ACCOUNTING AND AUDITING STANDARDS: PENDING PROPOSALS AND EMERGING ISSUES

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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U.S. HOUSE OF REPRESENTATIVES

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ACCOUNTING AND AUDITING STANDARDS: PENDING PROPOSALS AND EMERGING ISSUES

Friday, May 21, 2010

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Sherman, Perlmutter, Foster; Garrett, Royce, and Campbell.

Chairman KANJORSKI. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

Pursuant to committee rules, each side will have 15 minutes for opening statements. Without objection, all members' opening statements will be made a part of the record.

I yield myself 5 minutes.

Good morning. Since the start of the financial crisis, we have done much work to understand its root causes and to pass robust reform legislation, initially in the House, and yesterday in the Senate, that will end the era of "too-big-to-fail" financial companies; reform credit rating agency operations and regulations; and implement a broad array of sorely-needed measures that will better protect innocent Main Street investors from unscrupulous Wall Street operators.

In debating these matters, accounting and auditing issues have surfaced more than once. As a result, the House-passed Wall Street Reform bill includes my reforms aimed at responding to the Madoff fraud by better regulating the auditors for broker-dealers. This legislation also contains my provisions designed to enhance the ability of security authorities to coordinate foreign and domestic investigations and to improve the ability of the Public Company Accounting Oversight Board to collect from and share information with foreign entities.

The bill additionally includes a provision by Congressman Lee of New York providing for an annual accounting transparency hearing, like the one we are having today.

It further incorporates a provision by Congressman Miller of California to create a financial reporting forum for regulators.

Finally, Congressman Adler and Capital Market's Ranking Member Garrett, both of New Jersey, amended the bill to exempt small public companies from the Sarbanes-Oxley Act's requirements for external audits of international control, a provision which continues to concern me.

At today's hearing, we will doubtlessly re-examine each of these matters as well as the pending Supreme Court case on the process for appointing members of the Public Company Accounting Oversight Board. We will also continue to explore whether or not accounting and auditing standards helped to contribute to the financial crisis. Decisions to move problematic assets off of their balance sheets allowed some companies to hide the real nature of their financial health. Moreover, the recent court-appointed examiner's report of the Lehman Brothers' bankruptcy highlighted the troubling Repo 105 practice that some companies may use to embellish their financial viability and inaccurately portray leverage. These practices, motivated purely by short-term self-interest, are not literary works to be admired; rather, they are fictional stories based on half truths that have no place in our capital markets.

Accounting standards and those that apply them ought to portray a company's financial condition candidly and in a way that investors can readily understand. Today, we will also explore what progress regulators and standard setters have made to simplify our reporting framework and produce books that investors want to read.

We will further examine how to improve accounting transparency, decrease regulatory burdens, and address old issues, like auditor concentration, and newer ones, like converging accounting rules.

The financial crisis demonstrated just how interconnected our economic fortunes are. Capital now moves across international borders at lightning speed, as investors diversify their portfolios and take advantage of opportunities both here and abroad. Investors, therefore, need to have access to timely, accurate financial information that allows them to make apples-to-apples instead of apples-to-oranges comparisons at similar companies around the world.

While we have moved quickly on converging global accounting standards, we must also proceed carefully to ensure that these rules produce high-quality results for investors. America's markets and its financial reporting framework are among the most developed in the world because of the independence of standard setting and enforcement. To protect the credibility of our markets and to instill investor trust, we must ensure that any new international system continues to adhere to the core principles of independence, transparency, and accuracy.

In closing, I look forward to hearing from today's witnesses on the state of accounting and auditing regulations, the progress they have each made in improving standards and enforcement, their priorities, their coordination efforts, and the challenges they now or may soon face. I thank each of them for coming and look forward to their testimony.

I now recognize the gentleman from New Jersey, the ranking member, Mr. Garrett, for 5 minutes.

Mr. GARRETT. I thank the chairman for this important oversight hearing today.

Thank you to all the witnesses who are here today.

With all the changes occurring in our regulatory structure, I look forward to all your testimony, the reason being that accountants and auditors do play a crucial role within our financial markets of ensuring that investors basically have the appropriate and reliable information.

I would like, though, to begin my comments by mentioning the current case that is before the Supreme Court to determine the constitutionality of the Public Company Accounting Oversight Board, the PCAOB, that was created by the Sarbanes-Oxley Act, or SOX.

Let me be clear, I believe that the PCAOB, as currently established, is unconstitutional. I believe it is in direct violation of the appointments clause. And I believe that when the Supreme Court ruling is delivered, maybe as early as next week, they will agree with me on that point.

Several Congresses ago, I started a caucus in the House called the Constitution Caucus, and one of the goals of that caucus is to educate other Members of Congress about the constitutional limitations on congressional actions in legislation. Too many times, Members of this body simply abdicate their responsibility to examine each law and determine whether it adheres to the Constitution or not.

Our Founding Fathers expressly stated that it is incumbent on all three branches of government, not just the Judiciary, to examine and determine the constitutionality of each law before them. So no Member of Congress should ever pass legislation and say, we will just let the courts decide if this is constitutional or not. Each Member must look at each law and determine for themselves if the legislation is within the confines of the Constitution. Maybe if more Members had done this, for example, with the health care bill, we wouldn't have passed a basically unconstitutional monstrosity like the House and Senate did.

So, partly in response to my concerns on the constitutionality of PCAOB, I introduced legislation 3 years ago, we called it the Amend Misinterpreted Excessive Regulation in Corporate America Act, which basically came out to be the AMERICA Act. And one provision in the AMERICA Act just simply attempted to fix the appointment clause at the heart of the current Supreme Court case by requiring that the PCAOB, the Board, be appointed directly by the President and confirmed by the Senate. If you think about it, had more of my colleagues focused on this issue then, perhaps we would not have had to engage in this very long and drawn out and also costly legal battle that is going on across the street.

And when you consider the constitutionality of the PCAOB, it has been given question for a number of years, I am not sure why we are giving this same body additional powers and authorities until this is determined. We marked up legislation affecting the PCAOB in November of 2009, and less than a month later, the Supreme Court was hearing arguments as to whether or not the entity should even exist.

I believe it is prudent before Congress gives different entities more powers, that we make sure that those entities are operating in a manner in accord with the Constitution.

Now, another issue from the Sarbanes-Oxley law currently being debated as part of the financial regulatory reform package is whether to permanently exempt small businesses from the costly independent auditor attestation of management internal controls. Now, I know my good friend here, Chairman Kanjorski, and I differ on this topic, but during this economic downturn, where thousands of small businesses across the country are really struggling just to make payroll, I don't really see how adding one more costly, burdensome regulation—which at best has dubious benefits—will help improve the number of jobs in the country or improve the economy.

And so I will repeat my comments from yesterday by stating that this is one of numerous ways we can help small businesses without creating another TARP program or throwing another $30 billion at deficit spending.

In regards to the Financial Accounting Standards Board, FASB, I look forward to hearing how the changes and additional guidance you have provided to fair accounting so far have worked. I would also like to explore in greater detail with both FASB and the SEC the recent changes to the securitization rules and 166 and 167 and regulation A-B and the potential impact that those new rules, when you combine them and couple them with the new proposals, will basically have on the availability of the cost of credit.

I am also very interested in learning further on the progress, as some of you have talked about, of international convergence of accounting standards. I believe this is a critical long-term goal for international competitiveness, and I want to make sure that we are moving forward, as I think we will probably hear, on this expeditiously.

So, again, I want to thank the chairman for holding this oversight hearing. I think general oversight hearings with government regulators are very informative; they allow us as Members to discuss a wide range of issues. We are going to do another such hearing next week with the FHFA, and later on in June with the SEC and Chairman Schapiro. I do look forward to those.

And once again, I thank the members of the panel before us.

I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Garrett.

I will now recognize the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. I thank the chairman for holding these hearings. Due to my flight schedule, I may not be here to the very end, but I recognize the importance of these hearings.

The chairman comments on the action taken by the Senate. I have been informed that the Senate passed the bill without passing the manager's amendment. If that is true, then section 210(n)10 remains a phony limit on the amount that the FDIC can borrow of taxpayer funds in order to help the creditors of defunct financial institutions. I am confident that anyone who voted for the bill in the Senate really intended the manager's amendment to be part of it, and I am confident that those limits, which are so important to the bailout versus nonbailout question, will be dealt with.

These hearings are on auditing standards and accounting principles. I will leave to others the discussion of the auditing standards and the discussion of section 404, because accounting principles are so important.

Corporations dedicate their focus to showing higher earnings per share. He who controls the rules controls the behavior of corporate America. The FASB, therefore, has the highest ratio of anonymity-to-power of any entity in the business world.

I have been one of the loudest voices in Congress for the independence of the FASB, not because I was convinced they were doing a great job, but because I thought they could do better, and I wasn't so sure that Congress would be helpful. And I was also told again and again, don't worry, international standards are on the way, and they will solve all the problems.

Mr. Herz, we will get the international standards when you and I get hair.

And so, we do have to take a look at whether the accounting standards make any sense from an accounting theory standpoint.

Accounting theory would tell you that two companies should be comparable and that companies that are virtually identical should have identical results, notwithstanding superficial differences, and yet we still have one company to choose LIFO and another company to choose FIFO. Why? Because accounting theory isn't as important as just keeping everybody happy: Let the business world do what they want; investors, figure it out on your own.

We dealt with some non-optional requirements with stock options, and I think that may have been a step in the right direction. As to mark-to-market, these much ballyhooed rules don't really give you comparability, because if one bank invests in a $100 million loan on a shopping center which they hold for their own portfolio, they made the loan the old fashioned way, and another invests in $100 million worth of collateralized debts, collateralized by shopping centers, perhaps identical shopping centers, the two would be treated differently under this rule. And yet, all the shopping centers are down in value, not just the ones where the debt happened to be securitized.

But the biggest problem the FASB has is the desire to go with the verifiable rather than the relevant, the desire to make it easy on the auditor rather than useful for the investor. And the best example of this, and by far the most harmful act that nobody ever talks about, is FAS 2, which requires the write-off of all research expenses; penalizes those companies that choose to do research, while we in Congress are providing large benefits to those same companies, and while I think most people agree that the success of America depends upon the research done in the private sector. This isn't good accounting. Good accounting says you are supposed to capitalize research expenditures that provide useful results.

Why do we have FAS 2? Because good accounting theory would require accountants to distinguish between useful and useless research projects. That is difficult. That is like eliminating the strike zone in baseball and saying every pitch is a strike because the umpires don't want to be second-guessed as to their ball and strike calls. The fact is, for us to be penalizing those corporations that engage in research, making them write off the money they spend, providing higher earnings per share to those companies that choose not to do research, and to do this, not only in the high-tech sector where I think investors may be savvy enough to adjust for it, but in the rest of our economy where research is also important, is the most harmful thing that has been done to our economy that nobody knows about.

So I look forward to going back to good accounting, when it comes to research, instead of adopting a system that is easy for the umpire and terrible for everyone in the ballpark.

I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Sherman.

I now recognize the gentleman from California, Mr. Campbell, for 3 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman.

I am one of the two CPAs on the committee here, along with my California colleague, Mr. Sherman.

I remember when I was first getting my certificate and accounting was a very nice, steady thing, boring, and one of the three of your organizations didn't even exist. We would have probably never had this hearing because nobody would have cared and nobody would have come, but unfortunately, I guess that is not the case anymore.

And accounting, as my colleague, Mr. Sherman, pointed out, for many entities and many things is now under a great deal of scrutiny and under the spotlight.

One thing we do not, any of us, want this to yield is that we up here in Congress start to dictate accounting standards. That is the worst possible result we could ever get to because we will politicize them, and we will not make judgments on the basis of proper accounting, good accounting, any kind of reasonable judgement; we will make them on the basis of what groups here are powerful and what ones are not, and have different accounting standards for the same companies that are different sizes or in different States or with different treatments. We don't want to go there, and we don't want to be there.

But because of the focus on accounting, it means that FASB and other organizations will need to be more responsive and I think quicker in response to things that have happened out there.

A few things that I would like to talk about is, one thing we do deal with are reporting standards for public companies and also banking regulations. And a couple of things I will mention in my short time here that hopefully will come out over time is, I am, for example, supportive of going from quarterly financial statements to every 6 months financial statements, and other things that we might do in order to try and reduce volatility in the markets.

My colleague, Mr. Garrett, mentioned harmonization with international accounting standards. I would like to hear what you all think is happening or can happen and so forth on that because we shouldn't be having situations where two international companies based in different countries have completely different accounting reporting on the same fundamental results.

What is going to happen if—the banking sector is far from being out of the woods and far from being out of the problems of 2008—banking regulations start diverging from accounting regulations? If some of the things that we do and are looking at in terms of reserves and so forth diverge from accounting?

And also, I wondered about financial statements and financial reporting in general. It hasn't changed a whole lot since when I took the exam some years ago, decades ago, but yet markets today are using a whole lot of other measures and metrics to evaluate the performance of companies than the traditional three financial statements that we have been putting out for decades and decades. Now, much of that information may be derived from audited results, and I understand that, but should we be taking a look at what we are auditing and what we are reporting, given the realities of the market today?

I yield back. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Campbell.

I will now recognize Mr. Sherman for 5 seconds to clarify.

Mr. SHERMAN. I misspoke in a way when I said the manager's amendment had not been adopted by the Senate. They adopted the first manager's amendment. They failed to adopt the second manager's amendment, and we can breathe a little easier.

I yield back.

Chairman KANJORSKI. Only an accountant would want to correct—

Mr. SHERMAN. It is an occupational hazard, Mr. Chairman.

Chairman KANJORSKI. I now recognize the gentleman from Colorado for 2 minutes.

Mr. PERLMUTTER. And it will be much shorter than that.

I just appreciate you all being here today. We tangled a little bit the last time you all were here.

And I just want to say thank you to—working with various people, various parties, various industries in helping us move through a very difficult time for this country financially.

And I would say to my friend, Mr. Campbell, I agree, for the most part, the accounting profession, there are a lot of objective kinds of things, two plus two equals four. We have come through a time, though, where there was some subjective analysis that had to be involved. And I just appreciate the willingness of the Board, of the different agencies for looking at bigger picture and, quite frankly, helping us get through very difficult periods. So I look forward to your testimony, and appreciate you being here today.

Thank you. With that, I yield back.

Chairman KANJORSKI. Thank you, Mr. Perlmutter.

I now recognize the gentleman from Illinois for 3 minutes.

Mr. FOSTER. Thank you, Mr. Chairman.

In the wake of the financial crisis that we went through and the largest destruction of wealth in human history, of approximately $17.5 trillion of household net worth in the last 18 months of the previous Administration, a lot of attention has focused on the procyclical versus countercyclical effects of accounting standards. And much of the attention has focused on providing relief after the bubble has burst.

I think it is more important to adopt countercyclical accounting standards that actually suck energy out of the bubble on the way up. And it seems to me that the key principle there is to treat skeptically the value of recently appreciated assets. We are going to have a workshop next month at the American Enterprise Institute, which will include Alex Pollock and Mark Zandi, two frequent witnesses in front of this committee, on preventing the next real estate bubble, which I think is the single most important thing we have to do.

We are going to look, first, among other things, specifically at proposals to calculate the loan-to-value for mortgages using not simply the current market price but the current market price deflated by the amount that real estate has gone up regionally in the last several years. And if that had been in place, I think it is very clear that that would have just sucked all the energy out of these enormous real estate housing bubbles that we have gone through and that have been the big dog in destroying net worth. So that is one of the specific things I would like to hear your reactions on.

Second, the PCAOB I found to be a very interesting model as the possible way forward for the oversight of the rating agencies. I think, frankly, that there is no satisfactory solution to the conflict of interest in the rating agency models. The PCAOB was an attempt to deal with similar conflicts of interest in the accounting business, and I would be very interested in people's general reaction on how effective that approach has been because it is, to my mind, the best stab at that. And I was partly successful in getting amendments into the regulatory reform bill.

The third issue has to do with the high-frequency accounting standards for firms, especially large trading firms, where things can fluctuate on a day-to-day or hour-to-hour or even minute-to-minute basis. You are not going to be able to just publish reports that continuously update, but we are going to need to have some mechanism of looking over the shoulder of these large firms with very high volatility to understand and to give investor confidence that there are at least systems in place so that there is good real-time monitoring of these, and that is different than just publishing a report every 6 months or a year. Anyway, those are what I see are the big issues here, and I look forward to your testimony.

Chairman KANJORSKI. Thank you very much, Mr. Foster.

Are there any other members who desire time? If not, we will move to our panel.

Thank you for appearing today before this subcommittee. Without objection, your written statements will be made a part of the record. You will each be recognized for a 5-minute summary of your testimony.

And, first, we have Mr. James Kroeker, Chief Accountant, U.S. Securities and Exchange Commission.

Mr. Kroeker.

STATEMENT OF JAMES L. KROEKER, CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. KROEKER. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, I am Jim Kroeker, Chief Accountant in the Office of the Chief Accountant, which advises the

Commission on accounting and auditing matters, and I am pleased to testify today on behalf of the Commission.

One of the lessons from the financial crisis is that financial reporting plays a critical role in establishing, maintaining, and, in certain cases, rebuilding investor confidence. The objective of financial reporting is to provide decision-useful information for capital allocation. Market participants must be confident that the information they receive is neutral, it is reliable, and it portrays the economic results in an accurate and faithful manner.

As the agency empowered to be the investors' advocate, the Commission is responsible for this reporting. To further ensure the integrity of this reporting, the Federal securities laws mandate that an independent audit by qualified professionals be performed.

As more fully described in my written testimony, in discharging our responsibilities, we oversee the work of the FASB and the PCAOB, and we do that to monitor existing accounting and auditing standards for potential improvement, and to increase consistency in the application of those standards.

Let me just outline from my written testimony some of the pending proposals and emerging issues in these areas. Let me turn first to what is often referred to as off-balance sheet accounting. Last year, the FASB issued standards relating to the accounting and the related disclosure with respect to what are often referred to as special purpose vehicles, which include many securitization structures. The new standards should enhance financial reporting by better portraying a company's risk exposure. Of course, we will continue to review the reporting practices to determine if companies are complying with their requirements, and we will continue to see whether further improvement is warranted.

We are also focused on the Commission's ongoing consideration of global accounting standards and the convergence of U.S. GAAP and IFRS. The Commission is engaged in significant efforts toward the development of a single set of high-quality, globally accepted standards. These efforts are reaching a critical stage, and in February, the Commission directed my office to execute a work plan to evaluate the areas relevant to further incorporating IFRS into the U.S. financial reporting system. We will begin providing public progress reports on our work no later than October of this year.

Another critical component to our consideration is convergence between the FASB and the IASB, which is further covered in my written testimony.

Turning to auditing, PCAOB oversight of the auditing profession has provided clear benefits to financial reporting quality and to investor protection. As you may know, the PCAOB is currently facing a constitutional challenge before the Supreme Court, but we are hopeful that the PCAOB's constitutionality will be upheld so its important work can continue uninterrupted. If not, the Commission stands ready to issue any necessary guidance to provide continuity. If congressional action is needed, we will promptly provide technical assistance so changes can be considered as quickly as possible.

Another challenge facing the PCAOB is the inspection of overseas auditors whose reports are filed with the Commission or who perform audit work for U.S. issuers. Access to these firms has been hampered by the PCAOB's inability to share information with their foreign counterparts. I would like to thank Chairman Kanjorski and this subcommittee for their leadership in including a provision to address this issue in the House regulatory reform bill.

I would also like to thank the chairman and this subcommittee for another provision in the bill to address the important issue of PCAOB oversight of auditors of broker-dealers. Clarifying the PCAOB's authority will improve audit quality and strengthen both investor protection and broker-dealer compliance.

In closing, a significant lesson from the recent crisis is the same one underlying the commitment to securities regulation over 75 years ago, that is, transparent financial reporting is critical when pressures are highest and investor confidence may be shaken by uncertainty.

Thank you for the opportunity to appear today. I am happy to answer any questions that you may have.

[The prepared statement of Mr. Kroeker can be found on page 96 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Kroeker.

Next we have Mr. Robert Herz, chairman, Financial Accounting Standards Board.

Mr. Herz.

STATEMENT OF ROBERT H. HERZ, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

Mr. HERZ. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, thank you for inviting me to participate in today's hearing.

The FASB is an independent private sector organization whose mission is to establish standards of financial accounting and reporting for U.S. nongovernmental entities. Those standards are recognized as authoritative Generally Accepted Accounting Principles, or GAAP, by the SEC for public companies, and by the American Institute of Certified Public Accountants for other entities.

GAAP is essential to the efficient functioning of the U.S. economy because investors, creditors, donors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make their resource allocation decisions.

An independent standards-setting process is the best means of ensuring high-quality accounting standards since it relies on the collective judgment of experts informed by the input of all interested parties through a thorough, open, deliberative process.

However, we also fully appreciate that the FASB does not operate in a vacuum. The FASB is accountable in two important ways: first, by engaging in robust due process in setting standards, including wide consultation with stakeholders; and second, by being subject to oversight conducted in the public interest by both the Financial Accounting Foundation's Board of Trustees and by the SEC.

Our very extensive process involves public meetings, public roundtables, visits to interested parties, and of course the exposure of our proposals for public comment. We meet regularly on both a formal and informal basis with the SEC and the PCAOB and their staffs, and with bank regulators. FASB and FAF also regularly brief Members of Congress and their staffs on developments. Indeed, a number of FAF trustees and FASB Board members will be meeting with Members of Congress next week.

Over the past year, the FASB had acted vigorously to improve U.S. GAAP, especially by addressing reporting issues emanating from or highlighted by the financial crisis. The standards we issued in 2008 and 2009 made improvements to U.S. GAAP in a number of areas, including: the valuation of financial assets, especially in inactive markets; securitizations and other involvements with special purpose entities; accounting and disclosure for impairments, credit default swaps, and other derivatives; and for financial guarantee insurance. In these and other standards we have issued in recent years, we have focused on communicating clear objectives and principles supported by a sufficient level of implementation guidance.

The FASB has also reduced complexity in the U.S. financial reporting system through the launch last July of the Accounting Standards Codification. The codification will benefit everyone in the financial reporting system by replacing the previous myriad of separate accounting pronouncements with an easily accessible, topically organized online research system which also links in the XBRL U.S. GAAP financial reporting taxonomy.

During the past year, we have made good progress working with the International Accounting Standards Board on projects aimed at improving both U.S. GAAP and international financial reporting standards, and achieving convergence between those standards. Many of these projects are nearing their exposure draft stage.

On some of the projects, I believe the Boards are on track to both make the desired improvements to U.S. GAAP and IFRS and achieve convergence, while on other projects, achieving substantial convergence is proving to be quite a challenge. Let me be clear, we are committed to and are making every effort to foster convergence between U.S. GAAP and IFRS, but consistent with our mandate under Sarbanes-Oxley, we must also ensure that the resulting standards represent improvements that are in the best interests of U.S. investors and other users of U.S. GAAP information. My written testimony also details our extensive efforts regarding the private company and not-for-profit sectors.

