Remarks of Robert H. Herz

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

Positions of the FASB Board are arrived at only after extensive due process and deliberations.

- I am very pleased to be again one of the opening speakers at this terrific conference.
- As I noted last year, at the FASB we continue to focus on three key strategic goals:
  - Improvement of Accounting Standards
  - Simplification
  - International Convergence
- Now I've talked plenty in the past about what we are doing on both the Improvement and International Convergence fronts and no doubt some of those matters will also be covered in today's sessions.
- So I thought that for a bit of a change I would focus on Simplification. I also figured that those of you who are preparers or auditors are probably feeling a bit stretched and tired from all the hard work this past reporting season, including implementation of Section 404, and so a subject like Simplification might be a bit soothing and uplifting.
- So that's what I'm going to talk about.
- So why have we adopted Simplification as a key priority? What's the problem?
  - Well, and probably no surprise to many of you, I think there are at least two interrelated problems relating to the complexity of the current accounting literature. The first concerns the volume and disjointedness of standards, rules, and regulations and the second relates to the complexity of individual pronouncements.

- I'd like to explore each of these further, including what we are trying to do to try to try to start to reverse what has, in my view, been a building problem over many years.
- Let me begin by reading you an excerpt from a book published about 4 years ago.

The GAAP Engine Grinds On

"The chairman and the chief accountant of the SEC often proclaim that the United States has the best financial reporting system in the world. If quality is measured by the sheer number of pronouncements, rules, and regulations and by their level of detail and complexity, then America certainly leads the rest of the world. U.S. Generally Accepted Accounting Principles represents a vast array of official pronouncements made over the past 40 years by various bodies, including the FASB and its predecessors, the Accounting Principles Board (APB) and the Committee on Accounting Procedure (CAP), the FASB Emerging Issues Task Force (EITF), and the Accounting Standards Executive Committee (AcSEC) of the AICPA. These pronouncements appear in various forms: FASB statements, interpretations, technical bulletins and implementation guides, EITF consensuses, AcSEC Statements of Position, and industry accounting and audit guides, just to name the principal ones. The FASB alone has issued more than 130 FASB statements, 44 FASB interpretations, more than 400 EITF consensuses, 7 concepts statements, more than 50 technical bulletins, and a number of special implementation guides containing hundreds of questions and answers. If this weren't sufficient, for public companies there is also another whole set of rules and regulations that interpret and supplement the GAAP rues.

> Those interested will find them in the SEC's core rules, such as Regulations S-X and S-K, as well as in more than 100 specific Staff Accounting Bulletins, almost 50 Financial Reporting Releases, and hundreds of Accounting Series Releases.
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> Had enough yet? In order to stay fully current with GAAP, it is not sufficient to know and understand just the official pronouncements; the SEC staff regularly deems it appropriate and important to proclaim their latest views on particular reporting and disclosure matters through speeches and comments at EITF and other professional meetings, which, although not official, effectively carry the same weight for anyone trying to comply with all the rules.
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> All this effort ends up as an extraordinarily detailed and complicated set of rules about what companies can and cannot do in their external financial reporting. These rules have become so complex that a rapidly decreasing number of CFOs and professional accountants can fully comprehend all the rules and how to apply them."

Pretty powerful stuff. Well, by now it may be no surprise to learn that the author of those words was none other than yours truly and I wrote them back in late 1999. And I remain just as passionate about this now.

The fact is that we call U.S. GAAP is comprised of over 2000 individual pronouncements issued by various bodies and organizations in a variety of forms. FASB Statements, Interpretations, Technical Bulletins, Staff Q&As, APB Opinions and Interpretations, AcSEC Statements of Position, AICPA Audit & Accounting Guides and Technical Practice Aides, SEC Accounting Series Releases, Staff Accounting Bulletins, letters and speeches, EITF consensuses and D topics, and so on and so forth. And because the various standards, rules, and regulations can sometimes conflict, it needs to be organized into a GAAP hierarchy, you know levels A, B, C, D.

- So while all well intentioned, the result is a body of official accounting literature that is hard to understand and difficult to use. In one word, its nuts!
- In fact, let me give you some statistics from a survey we did last summer before embarking on the major codification project I'll discuss shortly.
- Last summer we surveyed over 1400 users of the accounting literature—line audit partners, managers and seniors in the major accounting firms as well as preparers involved in the financial reporting function at their companies.
- Less than 10% of these over 1400 respondents consider the structure of US GAAP as understandable in regard to research and training, a strong majority (over 60%) said they were uncomfortable with research results when needing to perform that research under normal conditions (i.e. with a limited amount of time to do the research) and only 19% felt very comfortable with research results even when they had unlimited research time. As a result, an overwhelming majority of the survey respondents (over 95%) supported the FASB undertaking a major codification project.
- Ok, so there is a real problem. What are we doing about it?
- Well the first problem we saw was that new accounting literature was continuing to emanate from multiple sources, i.e. there was water coming out several different faucets.

