Remarks of Robert H. Herz

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Robert H. Herz
Chairman, FASB
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This is the fourth time I have represented the FASB at this terrific conference, and it is always a great pleasure and honor to be a speaker here. I regard it as an opportunity to represent the FASB in front of a broad range of our constituents including preparers, users, auditors, and regulators who all play a vital role in the financial reporting system.

Two years ago I spoke at this conference about a financial reporting partnership built on the principle that sound, unbiased, and transparent financial reporting is a critical underpinning of our capital markets, our economic well-being, and our way of life. In that speech, I suggested that we all share a common goal of improving our financial reporting system and that achieving that goal would require all parties to act together in a spirit of partnership. Last year, I spoke about some critical challenges and cross-currents in the financial reporting system. Today, I would like to again pick up these themes, for I continue to believe that further progress is needed in improving the quality and transparency of financial reporting. I also believe that we need to reduce the complexity of our reporting system. Yesterday, Chairman Cox spoke about this subject. My comments today will expand on this topic by focusing on a number of fundamental structural, institutional, cultural, and behavioral forces that we believe have and continue to generate complexity in the system and that impede transparent reporting. And I will provide some thoughts on how together we might begin a journey to a less complex and more transparent system.

My comments today reflect not only my personal views, but also those of others at the FASB. I have also discussed these perspectives with members of the SEC staff and the commission, with representatives of the PCAOB, with members of our advisory councils, and with many others who seem to share similar views and concerns.

The reforms created by the Sarbanes-Oxley Act, together with follow-up actions by the SEC, the FASB, and the PCAOB, and a lot of hard work by many other parties, have clearly strengthened financial reporting and public confidence in the system. They have brought about needed changes in the system and refocused all parties on the critical importance of high-quality financial reporting to the health and vitality of our capital markets and our economy. However, we feel further improvement and actions are needed to address significant continuing issues in the reporting system. Accordingly, I believe that concerted and coordinated action by the SEC, the FASB, and the PCAOB, together with other key parties, is critical if there are to be needed further improvements in our reporting system.

In our view, despite the improvements in financial reporting resulting from Sarbanes-Oxley and related actions, our reporting system faces a number of important and difficult challenges. Perhaps most significant and pressing of these is the need to reduce complexity and improve the transparency and overall usefulness of reported financial information to investors and capital markets. I think this is an issue of both national and international importance.

In the over 70 years that have elapsed since passage of the Securities Act of 1933, accounting, auditing, and reporting guidance has grown to encompass thousands of pronouncements that make up U.S. generally accepted accounting and auditing standards and SEC rules, regulations, and interpretations governing financial reporting. These range from major standards on broad topics such as accounting for business combinations, to guidance on accounting practices for specific industries, to narrow interpretations and rulings on particular transactions. Although basic principles are to be found in many of the standards, these have often been overwhelmed by detailed rules, bright lines, and exceptions both in the standards themselves and in subsequent interpretations, rules, and regulations. And while detailed rules, bright lines, and safe harbors are often quite laudably intended to ease implementation and to promote greater consistency in reporting, they inevitably add to the overall complexity of the system and can reduce the transparency of the resulting financial information. This complex system of standards, rules, and regulations reflects, in part, the complexity inherent in reporting on increasingly diverse and complicated business transactions and arrangements. But the complexity has also been building for many years as a result of various structural, institutional, cultural, and behavioral forces in the system.

Long touted by some as a strength of our reporting system, the detail and volume of accounting, auditing, and reporting guidance now pose a major challenge to maintaining and enhancing the quality and transparency of financial reporting to investors and the capital markets. Many, including some members of the FASB, believe that the current system has engendered a check-the-box, form-over-substance approach to accounting, auditing, and reporting by preparers, auditors, and regulators, sapping professionalism and increasingly necessitating the involvement of technical experts to ensure compliance. It has also provided fertile ground for those attempting to structure form-over-substance arrangements to obtain desired accounting outcomes. This complexity has also added to the costs and effort involved in financial reporting, which often fall disproportionately on small and private companies and their auditors. It has also created a black box view of financial reporting by many who are not familiar with the intricacies of the underlying accounting, auditing, and reporting requirements. For professional investors and analysts, it results in a lack of transparency and significant analytical complexity in using reported financial information. And it is viewed as a contributory factor to the unacceptably high and increasing number of restatements of financial reports by public companies. For while many restatements are due to intentional misstatements, fraud, and lack of due care, many others reflect unintentional mistakes in implementing and auditing complex accounting and reporting requirements.