I have also been asked to comment on financial arrangements that companies may employ to manage their financial position near the end of a reporting period, presumably including arrangements such as the so-called Repo 105 transactions engaged in by Lehman Brothers. As I explained in a letter to the committee last month, the FASB does not have any regulatory or enforcement powers, but we do work very closely with the SEC and stand ready to take any additional standard-setting actions that may be appropriate as they obtain further information concerning the practices of financial institutions.

In conclusion, the demands on accounting standard setters that stemmed from the financial crisis, together with the goals of continuing to improve U.S. GAAP and achieving convergence between U.S. GAAP and IFRS, have made this past year one of the more challenging in the FASB's 37-year history, and I expect that the coming year will also be equally as challenging.

I thank you again, and I would be pleased to respond to any questions.

[The prepared statement of Mr. Herz can be found on page 59 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Herz.

And finally, we will hear from Mr. Daniel Goelzer, Acting Chairman, U.S. Public Company Accounting Oversight Board.

Mr. Goelzer.

STATEMENT OF DANIEL L. GOELZER, ACTING CHAIRMAN, U.S. PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)

Mr. GOELZER. Thank you.

Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, I appreciate the opportunity to appear before you today on behalf of the Public Company Accounting Oversight Board.

Congress created the Board in 2002 to provide rigorous, independent oversight of public company auditors. I would like to summarize how we discharge our responsibilities and how the Board has responded to issues raised by the financial crisis. I also want to mention some challenges we currently face.

The Board has four basic functions:

First, no accounting firm may prepare, or substantially contribute to, an audit report for a company that files financial statements with the Securities and Exchange Commission without first registering with the PCAOB. There are currently about 2,500 Board-registered accounting firms, in 87 countries.

Second, the Board conducts a continuing program of inspections of registered firms' public company auditing, including reviews of individual engagements and evaluations of firms' systems of quality control. Since 2003, the Board has performed more than 1,300 such inspections and reviewed aspects of over 6,000 audits, including 173 non-U.S. inspections.

Third, the Board has broad authority to sanction firms and associated persons that violate applicable laws and standards. The PCAOB has announced the resolution of 31 enforcement proceedings. These cases do not, however, fully reflect the Board's enforcement activity since they do not include ongoing investigations and contested disciplinary proceedings which are, by statute, nonpublic.

Fourth, the Board sets the professional standards for public company auditing. The Board has an active program to update and strengthen the auditing standards. Our standards-setting agenda is appended to my written testimony.

I want to turn next to the financial crisis. The financial crisis affected our work in three basic ways.

First, our inspections program is designed to focus on difficult audit issues. We are currently reviewing the results of the recent inspection cycles and intend to prepare a report on findings related to the impact of the financial crisis on auditing.

Second, this inspection experience has also informed several ongoing standards-setting projects, including risk assessment, use of specialists, and auditor communications with audit committees. In addition, the Board's chief auditor has issued a series of Practice Alerts on crisis-related audit issues.

Third, the enforcement staff has opened several investigations related to audits of public companies involved in the financial crisis. As I have noted, these matters are non-public.

Before closing, I want to mention three challenges we currently face. First, we are not able to conduct inspections in the European Union, Switzerland, or China. Significant audit work on which investors in SEC-reporting companies rely occurs in these countries. One of the obstacles, particularly in the EU, has been the Board's inability to share confidential inspections and investigation information with foreign audit oversight authorities.

Section 7602 of the Wall Street Reform Act, passed by the House last year, would correct this problem. The Senate financial services bill contains a similar provision. Hopefully, enactment of the information-sharing provisions will allow EU inspections to go forward.

The second challenge relates to overseeing auditors of securities broker-dealers. While such auditors must register with the PCAOB, we currently lack any authority over their work. Both the Reform Act and the Senate financial services bill would extend Board inspections, enforcement, and standard-setting to audits of broker-dealers. That would close the gap between broker-dealer auditor registration and Board authority over these firms.

Finally, there is a pending challenge to the Board's constitutionality. That litigation, now before the U.S. Supreme Court, deals principally with the way in which Board members are appointed and the circumstances under which we could be removed. I expect the Court to issue its decision within the next few weeks.

The PCAOB won in the District court and in the Court of Appeals, and we hope the Supreme Court will reach the same result. If the PCAOB does not prevail—and the decision requires a legislative change—I would urge Congress to act quickly to fix whatever structural problems the Court identifies. The need for investor protection through independent oversight of the auditing profession is as great today as in 2002 when the Board was created.

My written statement covers these topics in greater detail, and I would ask that it be made a part of the record. I would be happy to answer any questions.

Thank you.

[The prepared statement of Mr. Goelzer can be found on page 34 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Goelzer.

I thank the panel for their testimony, and I suspect we have some questions here from our panel.

Not to be facetious, Mr. Kroeker, I ask the question: Why do I get the feeling, sometimes, that we are playing a game of cops and robbers, waiting always behind the fact to find out what happened and then to close "loopholes" or take positions?

The Repo 105 problem, was that not observed and was that not evaluated at some point to be an attempt to avoid transparency, and if that were the case, does the SEC not have the authority, in conjunction with these other entities, to propound rules to prevent that from happening? Rather, if you do not have that authority, why was that not requested of the Congress for additional authority?

All these questions predicate on the fact that when I talk to my constituents, they are not nearly as sophisticated as you all are, but they do not understand why we are always catching up, playing the game of catch up, as opposed to why we do not have a system that prevents some of this abuse. Maybe you can give me--

Mr. KROEKER. I suspect, in some respects, it goes back to the issue of, are we going to continually be playing cops and robbers? It goes back to human nature in that when a standard is put in place, there are very ingenious people who work to design around that.

One of the things that the SEC did coming out of the post-Enron reforms was to do a study on accounting standards themselves, recommending the proper balances to come up with an objectives-based standard; that is, we shouldn't lean too heavily on only principles by which you can circumvent the principle or try to circumvent the principle by creative structuring. But if you lean too heavily on a rules-based system, we have seen the outcome of people saying, well, the rule didn't catch me, if you will, suggesting an optimal balance, in our view, of sufficient specificity of the objective of the standard, coupled with guidance that would help you operationalize that in practice. A number of the FASB's recent standards I would characterize in that vein, their standard on business combinations, their relook at off-balance sheet accounting and Statements 166 and 167 that dealt with off-balance sheet and securitization accounting, providing a clear objective of the standard.

So I suspect that, in some form, it will be human nature for some small minority to try and escape that, but the second piece of that question then is, do we have the authority? And yes, we do have the authority.

And important in my mind or my way of thinking, an important element of ensuring that the conduct doesn't continue, is enforcing standards where standards are already in place as opposed to suggesting that the standard itself should change if the standard is clear.

Chairman KANJORSKI. Well, in enforcing those standards, are we remiss in giving you certain authority? Let us say an accounting firm purposefully concentrates on avoidance for the purpose of changing leverage or giving a false impression of a company's financial condition—and that is quite apparent from what went on, nothing is 100 percent, but the high probability is up in the 90 percentile—do you have the power to say, "Look, if you persist in that type of operation, we are not only going to put some conditions on the company, or potentially fines or what can be levied, but we are going to bar you from practicing, that you are just not going to be allowed, for a given number of years, or we are going to fine you individually as an accounting firm?" It just seems to me we are constantly chasing—I use the term "cops and robbers"—to the level of real frustration.

I am trying to think of the operation down there in the South, the guys putting the accounts offshore, Stanford Financial. That was observed for a number of years, what he was doing, and that it was putting in jeopardy investors and citizens. When I talk to those groups, they just thought it was clearly something that government regulation had addressed and would not allow to happen. Now, that was not under the SEC, that was under bank regulators and others that would have the authority there, but it seems to me people just said, "Well, it is not a clear case for us to get involved in, so we are not going to get involved in it."

I guess the question I am asking you is: Is there something we can put in this reform bill now that makes it so clear that we are just not going to take it anymore, not just for creative accounting, but also for fraudulent accounting, for avoidance of truth, and injury to the average investor? Is there something we can do here?

Mr. KROEKER. Well, we do have authority, including authority of barring accountants from appearing and practicing. We have used that authority with respect to firms, I believe, since the 2002 era, about 66 times against firms and multiple of that against individual accountants. I can certainly think more fully and get back to you if there are more specifics.

Chairman KANJORSKI. I would appreciate that.

I am going to take 1 more minute, even though I am over time. It violates what I call the "bastard rule." I want to lead in with that because it sounds as if I am assuming that all accountants do not do their job. The fact is that most accountants and most business executives do the right thing, want to do the right thing, want to engage in fairness in their businesses. However, if you have an element of 3 or 5 percent—those are my "bastard violators"—you almost get forced into doing the same thing they did, or you are going to be at a decided disadvantage after a while. We have to find a way of getting them out of the system, so join me in my "bastard hunt," if you will.

Mr. KROEKER. I agree.

Chairman KANJORSKI. The gentleman from New Jersey.

Mr. GARRETT. Thank you. And I thank the panel again.

You may have heard, if you were listening to the hearing that we had the other day, I gave an example of a company in my district that manufactures products for our troops overseas. The company has a $3.5 million market cap, they have about 30 employees, the CEO, the CFO, and the COO work basically in the same room, if you will. And they told me weeks or a month ago that if they don't receive a permanent exemption from the 404(b) requirements, they will have to pay upwards to $100,000 by the end of the second quarter to get things up and working to be in compliance. So that is only 4, 5, 6 weeks away.

So, in light of where the economy is right now, I guess the short question is, what do I go back to tell them, that it is better that they spend about $100,000 to be in compliance with a little tiny company like them with 404(b) as opposed to using $100,000 to hire another employee or two or make sure their stuff is up to snuff with regard to what they are sending overseas to our troops?

Mr. KROEKER. The objective of the auditors opining on or giving an opinion with respect to 404 wasn't to put in place a costly or non-beneficial requirement. And investors that I speak to almost unanimously, both with respect to individual companies, but as well as the financial system as a whole, indicate that they receive significant benefit from knowing that there is increased quality to financial reporting. It goes back to the 1977 Foreign Corrupt Practices Act where an integral part of strengthening financial reporting is strong internal controls.

That doesn't mean that the cost should be disproportionate. The SEC, working with the PCAOB, has taken a number of steps to reform the costs going back to the outset of 404 and what we have heard—

Mr. GARRETT. You have to admit, $100,000, when you are dealing with little tiny company, a $3.5 million mark cap company, it is a lot of money. So I just don't know where, when you are talking about the transparency that you are trying to get with a little company like this, does the cost really meet the benefits? Isn't there some level that maybe the cost exceeds the benefits when you are getting down to this size? That is not talking about when you talk about the GMs of the world—or who knows whether GM—I guess we have a whole different situation with GM, let's see how well it worked with them, right?

Mr. KROEKER. Again, the confidence that the individual investor has when they put their money at stake in a company of that size, we hear from them, that they take tremendous confidence, not just from the GAAP financials, but the process. And I appreciate that obviously there is then balancing that tradeoff between what are the costs and what are those benefits?

Mr. GARRETT. Well, someone just mentioned to me, with regard to the SEC itself, with regard to their own internal control requirements, that GAO has certain internal audit requirements. Is it the case that the SEC has not met their own requirements that set those audits?

Mr. KROEKER. The GAO does effectively the equivalent of 404(b), the auditor opinion—

Mr. GARRETT. How did the SEC do?

Mr. KROEKER. We did have a material weakness. And the process by which we looked at our own controls, and the GAO taking an independent look at that, has actually caused a significant increase in our internal focus on financial reporting.

Mr. GARRETT. So we are asking this little company to try to meet some standards that the SEC can't meet. Now, of course, the different is the SEC gets all the money they need basically to do so, and this little company here is just—I don't want to say they are holding on, that would make them sound like they are not doing well, I think they are doing okay.

You can see how the CEO of a company like this might say, "Hey, it doesn't seem right. The SEC can't even meet its standards, and yet they are coming in and saying that we are supposed to meet a standard that they can't even meet." Do you see the problem I have in discussions with folks like that?

Mr. KROEKER. The standard, itself, is an opinion on controls, the same as the opinion, taking a self-look at controls, the SEC internally reported a material weakness and the GAO agreed, so it is the same assessment that we are asking companies to do.

Mr. GARRETT. But they just can't do it.

Just in the time that I have left, so we have the discussion with regard to trying to look at companies with regard to SIBs outside, these may be one of the areas we had problems with these in the past, where the companies actually had controls of the SIBs in the past, and say that they should all be on their own balance sheet, right? And that is a good thing? One word answer.

Yes. You are nodding yes. And so if that is a good thing, if we want to have transparency and openness and what-have-you, shouldn't we really be doing the same thing for the Federal Government? Don't we have an entity right here with the GSEs, Fannie Mae and Freddie Mac where you basically have an entity where the CBO says these are entities out there that are actually controlled by the Federal Government right now, and for all honesty and transparency, if we were to treat the GSEs like we are trying to treat all these public companies, wouldn't they have to bring the GSEs on to our budget? If you applied your rules to how we run our system?

Mr. HERZ. I have not done that exact analysis, but the criteria are, if, essentially in layman's terms, that if you are running the show and you have significant skin in the game, then it is on your books.

Mr. GARRETT. We control it. We fund it. We decide who is in charge of it, and there is one other criteria.

Mr. HERZ. Under our standards, that is the approach.

Mr. GARRETT. I see my little red light is on, but thanks for the nod and thanks for the "yes."

Chairman KANJORSKI. Thank you, Mr. Garrett.

Now we will hear from Mr. Perlmutter for his 5 minutes.

Mr. PERLMUTTER. Thank you. And again, I appreciate you being here, and I have to smile, Mr. Herz, I think you were a master of understatement when you said you had gone through a few challenges over the last 18 months. I think the accounting industry, pretty much every industry has been stressed to the max. And again, I do want to compliment the industry, the profession, the Board as a whole because this has been a heck of a time for this country. But as Americans do, they roll up their sleeves, they move forward, they deal with the problem and do the best job they can. And so I just want to start with that. You and I may not agree on some things from time to time. Mr. Garrett and I often don't agree. But we do agree on the point that he was making about his company and that the burden of some of the accounting measures to smaller organizations sometimes can just be too much. I know we here in the Congress need to consider that, and I would ask that you three do, as well.

Now, Mr. Goelzer, my question to you is Madoff, okay, who is watching? You can have lots of people looking over everybody's shoulder and it goes on and on and on and on. But in that instance, what repercussions, who is the policeman for the accountants who apparently said okay, year after year to the statements that were coming out of the Madoff organization?

Mr. GOELZER. Mr. Madoff's auditor was not registered with the PCAOB and was not required to be registered with the PCAOB because at that time, the SEC had exempted broker-dealer auditors from PCAOB registration so we had no contact whatsoever with them. My understanding is that they should have been subject to peer review, that is, a review by, under an industry-run system, by another firm. But they misled the AICPA as to whether they were conducting audits and therefore they weren't subject to peer review.

Mr. PERLMUTTER. You said, "at that time." Is there now a new regulation in place? Or is that kind of accounting still exempt?

Mr. GOELZER. Yes, the SEC's exemption that caused auditors of broker-dealers not to be registered with us expired at the end of 2008, shortly after the Madoff events became public. As a result of that, we picked up another probably 550 firms registered with us. All auditors of broker-dealers are now required to be registered with the PCAOB.

The difficulty is we have no other authority over them. We can't inspect their work. We can't write standards for how their work is performed. Perhaps, most importantly, we couldn't bring an enforcement action, if the Madoff situation repeated today. Mr. Madoff's firm would be registered with us, but we wouldn't be able to take any action.

Mr. PERLMUTTER. Now that they are registered with you, you are basically telling me you can't do anything, but they are registered with you?

Mr. GOELZER. I am telling you exactly that. However, fortunately, from our perspective, the financial services legislation that the House passed, thanks to this committee, includes an amendment that would give us authority—inspections, enforcement, and standard setting authority—over these now registered with us as broker-dealer auditors.

Mr. PERLMUTTER. Do you know if the Senate version has that? Because I don't know.

Mr. GOELZER. Yes the Senate has a slightly, a somewhat different version of it. But from a big picture standpoint, yes it does. And this is very important to us because we are concerned about the fact that the public might perceive that we have some responsibility now for these firms, particularly in light of the Madoff situation when, in fact, we simply currently lack the capacity to do anything with them.

Mr. PERLMUTTER. Mr. Chairman, I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Perlmutter.

The gentleman from California, Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman.

I wanted to focus a little bit on rules versus principles based accounting which was touched on a moment ago. We have increasingly moved to rules based accounting in part, I believe, because of litigation risk and because of the desire of accounting firms to have a—and the accounting industry to have a safe harbor, a place they know they can go and not have litigation.

But that has resulted in some very, very, very complex FASB pronouncements and so forth. I have one, I should have brought it. I have a KPMG summary of the stock option pronouncement which is about this thick. And I actually took a seminar on that, 8 hours on that. And it was the beginning seminar. There were 3 more days on that, if you wanted to do the rest of it.

What do each of you feel about rules versus principles based accounting? And should we be moving in one direction or the other and how do we get there?

I will start with you, Mr. Kroeker.

Mr. KROEKER. My reaction would be that you need to find a balance between the two. We should have a system that has a clear objective of the standard, but it goes to your opening remarks that one of the objectives of financial reporting is to have some degree of consistency as well, and so part of the reason I think that the accounting profession seeks bright lines is to ensure to some degree that the objective of the standard is prepared or that the filings are prepared with a relative degree of consistency so that companies that are engaging in similar activities can be compared on a comparable basis.

Mr. CAMPBELL. Mr. Herz?

Mr. HERZ. I wholeheartedly agree with Jim's comments.

And I believe we have been writing our standards with that focus in mind in recent years. I worked for some time in the profession in the U.K., and I'm also a chartered accountant, and that is at one extreme, the consolidation standard.

Mr. CAMPBELL. They are very much principles-based aren't they?

Mr. HERZ. They are principles-based, but to the point where some believe almost anything goes.

On the other hand, we in the past have had standards with lots of facts and very detailed implementation guidance, and I think the balance is somewhere in between starting with the articulation of clear objectives and principles.

Mr. CAMPBELL. So would you say that right now you are too far towards the rules based and that there is, we need to come back?

Mr. HERZ. We are currently doing a lot of our major projects together with the international board so what we are trying to do, is to write common standards. And when you are writing common standards essentially for major parts of the world, not just the United States or Europe, but other parts of the world that use IFRS or companies, a lot of companies, for example, in Japan use U.S. GAAP. You have to find those that kind of balance across those varying societies and economies and the like.

Mr. CAMPBELL. Mr. Goelzer, would you like to comment?

Mr. GOELZER. Sure. We don't have any responsibility for the accounting standards. So I will answer as to the auditing standards, although I think the answer would be about the same. We try to take what I would call an objectives-based approach when we set auditing standards, and each of our standards now includes at the beginning a statement of what the objective is.

We are charged with enforcing these standards also, so I think it is important to us that they be written in a clear and precise enough way that when we do an inspection or bring an enforcement case, we can make a determination about whether the standard was followed.

Mr. CAMPBELL. Let me ask this, because my time is starting to run out. As we harmonize with IFRS and so forth and have these joint—and if we were to move to more of this balance, the risk is that our litigation system is very different from that in the U.K. and in other countries.

We cannot go to a big three, okay, with Sarbanes-Oxley, you physically can't exist if we go to a big three.

Are we putting our accounting firms at risk with our current litigation system if we move two more principles based which I agree with you guys, I think we should, and are there changes we need to make in our litigation system to enable this to happen and harmonize with the international accounting standards but to make the litigation risk not so great if the accounting firms complied with what we ask them to do? Whomever wants to comment?

Mr. KROEKER. I agree with the sentiment that going from four to three would not be a good idea, would not be a good thing. In terms of the litigation system itself, it is a recommendation out of the Committee on Improvements to Financial Reporting, an SEC advisory committee, actually recommended guidance on how firms and how the SEC might look at judgment in a system that has less prescriptive guidance. And I am a big supporter of the idea that if a firm exercises, a company or an audit firm, exercises reasonable judgment, documents that in the context of what would be useful information to investors, that would go a long way for them and then defending, in any context, the subsequent result of that judgment.

Mr. CAMPBELL. Thank you. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Campbell.

Now, the gentleman from Illinois, Mr. Foster.

Mr. FOSTER. Thank you. I would like to start by thanking the ranking member for his concern over the liabilities of the GSEs. And of course, had we recognized all of those liabilities at the time that they were taken over by the previous Administration, people would realize, of course, that our financial situation inherited by the current Administration was, in fact, far worse than once recognized.

But I would like to ask first perhaps of Mr. Goelzer is the state of play of countercyclical concerns and the definition of accounting practices, how seriously is that being incorporated into the next generations?

Mr. GOELZER. I really think I would have to defer to my colleagues on that since we really have no jurisdiction over the accounting and disclosure principles. We have to enforce them as they write them.

Mr. HERZ. Well, the accounting standards involve measurements in reporting the underlying economic situation including the financial condition of the reporting companies, and therefore the goal is to report economic reality, not to adjust it through policy.

I believe that good accounting can be countercyclical in that it gives evidence of an early warning of additional risk, additional leverage, those kinds of things.

But I think it is then up to regulators and policymakers to take that information and do what they need to do in order to manage the economy and the markets.

Mr. FOSTER. So you are not seeing big changes in accounting standards, it is not regularly incorporated as one of the desired aspects of any—

Mr. HERZ. We are trying to kind of tell it like it is rather than to take numbers and adjust them for policy matters. But other people can do that and then take the right policy. But I think they need to start with the numbers, the right numbers.

Mr. FOSTER. Yes, Mr. Kroeker?

Mr. KROEKER. I would agree with Chairman Herz's remarks that the objective of financial reporting ought to be neutral, unbiased, and unvarnished reporting of the economic circumstances. They are, as a group of standard setters, both the IASB and the FASB looking at, for example, loan loss provisioning and whether or not being more forward looking if you will on the credit cycle would be useful information, would that be unbiased and useful information to investors.

And as part of that project, the objective isn't outcomes-based in that it would be less procyclical, but would investors have better information if they were aware earlier in the credit cycle of loan losses?

Mr. FOSTER. The next thing I would like to bring up is a lot of the uncertainties you have surround the valuation of structured financial products and SFX securities things like that. And as you are probably aware, there is an SEC initiative to encourage or mandate the publication of key underlying information on these, including in the case of mortgage-backed securities, you would have the ZIP codes, the credit scores, the income history and all this sort of thing, as well as the waterfall code that actually specifies the behavior of the tranches and so on, and this, in principle, will make things much more transparent.

And I was wondering, do you view that as something that is realistically going to be incorporated into the whole accounting and valuation game in a much more transparent way? Are you optimistic that is really going to lead to sort of a more objective analyses of the also values of different tranches of these?