- So what do you do? You try to turn off or at least turn down some of the faucets. And that's what we've been trying to do over the past two plus years.
- First of all, we went to the SEC staff and suggested that whenever possible and appropriate, if there was an accounting standard setting issue they believed needed action or attention, they first refer it to us instead of trying to do it either in formal ways (e.g. a SAB) or as had become their practice, to do it in ad hoc ways through staff speeches and announcements at EITF meetings. In this way such matters could be subjected to appropriate deliberation and public exposure as part of our due process. The SEC staff agreed to try to operate in this manner and as part of the SEC's redesignation of the FASB as the accounting standard setter for public companies, we established a working protocol between the SEC staff and the FASB whereby the staff will first look to us to try to address issues it identifies, with the understanding that the SEC, of course, reserves its ultimate authority to deal with issues if necessary. We have been operating in this way over the past two years and I think it has generally worked well.
- The second fundamental change in standard setting began in the fall of 2002 when the FASB and the AICPA agreed that, after a transition period, the AICPA and AcSEC would no longer issue authoritative accounting guidance. Previously, SOPs and Industry Accounting and Audit Guides "cleared" by the FASB were level B under the GAAP hierarchy. Going forward (except for transition projects), the Board will not be asked to clear any AICPA or

AcSEC documents; consequently, any such documents will fall under level D in the current GAAP hierarchy.

- And third, beginning in 2003, the operation of the EITF was fundamentally changed. In an effort to provide greater direction to the EITF in terms of the issues addressed by that group, two Board members were added to the EITF Agenda Committee. The FASB also took greater direct ownership of GAAP established by the EITF by requiring that consensus positions be ratified by the Board.
- The objective of those changes was to simplify the accounting standard-setting process by eliminating the various organizations that might potentially deal with an accounting issue. In so doing, we also looked at how we issue accounting guidance and acknowledged that we had contributed to the complexity of GAAP by issuing accounting guidance in a variety of forms. For example, our arsenal of guidance included Statements, Interpretations, Technical Bulletins, "D-Topic announcements," staff implementation guides (Q&As), Derivatives Implementation Guidance Issues, *Action Alert* announcements, and *The FASB Report* articles.
- We might have added to that confusion in 2002 (although hopefully only temporarily) by instituting a new form of guidance, FASB Staff Positions (FSPs). The original reason for introducing FSPs was to eliminate further use of many of these other terms our arsenal of guidance. Another reason was to have a means to publicly solicit constituent comments on proposed staff guidance,

which had not been the practice with some of the prior forms of guidance.

- Observers of our process may have noticed that the use of FSPs has evolved rapidly over their short history such that they are not only being used to provide interpretive guidance, but also to make minor amendments to existing standards. I would like to take this opportunity to point out that the due process used to issue an FSP is the same as the due process used to issue a new standard. Thus, it really does not matter whether something gets issued as an FASB Statement or an FSP on Topic "X." Regardless of the form of the final guidance, the FASB staff will study the issue, the Board will deliberate the issue and expose it for public comment, the staff will analyze the comments, and the Board will redeliberate the issue before the guidance is finalized. Our ultimate vision for simplification of standard setting is one process and one form of guidance.

The GAAP Hierarchy and the Codification Project

- While the FASB is charged with setting accounting standards, the authoritative guidance on what constitutes generally accepted accounting principles and the relative authority of those principles (i.e., the GAAP hierarchy) resides in the auditing literature. After concentrating standard setting with the FASB, it became obvious to the FASB (and the SEC) that the GAAP hierarchy should be embedded in the accounting literature, not the auditing literature. We are in the process of preparing an Exposure Draft of a standard that will move the GAAP hierarchy into the accounting literature. We have discussed this with representatives of both the AICPA and the Public Company Accounting Oversight Board (PCAOB), who have agreed to take actions necessary to effectively acknowledge the GAAP hierarchy once it becomes a part of the accounting literature.

