspective represents simplification vis-à-vis the current U.S. GAAP literature.

But achieving these objectives obviously implies change. That brings me to the first statement.

1. *The financial reporting system needs lots of improvement, but please slow down — I can't take any more!*

This is the question of the right pace of change. On the one hand, we hear a lot from professional users of financial information, from some very thoughtful academics, and from others that there are a lot of areas of accounting and financial reporting that do not properly reflect economics and that need to be fixed. We also hear that the whole reporting framework needs to be modernized in terms of content, timeliness, mode of delivery and use of technology.

I agree with many of these criticisms and suggestions. Many of the things we are currently doing at the FASB are aimed at improving the standards in key areas and at improving the conceptual framework. And I'm a strong supporter of expanding the business reporting model and making better use of technology in reporting through such things as XBRL and a layered or click-down approach to communicating the information.

I commend the SEC staff for their recent actions in trying to foster to use of XBRL and I applaud the efforts of all those involved in the AICPA's Enhanced Business Reporting initiative.

But, on the other hand, it is also very clear that there have already been a lot of major changes recently for the system to handle and that those on the front line, the preparers and auditors are feeling stretched and tired.

So, I think we need to be sensitive to the ability of the system to handle further change in a short period. Clearly, further changes and improvements are needed but I think these should be introduced and implemented at a measured pace that enables the system to move forward in an orderly and constructive way. And I think we have tried to be sensitive to the current demands on people's time and resources by deferring the effective dates of several new standards and by providing extended comment periods on certain proposals.

While improvements in accounting standards are often necessary, quite understandably, not everyone always warmly embraces the prospect of change.

Indeed, the fact that particular rules, bright lines, and exceptions in existing GAAP have influenced the development of and become embedded in companies' business and operating models sometimes poses a serious challenge to making needed improvements in accounting standards. For example, the so-called "3% rule" related to special purpose entities spawned a proliferation of those entities to the point that, following the revelations in the Enron case, it threatened public confidence in the reliability of financial reports. The bright line tests in FAS 13 relating to lease classification have facilitated what many regard as widespread form over substance off-balance sheet financing. And many attribute the growth in the use of stock options as a means of compensating employees, at least in part, to the exception that allowed so called fixed-plan options to escape being counted as compensation expense. So it's not surprising, but nevertheless disappointing, that companies will sometimes fight very aggressively to block proposed changes in accounting standards, even where investors and others believe the existing rules have resulted in accounting that does not properly reflect the underlying economics of the transactions.

With all the change recently and the prospect of further changes ahead who among us does not yearn for a simpler world? That brings me to my second statement.

2. *Give me principles, but make sure there's no doubt how to apply them (and make sure they don't change what I'm currently doing).*

This is the issue of whether we should be moving to more of a so-called "principles-based" system or what the SEC staff has called "objectives-oriented" standards.

On the one hand, there has been lots of talk and calls for the standards to be more clearly cast in terms of overarching principles, and to get away from detailed rules, bright-lines and exceptions.

On the other hand, given the very important and in my view necessary reforms under Sarbanes-Oxley, there is clearly a heightened sense of attention to getting the financial statements right by companies, auditors, and audit committees and Boards. That's terrific! But there also seems to be a real fear of being second-guessed by regulators, enforcers, the trial bar, and the business press and that has, at least for now very understandably seemed to reinforce the demand for detailed rules, bright-lines, and safe-harbors.

And we also continue to receive requests for scope exceptions and treatment alternatives from companies and industries seeking to preserve the status quo or to have accounting standards crafted to suit their particular business models.

So implementing a more principles-based or objectives-oriented approach is very challenging and will require steadfast determination not only by standard-setters, but also some important behavioral changes by others.

But I think it's the right way to go. I think we can do a better job of more clearly setting forth principles and objectives and then supporting them with good implementation guidance.

I also think that simplification of the authoritative literature is needed and is possible. Current U.S. GAAP encompasses over 2000 individual pronouncements issued in many different forms by numerous bodies over the last 40 plus years. It is categorized into a GAAP hierarchy—levels A, B, C, etc. making it difficult to understand, difficult to use, and increases compliance risk. We have taken some important steps over the past few years to try to get the beast under control; including rationalizing the standard-setting structure itself by reducing the number of bodies that establish new GAAP as well as reducing the number of different types of pronouncements, and by improving the Current Text and the FARS database. But more is needed and so we are embarking on the development of a structured codification, by topic, of all the existing U.S. GAAP literature. This will be a massive undertaking spanning several years and requiring the integration and synthesis of all the GAAP literature. Once completed and verified, this codification will become the authoritative source of GAAP, thereby allowing us to eliminate the GAAP hierarchy. Larry Smith will talk later about this very important initiative.

3. *The heck with relevance, give me accounting numbers I can nail to the wall!*

We hear this in many guises, mainly from preparers, but also from some auditors and other parties. Again, part of this no doubt relates to the fear of second-guessing and the attendant desire to be able to point to something exact, something directly vouchable or verifiable, if called upon to defend one's accounting or auditing. And again, that's very understandable.