Do you view that as an experiment that might or might not work on a fundamental game changer in the valuation of these complex financial products?

Mr. KROEKER. Right now, it is a proposal by the SEC, so we will obviously be informed by the feedback that we get. But I hope that it is a significant improvement in terms of price discovery so that would then flow through all the financial reporting.

Mr. FOSTER. Mr. Herz?

Mr. HERZ. Yes, I have been fairly strong and vocal on this subject. Accounting and reporting by companies was significantly challenged during the crisis essentially because we had markets for which there were not the necessary infrastructures and that included the markets for certain asset-backed securities. It is very hard to properly value something or provide for anticipated credit losses when there is no price discovery, when the effect of the waterfall and the condition of the collateral is not known.

So it took people with great sophistication, and a lot of labor intensity to be able to parse through a lot of these structures in order to then better understand what they had and then to value them. So I'm a big supporter of trying to put in what is the necessary infrastructure in order to, not just for my selfish point of view, but for the whole system to be able to do the better reporting.

Mr. FOSTER. Thank you. I guess my red light is on, so I will yield back.

Chairman KANJORSKI. Thank you, Mr. Foster.

Now, we will hear from the gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you. I am going to ask Mr. Herz a question, and it goes to an issue which in IFRS standards, international standards, frankly, would have handled the Lehman situation a lot differently than we did. Under IFRS, Lehman's leverage ratios would have shown up as much higher. It would have been harder for them to continue the overleveraging, as I understand it, than they did under the U.S. standards. And FAS 166 amended certain aspects of disclosure related to the classification of assets under FAS 140, requiring an institution to disclose all of its continuing involvement with transferred financial assets.

These amendments were related to Lehman Brothers' use of Repo 105s to take assets off the books at the end of the reporting period, and thereby, of course, disguise the true leverage that was afoot. Lehman officials even referred to these transactions as balance sheet "window dressing."

You wrote a letter to the committee on April 19th, and you mentioned that the accounting guidance for Repos has not changed since 1997. And I guess my question is, should FAS be considering amending the standards governing the use of Repo transactions in light of the use of Repo 105s by Lehman and other financial institutions, and, at the end of the day, I guess, to what extent would moving toward IFRS address this problem? Did the Europeans see something coming that we just failed to miss in terms of our accounting of it?

Mr. HERZ. A couple of points. We are not an enforcer or a regulatory agency, but in that letter, I did indicate some points as to whether or not the Repo 105 transactions actually qualified as sales under U.S. standards. And again, without all the facts, I could not tell. But the SEC has been doing an extensive information gathering process of the practices of major financial institutions with regard to Repos and security lending and the like. And to the extent that those reveal practices like that, we stand very ready to change the standards.

Mr. ROYCE. And just to get back to the bottom line, to what extent would moving toward IFRS address this problem?

Mr. HERZ. It is not clear to me whether under IFRS they would have appeared as financings or sales either. We have a joint project with the international board on the subject of derecognition which includes these kinds of items. And the goal has been to harmonize our standards there. There are many other current differences in the way financial institutions balance sheets are reported as between U.S. GAAP and IFRS including issues as to whether master netting agreements are sufficient to net derivatives and various other things which we are also exploring harmonizing.

Mr. ROYCE. I appreciate that. Now let me ask Mr. Kroeker a question as well, and this goes to the testimony that we had from Mr. Markopolos here who noted that for a number of years he tried to warn individuals from within the SEC about the Madoff Ponzi scheme.

And he found an ally in the Boston branch with industry experience in the SEC. But his problem was that he could never get beyond the New York office, I guess, because as he says, folks in

Washington simply couldn't comprehend the case, certainly the people in New York who held the case couldn't comprehend it, and he often noted the overlawyering at the SEC.

I know Ms. Schapiro is attempting to address this failure.

But I'm concerned that this won't be enough that the basic, if you look back over the years, the focus of the SEC, the way it has been overlawyered by those who have informed me that there isn't the technical knowledge about markets in the SEC to really uncover things like the Ponzi schemes that are out there, has always been a problem institutionally.

Could you comment on that?

Mr. KROEKER. Let me comment from my perspective on accounting and auditing. Our office is approximately 50 people. The vast majority are folks who were practicing either as accountants or as auditors. So from that perspective, our office is, again the vast majority are auditors, but to the heart of whether we can be more forward looking, what market practices are out there, I think we have taken significant steps. Just as one example, we are hiring a deputy within the Office of the Chief Accountant whose job it will be to monitor market practices, to look at new standards that have been put in place.

Mr. ROYCE. Just very quickly, the SEC official in Boston who did understand it had been a portfolio manager, he had been a trader, he had that experience in the market, and I think it is that kind of hiring at some point that has to be addressed.

I understand the British had the same problem with the FAS, so I just raise it again.

Mr. KROEKER. I agree.

Mr. ROYCE. Thank you very much, Mr. Chairman.

Chairman KANJORSKI. Thank you very much Mr. Royce.

Does the gentleman have any further questions? I do have an additional question. Do you want to take additional time?

Okay, if I may, in your opening remarks, Mr. Goelzer, you referred to the section 7602 fix that we have added to allow transmittal of information, investigative findings, between foreign entities and the American entities, and you indicated that fixes the E.U. problem, but you caution that it does not fix the China problem. While we are now going from the House and the Senate to conference, I am curious as to whether or not you have structured in your own mind what would fix the China problem, so that we could include it in the Act when it comes back. What should we do?

We anticipate there will be a problem, or there is potentially a problem, and we have not done anything about it. What do you suggest we do?

Mr. GOELZER. I appreciate the question because it is a very difficult issue. I don't think I have an answer as to what Congress could do to fix the problem with China.

Let me say, as to the E.U., the ability to share information would let us essentially resume the negotiations with them, and I am hopeful it would open the door to inspections. They have raised other issues with us that will also have to be resolved.

With respect to China, I think the best hope we would have at the moment is that as we bring all of the rest of the world into our inspection system, China will not want to be an outlier and will feel an incentive to negotiate with us and open the doors there also. I can certainly assure you that if we see any kind of legislative action that would help us with China, I will let you know. But at the moment, I don't see anything that would address the situation.

Chairman KANJORSKI. Well, if we do not address it—are you suggesting it would require some treaty arrangement with China?

Mr. GOELZER. I don't believe that any of these foreign auditor access issues we have should require treaties. I think it is simply a matter of negotiation and understanding between ourselves and the audit oversight body or other governmental authorities in each country.

Chairman KANJORSKI. Are we not one step away from a China disaster or China meltdown if we don't do something?

Mr. GOELZER. I think it is a very serious problem. I think there is much that is unknown to us about the quality of financial reporting in China and the quality of auditing in China, and there are an increasing number of Chinese-based companies that are in our markets. So yes I think it is a substantial risk to U.S. investors.

Chairman KANJORSKI. Does anyone else have any opinions on that? Mr. Herz, Mr. Kroeker?

Mr. KROEKER. As it relates to—

Chairman KANJORSKI. There is a provision in the reform regulations which are pending that allows, where it was disallowed before, for a transmittal of investigative information between the United States and foreign powers. We have now vitiated that, and Mr. Goelzer's opinion is that takes care of our problem with the E.U., but he indicated it does not take care of the problem with China.

Do you recognize that there may be a problem with China, and do you have any helpful hints?

Mr. KROEKER. Yes, one I agree, and a second provision that could be helpful is a provision that is in the House regulatory reform bill on section 106 of Sarbanes-Oxley that would give us greater ability to subpoena work papers from foreign audit firms. So I think that would be of assistance as well.

Chairman KANJORSKI. Does that allow retribution if they do not respond to our subpoenas?

Mr. KROEKER. It allows greater access, as I understand it, in serving a subpoena to and then enforcing a subpoena related to access to foreign work papers.

Mr. GOELZER. If I could just make one brief additional point. I do want to be clear that we do have existing authority to deregister foreign firms or any firm that doesn't cooperate in an inspection with us. And I don't want to take that off the table as a solution. Obviously, it would have significant ramifications if there were any foreign country where no auditor in essence was registered in the United States. But in terms of our existing authority, that is sort of the ultimate step that we could take.

Chairman KANJORSKI. Thank you, Mr. Goelzer.

The gentleman from New Jersey.

Mr. GARRETT. Thank you. So what I hear in general here and other places as well from you folks is that the accounting standard-setting folks are all about the transparency and disclosure and just making sure that the information is out there, right, and then that it is the regulators' job to deal with it, to mitigate and reconcile the applications of it, and that is the regulators' job to do it.

So we have the Financial Service Reform bill that is going through right now and that has a risk retention element to it, right? It mandates 5 percent on each loan or bond issue be held on. And so some folks look at that and say, hey, if you put that 5 percent risk retention aspect on it, that is going to sort of tighten down credit availability even further than with the market are today.

So with that whole issue out there looming right now, is it even more important than ever before that you have, I think your words have said, a decoupling of the accounting rules from what the regulators are putting in place, if you wanted to make sure that we still have some availability of credit availability going forward?

Mr. KROEKER. As I understand it, there already is that flexibility to decouple prudential supervision and the measures used by bank supervisors from accounting—accounting as set by the FASB as the starting point, but they have the flexibility to decouple so as I understand it that already exists. But I do think that it calls for continuing coordination between the FASB, the SEC, prudential supervisors as we do already, we meet no less than a quarterly basis at the senior staff level with bank supervisors, and my staff is talking to their staffs on a real-time continuous basis.

Mr. GARRETT. And I see you want to chime in on this. I guess the question, where we were before all this happened was whether or not that decoupling, to use that expression, really was occurring or not. Mr. Herz?

Mr. HERZ. It occurred to a certain degree, for example, the bank regulators have traditionally chosen to not factor in unrealized gains and losses on debt securities into their computations of regulatory capital even though for GAAP reporting it does affect the amount of stockholders equity that is reported. In our changes in statements 166 and 167, we did involve them, kept them very well apprised as we were going along in the development of those, they did factor them into the stress tests last year, and then they followed up late last year, or early this year with some guidance on the impacts that those new standards would have under their regulatory capital determinations, but they did provide a transition period for the regulated institutions to build the additional capital.

Mr. GARRETT. As long as you are still talking, with regard to the whole convergence issues which you touched on and some other people talked about, the G-20 has recommended procyclicality in accounting standards, accounting rules work together with the banking regulators to be less procyclical accounting, the ISAB has been working with the banking regulators, investors and others all on the one point and we haven't hit this too much today and that is on the one issue of mark-to-market, and that they have said they don't want mark-to-market.

You all take a contrary view, I guess you could put it. So can you just lay that out a little bit as to why we are taking a contrary view as to where the G-20, the banking regulators, and the investors are all on this issue.

Mr. HERZ. My understanding, the G-20, there is a group under the G-20, the Financial Stability Board which actually I meet with periodically as well. Obviously, being a Financial Stability Board, their first interest is in stability of the overall system. Our job, and I have absolutely nothing against and I am totally for stability, but our job is more transparency for investors to make the capital allocation process work better, so we work very closely with the banking regulators to try to understand their points of view.

We work closely with investors to understand their points of view. We get the points of view of the companies, and we really try to square the circle in terms of meeting all of those different needs in ways. A lot of investors would like to see more information on the current values of the financial assets of institutions.

Mr. GARRETT. You have a slightly different role than some of those. Okay, thanks.

Chairman KANJORSKI. Thank you, Mr. Garrett.

Mr. Campbell?

Mr. CAMPBELL. Thank you, Mr. Chairman. I want to follow up a little bit on something Mr. Garrett was on with you, Mr. Herz, on standard 166, 167. If there is a risk retention requirement, you have to keep 5 percent, bank sells off a loan into securitization, but they have to keep a slice of it, they have to keep 5 percent. Under 166, 167, that bank has to keep that whole loan on their—no? Okay. I am wrong. Talk to me.

Mr. HERZ. It really depends on what the 5 percent represents. If it represents the first loss, yes, the effect there is like being the equity participant in the transaction, they absorb the first losses. If it is more of a pro rata 5 percent retention, that would not be deemed significant.

Mr. CAMPBELL. Okay. But if it is the first loss, then they do have to keep the entire loan on their books, right?

Mr. HERZ. Yes.

Mr. CAMPBELL. So this is the kind of place—and again as we do these prescriptive, very prescriptive accounting standards, this is the sort of thing where when you did that you probably weren't anticipating this sort of thing and there may be some other actions in the future where we have a lot of banks with a lot of debt that there may be various ways that that debt can be moved to other places but where they are going to have to keep a slice of it somewhere in order to make the whole transaction work but we are trying to make some of these banks a little more solvent than they are in the future.

And this is where I think you can see that divergence where we may set up some banking regulation in order to try to make this thing work out and then you look at standard 166, 167 and you say, uh oh, but as far as the audited balance sheet of this bank, it is not going to improve it at all. Not a problem, and I'm curious for any of you, in that specific instance, not a problem, you guys can look at it and respond quickly or what?

Mr. KROEKER. In that instance, I don't view it as a problem as you said you had, in Bob's example, and it is not prescriptive in the standard. The objective is if you have significant skin in the game, if you will, significant risk, and you have control, you need to consolidate. If it was 5 percent first loss, you have the majority of the—let's say it is very high-quality assets, you might actually have most of the risk of those assets. And so I think that is the principle of standards, if you have in that fact pattern, if you have most of the risk of those assets, maybe they ought to be on your books, so not a problem, though, in terms of being able to respond quickly.

Mr. CAMPBELL. Part of it is if you have a $3 million loan you can lose $3 million in theory, and that is on your books and so forth. But if that loan goes somewhere else, and you have some tranche of it, that is first loss, but gives you a maximum $200,000 loss, let's just say, is that a different situation?

Mr. HERZ. Think of it in these terms. If you had a company and had some risk in it and you were the equity investor and the rest of the capital is provided by other people in the form of debt financing and you also ran the show, I think you would agree under long-standing accounting you would consolidate that entity. And so that is the basic analogy there.

Mr. CAMPBELL. But I guess, does it bother any of you if there is this divergence in transactions like I just described between the financial accounting standard and the way the banking regulators will treat the transaction?

Mr. HERZ. I think in an ideal world we would have the same reporting for financial reporting, for regulatory reporting, for tax reporting, but because they all start from different objectives sometimes that is not possible.

Mr. CAMPBELL. Okay. Mr. Kroeker?

Mr. KROEKER. In the instance of 166 and 167, I think, as I understand it, as bank regulators have looked at those standards, they have actually indicated it will help them do a better assessment of risk and, in fact, a process like that went through or was included in the stress tests effectively taking FASB's new guidance and saying would we get a better identification of risk through these new standards?

Mr. CAMPBELL. Quick question for Mr. Goelzer, on my way out here, relating to something else. I mentioned before about the markets using different data than the traditional three elements of the financial statement. Are there things that we ought to be, are there, and a lot of that comes from audited data, but does it all? And are there things that we ought to be auditing, numbers that ought to be audited for public companies that are not currently being audited? Because the markets are using it.

Mr. GOELZER. This is a hard question for me to answer in that form. I think from our perspective, the important thing would be that the scope of the auditors' responsibilities are clear and that if we are going to bring in additional information that is not currently part of the financial statements that it be information that is auditable, not solely dependent on judgments or management assessments that an auditor can't develop evidence to support an opinion on and that we have a chance to write a standard. As to what the sort of content would be of additional information brought under the auditing tenet, I think I would have to think about that a little.

Mr. CAMPBELL. Thank you, Mr. Chairman. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Campbell.

The gentleman from California, Mr. Royce.

Mr. ROYCE. Yes, thank you, Mr. Chairman. I am going to follow up on Mr. Garrett's and Mr. Campbell's lines of questioning here, because last week, we had FASB's Kevin Stoklosa submit testimony here that in many ways recognized or admits a certain dichotomy here, a certain problem when it comes to the impact or effect of this decision.

He said that keeping assets on the books will better reflect financial institutions' exposures to risk, but may also, in his words, affect their ability to comply with the regulatory capital requirements and therefore affect the liquidity available to real estate in the United States to commercial real estate specifically, and one of the debates that we have had about the vicious circle that we have ourselves caught in is the fact that in many cases, you have performing loans, but banks aren't allowed to be banks right now.

If the appraisal comes back and the value isn't what is necessary, regardless of the fact that it is a performing loan, and in the past, maybe you would keep it on the books, and you have to make that tough decision because the regulator is breathing down your neck.

And at that hearing, you had several witnesses involved in the commercial real estate industry express their grave concerns over this accounting treatment. I guess we are just getting back to what is FASB's response to those concerns in this case raised and acknowledged by your technical adviser there, by Kevin in that hearing last week.

At some point in time, do you give the banks the ability to work out some of these problems using their best judgment?

And then I would also just ask the SEC's perspective there as well because you will have to deal, this will affect companies that you oversee as we become more and more rigid in terms of the way in which we define and control the ability of bankers to use their judgment, ultimately you oversee those firms. You might have a comment on this.

So go ahead, please, Mr. Herz.

Mr. HERZ. Well, again, the goal of financial reporting is to reflect the underlying economic reality as best we can with the tools available and often requiring the necessary judgments of the companies and the auditors involved.

We believe the new standard strikes the right balance in that area, the bank regulators seem to agree that for their purposes it does as well. Arguably, some of the problems that caused the crisis were too much free rein, too much liquidity, too many things that were improperly shown off the balance sheets and the risks not captured.

Mr. ROYCE. Mr. Herz, I grant you all of that and I concur with that. But somehow when you get to point where you have performing loans which no longer make the test, you are in something of unchartered waters here when you notice that it begins to have this domino effect in communities and it is almost a self-fulfilling prophecy in that sense. If you don't roll over these performing loans because you don't make these—the reality is they are performing loans at least for here and now, and that is sort of the dichotomy I think we are in. Right?

Mr. HERZ. I'm not sure those are elements of 166 or 167.

Mr. ROYCE. But the further crimp on liquidity for commercial real estate compounds this problem where we already have this lack of liquidity and we just keep tightening the screws on that, and at the end of the day there isn't the capital there, and so the decision is made not to roll over the performing loan on the basis of the lack of it.

Mr. HERZ. Again, the capital requirements are things that the bank regulators determine. They have given some forbearance for a transition period related to our new standard, but they concluded that the new standards provide a better basis for them to make the capital determinations, but that is up to them.

Mr. ROYCE. Let me ask the SEC quickly, and then I'm finished.

Mr. KROEKER. I don't think banks should have greater flexibility in terms of keeping risk off-balance sheet, and it is probably a better question for bank regulators, but again, as I understand it, they have the flexibility then in terms of how they will respond if that risk is on balance sheet.

Mr. ROYCE. The flexibility hasn't be used to our ability to discern it. But thank you very much.

Chairman KANJORSKI. Thank you very much, Mr. Royce.

It is not surprising—this actually was an interesting commentary when I started out, I suggested that we who were not accountants could get bored to death, but quite frankly, I have really enjoyed the witnesses' testimony. I want to thank them. Also, I want to send this message to you: In the next several weeks or week, rather, we will be convening a conference on the Senate and the House bill as it presently exists, and obviously, there is a need to reconcile some differences and potentially to add some parts of the bill that may be missing. All three of you witnesses are in a peculiar and favored position to be able to help the committee, as we put the final bill together. If you see something lacking, I can assure you I am one telephone call away, and I am sure Mr. Garrett is one telephone call away. We are looking for the best expert help in structuring the finest enforcement bill we can put together to make sure—although we hear this all the time—that this will never happen again. I, for one, concede something is going to happen again, so we should not use that terminology, but that we could gain a great deal from the crisis of 18 months ago and certainly, put a piece of legislation in place that will forestall that type of activity from occurring again for many, many, many decades.

Toward that end, I solicit your assistance and help and any of my staff who do not take your calls, you let me know, and we will have new staff in place, but I know they will, and we want to encourage you to take advantage of that invitation.

With that, the Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record. Without objection, it is so ordered.

Before we adjourn, the following material will be made a part of the record of this hearing: a May 20th letter from the Independent Community Bankers of America. Without objection, it is so ordered.

The panel is dismissed.
And this hearing is adjourned. Thank you, gentlemen.
[Whereupon, at 11:50 a.m., the hearing was adjourned.]

A P P E N D I X

May 21, 2010

OPENING STATEMENT OF
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON ACCOUNTING AND AUDITING STANDARDS: PENDING PROPOSALS AND EMERGING ISSUES

MAY 21, 2010

Good morning. Since the start of the financial crisis, we have done much work to understand its root causes and to pass robust reform legislation initially in the House and the Senate that will end the era of too-big-to-fail financial companies, reform credit rating agency operations and regulation, and implement a broad array of sorely needed measures that will better protect innocent Main Street investors from unscrupulous Wall Street operators.

In debating these matters, accounting and auditing issues have surfaced more than once. As a result, the House-passed Wall Street reform bill includes my reforms aimed at responding to the Madoff fraud by better regulating the auditors of broker-dealers. This legislation also contains my provisions designed to enhance the ability of securities authorities to coordinate foreign and domestic investigations and to improve the ability of the Public Company Accounting Oversight Board to collect from and share information with foreign entities.

The bill additionally includes a provision by Congressman Lee of New York providing for an annual accounting transparency hearing, like the one we are having today. It further incorporates a provision by Congressman Miller of California to create a Financial Reporting Forum for regulators. Finally, Congressman Adler and Capital Markets Ranking Member Garrett, both of New Jersey, amended the bill to exempt small public companies from the Sarbanes-Oxley Act's requirements for external audits of internal controls, a provision which continues to concern me.

At today's hearing, we will doubtlessly reexamine each of these matters, as well as the pending Supreme Court case on the process for appointing members of the Public Company Accounting Oversight Board. We will also continue to explore whether or not accounting and auditing standards helped to contribute to the financial crisis.

Decisions to move problematic assets off of their balance sheets allowed some companies to hide the real nature of their financial health. Moreover, the recent court-appointed examiner's report of the Lehman Brothers bankruptcy highlighted the troubling Repo 105 practice that some companies may use to embellish their financial viability and inaccurately portray leverage.

These practices, motivated purely by short term self-interest, are not literary works to be admired. Rather, they are fictional stories based on half truths that have no place in our capital markets. Accounting standards and those that apply them ought to portray a company's financial condition candidly and in a way that investors can readily understand.

Today, we will also explore what progress regulators and standard setters have made to simplify our reporting framework and produce books that investors want to read. We will further examine how to improve accounting transparency, decrease regulatory burdens, and address old issues like auditor concentration and newer ones like converging accounting rules.

The financial crisis demonstrated just how interconnected our economic fortunes are. Capital now moves across international borders at lightening speed as investors diversify their portfolios and take advantage of opportunities both here and abroad. Investors therefore need to have access to timely, accurate financial information that allows them to make apples-to-apples instead of apples-to-oranges comparisons at similar companies around the world.