So we have both a complexity problem and a transparency issue. On the one hand, for preparers and auditors, I think the complexity starts with trying to determine which standards, rules, or regulations apply in a particular circumstance, that is complexity in determining what to do. There can also be "how to" complexity, that is complexity and added cost and effort in implementing a particular accounting treatment, for example, in the case of key accounting estimates and certain fair measurements in gathering the data and implementing the processes, judgments, internal controls, and auditing procedures needed to develop or to audit the accounting measures. On the other hand, investors and other users face a lack of transparency relating to the analytical complexity associated with trying to understand what was done in preparing the financial statements, whether and to what extent various treatments properly reflect the underlying business and economic realities, and in making comparisons between companies and over time.

So, not surprisingly, because there are varying perspectives on what constitutes "complexity", there are also different views on what reducing complexity means. To many preparers, reducing complexity seems to imply accounting and reporting that is easier to do. Similarly, for many auditors it would seem to imply accounting and reporting that is easier to audit. But for many users, it seems to mean making reported financial information more understandable and more useful, which includes making it more relevant and more representationally faithful of the underlying economics, objectives which, of course, may not translate into accounting and reporting that is easier to do or easier to audit.

Anyway, how did we get to this point of having such a complex reporting system? Well, certainly business has gotten more complex over time. But, in my view, there are also a number of other powerful forces that have and continue to generate complexity in the reporting system and impede improving financial reporting. Among these forces are the conflicting perspectives and agendas of the participants in the reporting process; resistance to change; outdated rules-based legacy accounting standards that fail to report the economic effects of transactions and events; an evolutionary approach to standard setting that can result in non-conceptually based compromises, exceptions, and inconsistencies in standards over time; a continuing focus and emphasis on short-term earnings; gaps in the education and training of accountants; anti-abuse rules to try to curb the continuing use of accounting-motivated transactions to burnish reported financial results; attempts to politicize standard-setting and regulation; and a palpable fear of the potential consequences of being second-guessed by regulators, enforcers, and the trial bar. And in our culture, many of these forces create a constant demand for detailed rules, exceptions, bright lines, and safe harbors; deter preparers, auditors, audit committees and boards from exercising professional judgment; and result in disclosures that while lengthy and dense, all too often are boilerplate, overly legalistic, and fail to effectively communicate important information.

Thus, I also believe that any solution to this "Catch 22" problem will necessitate not only systematic, concerted, and coordinated action by the SEC, the FASB, and the PCAOB, but also fundamental cultural and behavioral changes by others. Accordingly, the support and cooperation of policymakers and other key parties is necessary if there are to be needed changes in the direction of the reporting system of the type suggested in our October 2002 proposal on Principles-Based Accounting Standard Setting, in the SEC staff's July 2003 report to Congress on Adoption of a Principles-Based System, and in their June 2005 report to Congress on Off-Balance Sheet Arrangements.

For our part, as noted by Chairman Cox, the FASB, with the encouragement of the SEC, has undertaken a three-pronged effort aimed at trying to do what we can to respond to these issues. First, we have been and plan to continue to systematically readdress accounting standards in major areas for which the existing complex and outdated rules fail to provide relevant and transparent financial information. Second, the Board has three broad initiatives aimed at improving the understandability, consistency, and overall usability of the existing accounting literature. These include (1) undertaking a massive project to develop a comprehensive and integrated codification of all existing accounting literature organized by subject matter that would become an easily retrievable single source for all of GAAP and that should provide a useful roadmap to identifying those areas in GAAP in most need of simplification, (2) attempting to stem the proliferation of new pronouncements emanating from multiple sources by consolidating U.S. accounting standard setting under its auspices, and (3) developing new standards more consistent with a "principles-based" or "objectives-oriented" system. And third, the FASB has undertaken a very major project to strengthen its existing conceptual framework in order to provide a more solid and consistent foundation for the development of principles-based standards in the future. Consistent with the move toward international convergence of accounting standards, many of the FASB's technical projects are being conducted jointly with the IASB, whose standards are now being used in over 90 countries around the world.