And concerning the potential further use of fair value measurements in accounting we hear things like "fair value—too subjective, I don't understand it, I don't like it and I don't want to do it" or "I'm a traditional accountant—they never taught me this stuff."

Like it or not that is the world of today's accountants and these are valid real world issues and concerns that we understand and take seriously.

But on the other hand, we also hear from many, particularly professional users, that they want more information on current values and on the effects of market and other environmental changes on a company's financial position and results. And we hear from economists that some of our traditional accounting measures that are based on sunk costs, and multi-year allocations of cost are not representationally faithful of the underlying economics and not particularly decision useful.

So I think our big challenge is to try to figure out ways to provide what may be more relevant and useful information and ways to provide meaningful comfort on its reasonableness, without putting companies and auditors in the unfair position of having to assert that such information is exact, free from measurement uncertainty and subjectivity.

We are trying to do some of this in our projects on Fair Value Measurement and on Reporting on Financial Performance. Moreover, issues relating to relevance vs. reliability and to the use of fair value measurements in accounting will be key areas of focus in our major project to improve the conceptual framework.

And I think the SEC has done some good things in terms of MD&A and the disclosures on Critical Accounting Estimates, and maybe there are some things that could be done in terms of the form and content of the auditors' report.

Bottom line—Both relevance and reliability are very important and neither of these should be subordinated to the other if we are to continue to improve the usefulness of financial reports to investors and the capital markets.

Now a few more words about international convergence.

4. I have two versions of the next statement. First version—*Why is International Convergence taking so long? Get on with it!* That's what we hear from many of the professional users, such as global equity analysts and institutional investors, many

foreign based multinationals, and some U.S. based global companies. The second version—*I'm in favor of convergence, but make them do it our way*—is what we hear from many U.S. preparers. We are trying to get on with it in a systematic way together with our colleagues at the IASB through coordinating our agendas, joint projects on major subjects, working together to improve the conceptual framework, and through proposing changes on both sides to reduce the number of specific areas of differences between U.S. GAAP and international standards. But convergence clearly means change and we need to make sure we adhere to thorough due process so that we ensure that it's not just convergence for the sake of convergence, but also helps improve the quality of the accounting standards and the resulting financial reporting. Convergence is both a process and a destination with many stations along the way.

5. *All this potential future change you are talking about like more fair value information and international convergence sounds okay for the large public companies, but isn't needed or cost effective for private companies and small business.*

This is of course the issue of big GAAP/little GAAP or what is now being called differential reporting. It's certainly not a new issue, having been studied many times over the past 25 years with the conclusion each time being that a two-tier GAAP accounting system did not make sense in this country. So while we have often provided for deferred effective dates on new standards for nonpublic companies and recently also for small business issuers that file with the SEC, and we sometimes have allowed reduced disclosures for nonpublic companies, we have not generally prescribed different accounting treatments for private and small businesses.

But these are new times and a fresh look may well be in order. We recently formed a Small Business Advisory Committee to increase the voice and participation of this very important constituency in our activities and the AICPA has been studying this subject. Small businesses are a very critical part of our economy and as standard-setters we must ensure that our standards are cost effective, but we also need to make sure that we meet the needs of the users of the financial statements of these businesses. So any kind of differential reporting would have to be conceptually sound and should meet the needs of users and not just be something designed for the convenience of preparers and small practitioners.

So those are some of the key challenges and cross-currents I see in terms of the pace of change, in moving toward a more principles-based and simpler system, on the debates regarding relevance and reliability and fair value measurement in accounting, on international convergence and on reporting by small and private businesses. I would be remiss, however, if I also did not briefly mention another big challenge we are facing, and that's the political one. We are seeing this here in terms of the debate over the accounting for employee stock options and the IASB has experienced it in Europe in regard to certain aspects of accounting for financial instruments. In both cases, special interest groups have lobbied mightily to block improvements in accounting that investors and many other parties support. Needless to say, how these situations play out will have important implications for the future of accounting standards and financial reporting, for international convergence, and, most importantly, for the effective operation of the capital markets.

We all witnessed the erosion of investor confidence in financial reporting that resulted from the wave of scandals involving major companies that deliberately violated accounting rules. Imagine then the potential loss of public trust in the integrity of the reporting system if the standard-setting process was perceived as being captive to special interest politics such that the accounting standards themselves were purposefully skewed to produce or retain distorted results that favored particular groups over the interests of investors and other parties who participate in the capital markets.

Thank you for listening to my thoughts. In turn, I very much welcome your views and really appreciate the terrific input we regularly receive from constituents on our various projects and activities at the FASB. As I noted at this conference last year, my fervent hope and desire is that all parties in the financial reporting system can work collaboratively and cooperatively together in the spirit of partnership to continue to improve the system for the benefit of investors and the capital markets. It's a great honor to be part of that effort.