While we should move quickly on converging global accounting standards, we must also proceed carefully to ensure that these rules produce high quality results for investors. America's markets and its financial reporting framework are among the most developed in the world because of the independence of standard setting and enforcement. To protect the credibility of our markets and instill investor trust, we must ensure that any new international system continues to adhere to the core principles of independence, transparency and accuracy.

In closing, I look forward to hearing from today's witnesses on the state of accounting and auditing regulation, the progress they have each made in improving standards and enforcement, their priorities, their coordination efforts, and the challenges they now, or may soon, face. I thank each of them for coming and look forward to their testimony.

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Statement of Daniel L. Goelzer
Acting Chairman
Public Company Accounting Oversight Board

Before the

United States House of Representatives
Financial Services Committee,
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises

Hearing on Accounting and Auditing Standards:
Pending Proposals and Emerging Issues

2128 Rayburn House Office Building
May 21, 2010

PCAOB
Public Company Accounting Oversight Board

Statement of Daniel L. Goelzer
Acting Chairman
Public Company Accounting Oversight Board

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

I appreciate the opportunity to appear before you today on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board") to testify on the work of the PCAOB. I want to begin by thanking the Financial Services Committee and this Subcommittee for their support of the Board's mission. In light of the extraordinary events over the past two years, the statutes – and the regulators that implement them – over which you have jurisdiction could not be more important to the future financial well-being of the American people. I look forward to discussing with the Subcommittee the role that the Board plays in protecting investors and fostering confidence in our securities markets.

More than half of American households invest their savings in securities to provide for retirement, education, and other goals. The auditor's job is to protect these investors' interest in accurate, complete, and fairly presented financial information by independently reviewing and reporting on management's financial statements. Reliable financial reporting is one of the linchpins on which our capital markets depend. If investors lose confidence in financial reporting, they may demand prohibitively high returns as a condition of investing or they may withdraw from the markets altogether. The result would be to make it more difficult and expensive to finance the businesses on which our economy depends. Moreover, inaccurate financial reporting can mask poor business strategies that, if left uncorrected, may result in the misallocation of capital and in business failures and layoffs.

As the accounting scandals related to Enron and WorldCom demonstrated, auditors can face strong pressures and incentives to acquiesce in rosy accounting. The Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act" or the "Act") was passed in the wake of the collapse of confidence that resulted from these and other financial reporting break-downs. Title I of the Act created the PCAOB to serve as a counterweight to those pressures and incentives. Congress rightly determined in 2002 that rigorous, independent oversight was essential to the credibility of the auditor's watchdog function. In the balance of my testimony, I want to explain how we have sought to translate that vision into reality.

PCAOB
Public Company Accounting Oversight Board

Statement of PCAOB Acting Chairman Daniel L. Goelzer
May 21, 2010
Page 2

I. The Responsibilities of the PCAOB

Prior to the creation of the PCAOB, public company auditors were subject to oversight by their professional association and to peer reviews conducted by other auditing firms. Title I of the Sarbanes-Oxley Act profoundly changed the environment in which public company auditors operate by providing for ongoing accountability to the PCAOB, which is independent of the profession. The Board exercises that oversight through four basic functions –

- ***Registration of accounting firms*** – No accounting firm may prepare, or substantially contribute to, an audit report for a public company that files financial statements with the Securities and Exchange Commission ("SEC" or "Commission") without first registering with the PCAOB. Since 2009, securities broker-dealers must also have the balance sheets and income statements they file with the SEC audited by PCAOB-registered firms. There are currently 2,484 accounting firms registered with the Board. This includes 935 non-U.S. firms and 530 firms that registered because they have broker-dealer audit clients. Beginning this year, all registered firms must file annual and other reports that provide the Board and the public with updated information about the firm and its audit practice.

- ***Inspection of firms and their public company audits*** – Since 2003, the Board has conducted more than 1,300 inspections of firms' quality controls and reviewed aspects of more than 6,000 public company audits. The audit engagements we review are not selected at random. To make the most effective use of its resources, the PCAOB uses a variety of analytical techniques to help the inspection staff select engagements and audit areas that are likely to raise challenging or difficult issues.[1] PCAOB inspections have identified numerous audit deficiencies, including failures by the largest

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[1] The PCAOB devotes considerable resources to collecting, quality checking, and analyzing data from public sources, vendors, registered firms and internal sources. The PCAOB uses this data to monitor financial reporting and auditing risks. The PCAOB's screening techniques combine non-public data collected in the inspection process with publicly-available data to identify those firms, offices, partners, engagements, and issues that present the greatest audit risks. PCAOB analysts perform in-depth analysis of these high-risk issuer-audits to provide our inspectors with actionable intelligence when they go into the field.

U.S. and non-U.S. firms. These findings have led to changes in firm quality controls, and, in some cases, to corrections of client financial statements.

- ***Investigation and disciplinary proceedings*** – The Board has broad authority to impose sanctions on registered firms and associated persons that have violated applicable laws and standards. The PCAOB has publicly announced the resolution of 31 enforcement proceedings, which involved a combined total of 55 registered firms and individual auditors of those firms. Among these 55 parties are 32 individual auditors, including partners and other individuals associated with major accounting firms, who have have consented to suspensions or bars from working on public company audits. These proceedings also include 15 settled revocations of firms' registrations, preventing them auditing public companies in the future. Sanctions have also included significant monetary penalties. These settlements do not, however, reflect the full extent of PCAOB enforcement activity. Under the Sarbanes-Oxley Act, all Board investigations and all contested proceedings (i.e., cases in which the Board files charges and the respondent elects to litigate, rather than settle) are non-public. There are a significant number of matters under active investigation and an additional number in litigation.

  The Board closely coordinates its enforcement efforts with the SEC. In certain instances, the PCAOB investigates the auditor's conduct and the SEC focuses its investigation on the public company, its management, and other parties. In other cases, the SEC's Division of Enforcement takes responsibility for an investigation and requests that PCAOB defer to that investigation.

- ***Establishing auditing, quality control, ethics, independence, and other standards*** – The Board is responsible for establishing the auditing and related standards under which public company audits are performed. Prior to the Sarbanes-Oxley Act, public company audits were performed according to standards set by the profession itself. The PCAOB has an active standard-setting agenda, as I will describe later in my testimony.

All of the Board's responsibilities are discharged under the oversight of the SEC. The SEC appoints, and may remove, Board members. The PCAOB's annual budgets must be approved by the SEC. The PCAOB's rules, including its auditing and related professional practice standards, are not effective unless approved by the SEC. PCAOB inspection reports, remediation determinations, and disciplinary actions are appealable to the SEC. In addition to these formal oversight mechanisms, we work closely with the Commission on a daily basis. Chairman Schapiro and Chief Accountant Kroeker have taken a deep interest in the Board's work, and I am grateful to them for their support and for the strong working relationship they have fostered between our organizations.

The PCAOB receives no appropriated funds. Once approved by the SEC, the Board's budget is funded through an annual accounting support fee assessed on public companies in proportion to their average equity market capitalizations. As a result, roughly three-quarters of the PCAOB's accounting support fee is paid by the largest 500 public companies. The Financial Accounting Standards Board ("FASB") is funded in a similar way, and the PCAOB serves as the collection agent for FASB assessments.

II. The PCAOB's Recent Work in Connection with the Financial Crisis

The Subcommittee asked that I describe how the PCAOB has responded to audit issues raised by the financial crisis. PCAOB auditor oversight is not intended to assess financial institution capital adequacy or risk management, which many have suggested were the proximate reasons for institutions' failure or need for bail-out funds. Nor does the PCAOB set accounting and disclosure requirements. That is the purview of the FASB, the International Accounting Standards Board, in the case of institutions permitted to use International Financial Reporting Standards, and the SEC. Rather, the PCAOB focuses on whether auditors have done their job, which is to make sure an institution's financial statements and related disclosures fairly present its results – good or bad – to investors in conformity with applicable accounting and disclosure standards.

Each of our core programs has adjusted its focus to address issues that have arisen from the financial crisis. I want to briefly summarize these responses.

A. Inspections

The PCAOB's inspection program is the core of its oversight of registered firms' public company audit work. The PCAOB conducts annual inspections of firms that regularly audit the financial statements of more than 100 public companies. In 2009, the PCAOB inspected ten such firms. Firms that regularly audit the financial statements of 100 or fewer public companies must be inspected at least once every three years. The PCAOB inspected 277 such firms in 2009, including 82 non-U.S. firms located in 26 countries. In the course of these inspections, PCAOB inspectors reviewed portions of more than 350 audits performed by the ten firms subject to annual inspection, and portions of more than 730 audits performed by the remaining 277 inspected firms. During 2009, the PCAOB inspected aspects of audits for some of the largest public companies in the world, including financial services and other companies with complex financial instruments and transactions and risks relating to market volatility.

The Board is required to issue a report with respect to each inspection it conducts. The public portion of an inspection report describes matters that inspectors have identified as significant audit failures. These findings, presented in Part I of the report, generally involve situations in which PCAOB inspectors believe that the auditor failed, in some material respect, to obtain sufficient evidence to support the audit opinion or failed to identify a material departure from generally accepted accounting principles. Consistent with restrictions in the Sarbanes-Oxley Act, however, the Board does not publicly disclose the identity of the companies that are the subject of audits discussed in an inspection report.[2]

Most of the audits that the Board inspected during 2009 were of financial statements for fiscal years ending in 2008. We are now in the process of evaluating firms' responses to questions and comments we have raised and preparing our inspection reports. So far, 112 reports on 2009 inspections have been released, including two with respect to firms subject to annual inspection. Because the 2009 reporting cycle is still ongoing, it is not possible to generalize concerning the kinds of audit problems we found. However, in order to broaden the field of auditors and others who may benefit from understanding the nature of common audit deficiencies inspectors identified last year, the Board plans to issue a summary report, under PCAOB Rule

[2] The PCAOB discusses any criticism of or potential defects in a firm's system of quality control in Part II of its inspection reports. The Act affords inspected firms one year within which to remediate Board criticisms concerning firm quality controls. If the Board is not satisfied with a firm's remediation efforts, the portion of the report containing the discussion of the quality control deficiencies becomes public.

The Board transmits full inspection reports, including the nonpublic portions of such reports, to the SEC and appropriate state boards of accountancy. The Board is also permitted to share full reports with certain other U.S. regulatory and oversight authorities. In addition, the Board sends a special report to the Commission when, as a result of information developed in an inspection, the Board believes that financial statements filed with the Commission, and on which the public is relying, are materially inaccurate.

4010,[3] on audit issues presented by the financial crisis. I anticipate that this report will afford those interested in auditing and financial reporting with additional insight concerning the audit challenges that have emerged from the financial crisis.

In addition, in light of the allegations raised in the Lehman bankruptcy examiner's report, the PCAOB has asked certain firms to provide information on their audit procedures in connection with audit clients in the financial services industry that have applied sales accounting treatment to repurchase agreements involving financial assets. Repurchase transactions may not be the only method companies may have used to dress-up their financial statements at period-end, however. The PCAOB is looking for other strategies companies may use to manipulate reported debt.

More broadly, the PCAOB plans to enhance its focus on the quality control mechanisms of large firms that participate in global networks as well as on audit work performed by non-U.S. firms on subsidiaries or other segments of multi-national audit clients. We will examine firms' supervision of work performed by affiliated firms, including by assessing firms' controls over consultations on accounting and auditing standards, instructions to affiliates, and evaluation of affiliates' work.

B. Enforcement

Based on referrals from the PCAOB's Office of Research and Analysis, from the inspections program, and from other information sources, the Board's enforcement staff is conducting several investigations related to audits of the financial statements of public companies involved in the financial crisis. As with most regulatory bodies, our investigations are by statute confidential.

As I noted earlier, unlike most regulators, including the SEC, the Board's contested disciplinary proceedings also are, by law, non-public and confidential. As a result, unfortunately, the facts and circumstances of any matters stemming from the financial crisis that the Board believes warrant enforcement action are unlikely to become public for a considerable period of time. Moreover, this feature of the Act

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[3] Information received or prepared by the Board in connection with any inspection is subject to certain confidentiality restrictions set out in Sections 104(g)(2) and 105(b)(5) of the Act. Under the Board's Rule 4010, however, the Board may publish summaries, compilations, or general reports concerning the results of its various inspections, provided that no such published report may identify the firm or firms to which any quality control criticisms in the report relate.

provides respondents with an incentive to litigate, rather than settle, in order to delay any adverse publicity.

C. Auditing Standard-setting

The Committee has also asked me to address the role of auditing standards in the financial crisis and in the transparent portrayal of companies' overall financial health. Auditing standards do not set forth reporting or disclosure requirements for companies. Rather, they set forth required procedures for auditors to evaluate whether financial statements present the company's financial position fairly in accordance with applicable accounting standards.

Nevertheless, the Board's standard-setting program has responded to the financial crisis by reminding auditors how existing standards apply in the context of current challenges. The PCAOB has issued Staff Audit Practice Alerts to explain to auditors how applicable requirements bear on various issues raised by the crisis. For example, in December 2008, the PCAOB issued Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (December 5, 2008). This alert helped PCAOB inspectors focus firms on applicable audit requirements in our 2009 inspections. It covered several audit topics relevant to the crisis, including auditing fair value measurements and accounting estimates, auditing the adequacy of disclosures, the auditor's consideration of a company's ability to continue as a going concern, and additional audit considerations for selected financial reporting areas.

More recently, in light of the Lehman bankruptcy examiner's report, as well as deficiencies PCAOB inspectors have identified in connection with the auditing of significant unusual transactions, the PCAOB issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010). This alert reminded auditors of their obligation to evaluate significant transactions that may be mechanisms to dress up a company's balance sheet, as opposed to serving a valid business purpose.

Practice Alerts only remind auditors of existing requirements. The Board also has the ability to use information that it learns in its inspections and from other sources to change the underlying auditing standards. The Board's Office of the Chief Auditor, which is responsible for PCAOB standard-setting, is reviewing the results of the 2009 inspections program to determine whether there are additional issues that should be added to the Board's standards agenda. As explained below, we have an ambitious agenda of standards projects, several of which would respond directly to current auditing challenges.

III. Challenges Facing the PCAOB

I believe that the Board has made excellent progress during the past seven years in turning the blueprint that Congress provided in Title I of the Sarbanes-Oxley Act into a functioning organization that is making a meaningful contribution to investor protection. However, we still face a variety of challenges to realizing fully the audit oversight that Congress envisioned. I want to touch briefly on four of those challenges.

A. Inspecting Non-U.S. Audits

Approximately 250 non-U.S. firms are subject to regular PCAOB inspection.[4] To date, the Board has inspected 173 non-U.S. firms in 33 jurisdictions, with some firms being inspected more than once. As I mentioned earlier, in 2009 the PCAOB inspected 82 non-U.S. firms in 26 jurisdictions. Twenty-nine of these 82 inspections were performed on a joint basis with the local auditor oversight authority pursuant to negotiated cooperative arrangements. In each of the joint inspections, as well as most other foreign inspections not conducted on a joint basis, the PCAOB and its foreign counterpart have been able to resolve conflicts of law, sovereignty, and other issues that may arise when we are operating in another country.

Unfortunately, however, we are not currently able to conduct inspections in the European Union, Switzerland, and China.[5] In previous years, the PCAOB was able to

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[4] About 930 registered firms are located outside of the United States, in 86 countries. Not all of these firms are subject to regular, periodic PCAOB inspection. Only a firm that, during a three-calendar-year period, issues an audit report or plays a substantial role in the preparation or furnishing of an audit report with respect to an issuer is subject to regular PCAOB inspections. Many of the Board's foreign registrants are members of a global network of firms that share a common name and certain policies, audit methodologies and business interests with firms that operate in the U.S.

[5] As a transparency measure, earlier this week, the PCAOB published a list of more than 400 non-U.S. issuers whose securities trade in U.S. markets, but whose PCAOB-registered auditors the Board currently cannot inspect because of asserted non-U.S. legal obstacles. In addition, the PCAOB has previously published a list identifying each registered firm that has not yet been inspected even though more than

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conduct joint inspections in some EU Member States, but in February 2009, the EU barred further joint inspections pending resolution of the information-sharing issue discussed below. As a result, inspections of 20 EU firms scheduled for 2009 did not occur.[6] In the case of Switzerland, although the PCAOB was on track to conduct two joint inspections with the Swiss audit regulator, the Swiss informed us in early 2009 that those inspections could not go forward. The Swiss objections related in large part to our ability to transfer information gathered during inspections to other U.S. regulators, such as the U.S. Department of Justice.[7] With regard to China, the objection is based primarily on national sovereignty. There, inspections of two mainland Chinese firms were scheduled in 2009 but did not occur, and inspections of eight Hong Kong firms have been commenced but not completed because we were denied access to documents relating to companies operating in mainland China.[8]

One of the obstacles to reaching an agreement to resume inspections in the EU Member States has been the Board's inability under the Sarbanes-Oxley Act to share inspections and investigation information with foreign auditor oversight authorities. While the Act protects PCAOB inspection and investigative processes from public disclosure and from discovery in private legal proceedings, it allows the PCAOB to

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four years have passed since the firm first issued an audit report while registered. These lists are available at http://pcaobus.org/Featured/Pages/International.aspx.

[6] There are 307 firms from 26 countries in the EU (including Norway) registered with the PCAOB; 73 of those firms (in 20 countries) are subject to inspection because they audit, or play a substantial role in auditing the financial statements of a U.S. public company's foreign operations or a foreign private issuer listed on a U.S. exchange.

[7] Nine Swiss firms are currently registered with the PCAOB; five of those firms are subject to inspection because they audit, or play a substantial role in auditing the financial statements of a U.S. public company's Swiss operations or a foreign private issuer listed on a U.S. exchange.

[8] There are 53 Chinese firms, and 59 Hong Kong firms, registered with the PCAOB; 52 (24 in mainland China and 28 in Hong Kong) of those firms are subject to inspection because they audit, or play a substantial role in auditing the financial statements of a U.S. public company's Chinese operations or a foreign private issuer listed on a U.S. exchange.

share information prepared or gathered during those processes with certain U.S. federal and state authorities.[9] However, since non-U.S. audit oversight bodies are not included, the PCAOB is currently unable to enter into agreements to provide information to non-U.S. regulators. Information sharing is important to many of our foreign counterparts, and our inability to provide it is a serious handicap.

Thanks to this Committee's efforts, Section 7602 of the Reform Act, as passed by the House of Representatives last year, would correct this problem by permitting the PCAOB to share information with non-U.S. audit oversight bodies. A similar provision has been included in the Restoring American Financial Stability Act of 2010 in the U.S. Senate. Final enactment of the information sharing provisions would enable the Board to proceed with meaningful discussions with its EU counterparts. The Board understands that this provision enjoys widespread investor and profession support.

B. Auditing Standards

The second area I would like to mention is the setting of auditing standards. The PCAOB is engaged in several standard-setting initiatives, in consultation with the SEC, that are intended to modernize, or address weaknesses in, existing standards. Those standards were originally developed by the profession itself and adopted by the PCAOB in 2003 as interim standards. I regard this area as a current challenge simply because of the range and scope of the current projects we have under way.

As I noted earlier, in creating the Board, Congress shifted responsibility for public company auditing standards from the auditing profession itself to the PCAOB.

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[9] The list of authorities that may receive such information is limited to the SEC, the Attorney General of the United States, appropriate Federal functional regulators (such as bank regulators), State attorneys general in connection with criminal investigations, and appropriate State regulatory agencies (such as state boards of accountancy). Section 7608 of H.R. 4173, the Wall Street Reform and Consumer Protection Act ("Reform Act"), would enable the PCAOB to share confidential information with the Congress.

The omission of foreign audit oversight authorities from the list of permissible recipients of confidential information is due to the fact that when the current provisions were written, very few countries had bodies similar to the PCAOB. Since the establishment of the PCAOB, more than 30 countries have established or empowered bodies to inspect public accounting firms.

Nonetheless, in our standard-setting, the Board takes into account initiatives of the profession, including the International Auditing and Assurance Standards Board ("IAASB"), which is an arm of the International Federation of Accountants ("IFAC") and sets standards known as International Standards of Auditing. The Board is an observer to the IAASB's Consultative Advisory Group and monitors various IAASB projects; and the IAASB is an observer to our comparable advisory body – the Standing Advisory Group ("SAG"). Most important, though, the PCAOB takes into account information learned in inspections, investigations and other oversight activities, in order to develop standards focused on improving investor protection.

The Board has four standards-setting projects that are in various stages of public exposure. These are –

- ***Risk Assessment*** – On December 17, 2009, the Board re-proposed seven new auditing standards, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* that, collectively, would update the requirements for assessing and responding to risk in an audit. The re-proposed standards are intended to provide for more robust risk assessments and more rigorous procedures to respond to identified risks. The Board is considering comments received on this proposal and plans to finalize its project later this year.

- ***Audit Confirmation Evidence*** – One of the most widely used substantive tests for obtaining evidence regarding the existence and, to a lesser extent, the valuation of various accounts, is direct communication by the auditor with third parties independent of management, commonly referred to as confirmation. The Board issued a *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations* in 2009, seeking public comment on the potential direction of a standard-setting project. The concept release identified possible changes to the existing standard on confirmation, including changes that would reflect the prevalence of electronic confirmation requests and electronic records, as well as changes related to the risks of management interception or other intervention in the confirmation process. The Board is considering the comments and plans to issue a proposal to change the standard in the near future.

- ***Communications with Audit Committees*** – The Board recently proposed a new standard on auditor-audit committee communications. A fundamental objective of the Sarbanes-Oxley Act is to strengthen the role of the audit committee by placing it squarely at the center of the relationship between a public company and its auditor. The proposed new standard is intended to implement that objective by enhancing and making more concrete the substance of auditor-audit committee communications. In particular, the proposal focuses on communications regarding audit risk.

- ***Engagement Partner Audit Report Signature*** – The Board issued in 2009 a *Concept Release on Requiring the Engagement Partner to Sign the Audit Report* to solicit public comment on whether it should require the engagement partner to sign the audit report. The partner's signature would be in addition to the PCAOB's current requirement for the registered public accounting firm to sign the audit report. The Board is currently considering comments.

There are several other projects as to which we intend to publish proposals within the next few months. These include –

- ***Cross-border Audits of Multi-national Companies*** – The Board is considering revising the PCAOB's interim standard on the principal, or signing, auditor's use of other audit firms in conducting audits of financial statements of multi-national companies. In addition, because most such audits are performed by firms that participate in a network of affiliates and hold themselves out as offering a common brand, the PCAOB is evaluating the adequacy of its quality control standards and considering whether changes may be appropriate to enhance networked firms' controls over interaction with and use of other firms in their networks.

- ***Use of a Specialist*** – The Board is considering enhancing the audit requirements when the auditor uses someone with expertise outside the area of accounting and auditing to assist in the audit.

- ***Related Party Transactions*** – In light of issues raised in the financial crisis, the Board is considering revising its standard on auditing related party transactions, as well as other significant unusual transactions, that may not be on arms-length terms. Accounting for related party transactions is sometimes abused to make a company appear to be doing better than it is.