While these activities aimed at reducing complexity and improving accounting standards are integral to reversing the trend that has been building for a number of years, on their own they are unlikely to prove successful in achieving our common goal. In my view, that will require proactively addressing the structural, institutional, cultural, and behavioral forces mentioned earlier. As I said, it will require not only continued collaboration and coordination between the SEC, the FASB, and the PCAOB, but also the active involvement and assistance of other key parties in the financial reporting system to develop a constructive path forward. For example, the FASB's effort to move toward a more principles-based system of "objectives-oriented" standards, as noted in our October 2002 proposal on Principles-Based Accounting Standard Setting and as reiterated in our response to the July 2003 SEC staff report on that subject, depends greatly on the ability and willingness of preparers, auditors, audit committees, boards, and others to exercise sound professional judgment. Unfortunately, over the last few years, counter to the goals of a principles-based system, at the FASB we have experienced a constant flow of requests for detailed rules, bright lines, and safe harbors from preparers and auditors. Many of those requests seem to stem from a fear of the potential consequences of second-guessing by regulators, enforcers, and the trial bar. Accordingly, some believe that changes in the legal, regulatory, and enforcement frameworks surrounding financial reporting are prerequisites for any move to a more principles-based or objectives-oriented system. Principles-based standards, it is argued, cannot succeed without more principles-based regulatory review and enforcement and without a more principles-based legal framework around financial reporting.

We also continue to receive regular demands from companies and industry groups for special exceptions and accounting treatments to suit their particular business models, practices, and objectives. Such exceptions invariably add to the overall complexity of reporting and reduce the transparency and comparability of reported financial information to investors and other users.

Many proposed solutions and ideas have been suggested to reduce complexity and increase transparency within our reporting system. For example, some see fair value accounting as a way to simplify accounting standards and to improve the relevance and transparency of financial statements. But, of course, others view fair value accounting very differently, believing it introduces unacceptable subjectivity, misleading volatility, and significant additional complexity into financial reporting. Others suggest that the future of financial reporting lies in the greater use of new technologies such as XBRL and "click-down" approaches to developing and communicating financial information in ways that better fulfill the needs of different users and that could render general purpose financial statements a relic of the past. Many also continue to call for the expansion of the reporting model to systematically cover information on nonfinancial performance indicators, greater discussion of risks and rewards, and more forward-looking information. But others maintain that we already have disclosure overload and any effort should be focused on pruning requirements rather than adding to or changing them.

Whatever the solution, and there may be many, continued progress on reducing complexity and improving the transparency and usefulness of reported financial information is imperative and consistent with our nation's longstanding commitment to the importance of high-quality financial reporting to the health and vitality of our capital markets and our economy.

We at the FASB strongly support the goal of reducing the complexity of and increasing the quality and transparency of financial reporting. As discussed above, we have taken a number of steps to try to do our part to begin addressing these matters. Additionally, over the past few months, I have met with many preparers, auditors, users, and regulators to discuss the topics of complexity and transparency, and to discuss how, collectively, we might both reduce the complexity of our reporting system and increase the quality and transparency of reported information. Your insights and candidness have been much appreciated and very helpful. I thank you. They have served to reinforce and strengthen my belief that these are serious issues needing attention.

So, while I and others within the financial reporting community have been vocal about the need to reduce complexity and improve transparency of financial reporting, I believe it is time to stop observing the problem and start thinking about how to solve these issues. For I am concerned that failure to take action will inevitably lead to more complexity, less transparency, and potentially less relevance of reported financial information. Accordingly, we have been discussing with the SEC and the PCAOB the kinds of steps and actions that would be needed to begin to seriously focus on and address these issues. In my mind, this would start with a thorough review and analysis of the challenges facing the reporting system, with a particular focus on the factors and forces that cause complexity and impede transparent reporting, and would then proceed to looking at potential solutions to these issues. And, as I have tried to emphasize in my remarks today, I believe that to be successful any effort of this kind would require the active participation and commitment of all key parties in the system, for as I have also tried to stress today, solving these issues is beyond just the FASB or even the SEC, the PCAOB, and the FASB acting together.

As you can probably tell, I feel pretty strongly that the time has come for collective action to address these issues. And while I recognize that such an effort could result in significant changes to our reporting system, including institutional and structural changes some of which could impact the FASB, from where I sit, I believe the status quo is neither acceptable nor sustainable. Our reporting system, while probably the best in the world, is too complex and is capable of providing more transparent, more understandable, and more useful information to investors and the capital markets.

From the creation of the SEC over 70 years ago through the Sarbanes-Oxley Act of 2002, the need for sound, transparent, and credible information for investors and the capital markets has been recognized as a national priority on which the success of our capital markets in contributing to our economic well-being rests. By acting together in the public interest we can ensure that we continue to honor and fulfill this longstanding commitment to high-quality financial reporting. Given the many structural, institutional, cultural, and behavioral issues facing the system, the effort to reduce complexity and improve transparency will not be easy and will take time, but I hope you agree that it is one of national importance and one that deserves the support of all of us.