- The Board decided to adopt the GAAP hierarchy in the same fundamental form as it now exists in the auditing literature. However, the Exposure Draft will include the Board's vision of the future GAAP hierarchy—only two levels, authoritative and nonauthoritative. Users of GAAP will no longer have to worry about what literature trumps other literature. In fact, there will be only one set of "authoritative" literature, which we are currently referring to as the Codification.
- During the summer of 2004, the trustees of the Financial Accounting Foundation approved one of the largest projects ever undertaken by the FASB. Prior to obtaining that approval, we had cleared with both the AICPA and the SEC the right to use in the Codification their literature that is currently part of GAAP. The Codification will be a compilation of existing U.S. GAAP, organized by accounting topic, regardless of its source (i.e., FASB Statement, EITF consensus, AcSEC SOP, etc.). There will be a standard structure to the codification, such that users will quickly know what subsections address the specific aspects of a topic (e.g., recognition, measurement, disclosure, implementation guidance, etc.).1
- While the Codification will present existing GAAP differently, its purpose is not to change the requirements of GAAP. Nevertheless, as the various sources of literature are put together to prepare the

Codification, inconsistencies in accounting requirements will be identified and resolved by the Board. Constituents will have an opportunity to comment on the resolution of identified inconsistencies, as well as other aspects of the Codification, during an extended "verification process." The verification process will begin once a sufficient portion of the Codification has been completed. The Codification is a multiple-year project whose time is long overdue.

- So trying to move to one standard-setter and doing the codification are major actions intended to slow down and begin to reverse the proliferation of new accounting literature and to better organize the mass of literature that currently exists. We hope these will go a long way towards simplification.
- But there is another piece and that relates to the way we write future standards, to making them more readable and understandable and more "principles-based" or as the SEC staff terms it, more "objective-oriented."

Principles-Based Standards

- I am not going to recap here all that has been said for and against principles-based standards. Quite frankly, its time for some action, not words. The problem is that while it may appear that this action is totally within the control of the FASB as the promulgator of accounting standards, in reality, it is not. To understand why it is not totally within the control of the FASB, just read some comment letters we receive relative to a particular issue, or sit in a meeting with some constituents from a specific industry asking to be excluded from the scope of a standard, or talk to auditors fearful of second-guessing by the PCAOB, the SEC, or the trial bar.

- A number of factors will influence how successful the Board is in moving toward principles-based standards, and that success will be subject to each individual's interpretation of what is meant by "principles based." The goal, in my mind, should be that there are few scope exceptions, few bright lines, and understandable objectives upon which reasonable people can exercise judgment that will not be the subject of second guessing by auditors, regulators, and the plaintiffs' bar supported by good implementation guidance. Our hope is that the other forces that influence the financial reporting system will enable us to continue moving toward that goal.
- Early returns are not great as right now, preparers and auditors, fearful of second guessing, continue to barrage us with requests for rules, bright lines and all sorts of exceptions and ask the SEC staff for "safe harbors. " But we will continue trying. In that regard, see what you think about the approach and format in our forthcoming joint ED's with the IASB on Purchase Method Procedures and Non-Controlling Interests (written in a more objectives-oriented manner).
- Moreover, the fact that particular accounting treatments, bright lines, and exceptions in existing GAAP have influenced the development of and become imbedded in companies' business and operating models often makes it a real 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 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 aggressively to block proposed changes in accounting standards, even where investors believe the existing rules result in accounting that does not properly reflect the underlying economics.

- And all of this, of course, has also resulted in complex accounting standards, rules, regulations and the need for additional disclosures in a number of areas like pension accounting and financial instruments. So I ask all of us to consider carefully the price of maintaining the status quo in these areas — in my view, an unacceptably high price both in terms of the quality and usefulness of the information for investors and the marketplace and in terms of the complexity of the standards, rules and regulations.
- So to repeat and summarize, simplification as we see it involves continuing to move to one standard-setter, restructuring, reorganizing, and codifying the existing literature, thereby also allowing us to eliminate the GAAP hierarchy, and writing future standards in a more readable, understandable less complex and

more principles-based way and that better reflects the underlying economics.

- Before closing, I can't help but also say just a few more words about the continued need for improvement in accounting standards, in companies' faithful compliance with them, and in overall reporting and disclosure practices. Certainly, we recognize that there have been many reforms and changes for the system to absorb over the past few years and that those on the frontline, preparers and auditors are feeling stretched and tired.
- But I think it's also clear that we have a way to go in fully restoring and then maintaining investor confidence in financial reporting. Whether it's been the recent trials relating to the prior scandals at Enron, WorldComm, HealthSouth, or the new wave of reporting scandals at some very major companies or the fact that restatements continue at an unacceptable rate, or that the SEC Chief Accountant had to send out a letter dealing with some very basic requirements of lease accounting that hundreds of companies were apparently not complying with, it is not surprising that the investing public still has concerns and skepticism over the quality and integrity of public company financial reporting.
- So neither a return to the past nor sticking to the status quo are acceptable. We need to do better and I sincerely believe we all can do better. Only by viewing financial reporting as an exercise in honest communication and not solely as a compliance matter or as a way to paint pictures that are more flattering than the underlying reality can we, in my view, we make significant strides forward.

- So I ask all of us to rededicate ourselves to that mission and your participation and that of all our constituents in our standard setting process is therefore very important and much appreciated as we continue to carry out our efforts to improve accounting standards.