There are other auditing standards projects under consideration. I have attached a copy of the PCAOB's most recent standard-setting agenda as Appendix A.

C. Expanding Authority – Broker-Dealer Auditor Oversight

Another challenge the Board currently faces relates to the likelihood that our jurisdiction will significantly expand this year. Both the Reform Act passed by the House last year and the Restoring American Financial Stability Act of 2010 in the Senate would extend the Board's inspections, enforcement, and standard-setting authority to include audits of securities broker-dealers. The Board supports this provision, since it would close the gap that currently exists between the requirement that broker-dealer auditors register and the absence of any Board authority to oversee the work of these firms. This authority would, however, require us to add to the expertise of our staff and to adjust the focus of our programs in order to address this new area of oversight.

In December 2008, in the wake of the revelation of the Madoff Ponzi scheme, the SEC discontinued the exemption from PCAOB registration previously applicable to accounting firms that audit the 5,000 or so SEC-registered nonpublic broker-dealers.[10] As a result, more than 500 additional audit firms with broker-dealer audit clients have been registered by the Board. However, the Sarbanes-Oxley Act does not empower the Board to inspect, set standards for, or investigate deficiencies in broker-dealer audits.[11] This creates a risk that brokerage firm clients may believe that, because broker-dealer auditors are registered with the PCAOB, we are exercising oversight of the audit work of those firms, especially as it relates to the auditor's review of procedures the broker employs to protect client cash and securities.

Section 7601 of the Reform Act, and Section 982 of the Restoring American

[10] Every SEC-registered broker and dealer is required by Section 17(e)(1)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78q(e)(1)(A)), as amended by the Sarbanes-Oxley Act, to file with the SEC a balance sheet and income statement certified by a registered public accounting firm. The SEC issued a series of orders which deferred effectiveness of the PCAOB registration requirement for these auditors. The last such order expired on December 31, 2008.

[11] On January 8, 2009, the Board issued a statement to raise public awareness that the Sarbanes-Oxley Act does not provide for PCAOB oversight of brokerage firm audits.

Financial Stability Act of 2010 in the U.S. Senate, would give the Board full oversight authority.[12] If this legislation is enacted, the Board would be required to expand its rules to cover audits of brokers and dealers as well as issuers, develop standards and an inspection methodology for audits of broker-dealers, and hire and train additional staff with experience related to broker-dealer audits. The PCAOB would also need to establish a budget for these new activities, as well as adjust its funding system so that broker-dealers, like public companies, contribute to the cost of overseeing their auditors.

D. FEF v. PCAOB

Finally, no discussion of challenges facing the Board would be complete without mentioning the pending challenge to the Board's constitutionality. In December 2009, the Supreme Court heard argument in a case challenging the constitutionality of the Board's structure.[13] The litigation deals principally with the way in which Board members are appointed and the circumstances under which Board members could be removed. The case does not challenge the mission of independent oversight of the auditing profession, and the Board remains focused on that mission as it awaits the Court's decision.

The Board has vigorously defended its constitutionality since the case was originally filed in 2006, maintaining that its members are properly appointed by the SEC because Board members are "inferior officers," and that the SEC's plenary power over the Board brings the Board well within separation of powers requirements. The United States, which joined the case through the Department of Justice and the SEC, has also argued – through two consecutive Administrations – that the Board's structure passes

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[12] The provision passed in Section 7601 of H.R. 4173 and the provision in Section 982 of S. 3217 contain different approaches to registration. The House bill would permit the PCAOB to decide, by rule and with SEC approval, whether to inspect the audits of certain categories of brokers and dealers, and then would grant an exemption from the requirement to register with the Board to those firms that would not be inspected. The Senate bill would require auditors of all SEC-registered brokers and dealers to remain registered with the Board, but would grant the Board discretion, subject to SEC approval, to determine the inspection cycle for different categories of firms.

[13] *Free Enter. Fund and Beckstead and Watts, L.L.P. v. Pub. Co. Accounting Oversight Bd., et al.*, No. 08-861 (U.S. argued Dec. 7, 2009).

constitutional muster. Both investors and the accounting profession filed amicus briefs in the Supreme Court in support of the Board.

We expect the Supreme Court to issue its decision by the end of June. The PCAOB prevailed in the District Court and the Court of Appeals,[14] and we hope that the Supreme Court will reach the same result. In the event that the PCAOB does not prevail – and the decision requires a legislative change – I would urge Congress to act quickly to fix whatever structural problems the Court identifies. The Board stands ready to assist Congress in that effort. As recent events have shown, the need for investor protection through independent oversight of the auditing profession is as urgent today as it was in 2002 when the Sarbanes-Oxley Act was enacted.

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That completes my overview of the current work of the Public Company Accounting Oversight Board and of some of the challenges we face. I would be happy to answer any questions.

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[14] *Free Enter. Fund and Beckstead and Watts, L.L.P. v. Pub. Co. Accounting Oversight Bd., et al.*, 2007 U.S. Dist. LEXIS 24310 (D.D.C. Mar. 21, 2007), *affirmed*, 537 F.3d 667 (D.C. Cir. 2008).

PCAOB
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Appendix A
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STANDING ADVISORY GROUP MEETING

OCA CURRENT STANDARD-SETTING AGENDA

APRIL 7-8, 2010

The table, followed by a brief project overview, presents the Office of the Chief Auditor's ("OCA") current standard-setting agenda with key milestones. Project milestones have been developed for planning and budgeting purposes and may change due to a variety of reasons. Specifically, the projected project milestones are contingent on the Board determining that the staff should pursue a standard-setting project in each area. If the Board determines to issue a concept release for public comment before proposing a standard, the Board will analyze the comments received and determine if it is appropriate to proceed with a proposed standard. Additionally, after the Board receives public comment on a proposed standard the Board will determine whether to adopt a final standard or seek additional comment through re-proposal. Finally, emerging issues, new accounting developments, and any new legislative initiatives could impact the projected milestones or could result in other priorities not on the agenda.

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Project*	2010				2011			
	1st Quarter	**2nd Quarter**	**3rd Quarter**	**4th Quarter**	**1st Quarter**	**2nd Quarter**	**3rd Quarter**	**4th Quarter**
1. Risk Assessment, including fraud risk assessment			Adopt final standards					
2. Communications with Audit Committees	Issued proposed standard for public comment			Adopt final standard or re-propose standard for public comment		Adopt final standard		
3. Audit Confirmations		Issue proposed standard for public comment		Adopt final standard				
4. Signing the Auditor's Report		Board to determine whether to proceed with proposal	Issue proposed amendments to standards for public comment		Adopt final amendments to standards			

*The projected project milestones are contingent on the Board determining that the staff should pursue a standard-setting project in each area. If the Board determines to issue a concept release for public comment before proposing a standard, the Board will analyze the comments received and determine if it is appropriate to proceed with a proposed standard. Additionally, after the Board receives public comment on a proposed standard the Board will determine whether to adopt a final standard or seek additional comment through re-proposal. Finally, emerging issues, new accounting developments, and any new legislative initiatives could impact the projected milestones or could result in other priorities not on the agenda.

Project*	2010				2011			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
5. Application of the Sarbanes-Oxley Act's Provision on "Failure to Supervise"		Issue release, including request for comment on possible related rules or standards	Board to consider whether to propose related rules or standards	Issue proposed rules or standards for public comment		Adopt final rules or standards		
6. Related Parties		Issue proposed standard for public comment			Adopt final standard or re-propose standard for public comment		Adopt final standard	
7. Specialists		Issue proposed standards for public comment			Adopt final standards or re-propose standards for public comment		Adopt final standard	

*The projected project milestones are contingent on the Board determining that the staff should pursue a standard-setting project in each area. If the Board determines to issue a concept release for public comment before proposing a standard, the Board will analyze the comments received and determine if it is appropriate to proceed with a proposed standard. Additionally, after the Board receives public comment on a proposed standard the Board will determine whether to adopt a final standard or seek additional comment through re-proposal. Finally, emerging issues, new accounting developments, and any new legislative initiatives could impact the projected milestones or could result in other priorities not on the agenda.

Project*	2010				2011			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
8. Fair Value Measurements and Other Accounting Estimates			Issue proposed standards for public comment		Adopt final standards or re-propose standards for public comment		Adopt final standard	
9. Principal Auditor / Multi-Location Audits			Issue proposed standard for public comment			Adopt final standard or re-propose standard for public comment		Adopt final standard
10. Quality Control Standards, Including Quality Controls Over the Work of Affiliated Firms				Issue concept release for public comment		Issue proposed standard for public comment		Adopt final standard

*The projected project milestones are contingent on the Board determining that the staff should pursue a standard-setting project in each area. If the Board determines to issue a concept release for public comment before proposing a standard, the Board will analyze the comments received and determine if it is appropriate to proceed with a proposed standard. Additionally, after the Board receives public comment on a proposed standard the Board will determine whether to adopt a final standard or seek additional comment through re-proposal. Finally, emerging issues, new accounting developments, and any new legislative initiatives could impact the projected milestones or could result in other priorities not on the agenda.

Project*	2010				2011			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
11. Applicability of SECPS Requirements to all Registered Firms		Board to determine whether to proceed with a standard-setting project		Issue proposed amendments for public comment		Adopt final standard or re-propose standard for public comment		Adopt final standard
12. Going Concern		Board to determine whether to proceed with a standard-setting project						
13. Subsequent Events		Board to determine whether to proceed with a standard-setting project						

*The projected project milestones are contingent on the Board determining that the staff should pursue a standard-setting project in each area. If the Board determines to issue a concept release for public comment before proposing a standard, the Board will analyze the comments received and determine if it is appropriate to proceed with a proposed standard. Additionally, after the Board receives public comment on a proposed standard the Board will determine whether to adopt a final standard or seek additional comment through re-proposal. Finally, emerging issues, new accounting developments, and any new legislative initiatives could impact the projected milestones or could result in other priorities not on the agenda.

Standards-setting Brief Project Overview

1. Risk Assessment – The Board re-proposed the standards for public comment on December 17, 2009. The comment period ended on March 2, 2010. The staff is analyzing the comments received and will discuss with the Board its views on how to address the comments.

2. Communications with Audit Committees – The Board proposed the auditing standard for public comment on March 29, 2010. Comments are due on May 28, 2010.

3. Audit Confirmations – In response to the comments received on the May 29, 2009 concept release, the staff is evaluating potential revisions to the audit confirmations auditing standard.

4. Signing the Auditor's Report (Advisory Committee on the Auditing Profession to the U.S. Department of Treasury ("ACAP") Recommendation Firm Structure and Finance Recommendation No. 6) – It was recommended that the PCAOB "[u]ndertake a standard-setting initiative to consider mandating the engagement partner's signature on the auditor's report." – The staff is analyzing the comments received on the July 28, 2009 concept release and is discussing with the Board the staff's views on how to address the comments.

5. Application of the Sarbanes-Oxley Act's Provision on "Failure to Supervise" – The staff is currently preparing a draft release for the Board's consideration relating to the Board's application of Section 105(c)(6) of the Act, which authorizes the Board to impose sanctions on firms and individuals for failure to supervise. The release would also seek comment on concepts relating to what, if any, rulemaking or standard-setting might usefully supplement the Board's application of that provision.

6. Related Parties – In response to comments received at the October 14-15, 2009 SAG meeting, the staff is evaluating potential revisions to the related parties auditing standard.

7. Specialists – In response to the comments received at the October 14-15, 2009 SAG meeting, the staff is evaluating potential revisions to the specialist auditing standard.

8. Fair Value Measurements and Other Accounting Estimates – In response to the comments received at the October 14-15, 2009 SAG meeting, the staff is evaluating potential revisions to the standards on fair value measurements and other accounting estimates.

9. Principal Auditor / Multi-Location Audits – The staff is evaluating potential revisions to the principal auditor auditing standard. The staff will discuss this topic with the Standing Advisory Group at the April 7-8, 2010 meeting.

10. Quality Control Standards, Including Quality Control Over the Work of Affiliated Firms – The staff is evaluating potential revisions to the quality control standards. This will include an evaluation of Appendix K.

11. Applicability of SECPS Requirements to all Registered Firms – Because registered firms (generally non-U.S. firms and some smaller firms) that were not members of the SECPS in April 2003 when the Board adopted certain of the SECPS requirements are not subject to these interim quality control requirements, the staff is analyzing different options to determine if it is feasible to extend the SECPS requirements to all registered firms. This excludes Appendices E (superseded by AS No. 7) and K (part of global quality control standards standards-setting project).

12. Going Concern – The staff is monitoring FASB's project and plans to update the timeline when the FASB determines their action plan for the accounting standard. OCA will assess if any conforming amendments are needed to the Board's auditing standards to align with the FASB's final standard. The staff will also evaluate any additional issues and determine whether to pursue a standard-setting project on going concern.

13. Subsequent Events – The staff is evaluating potential revisions to the subsequent events auditing standard in light of FASB's new accounting standard on subsequent events.

Other Projects

OCA is also considering the following recommendations relating to standards-setting from the Advisory Committee on the Auditing Profession to the U.S. Department of Treasury ("ACAP") and the Advisory Committee on Improvements to Financial Reporting to the U.S. Securities and Exchange Commission ("CiFIR")[1/] –

- ACAP Concentration and Competition Recommendation No. 4(a) – Compile the SEC and PCAOB independence requirements into a single document and make this document website accessible.

- ACAP, Firm Structure and Finance Recommendation No. 5 – Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model. Further, urge that the PCAOB and the SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards. The staff will discuss this topic with the Standing Advisory Group at the April 7-8, 2010 meeting.

- CIFiR Recommendation III.E, Clarifying Guidance on Financial Restatements and Accounting Judgments – In recognition of the increasing exercise of accounting and audit judgments, we recommend that the SEC and PCAOB adopt policy statements on this subject.

Interim Professional Auditing Standards adopted by the PCAOB in April 2003

Similar to past practice, OCA continually evaluates the Board's interim standards and takes a priority-based approach in determining which interim standards need to be amended. As part of developing the standards-setting priorities on an annual basis, OCA takes into consideration the results of the Board's oversight activities of registered accounting firms,

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1/ *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (October 6, 2008), available at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf, and *Final Report of Advisory Committee on Improvements to Financial Reporting to the U.S. Securities and Exchange Commission* (August 1, 2008) available at http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf.

the work of other standards setters (e.g. FASB, IAASB), advice from the Standing Advisory Group, emerging issues, research, and solicitation of public comments. The final set of priorities is determined based on the results of the PCAOB's oversight of registered public accounting firms, monitoring of the environment, and consultation with the Board's Standing Advisory Group, among other factors.

* * *

The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

Testimony of

Robert H. Herz, Chairman

Financial Accounting Standards Board

before the

U.S. House of Representatives Financial Services Subcommittee
On Capital Markets, Insurance, and Government Sponsored Entities

Accounting & Auditing Standards: Pending Proposals & Emerging Issues

May 21, 2010

Introduction

Chairman Kanjorksi, Ranking Minority Member Garrett, and Members of the Subcommittee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). Thank you for inviting me to participate in today's important hearing.

I have brief prepared remarks and would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

My testimony this morning includes a brief overview of the FASB and its parent organization, the Financial Accounting Foundation ("FAF"), with an emphasis on both the FASB's role within the U.S. financial system and how we remain accountable to our constituents in performing that role. My testimony then reports on what the FASB has done over the past year, as well as on our planned activities during the coming year. Finally, it includes some information on matters on which I have been asked to comment.

The FASB and the FAF

The FASB is an independent private-sector organization, which operates under the oversight of the FAF, a not-for-profit organization that is tax-exempt under Section 501(c)(3) of the Internal Revenue Code. Since 1973, the FASB has established standards of financial accounting and reporting for nongovernmental entities, including both businesses (public and private) and not-for-profit organizations. Those standards are recognized as authoritative generally accepted accounting principles ("GAAP") by the U.S. Securities and Exchange Commission ("SEC" or "Commission") for public companies and by the American Institute of Certified Public Accountants ("AICPA") for other nongovernmental entities. GAAP is essential to the efficient functioning of the U.S. economy because investors, creditors, donors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make resource allocation decisions.

An independent standard-setting process is the best means of ensuring high-quality accounting standards, since it relies on the collective judgment of experts, informed by the input of all interested parties through a thorough, open, deliberative process. Although the FASB's mission is to set standards through an independent process, the FASB does not operate in a vacuum. The FASB is accountable in two important ways: (1) by engaging in robust due process in setting standards, including wide consultation with stakeholders, and (2) by being subject to oversight conducted in the public interest.

Because the actions of the FASB affect so many organizations, its decision-making process must be fair and objective. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial information. Our Rules of Procedure, set by the Board within the parameters of the FAF's bylaws, require an extensive due process. That process involves public meetings, public roundtables, field visits or field tests, liaison meetings and presentations to interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with interested constituents to obtain their input and better our understanding of their views. We meet regularly on both a formal and an informal basis with our counterparts at various levels at the SEC and the Public Company Accounting Oversight Board ("PCAOB"), and SEC and PCAOB staff members serve as observers on our advisory groups and often participate in our working groups. We also have observer status on the PCAOB's principal advisory group. Because bank regulators have a keen interest in GAAP financial statements as a starting point in the assessment of the safety and soundness of financial institutions, we meet with them on a quarterly basis and otherwise as appropriate. We also understand Congress's great interest and regularly brief Members and their staffs on developments. Indeed, a number of FAF trustees and FASB members will be meeting with Members of Congress next week.

The Board makes final decisions on standards only after carefully considering and analyzing the input of all parties. While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides far greater opportunities for interaction with the Board by all interested parties. The Board is also focused on making technical, rather than policy or legal, judgments. In making those technical judgments, the FASB's mission and Rules of Procedure require that the Board balance the often-conflicting perspectives of our various constituents and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

Due process procedures are intended to ensure that all stakeholders have an adequate opportunity and time to make their views known before changes in accounting standards are made. Wide consultation helps the Board to assess whether the benefits to users of contemplated changes outweigh the costs of the changes to preparers and others. Wide consultation also promotes excellence, neutrality, the identification of unintended consequences, and, ultimately, broad acceptance of the legitimacy of the standards that are adopted.

Accountability also derives from oversight of the Board, at two levels. First, the Board is monitored by the independent Board of Trustees of the FAF with regard to its standard-setting process for public companies, private companies, and not-for-profit organizations. Second, the Board is also subject to oversight by the SEC with respect to standard setting for public companies.

In addition to the important and ongoing role of the FAF trustees in appointing FASB members, evaluating the FASB chair, and otherwise ensuring that the FASB has adequate and appropriate human and financial resources to accomplish its mission, the FAF recently initiated a couple of new processes aimed at strengthening its oversight of the FASB. First, it has established a post-implementation review process for assessing whether the FASB followed its rigorous due process procedures in issuing key standards and whether those standards are having the intended effect. Second, the FAF has undertaken its own regular outreach efforts to hear directly from stakeholders, beginning with a "listening tour" last summer.

As I indicated earlier, the FASB and the FAF are also overseen by the SEC, which has the authority and responsibility under the U.S. federal securities laws to set accounting standards for public companies, but has historically looked to private-sector standard-setting bodies to set and improve standards and has deferred to their judgment. In 2003, the SEC studied the FASB and the FAF and determined that they met the criteria prescribed by Section 108 of the Sarbanes-Oxley Act of 2002 so that the FASB's standards may be recognized as "generally accepted" for purposes of the U.S. federal securities laws.[1] The SEC monitors the FASB and the FAF on an ongoing basis to ensure they continue to meet the statutory criteria and other SEC expectations.

Additional information about the FASB and the FAF can be found in the 2009 Annual Report of the FAF the complete text of the Annual Report is available electronically at http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB/Document_C/DocumentPage&cid=1176156817431.

FASB Activities

Addressing Financial-Crisis-Related Issues

Over the past year, the FASB has issued a number of standards addressing reporting issues emanating from or highlighted by the Financial Crisis.[2] Most notably, these have included certain standards for two important financial reporting areas: (1) fair value and impairments and (2) securitizations and other involvements with special-purpose entities (SPEs):

1. Fair Value and Impairments

[1] See SEC Release No. 33-8221, *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter* (April 23, 2003).
[2] A complete list of all standards issued by the FASB since January 1, 2009, is attached to this testimony.

- FASB Staff Position (FSP) FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (April 2009)

- FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (April 2009)

- FSP FAS 115-2 and 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (April 2009).

2. Securitizations and Other Involvements with SPEs:

- Statement 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* (June 2009)

- Statement 167, *Amendments to FASB Interpretation No. 46(R)* (June 2009).

In issuing the FSPs on fair value and impairments, the FASB provided important timely guidance in the midst of the Financial Crisis, while still engaging in extensive due process, following the Subcommittee's hearing at which I appeared in March 2009:

- FSP FAS 157-4 provided important clarifying guidance on the intent of Statement 157,[3] reminding preparers and auditors to use judgment and all appropriate valuation techniques and inputs in measuring the fair value of assets in inactive markets, rather than simply defaulting to stale market data in such circumstances. The FSP also included helpful indicators for when a market may be considered inactive and/or an asset sale forced rather than orderly.

- FSP FAS 107-1 and APB 28-1 helped foster more timely information to help "red flag" potential losses in financial instruments carried at amortized cost (such as loans held for investment and debt securities held to maturity) by requiring public companies to disclose fair value information for such instruments in the notes to their financial statements on a quarterly, rather than an annual, basis.

[3] Statement 157, *Fair Value Measurements* (September 2006).

- FSP FAS 115-2 and 124-2 amended the other-than-temporary impairment guidance for debt securities held outside an entity's trading portfolio, most importantly to allow the non-credit-related portion of such impairment (for example, declines in fair value stemming from market illiquidity) to be reported in other comprehensive income instead of earnings.

In issuing Statements 166 and 167, the FASB provided necessary improvements to the accounting and reporting of securitizations and other involvements with SPEs, effective in January 2010. These improvements should result in more assets involved in such transactions staying on the books of sponsoring institutions, by significantly reducing their ability to give off-balance-sheet treatment to securitizations and similar arrangements for which they retain significant risk. These improvements were taken into account by the U.S. banking regulators in their 2009 "stress tests" of the nation's largest financial institutions, and those regulators have been providing guidance on the regulatory effects of the new FASB standards. Statements 166 and 167 were preceded by interim improvements made to the disclosures requirements in this area through an FSP issued in December 2008.[4]

Also addressing deficiencies in financial reporting involving matters highlighted by the Financial Crisis were three pronouncements that the FASB issued in 2008 which became effective in 2009. Together, these improved the disclosure standards for derivatives, including credit derivatives such as credit default swaps, and the accounting and disclosure standards for financial guarantee insurance contracts:

- Statement 161, *Disclosures about Derivative Instruments and Hedging Activities* (March 2008)

- Statement 163, *Accounting for Financial Guarantee Insurance Contracts* (May 2008)

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[4] FSP FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities.*

- FSP FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees* (September 2008).

In the coming year, the FASB expects to complete two other key projects aimed at improving accounting for financial instruments: Disclosures about Credit Quality and the Allowance for Credit Losses (the "Credit Loss Disclosures" project), and Accounting for Financial Instruments. The Credit Loss Disclosures project, to be completed soon, is aimed at improving the disclosures by financial institutions and other creditors of financing receivables (loans, finance leases, and trade receivables with terms that exceed one year) about the allowance for credit losses and the credit risks inherent in their portfolio of financing receivables.

The Accounting for Financial Instruments project represents a comprehensive reexamination of the standards for financial instruments, including classification and measurement, impairment, and hedge accounting. It is aimed at improving and simplifying the accounting and reporting of such instruments and, to the extent possible, achieving convergence of U.S. GAAP and International Financial Reporting Standards ("IFRS"). (This and other projects covered by our Memorandum of Understanding with the International Accounting Standards Board ["IASB"], aimed at improvement and convergence, are discussed further below.) Later this month we expect to issue an Exposure Draft on financial instruments for public comment, with the goal of finalizing the standard in early 2011, with a subsequent effective date to be determined.

In the Board's deliberations of those two projects, we have given careful consideration to nonpublic entities, including credit unions and many community banks. In the final credit loss disclosures standard, we will provide a one-year deferral of the effective date for all nonpublic entities, so that the standard's requirements will take effect for their 2011 calendar-year-end financial statements. In addition, the expected Exposure Draft on financial instruments will propose a four-year deferral of the effective date for all nonpublic entities with less than $1 billion in assets. This proposed deferral will allow extra time for those nonpublic entities to adopt the new requirements that would likely necessitate the greatest changes in their financial information systems. It is important to note that approximately 90 percent of all U.S. financial institutions, which together represent about 10 percent of the assets in the system, would be eligible for this four-year deferral.

Reducing Complexity in the U.S. Financial Reporting System

In issuing the standards that I just described, as well as other standards it has issued in recent years, the FASB has aimed to make its standards more understandable through a focus on clear objectives and principles (generally set forth in boldface paragraphs), supported by a sufficient level of implementation guidance.

In addition to its standard-setting activities, the FASB has taken other significant steps during the past year to reduce complexity in the U.S. financial reporting system.

On July 1, 2009, following an 18-month "verification" trial period by the public, we officially launched the *FASB Accounting Standards Codification*™ (the "Codification") as the source of authoritative nongovernmental U.S. GAAP. This was a milestone event for the FASB and the U.S. financial reporting system, ushering in a new era of modern accounting research to accounting and financial reporting professionals, as well as to analysts and investors. The Codification's launch culminated a multi-year effort to make the U.S. GAAP literature more accessible and user-friendly. Instead of GAAP standards scattered among many pronouncements issued by various standard setters over the years, the Codification provides constituents with one topically organized, easily accessible online research system.

We expect that the new system will significantly reduce the amount of time and effort required to research accounting issues, mitigate the risk of noncompliance with standards through improved usability of the literature, provide accurate information with real-time updates as new standards are released, and assist the FASB with the research efforts and literature amendments required during the standard-setting process.

With the launch of the Codification, the FASB is no longer adding numbered Statements, Interpretations, and FSPs to GAAP but, rather, is issuing Accounting Standards Updates (ASUs) that amend the relevant sections of the Codification.

The Codification's launch was further enhanced by the inclusion of XBRL (eXtensible Business Reporting Language) functionality, making it easier for users of the Codification to access information about the U.S. GAAP financial reporting taxonomy elements that link to the Codification. To ensure continued coordination of GAAP standards and the XBRL taxonomy, the FAF recently assumed responsibility for the ongoing maintenance of the U.S. GAAP financial reporting taxonomy, including updates for changes in U.S. GAAP, reviews of best practices, and technological enhancements.

International Convergence

During the past year, the FASB has also made much progress, intensifying our efforts, on our joint projects with the IASB that are aimed at improving both U.S. GAAP and IFRS and achieving convergence in a number of key areas:

- Consolidations
- Derecognition
- Fair Value Measurement
- Financial Instruments
- Financial Instruments with Characteristics of Equity
- Financial Statement Presentation
- Insurance
- Leases
- Revenue Recognition.

These projects are discussed in the attached March 2010 Quarterly Progress Report.

The FASB's commitment to international convergence of accounting standards is a longstanding one. In 2002, the FASB and the IASB laid the groundwork for convergence projects through an agreement (the "Norwalk Agreement") in which they "acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting" and pledged to use their best efforts to achieve such compatibility. In the first few years after signing the Norwalk Agreement, the Boards harmonized their standards in a number of areas, such as employee stock compensation and segment reporting. The current projects became a significant part of both Boards' agendas as the result of a Memorandum of Understanding (MOU) that they entered into in 2006, reflecting the decision by the Boards, with concurrence of the SEC and the European Commission, that their resources should best be focused on developing converged and improved standards in those areas in U.S. GAAP and IFRS that were most in need of improvement. The Boards completed the first such major improvement and convergence project, on Business Combinations, at the end of 2007,[5] and updated the MOU in 2008. The updated MOU targeted 2011 for completion of the various projects.

For many of our constituents, the recent Financial Crisis underscored the need for expeditious progress on these projects, especially those projects that are most relevant to financial institutions (Financial Instruments, Fair Value Measurement, and Consolidations/ Derecognition). At their September 2009 summit in Pittsburgh, the leaders of the G-20 nations called for the Boards to "redouble" their efforts to achieve convergence in these areas by the 2011 target date.[6] In their February 24, 2010 statement,[7] the SEC indicated that along with the execution of an SEC staff work plan, "completion of the convergence projects of the FASB and the IASB according to their current work plan...will position the Commission in 2011 to make a determination regarding incorporating IFRS into the financial reporting system for U.S. issuers."

[5] FASB Statements 141 (revised 2007), *Business Combinations*, and 160, *Noncontrolling Interests in Consolidated Financial Statements* (both, December 2007), and IFRS 3, *Business Combinations* (January 2008).
[6] *Leaders' Statement: The Pittsburgh Summit*, September 24-25, 2009.
[7] SEC Release Nos. 33-9109 and 34-61578, *Commission Statement in Support of Convergence and Global Accounting Standards.*

Many of these projects are nearing their Exposure Draft stage. Achieving both improvement to U.S. GAAP and convergence with IFRS on the MOU projects, while making necessary improvements to U.S. GAAP on other projects such as those described in the preceding sections of this testimony, remains a significant challenge for the FASB. In some of the MOU projects, the Boards are on track to both make the desired improvements to U.S. GAAP and IFRS and achieve convergence. In other MOU projects, achieving convergence is proving to be quite challenging.

Section 108 of the Sarbanes-Oxley Act and the SEC's 2003 Policy Statement (discussed on page 3 above) require us, in serving as a recognized authoritative standard setter, to "consider, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and the protection of investors." Along these lines, while we are committed to, and are making every effort to, foster convergence between U.S. GAAP and IFRS through the MOU projects, we must ensure that, first and foremost, the resulting standards represent improvements that are in the best interest of U.S. investors and other users of GAAP information.

Activities Related to Private Companies and Not-for-Profit Organizations

While a significant portion of the FASB's attention has been, and continues to be, focused on international convergence of standards and other matters that affect U.S. public companies, privately-held companies and not-for-profit organizations remain very important to the FASB's and the FAF's mission. We extensively outreach to these sectors during our due process and carefully consider their differential needs, with the result often being a deferral of effective dates of new pronouncements and sometimes a reduction in disclosure requirements for those sectors versus public companies. For example, we deferred the effective date of Interpretation 48, *Accounting for Uncertainty in Income Taxes*, for nonpublic entities by two years and we exempted them from some of the quantitative disclosure requirements. And, as noted above, we will be proposing to defer by several years, for many nonpublic entities, some of the significant requirements in our upcoming proposed ASU on Accounting for Financial Instruments.

In our outreach to privately-held companies and not-for-profit organizations, we benefit from the input received from important advisory groups. For private business enterprises, the FASB regularly consults with both its Small Business Advisory Committee (whose members also represent small public companies) and its Private Company Financial Reporting Committee ("PCFRC"), on specific areas in proposed or existing standards where differences for private companies might be appropriate based on user needs or cost-benefit considerations.

Beyond these routine consultations, however, there are a number of forces in play that have challenged the approach that the U.S. has traditionally had, of one set of standards for both public and private companies (with exceptions as appropriate) rather than the type of parallel system of "Big GAAP/Little GAAP" that is present in certain other countries. These include the potential move to IFRS for public companies (and the uncertainty that has created for private companies), the available use of IFRS for Small and Medium-Sized Entities by U.S. private companies, recent developments in other countries that have adopted IFRS for their public companies but not for their private companies, and continuing concerns expressed by some constituents over the relevance and cost/benefit to private companies of certain U.S. GAAP requirements. In response to hearing these concerns from private company constituents during the Trustees' listening tour last summer, as well as receiving input from the PCFRC, in December 2009 the FAF created the "Blue-Ribbon Panel" on Standard-Setting for Private Companies (the "Panel"), sponsored jointly by the AICPA and the National Association of State Boards of Accountancy. The Panel, which includes a cross-section of private company financial reporting constituencies, including lenders, investors, and owners, as well as preparers and auditors, will examine these matters and issue its report with recommendations to the Trustees in early 2011.

As I indicated earlier, standard-setting for not-for-profit organizations is also important to the FASB's and FAF's mission. In October 2009, the FASB established a Not-for-Profit

Advisory Committee ("NAC"). The FASB has just appointed the initial members of the NAC, which will hold its first meeting in September. The NAC will provide us with input on reporting issues in that sector, including issues that may arise if and when U.S. public companies move to IFRS, because IFRS does not explicitly cover not-for-profit entities.

Other Matters

I have been asked to comment on financial arrangements that companies may employ to manage their financial position near the end of a reporting period—presumably including arrangements such as the so-called Repo 105 and Repo 108 transactions engaged in by Lehman Brothers. I would respectfully refer the Subcommittee members to the attached letter that I sent to Committee Chairman Frank and Ranking Minority Member Bachus in connection with the Committee's April 20, 2010 hearing, "Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner." As noted in the letter, the FASB does not have any regulatory or enforcement powers, but we do work closely with the SEC whenever there are reports of any significant accounting or reporting issues such as the ones highlighted in that examiner's report. We stand ready to take any additional standard-setting actions that may be warranted as the result of our ongoing discussions with the SEC staff as they evaluate that report and any information they obtain concerning practices of other financial institutions in the area of repurchase agreements and consolidation of SPEs.

Conclusion

The demands on accounting standard setters that have stemmed from the Financial Crisis, together with the goal of continuing to improve U.S. GAAP and of achieving convergence of GAAP and IFRS, have made this past year one of the most challenging in the FASB's 37-year history. The coming year will likely be equally if not more challenging as we work towards completion of the various MOU projects. I and others at the FASB very much look forward to the challenge.

Thank you, Mr. Chairman, for the opportunity to appear here today. I would be pleased to answer any questions.

Attachments:

1. List of Standards Issued by the FASB since January 1, 2009

2. IASB and FASB Commitment to Memorandum of Understanding: Quarterly Progress Report, 31 March 2010

3. Letter from Robert H. Herz to House Financial Services Committee Chairman Barney Frank and Ranking Minority Member Spencer T. Bacchus III, dated April 19, 2010

Standards Issued by the FASB since January 1, 2009

Prior to the *FASB Accounting Standards Codification*™:

FASB Staff Position EITF 99-20-1, **Amendments to the Impairment Guidance of EITF Issue No. 99-20** (January 2009)

FASB Staff Position FAS 141(R)-1, ***Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*** (April 2009)

FASB Staff Position FAS 157-4, ***Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*** (April 2009)

FASB Staff Position FAS 107-1 and APB 28-1, ***Interim Disclosures about Fair Value of Financial Instruments*** (April 2009)

FASB Staff Position FAS 115-2 and FAS 124-2, **Recognition and Presentation of Other-Than-Temporary Impairments** (April 2009)

FASB Statement No. 164, ***Not-for-Profit Entities: Mergers and Acquisitions—including an amendment of FASB Statement No. 142*** (May 2009)

FASB Statement No. 165, ***Subsequent Events*** (May 2009)

EITF Issue No. 09-1, ***Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance*** (June 2009)

FASB Statement No. 166, ***Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*** (June 2009)

FASB Statement No. 167, ***Amendments to FASB Interpretation No. 46(R)*** (June 2009)

FASB Statement No. 168, ***The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*** (June 2009)

Accounting Standards Updates amending the *FASB Accounting Standards Codification*™ [1]:

Accounting Standards Update No. 2009-01, ***Topic 105—Generally Accepted Accounting Principles—amendments based on—Statement of Financial Accounting Standards No. 168—The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles*** (June 2009)

[1] Excludes Accounting Standards Updates by the SEC staff that amend the SEC-maintained sections of the Codification.

Accounting Standards Update No. 2009-02, ***Omnibus Update—Amendments to Various Topics for Technical Corrections*** (June 2009)

Accounting Standards Update No. 2009-05, ***Fair Value Measurements and Disclosures (Topic 820)—Measuring Liabilities at Fair Value*** (August 2009)

Accounting Standards Update No. 2009-06, ***Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*** (September 2009)

Accounting Standards Update No. 2009-12, ***Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*** (September 2009)

Accounting Standards Update No. 2009-13, ***Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force*** (October 2009)

Accounting Standards Update No. 2009-14, ***Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force*** (October 2009)

Accounting Standards Update No. 2009-15, ***Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force*** (October 2009)

Accounting Standards Update No. 2009-16, ***Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*** (December 2009)

Accounting Standards Update No. 2009-17, ***Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*** (December 2009)

Accounting Standards Update No. 2010-01, ***Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*** (January 2010)

Accounting Standards Update No. 2010-02, ***Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*** (January 2010)

Accounting Standards Update No. 2010-03, ***Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures*** (January 2010)

Accounting Standards Update No. 2010-06, ***Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*** (January 2010)

Accounting Standards Update No. 2010-07, ***Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*** (January 2010)

Accounting Standards Update No. 2010-08, ***Technical Corrections to Various Topics*** (February 2010)

Accounting Standards Update No. 2010-09, ***Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*** (February 2010)

Accounting Standards Update No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds* (February 2010)

Accounting Standards Update No. 2010-11, *Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives* (March 2010)

Accounting Standards Update No. 2010-13, *Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force* (April 2010)

Accounting Standards Update No. 2010-15, *Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force* (April 2010)

Accounting Standards Update No. 2010-16, *Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force* (April 2010)

Accounting Standards Update No. 2010-17, *Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force* (April 2010)

Accounting Standards Update No. 2010-18, *Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force* (April 2010)

IASB and FASB Commitment to Memorandum of Understanding

Quarterly Progress Report

31 March 2010

Introduction

In November 2009, we, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB), released a joint statement in which we:

- reaffirmed our commitment to improving International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP) and achieving their convergence.
- agreed to intensify our efforts to complete the major joint projects described in the 2006 Memorandum of Understanding (MoU), as updated in 2008.
- described our plans for completing those major projects, including milestone targets for each project.
- Committed to providing transparency and accountability regarding those milestones by reporting quarterly on our progress and making those reports available on our websites.

This is the joint progress report for the quarter ended 31 March 2010. The chairmen of the FASB and IASB discussed a draft of this report with the joint working group of their respective oversight bodies at a meeting on 29 March.

As of 31 March 2010, we had achieved substantially all of the milestone targets for the first quarter of 2010. As we explain more fully in a later section of this report:

- for five of the major MoU projects, we are on track to publish, by mid-2010, exposure drafts that would improve and achieve substantial convergence of US GAAP and IFRSs in those areas.
- on two major projects, financial instruments and insurance contracts, we have reached different conclusions on some important technical issues. Addressing those differences in ways that foster convergence could affect the project timetables described in this report.
- the boards also agreed in late March to explore an alternative approach to lessor accounting. That decision could affect the project timetables described herein.

The exposure drafts scheduled for publication in the second quarter of 2010 are significant both in nature and number (eleven for the FASB (eight on major projects) and eleven for the IASB (seven on major projects)). We will provide comment periods commensurate with the degree of change and complexity of each exposure draft. However, we recognise the effort that will be required by stakeholders to consider carefully and respond thoughtfully to these many different proposals. We are developing outreach programmes to provide potential respondents with enhanced opportunities to engage with the boards to help them consider the proposals.

That outreach will also provide the boards with more opportunities to hear and absorb that input and thoughtfully complete their redeliberations.

The boards are also aware of the significant challenges that will arise from implementing the many major MoU standards targeted for completion in mid-2011. The boards will publish a separate discussion paper to seek views on ways to implement these improvements so as to minimise the disruption and cost to the financial reporting system.

This remainder of this report is presented in three parts:

- The first part describes changes the boards have made to their work methods to foster completion of their joint projects by the June 2011 target.
- The second part describes progress made on each project since the November 2009 report and updated milestone targets.
- The third part is a complete list of all documents the FASB and IASB expect to publish in connection with the completion of the MoU and the expected publication timing.

Part 1: Work method improvements

We changed our work methods to enhance the likelihood that we will complete the major MoU projects in the time frame outlined in the MoU and that the resulting standards will both improve IFRSs and US GAAP and reduce the differences between them.

- **Intensification of work programme:** We fulfilled our November 2009 commitment to meet jointly at least every month. The boards had full-day meetings on three consecutive days in each of November, December, January and February. In March, the boards met jointly for three consecutive afternoons by video, followed the next week by a three-day, face-to-face joint meeting in London.
- **Willingness to schedule special meetings to address key issues:** To address issues requiring their joint attention, the boards called seven further special sessions during this period.
- **Continuing work:** The boards have meetings scheduled for 8 April, 20-22 April, 4 May, 17-19 May, 1 June and 15-17 June.
- **Enhanced stakeholder outreach on projects:** We are developing extensive outreach programmes to ensure broad stakeholder participation in the standard-setting due process (we will post those programmes on our websites). Those programmes will include public educational outreach sessions in Asia-Oceania, North America and Europe. We have already scheduled such sessions for August in Tokyo, Norwalk in early September (hosted by the FASB) and London in mid-September (hosted by the IASB).

Part 2: Updates on convergence projects

Financial instruments

Our goal is to issue comprehensive improvements to this complex and contentious area that will foster international comparability of financial information about financial instruments.

As we noted in our November statement, each board has faced different imperatives that pushed our development timetables out of alignment. In particular, the IASB has been replacing its financial instrument requirements in a phased approach, whereas the FASB has been developing a comprehensive proposal. Those differing development timetables and other factors have contributed to the boards reaching differing conclusions on a number of important technical issues (a summary description of those differences is available on our websites).

Our strategy for addressing those differences calls for each board to publish its proposals and that of the other board, as a way of giving interested parties the opportunity to compare and assess the relative merits of both boards' proposals. Additionally, we established an *expert advisory panel* to help the boards identify and resolve operational aspects of their respective credit impairment models.

Our strategy also calls for us to consider together the comment letters and other feedback we receive in an effort to reconcile our differences in ways that foster convergence. We expect to begin those joint discussions in the third quarter of 2010. Although our recent experiences with joint meetings show that we have been able to resolve differences on several projects, there is no guarantee we will be able to resolve all, or any, of our differences on this project.

First quarter 2010 milestone targets achieved

The following first quarter milestones were achieved in accordance with the timetable published in November.

- The IASB issued new requirements for the classification and measurement of financial assets in early November 2009.
- On 5 November 2009 the IASB published for public comment an exposure draft on the amortised cost measurement and impairment of financial instruments, with comments due by 30 June 2010.

Updated milestone targets

Milestone targets for financial instruments	
Q2 2010	The IASB has been developing improved financial reporting requirements for financial instruments in phases, in response to requests to accelerate particular parts of the project. In the next phase the IASB will publish in April proposals for the classification and measurement of financial liabilities, rather than by March as previously planned. (The IASB published proposals for the classification and measurement of financial liabilities in July 2009 but decided not to include financial liabilities within the scope of the first phase of the financial instruments project). The FASB expects to publish its comprehensive proposal covering classification and measurement, impairment and hedging during the first week of May 2010 rather than March as previously planned. As part of that proposal, the FASB will solicit views on the IASB's proposals for recognition and measurement (of both assets and liabilities) and impairment. The IASB also will publish a request for views on the FASB's comprehensive exposure draft. Since November, the IASB has decided to include non-financial hedges in the phase of the project addressing hedge accounting. As a consequence, the IASB will publish its initial proposals on hedge accounting in mid-2010 (rather

	than by March as previously planned). The IASB will review the application of its requirements for classification and measurement of financial assets by those entities adopting the requirements early.
Q3 2010	The boards will begin to consider together the comment letters and other feedback received on each of the boards' various proposals.
Q4 2010 / Q1 2011	The boards will complete their joint consideration of feedback received and expect to finalise and issue new requirements.

Consolidations

The agendas of both boards include projects on consolidation. In 2008 the IASB published an exposure draft of a comprehensive replacement of its consolidation requirements, and in 2009 the FASB finalised one aspect of that project that amended and improved US GAAP relating to consolidation of variable interest entities and related disclosures.

The boards concluded last November that, ideally, their standards for consolidation would include objectives and principles for assessing control that would be applied consistently for all types of entities and produce globally comparable results. Consistently with that conclusion:

- the IASB agreed in November 2009 to amend its timetable to give the boards the opportunity to jointly deliberate the consolidation requirements.
- the FASB set a goal of publishing an exposure draft in the second quarter of 2010.
- the IASB agreed to make available a staff draft of its proposed standard and publish a request for views on the FASB's proposal.
- the two boards agreed to jointly deliberate the issues with the expectation they would produce improved and common final standards by the third quarter of 2010.

The IASB proposal, originally published in 2008, included enhanced disclosures about unconsolidated entities. The IASB decided in February 2010 to accelerate its work plan and issue in the second quarter of 2010 final disclosure requirements for securitisation and investment vehicles (such as special purpose entities and structured investment vehicles) that an entity has sponsored or with which it has a special relationship, but does not control.

First quarter 2010 milestone targets achieved

There were no first quarter 2010 milestone targets for this project.

Updated milestone targets

Milestone targets for consolidations	
Q2 2010	The IASB expects to finalise and publish required disclosures about securitisation and investment vehicles that any entity does not control but has sponsored or with which it has a special relationship (which the IASB had previously planned for publication in Q4 2010). The FASB expects to publish a comprehensive exposure draft on consolidations that is not expected to significantly affect consolidation of variable interest entities (previously expected in Q1 2010). The IASB will make available a staff draft of its proposed standard and will also publish a request for views on the FASB's proposals.
Q4 2010 or Q1 2011	The IASB and FASB aim to issue common standards on consolidation covering all entity types.

Derecognition

In late 2009 the FASB finalised a project to amend and improve its requirements in relating to the derecognition of some financial assets and liabilities.

The IASB is also undertaking a project to improve the derecognition requirements for financial assets and to provide users with better information about an entity's exposure to the risks of transferred financial assets. The current requirements are perceived as complex and difficult to understand and apply in practice. The IASB published proposals in 2009 and the responses showed stronger support for the alternative model proposed. The IASB has completed development of that alternative and in April the FASB will consider that model.

In their next quarterly update the boards expect to provide further details on their plans to improve and develop common standards for derecognition of financial assets and liabilities

First quarter 2010 milestone targets achieved

There were no first quarter 2010 milestone targets for this project.

Updated milestone targets

Milestone targets for derecognition	
Q2 2010	The IASB staff will present to the FASB a proposed model for derecognition of financial assets and liabilities. The boards will develop and provide further details regarding their plans and milestone targets for this project.

Fair value measurement

The FASB issued Statement 157 *Fair Value Measurements* in 2006 and those requirements have been in effect since November 2007. In May 2009 the IASB published an exposure draft of an IFRS on fair value measurement. The exposure draft is largely consistent with the FASB requirements.

In November, the boards reached agreement on the following:

- Their objective is to ensure that fair value has the same meaning in US GAAP and IFRSs, by making US GAAP and IFRS fair value measurement requirements the same other than minor necessary differences in wording or style.
- The boards agreed to consider together the comments received on the IASB's exposure draft. The FASB agreed to propose amendments to US GAAP fair value measurement requirements, if necessary.
- The boards also agreed that if they become aware of perceptions that the FASB and IFRS fair value measurement requirements are different they will work together to address those perceptions.

First quarter 2010 milestone targets achieved

The IASB held public round-table meetings in Asia, Europe, and North America in conjunction with the FASB.

Updated milestone targets

Milestone targets for fair value measurement	
Q2 2010	The FASB expects to issue an exposure draft of proposed amendments to its fair value measurement requirements that would improve them and achieve convergence with the proposed IFRS (previously expected to be issued in Q1 2010).
Q3 2010	The FASB expects to hold a public round-table meeting to discuss its proposal.
Q4 2010	After the close of the public comment period for the FASB exposure draft, the boards will deliberate issues jointly, with a goal of issuing common standards in the fourth quarter.

Revenue Recognition

The boards are working together to provide a single revenue recognition model that can be applied to a wide range of industries and transaction types. US GAAP currently has many industry-specific requirements that are not always consistent with each other. IFRSs are perceived as lacking necessary application guidance. The new model will eliminate weaknesses and inconsistencies in the existing standards.

The boards published a joint discussion paper in December 2008 that proposed a single revenue recognition model built on the principle that an entity should recognise revenue when it satisfies its performance obligations in a contract by transferring goods and services to a customer. That principle is similar to many existing requirements. However, the boards think that clarifying that principle and applying it consistently to all contracts with customers will improve the comparability and understandability of revenue for users of financial statements.

The boards have been considering the comments received on their discussion paper as well as feedback from their outreach programmes.

First quarter 2010 milestone targets achieved

The boards conducted a series of workshops to learn how various types of entities would apply the proposed requirements. The feedback received was positive and provided additional comfort that the proposals are operational.

Updated milestone targets

Milestone targets for revenue recognition	
Q2 2010	The IASB and FASB expect to publish an exposure draft that would improve their respective requirements and achieve convergence.
Q2 2011	The IASB and FASB aim to issue improved and common standards.

Leases

The IASB and FASB are developing together a new single approach to lease accounting that would ensure that all assets and liabilities arising under lease contracts are recognised in the statement of financial position. The project is addressing the accounting from the perspective of both the lessor and lessee.

The boards continued to deliberate technical issues during the first quarter of 2010.

First quarter 2010 milestone targets achieved

There were no first quarter 2010 milestone targets for this project.

Updated milestone targets

Although the boards have retained their second quarter 2010 milestone target for publishing exposure drafts, their decision in March to explore an alternative approach to the accounting by a lessor may affect that milestone target.

Milestone targets for leasing	
Q2 2010	The IASB and FASB will publish exposure drafts proposing the accounting for leases, from the perspective of the lessor and the lessee.
Q2 2011	The IASB and FASB aim to issue improved and common standards.

Financial instruments with the characteristics of equity

The FASB and IASB have been working together to improve and, as a consequence, simplify, the financial reporting requirements for financial instruments with characteristics of equity. The purpose of this project is to develop a better way to distinguish instruments that are equity from those that are assets or liabilities. Some aspects of the current IFRS and US GAAP requirements have been criticised for their complexity or inconsistency.

As of November 2009, the boards had agreed to assess the feasibility of an approach that would classify as equity particular share-settled instruments. The boards noted they were unable to establish a timetable until they completed that assessment.

First quarter 2010 milestone targets achieved

- The boards completed their assessment and decided to propose for public comment an approach that would classify as equity particular share-settled instruments.
- The boards agreed on milestone targets for this project.

Updated milestone targets

Milestone targets for liabilities and equity	
Q2 2010	The FASB and IASB expect to publish exposure drafts of proposed requirements for identifying financial instruments that should be classified as equity and those that should be classified as an asset or as a liability. The exposure drafts will have a 120-day comment period.
Q2 2011	The boards expect to issue improved and common standards.

Financial statement presentation

The FASB and IASB are working together to establish a common standard that would improve how information is organised and presented in the financial statements. The IASB has already implemented the decisions reached in the first phase of this project into its existing IFRS for the presentation of information in financial statements. Accordingly, the FASB's proposals will include improvements related to that phase as well as the matters the boards are currently discussing together.

In 2008 the boards published a discussion paper in which they set out the principles for presenting financial statements in a manner that portrays a cohesive financial picture of an entity's activities, disaggregates information so that it is useful in predicting an entity's future cash flows and helps users to assess an entity's liquidity and financial flexibility.

As of November, the Boards had decided to accelerate aspects of this project relating to the presentation of other comprehensive income and discontinued operations. In particular:

- the boards agreed to publish together a proposal that would make it easier to compare income statements prepared in accordance with IFRSs or US GAAP. The proposals are designed to improve how items of other comprehensive income are presented in the financial statements.
- the boards agreed to explore a definition of discontinued operations based on existing IFRSs and to work together to improve related note disclosures.

First quarter 2010 milestone targets achieved

- The boards agreed to base the definition of discontinued operations on existing IFRSs and agreed on improvements to related note disclosures.

Updated milestone targets

Milestone targets for financial statement presentation	
Q2 2010	The IASB and FASB expect to publish in April exposure drafts proposing improvements to how items of other comprehensive income items are presented in the financial statements (the previous report called for an ED in March). The FASB and IASB expect to publish in April exposure drafts that would bring together their requirements for defining discontinued operations and improve related disclosure requirements (the previous report called for an ED in March). The IASB and FASB both expect to publish an ED on *Financial Statement Presentation* with a five-month comment period.
Q4 2010	The IASB and FASB aim to finalise amendments to their requirements for reporting discontinued operations.
Q1 2011	The IASB and FASB aim to finalise improvements to how items of other comprehensive income are presented in the financial statements.
Q2 2011	The IASB and FASB aim to issue improved and common standards on *Financial Statement Presentation*.

Other MoU projects

The IASB has been developing proposals to improve the accounting for **joint ventures**, and remove differences between IFRSs and US GAAP. The IASB plans to finalise its new requirements in June 2010, which includes removing the ability to use proportionate consolidation for joint ventures, thereby providing a more representative portrayal of the assets the reporting entity controls.

In response to calls from preparers and users of financial statements, the IASB is conducting a project that will result in significant improvements to the accounting for **post-employment benefits.** Having reviewed comments received on a discussion paper published in March 2008, the IASB focused on improvements to the recognition and presentation of changes in defined benefit obligations and plan assets. The resulting proposals, which include eliminating the corridor approach and revised disclosure requirements, will be published in April.

Other joint projects

The boards are also working together on other projects that are not part of the MoU. They have been developing together a new **Conceptual Framework.** The first two chapters of the Framework, which address the *objectives* and *qualitative characteristics* of financial reporting, will be published in the second quarter of 2010 (rather than towards the end of 2009, as indicated in the previous report). As indicated in the previous report, in the first quarter of 2010 the boards published together an exposure draft for a chapter addressing the *reporting entity.*

Both boards understand the importance of **emissions trading schemes** as a mechanism to help manage CO_2 emissions. The financial reporting consequences of the many different allocation and trading systems will become increasingly important. The boards have been working together on this project and expect to publish an exposure draft together in 2010 with the aim of issuing common standards in 2011.

The IASB published in 2007 a discussion paper ***Preliminary Views on Insurance Contracts*** and has been developing proposals on the basis of that discussion paper, in the light of comments received. In 2007, the FASB issued an Invitation to Comment containing the IASB's discussion paper to solicit input on whether it should undertake a comparable project jointly with the IASB. In October 2008 the FASB added a project on insurance to its agenda and the boards agreed to undertake it jointly. They began discussing the project together in 2009 and, to date, have reached different conclusions on several important technical issues (a summary of those differences is available on our websites). While the boards have a milestone target of publishing together exposure drafts in Q2 2010 (with a view to finalising a high quality common standard by mid-2011), the nature and timing of the milestone targets may change depending on the outcome of our efforts to reconcile our differences

Part 3: Publications expected in the second quarter of 2010

A clear sign of continued progress towards completing the improvements to IFRSs and US GAAP identified in our November statement is the forthcoming publication of proposals on the topics listed below.

IASB

- Consolidation: Disclosures about unconsolidated SPEs/structured entities (IFRS)
- Financial Instruments - Classification and Measurement: Financial Liabilities (exposure draft)
- Financial Instruments – Hedge Accounting (exposure draft)
- Joint Arrangements (IFRS)
- Post-employment Benefits – Defined Benefit Plans (exposure draft)
- Derecognition (exposure draft)

FASB

- Financial Instruments (exposure draft)
- Consolidation (exposure draft)
- Fair Value Measurement (exposure draft)

IASB and FASB

- Financial Statement Presentation – organisation and presentation of information in the financial statements (exposure draft)
- Financial Statement Presentation – Presentation of Items of Other Comprehensive Income (exposure draft)
- Financial Statement Presentation – Discontinued Operations (exposure draft)
- Financial Instruments with Characteristics of Equity (exposure draft)
- Revenue Recognition (exposure draft)
- Leases (exposure draft)
- Insurance Contracts (exposure draft)

Appendix A to this quarterly update includes a comprehensive a schedule of all publications relating to joint and MoU standards projects.

Appendix A

TIMETABLE FOR DOCUMENT PUBLICATION—APRIL 2010 to DECEMBER 2011

	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 H2
Financial instruments:						
IASB proposal: liability classification and measurement	ED (May)		IFRS			
IASB proposal: hedging	ED (June)		IFRS			
FASB: comprehensive proposal (including request for comment on the IASB proposal)	ED (May)			Final		
IASB: request for views on FASB proposal	DP (April)					
Consolidations:						
IASB: Disclosures about securitisation and investment vehicles	IFRS (June)					
FASB: Exposure draft of a comprehensive standard on consolidation that is not expected to significantly affect the consolidation of variable interest entities.	ED (May)		Final			
IASB: staff draft of proposed standard and request for views on FASB proposal	May		IFRS			
Derecognition						
IASB proposal: timing to be determined						
FASB proposal: timing to be determined						
Fair value measurement						
FASB proposal: changes to improve requirements and converge with IASB proposed standard IASB: final IFRS	ED (May)		Final			
Revenue recognition			IFRS			
IASB proposal: comprehensive standard	ED (May)				IFRS	
FASB proposal: comprehensive standard	ED (May)				Final	
Leasing						

Appendix A

TIMETABLE FOR DOCUMENT PUBLICATION—APRIL 2010 to DECEMBER 2011

	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 H2
IASB proposal: comprehensive standard	ED (June)				IFRS	
FASB proposal: comprehensive standard	ED (June)				Final	
Financial Instruments with characteristics of equity						
IASB proposal: comprehensive standard	ED (June)				IFRS	
FASB proposal: comprehensive standard	ED (June)				Final	
Financial Statement Presentation						
IASB: reporting comprehensive income	ED (April)			IFRS		
IASB: disclosures about discontinued operations	ED (April)		IFRS			
IASB: main standard, replacement of IAS 1 and IAS 7	ED (May)				IFRS	
FASB: reporting comprehensive income	ED (April)			Final		
FASB: disclosures about discontinued operations	ED (April)					
FASB: comprehensive standard	ED (May)				Final	
Other MoU Projects						
Joint ventures: IASB only		IFRS (June)				
Pension accounting: IASB only	ED (April)			IFRS		
Other Joint Projects						
Emissions trading – both FASB and IASB, timing to be determined						
Insurance – both FASB and IASB	ED (June)				Final	

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ROBERT H. HERZ
Chairman

April 19, 2010

The Honorable Barney Frank, Chairman
The Honorable Spencer T. Bachus III, Ranking Minority Member
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Re: Discussion of Selected Accounting Guidance Relevant to Lehman Accounting Practices

Dear Chairman Frank and Ranking Minority Member Bachus:

Thank you for the opportunity to submit an explanation of the accounting standards and relevant guidance relating to repurchase agreements for your April 20, 2010 hearing "Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner." In order to focus my response on the most relevant financial accounting guidance, I have referred to certain matters discussed in the report of the Lehman Bankruptcy Examiner.[1] Additionally, I have also provided a brief discussion of the relevant accounting guidance relating to consolidation of special-purpose entities, which I believe may be helpful to the Members of the Committee as they deliberate the public policy issues relating to Lehman's bankruptcy.

The FASB does not have regulatory or enforcement powers. However, whenever there are reports of significant accounting or financial reporting issues, we monitor developments closely to assess whether standard-setting actions by us may be needed. In some cases, a misreporting is due to outright fraud and/or violation of our standards, in which case accounting standard-setting action is not necessarily the remedy. Other cases reveal weaknesses in current standards or inappropriate structuring to circumvent the standards, in which case revision of the standards may be appropriate. In some cases, there are elements of both.

At this point in time, while we have read the report of the Lehman Bankruptcy Examiner, press accounts, and other reports, we do not have sufficient information to assess whether Lehman complied with or violated particular standards relating to accounting for repurchase agreements or consolidation of special-purpose entities. Furthermore, we do not know whether other major financial institutions may have engaged in accounting and reporting practices similar to those apparently employed by Lehman.

[1] Report of Anton R. Valukas, Examiner, United States Bankruptcy Court Southern District of New York, In re Lehman Brothers Holdings Inc., et al., Debtors, March 11, 2010.

In that regard, we work closely with the SEC. We understand that the SEC staff is in the process of obtaining information directly from a number of financial institutions relating to their practices in these areas. As they obtain and evaluate that information, we will continue to work closely with them to discuss and consider whether any standard-setting actions by us may be warranted.

However, in the meantime, this letter and its attachments summarize the current accounting and reporting standards relating to repurchase agreements and consolidation of special-purpose entities, including some of the recent changes the FASB has put in place.

Accounting and Reporting Standards for Repurchase Agreements

In a typical repurchase (repo) transaction, a bank transfers securities to a counterparty in exchange for cash with a simultaneous agreement for the counterparty to return the same or equivalent securities for a fixed price at a later date, usually a few days or weeks. Accounting standards prescribe when a company can and cannot recognize a sale of a financial asset based on whether it has surrendered control over the asset. In this context, two of the criteria key in determining whether a sale has occurred are:

(a) The transferred financial assets must be *legally isolated* from the company that transferred the assets. In other words, Lehman or its creditors would not be able to reclaim the transferred securities during the term of the repo, even in the event of Lehman's bankruptcy.[2]
(b) The company that transferred the assets does not maintain *effective control* over those assets. Specific tests relate to whether the company has maintained effective control, which are described below.

If both of these criteria are met (among other criteria), the repo would be accounted for as a sale. If either of these criteria is not met, the repo would be accounted for as a secured borrowing. As a general matter, most standard repo transactions fail one or both of these criteria and, therefore, are accounted for as financings.

In the case of repos, one of the relevant tests for assessing effective control relates to the amount of cash collateral that has been provided, relative to the value of the securities transferred. The rationale behind this condition is that the counterparty has promised to return the securities, but even if it defaults, the arrangement provides for sufficient cash collateral at all times, so that the company could buy replacement securities in the market.

My understanding of Lehman's Repo 105 and 108 transactions is based on what I have read in the Examiner's report, press accounts, and other reports. Lehman apparently engaged in structured transactions, known within Lehman as "Repo 105" and "Repo 108" transactions,

[2] The Audit Issues Task Force Working Group of the AICPA issued an Auditing Interpretation, "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Statement of Financial Accounting Standards No. 140," to assist auditors in their analysis. I have separately provided a copy to the Committee staff.

to temporarily remove securities inventory from its balance sheet, usually for a period of seven to ten days. Lehman reported its Repo 105 and Repo 108 transfers as sales rather than secured borrowings. The cash received in the transfers was used to pay down liabilities.

Lehman reported its Repo 105 and Repo 108 transactions as sales rather than secured borrowings, apparently by attempting to structure the transactions so as to try to support the following conclusions:

(a) That the transferred securities had been legally isolated from Lehman (based on a true sale opinion from a U.K. law firm), and
(b) That the collateralization in the transactions did not provide Lehman with effective control over the transferred securities.

Based on the Examiner's report, Lehman's Repo 105 and Repo 108 transactions were structurally similar to ordinary repo transactions. The transactions were conducted with the same collateral and with substantially the same counterparties.[3]

Additionally, the following two points may be relevant to the analysis of Lehman's accounting for Repo 105 and Repo 108 transactions.

First, the assessment of legal isolation may have only considered whether the securities were isolated from a U.K. subsidiary, as opposed to the consolidated U.S. entity. We understand that, at least in some cases, the securities were first transferred from a U.S.-based entity to a U.K. subsidiary, and were then repoed with a counterparty in the U.K. Attorneys have told us that there are significant legal differences in how repo transactions are viewed in the event of the insolvency of a repo seller under U.S. and English laws. In the United States, case law related to repurchase transactions has been varied enough that most attorneys generally would not provide a true sale opinion. In England, there is apparently significantly less uncertainty about how a transfer related to a repo would be viewed by a court of law in the event of the insolvency of the repo seller (transferor). Under English law, a transfer in which the documents clearly demonstrate a seller intends to transfer outright to the buyer his entire proprietary interest in an asset apparently would be considered a true sale.

We understand that the opinion prepared by the English law firm may have limited applicability and pertains only to the portion of the transaction executed by the U.K. subsidiary with the repo counterparty. It is not clear that claims could not be pressed in another jurisdiction such as the U.S., since the securities were registered in the U.S. and it is not clear whether the transfer from Lehman to its U.K. subsidiary would be deemed to be a true sale under U.S. law. It is also not clear that the transfers would have resulted in isolation (including in bankruptcy) of the transferred assets from the consolidated Lehman entity, not just the U.K. subsidiary, and thus any legal analysis would likely need to address all relevant jurisdictions including U.K. and U.S. law.

[3] Report of Anton R. Valukas, Examiner, United States Bankruptcy Court Southern District of New York, In re Lehman Brothers Holdings Inc., et al., Debtors, March 11, 2010, v3, pg. 746.

Second, with respect to the level of collateralization in the arrangement, Lehman apparently took a discount on the face value of the transferred assets (known as a "haircut") offered to the counterparty. Instead of transferring approximately $100 worth of securities for every $100 of cash received, Lehman transferred $105 worth of debt securities or $108 of equity securities for every $100 in cash received (hence, the names Repo 105 and Repo 108). It appears that Lehman structured the transactions in an attempt to support a conclusion that there was inadequate cash collateral to ensure the repurchase of the securities in the event of a default by the counterparty, and, on that basis, Lehman determined that sale accounting was appropriate. Under sale accounting, Lehman

(a) Removed the transferred securities from its balance sheet,
(b) Recognized the cash received, and
(c) Recognized the difference ($105 or $108 securities derecognized less $100 cash received) as a forward purchase commitment.

When developing the guidance for determining whether a company maintains effective control over transferred assets, the FASB noted that repo transactions have attributes of both sales and secured borrowings. On one hand, having a forward purchase contract—a right and obligation to buy an asset—is not the same as owning the asset. On the other hand, the contemporaneous transfer and repurchase commitment entered into in a repo transaction raises questions about whether control actually has been relinquished. To differentiate between the two, the FASB developed criteria for determining whether a company maintains effective control over securities transferred in a repo transaction.

As noted above, one of those criteria requires a company to obtain adequate cash or collateral during the contract term to be able to purchase replacement securities from others if the counterparty defaults on its obligation to return the transferred securities ("collateral maintenance requirement"). The accounting guidance provides the following example of a collateral maintenance requirement that does maintain effective control:

> Arrangements to repurchase securities typically with as much as 98–102% collateralization, valued daily and adjusted up or down frequently for changes in market prices, and with clear powers to use that collateral quickly in the event of the counterparty's default, typically fall clearly within that guideline.

The accounting guidance emphasizes the need for understanding the terms of a repo agreement and applying judgment in other situations to determine whether a company maintains effective control over the transferred securities. That example was not intended to, nor does it, create a "bright-line" for making that determination. Rather, the example describes typical collateral arrangements in repurchase agreements involving marketable securities indicating that these typical arrangements clearly result in the transferor maintaining effective control over the transferred securities.

The accounting guidance for repos has been in place since 1997 and has not been changed significantly over the years.

When there are material structured or unusual transactions, disclosure is also very important. The Examiner's report indicates that Lehman's disclosure was incorrect and misleading. According to the Examiner's report, Lehman disclosed that it accounted for all repos as secured borrowings.

Accounting and Reporting Standards for Consolidation of Special-Purpose Entities

A recent press account indicates that Lehman used a small company run by former Lehman employees apparently to shift investments off its books.[4] Based on that press account, it is not possible to determine whether that company was an operating business or a special-purpose entity (SPE). Although the press account does not describe whether and how the presence of related parties may have affected Lehman's consolidation analysis, consolidation accounting standards require consideration of related parties and de-facto agents in the consolidation analysis. In addition, accounting standards require companies to disclose significant related party transactions and de-facto agent arrangements.

The financial crisis revealed that accounting standards governing which entity must recognize and report interests in SPEs were inadequate to protect against "surprise" risks to institutions that had treated these entities as "off balance sheet." Before the recent changes to the accounting standards on consolidation described below, certain entities were exempt from consolidation requirements. Those exemptions assumed that some SPEs (including mortgage trusts) could function on "autopilot," in which no entity was deemed to be in control of such SPEs. This assumption has not been borne out in the recent period of severe stress in the mortgage market. Consolidation requirements before the recent changes had a simple concept that a company should consolidate an SPE if it has the majority of risks and/or rewards of that entity. However, the implementation of this concept was effected through complex mathematical calculations that often excluded the effect of key risks such as liquidity risk. With the benefit of hindsight, it seems that judgments were made based on overly optimistic forecasts of returns and risk, enabling companies to avoid consolidating entities in which they retained significant continuing risks and obligations. While there were numerous required disclosures under generally accepted accounting principles and SEC rules, many financial companies failed to clearly disclose retained risks, obligations, and involvements with SPEs.

Also, with the benefit of hindsight, it appears that arrangements were structured to achieve the desired outcomes of removing financial assets and obligations from balance sheets and reporting lower ongoing risk and leverage. From an investor's viewpoint, this obfuscated important risks and obligations.

To address this, the FASB, at the request of the SEC, completed targeted projects that resulted in removing the exemption for certain entities from consolidation requirements (FAS 166 on transfer of financial assets) and in tightening the requirements governing when such entities should be consolidated (FAS 167 on consolidation of variable interest entities). In addition, the FASB enhanced disclosure requirements to improve disclosure of a company's

[4] Article in New York Times on April 13, 2010, titled *Lehman Channeled Risks Through "Alter Ego" Firm.*

involvements with transferred financial assets and SPEs. FAS 166 and 167 were issued in June 2009 and became effective in January 2010.[5] The enhanced disclosure requirements became effective in December 2008.

Under FAS 167, entities with the power to control key decisions and the exposure to risks and rewards will more likely report the assets and liabilities on their financial statements. FAS 167 requires an entity to provide enhanced disclosures about its continuing involvement with an SPE, regardless of whether that SPE is on- or off-balance sheet. Along with disclosures about the judgments used in assessing control and evaluating ongoing returns and risk, the revised accounting will put investors in a better position to determine who will ultimately bear the losses and reap the rewards of SPEs.

We are currently working with the International Accounting Standards Board (IASB), which promulgates International Financial Reporting Standards that are used in a number of other jurisdictions, to develop a joint standard on derecognition of financial assets, and the accounting for repurchase agreements is being considered. We are also working with the IASB to develop a joint standard relating to consolidation policy that would apply to traditional operating entities as well as SPEs. We stand ready to consider any further standard-setting actions that may be necessary.

Thank you for the opportunity to provide information on these important issues. FASB members and members of our technical staff would be pleased to respond to further inquiries or to discuss these matters further with you and your staff.

Sincerely,

Robert H. Herz

Robert H. Herz
Chairman

[5] I have separately provided a copy to the Committee staff.

Testimony Concerning Accounting and Auditing Standards:
Pending Proposals and Emerging Issues

by

James L. Kroeker
Chief Accountant
U.S. Securities and Exchange Commission

Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
of the House Committee on Financial Services

May 21, 2010

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

I am Jim Kroeker, Chief Accountant of the Office of the Chief Accountant (OCA), and I serve as the principal advisor to the Securities and Exchange Commission on accounting and auditing matters. Thank you for the opportunity to testify today on behalf of the Commission regarding Accounting and Auditing Standards: Pending Proposals and Emerging Issues.

Financial Reporting and the Commission

It is clear that financial reporting plays a critical role in establishing, maintaining, and in certain cases, rebuilding the confidence of the investing public. The objective of financial reporting is to provide information useful to providers of capital in their decision-making processes. Participants in our capital markets must have confidence that the information provided to them is neutral, reliable, and portrays economic results in an accurate and faithful manner.

The U.S. system of financial reporting has long been considered a major asset of our capital markets. The prominence and reputation of the U.S. capital markets is directly linked to our system's ongoing commitment to fairness, transparency, and objectivity in financial reporting. This provides investors with confidence, helping to minimize the cost of capital from uncertainty or suspicion as to an issuer's true economic fundamentals and prospects. Financial reporting becomes even more important in the height of a financial crisis, when concern about a company's fundamentals is most acute.

As the agency empowered by the federal securities laws to be the investor's advocate, the Commission has the authority and responsibility to prescribe the methods to be followed in the preparation of issuer accounts and the form and content of financial statements to be filed under those laws. The federal securities laws also mandate an independent audit by qualified professionals to provide further assurance as to the faithfulness and integrity of the reporting presented.

The Sarbanes-Oxley Act of 2002 reaffirmed the Commission's historical practice of recognizing the accounting principles of a properly purposed and executed private sector entity as "generally accepted" for purposes of the federal securities laws. For over 35 years, the standards of the Financial Accounting Standards Board (FASB),[1] under Commission oversight, have been recognized by the Commission as "generally accepted."

As to auditing, the Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB) under the Commission's oversight to supplement the Commission's role in overseeing the audits of public companies. An oversight model that a number of other jurisdictions have subsequently emulated, the PCAOB registers, inspects, sets standards for, and, where appropriate, disciplines auditors in its singular mission to improve audit quality. In the seven years since the Commission declared the PCAOB operational, the organization has moved from a start-up to a fully functioning regulator. The Commission exercises comprehensive oversight over the PCAOB, including approval of all PCAOB rules and interpretations as well as the PCAOB's budget.

While the oversight structure surrounding accounting standards does not entail direct approval of each standard, the objective is the same, as the Commission retains ultimate responsibility for accounting requirements. We thus closely oversee and work with the FASB to ensure that it:

i. Continues to improve the accuracy and effectiveness of financial reporting and the protection of investors;
ii. Promptly considers changes to accounting principles necessary to address emerging issues and changes in the business environment; and
iii. Considers, to the extent appropriate, international convergence of accounting standards.

As the Commission Office charged with executing oversight responsibilities over the Boards, with a staff of approximately 50 professionals the Office of the Chief Accountant oversees the activities of the Boards on a continuous basis, providing comment and communicating areas for further consideration during the development of standards and when standards are exposed for comment. OCA staff members serve as observers on the Boards' advisory committees, the FASB Emerging Issues Task Force, and on numerous working groups and task forces of the Boards. In addition to day-to-day interaction on specific projects, OCA senior staff meet on no less than a quarterly basis jointly with senior leadership of the PCAOB and FASB to communicate current efforts, discuss the

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[1] The FASB operates under the Financial Accounting Foundation, which is incorporated to operate exclusively for charitable, educational, scientific, and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code. The FASB is funded by an annual accounting support fee established by the Sarbanes-Oxley Act.

effectiveness of recent standards, and share information regarding areas for consideration in advancing investor protection. In discharging these oversight responsibilities, OCA staff also work closely with the other Offices and Divisions of the Commission, to:

i. Monitor existing accounting and auditing standards in practice to determine areas where improvement or new standards may be warranted;
ii. Increase standardization in the application of accounting and auditing standards and related interpretations – working closely with the FASB and PCAOB; and
iii. Coordinate enforcement efforts with the PCAOB.

Accounting

Recently, there has been much discussion regarding the accounting and disclosure issues as a result of the Lehman Brothers Examiner's Report (Examiner's Report). The Examiner's Report highlighted questions as to whether companies structure transactions to obscure transparency and thus threaten investor confidence. Underlying this discussion are two fundamental issues: 1) whether there has in fact been compliance with existing accounting and disclosure requirements; and 2) what should properly be reported on an issuer's financial statements or otherwise disclosed to assure that they reflect the financial condition of that entity.

Repo 105 Transactions

The Examiner's Report highlighted Lehman's use of certain transactions in an attempt to affect liquidity measures, particularly through transactions that were so-called "Repo 105" transactions.[2] A repurchase agreement is a contract to sell a security today and to repurchase that same security at a date in the future for a set price.

U.S. GAAP provides guidance on accounting for transfers of assets. Under that guidance, typical repo transactions are treated as secured borrowings. However, in the case of Repo 105 transactions, Lehman treated the transactions as sales for accounting purposes. According to the Examiner's Report, a careful review of Lehman's Forms 10-K and 10-Q would not reveal Lehman's use of Repo 105 transactions, and internal Lehman officials appear to have indicated that the only purpose or motive for the transactions was reduction in the balance sheet. Nevertheless, in treating these transactions as sales, the securities were taken off of the balance sheet until the securities were repurchased. According to the Examiner's Report, the cash received in the transfers was then used to pay down other liabilities. In accounting for these transactions as sales rather than secured borrowings, Lehman apparently concluded that the transferred securities had been legally isolated and that the collateralization did not provide effective control over the transferred securities.

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[2] The Examiner's Report referred to variants of these structures, such as "Repo 108" transactions, although for convenience I refer to them collectively as "Repo 105" transactions.

Serious questions were raised in the Examiner's Report as to whether Lehman complied with existing accounting standards and further, whether it was transparent with its investors about the nature and purpose of the transactions. In addition to questions about the proper accounting for these transactions – that is, whether the Repo 105 transactions should have been recorded on Lehman's balance sheet – there are also questions about whether there was proper disclosure. Lehman did not disclose that it accounted for its repurchase transactions as sales. To the contrary, it reported that it accounted for its repo transactions as financings, the typical accounting treatment for repurchase transactions. There are serious questions about compliance with existing accounting and disclosure requirements related to the Repo 105 transactions.

If entities are using transaction structures solely to achieve an artificial result and mask transparency to investors, this represents a serious threat to investor confidence and the integrity of our financial reporting system. In letters to 19 large public companies, the Division of Corporation Finance requested information regarding their use of repurchase agreements. In response, each company was asked to explain the extent to which, if any, they used repurchase agreements and how they accounted for them in their financial statements. Based on the requests, no information has come to our attention that would lead the staff to conclude that inappropriate practices were widespread. Nevertheless, following our evaluation of these responses, the Division asked several companies to enhance their disclosure about their accounting for repurchase and similar transactions and to expand their discussions of off-balance sheet arrangements in their quarterly reports for March 31, 2010. A number of the companies have already filed the reports with the enhanced disclosure.

We will continue to review companies' accounting and reporting practices to determine if companies are complying with existing requirements and to determine whether changes to those requirements are warranted. As Chairman Schapiro testified in April before the full Committee, we will take appropriate action where we find that companies are not publicly reporting their financial condition consistent with their underlying transactions. We also will continue to consider whether existing disclosure requirements are adequate to provide full and transparent disclosure.

Off-Balance Sheet Accounting

With regard to the broader question of what should be properly reported on an issuer's balance sheet, the FASB has engaged in a broader standard-setting initiative with respect to the recording of assets and liabilities in securitization structures and other special purpose type entities (often referred to as "off balance sheet" accounting) that is now in place to improve financial reporting effective in January for calendar year companies.

As I mentioned before, investors – and the market as a whole – are best served by financial information that is presented fully and clearly. The objective of financial reporting is served by finding the right balance of information to be included in an issuer's financial statements.

Finding that right balance is at the heart of some of the most complex issues in financial reporting. The Commission staff, pursuant to the Sarbanes-Oxley Act, studied and released a report in 2005 that examined a broad range of topics with off-balance sheet implications.[3] That report has served as an important building block in moving toward greater transparency in financial reporting, particularly for structured financing entities.

The market crisis highlighted the type of information that investors, regulators, and other users of financial reports need to see reported on a company's financial statements. Even before the worst of the crisis hit, OCA requested in January 2008 that the FASB improve the accounting and disclosure for many financings, securitizations, and other transactions that had not been previously consolidated on the balance sheet. The existing standards were in need of improvement regarding what companies should be reporting as their own assets and liabilities, and we believed immediate action was needed. The President's Working Group on Financial Markets made similar recommendations in March 2008.

Last year, the FASB completed a major standard-setting initiative for the accounting of financial asset transfers and consolidation. These requirements became effective for reporting this year. A critical component of these reforms was to eliminate the previous exemption for so-called "qualifying special purpose entities." This structure was used for many securitizations. This so-called "scope exception" had grown beyond its original purpose, and the FASB determined to place all securitization structures and other structured entities under a single accounting model.

The new model addressed concerns that accounting and consolidation determinations were too often based on complex mathematical calculations rather than a more qualitative, objectives-based analysis. This was consistent with another Commission staff study in response to the Sarbanes-Oxley Act on appropriate models for accounting.[4] In addition, recognizing that it is not possible to predict each type of structure that could be created to circumvent or otherwise avoid the new consolidation guidance, the FASB included a general protective measure that non-substantive terms, transactions, and arrangements are to be disregarded when applying the consolidation criteria.

The new standards also require a number of new disclosures that are designed to provide better information about a company's exposure to risks, regardless of whether that asset or liability is recorded on the balance sheet. Among other disclosure requirements, companies are required to disclose the significant judgments and assumptions made in forming their consolidation determinations.

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[3] 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, available at http://sec.gov/news/studies/soxoffbalancerpt.pdf.

[4] 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, available at http://www.sec.gov/news/studies/principlesbasedstand.htm.

These new standards should enhance financial reporting transparency. However, Commission staff will be continually monitoring their effectiveness. This includes not only guarding against attempts to circumvent the new model, but also relaying to the FASB, based on our experience with the resulting reporting, further refinements that may be needed.

There also has been discussion of the effect these changes may have on lending institutions. In the United States, we have historically separated the functions of securities regulation and prudential regulation, as the two types of regulation serve complementary but distinct purposes. Prudential regulation is focused on the safety and soundness of individual institutions and the financial system, while securities regulation is focused on protecting investors and maintaining fair and orderly markets, which includes providing transparent, decision-useful information to protect the investors who participate in the capital markets.

Prudential regulators use the results of general purpose financial reporting as a base for evaluating prudential requirements, such as regulatory capital requirements. The Commission does the same with respect to calculating net capital requirements for registered broker-dealers. However, there are instances in which the prudential banking regulators have determined that adjustments should be made to U.S. GAAP accounting results for regulatory capital purposes, thereby reflecting the potentially important differences between the objectives of U.S. GAAP reporting and the objectives of regulatory capital requirements.

Given the use of accounting standards by prudential regulators, we engage in regular and meaningful dialogue, interaction, and consultation with banking regulators. In the instance of the FASB's new accounting requirements on off-balance sheet accounting, the bank regulatory agencies stated in their recent rulemaking that they believe the effects of these new accounting requirements on banking organizations' risk-based capital ratios will result in regulatory capital requirements that better reflect, in many cases, banking organizations' exposure to credit risk. In this instance, therefore, they have determined not to provide an adjustment, but rather an additional short transition period.

Global Accounting Standards

Another area that has required attention is the Commission's continued consideration of global accounting standards and the continued support of converging U.S. GAAP and International Financial Reporting Standards (IFRS).

Over three decades ago, the Commission outlined the conceptual benefits of a single set of high quality globally accepted accounting standards. These benefits included reduced country-by-country disparity in financial reporting and potentially improved financial reporting within the United States. It could facilitate cross-border capital formation, while also providing investors with the comparable and material information they need to make informed investment decisions.

The Commission also has noted potential challenges in working toward a single set of high quality globally accepted accounting standards. It is true that successfully transforming the concept of such standards into reality involves many important considerations, including not only confidence in the standards themselves, but also confidence in the institutions that make up the financial reporting framework, the long term prospects of these institutions, and the actual uniformity in application of globally accepted standards.

The Commission has engaged in significant efforts to facilitate the development of a single set of high quality globally accepted accounting standards. These efforts are reaching a critical stage. In February, the Commission directed my office to execute a public work plan to evaluate the specific areas and factors relevant to a Commission consideration of:

- "whether to incorporate IFRS into the financial reporting system for U.S. issuers;" and

- "transitional considerations that will enable the Staff to better evaluate the scope of, timing of, and approach to changes that would be necessary to effectively incorporate IFRS into the financial reporting system for U.S. issuers, should the Commission determine in the future to do so."

Incorporation of IFRS into the U.S. financial reporting system would be a significant event for our capital markets, and we received more than 200 comment letters to the Commission's first proposal on this topic, the "Proposed Roadmap," in 2008. Commenters overall supported the long-term goal, but many also clearly expressed views that more thought, study, and time was needed. Accordingly, we developed the work plan to provide action steps to address commenter concerns.

Specifically, the work plan will study the following areas of concern:

i. Sufficient development and application of IFRS for the U.S. domestic reporting system, including enforceability and auditability of the standards, as well as comparability of IFRS reporting across jurisdictions;
ii. The independence of international accounting standard-setting for the benefit of investors;
iii. Investor understanding and education regarding IFRS;
iv. Examination of the U.S. regulatory environment that would be affected by a change in accounting standards;
v. The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies; and
vi. Human capital readiness.

Execution of the work plan will involve significant resources throughout the agency. We are fully engaged in this effort and are proceeding with open minds as to the

Commission's ultimate decision. Indeed, the Commission and the public expect a rigorous review of the issues presented.

In executing this work plan, we will gather information using a variety of methods, including seeking input from U.S. investors, issuers, auditors, and other constituents, evaluating the filings of foreign private issuers that assert compliance with IFRS in their filings with the Commission, and researching the experiences of other jurisdictions that have incorporated IFRS into their financial reporting systems. As we move forward, we are committed to providing public progress reports beginning no later than October 2010 and frequently thereafter until the work is complete.

As noted in the Commission's statement, we anticipate that, following successful completion of the work plan and the FASB-IASB convergence projects according to their current work plan, the Commission will be in a position in 2011 to determine whether and how to incorporate IFRS into the U.S. financial reporting system for U.S. issuers. As part of the work plan, we also will evaluate the time needed, if the Commission were to determine further action, to effectively incorporate IFRS. Of course, consideration of investor needs and protection will be paramount throughout the staff's execution of the work plan, and any eventual recommendation will only be made if it is in the best interest of U.S. investors.

The Commission also noted that the FASB will continue to play a critical and substantive role in achieving the goal of a single set of global accounting standards, and that role would continue even after any incorporation of IFRS. This is consistent with the approach of many developed countries of maintaining a national standard setter or other mechanisms in connection with the incorporation of IFRS into their capital markets.

Convergence

As noted above, a critical component of the evaluation of the use of global accounting standards in the U.S. capital markets is the convergence project between the FASB and the IASB. This effort demonstrates that the United States is willing to consider direct changes to our accounting standards in conjunction with the IASB in areas where both sets of standards are in need of improvement.

The recent financial crisis has highlighted the importance of developing, implementing, and enforcing high quality and consistent accounting standards around the world. The FASB and the IASB have also been committed for many years to improve accounting standards through their convergence efforts. These efforts have been based on the following fundamental principles:

- Achieve convergence by developing high quality, common standards over time;
- Develop new standards to improve reporting to investors instead of eliminating differences between standards in need of improvement; and
- Serve the needs of investors by replacing weaker standards with stronger ones.

In November 2009, the Boards reaffirmed their commitment to improve both IFRS and U.S. GAAP and to bring about convergence. It is important for the FASB to continue to work closely with the IASB to raise the quality of financial reporting standards in the United States and around the world. Efforts are already underway involving monthly joint meetings of the Boards and quarterly progress reports on convergence efforts.

The FASB-IASB convergence projects currently include the accounting requirements for the following:

- *Financial instruments, including the role of fair value for such instruments.* While a highly controversial topic, the existing standards have been criticized for being overly complex and not sufficiently informative.
- *Revenue recognition.* This is an area of financial reporting that has been historically susceptible to fraud. U.S. GAAP consists of numerous pieces of literature often focused on individual industries or arrangements developed over time, while guidance under IFRS may not provide users with sufficient specificity to implement the standard without significant diversity.
- *Leases.* Previous SEC staff and other studies have noted the need for improvement in existing U.S. GAAP. The two Boards are looking at an approach that will require all assets and liabilities from lease contracts to be recognized on the balance sheet.
- *Debt vs. Equity.* The Boards are grappling with a long-standing struggle in financial reporting as to the appropriate characterization of complex instruments on the balance sheet.
- *Financial statement presentation.* The Boards are working together on whether improvements are needed to the existing structure and presentation of financial statements.

The target for the Boards' joint projects is aggressive, reflecting a commitment on both sides to bring about improvements to financial reporting in the United States and abroad. While both Boards share the same mission, they may not agree on every detail of a standard. Although reasonable differences of opinion may exist, we will continue to encourage the two Boards to work closely together. Timing for completion of individual projects may shift as the Boards seek to ensure that their respective and collaborative procedures are rigorous. Standard-setting, like rulemaking by the Commission or legislation by Congress, demands a continual balancing of expedience and thorough analysis. However, the ultimate goal is improved, sustainable standards for investors.

Interactive Data

As part of the ongoing evolution and enhancement of the Commission's disclosure program, the Commission has been implementing the use of interactive data for filings on the EDGAR system. In early 2009, the Commission published three final rules requiring electronic "tagging" of certain disclosure information for operating companies, mutual funds, and credit rating agencies against a standardized list of tags. As evidenced in recent rule proposals for money market funds and asset-backed securities, among others, the Commission continues to move toward a more comprehensive use of interactive data in its disclosure system in service of users of disclosure data.

The interactive data rules for operating companies require the submission of financial statements and notes to the financial statements in a format called XBRL. The rules are being phased in over three years based on company size, and companies also have a phase in to move to full detail tagging for the notes to the financial statements. To date, approximately 500 companies have submitted over 1,500 sets of XBRL-encoded financial statements to the Commission's EDGAR system.

Additional companies will begin complying with the rules in June 2010, with the remainder beginning to comply in June 2011. Based on initial assessments by the Commission staff, the program is operating effectively, and companies have provided high quality submissions.

The FASB, along with its parent organization the Financial Accounting Foundation, has the responsibility for updating the financial statement taxonomy to ensure the taxonomy accurately reflects current accounting standards and practices. The XBRL list of tags has already been integrated into the FASB's Accounting Standards Codification, making it possible to navigate from financial statements filed with the Commission to the underlying accounting standards, or to navigate from an accounting standard to where it has been applied in practice. The integration of the list of tags into the Codification also will enable the FASB, SEC, and others to better monitor how standards are being applied in practice.

In addition to providing direct investor access to the XBRL-tagged data, the Commission staff seeks to apply the benefits of interactive data internally to serve the Commission's mission of protecting investors.

Auditing

An audit by an independent public accountant is critical to investor confidence and the functioning of our capital markets, and it can be one of the most effective deterrents to fraud. Moreover, an independent audit also has long been associated with more accurate reporting. The formation of the PCAOB resulted from the reforms enacted by Congress in the Sarbanes-Oxley Act following the revelation of multiple instances of accounting fraud at prominent public companies, including Enron. The enhanced oversight of the auditing profession has provided tangible benefits to the quality of financial reporting and the protection of investors. The recent financial crisis has once again highlighted both the importance of, and the challenges faced by, those in the auditing profession. There are a number of challenges facing the PCAOB, including a challenge to its constitutionality, difficulties with inspections in foreign jurisdictions, the need for oversight over auditors of broker-dealers, and questions regarding the benefits of Section 404 of the Sarbanes-Oxley Act.

Constitutional Challenge

As you know, a challenge to the PCAOB's constitutionality is currently pending before the U.S. Supreme Court (the Court). We have supported the PCAOB and agree that the claims are without merit due to the Commission's comprehensive oversight over the PCAOB. Hopefully, the Court will uphold the constitutionality of the PCAOB so that the work of improving audit quality continues unabated. However, the Commission stands ready to issue any interpretive guidance that may be necessary to provide continuity and minimize any disruption in the U.S. capital markets. If Congressional action is determined to be necessary after the Court's decision, we will promptly provide technical assistance so that any needed legislative changes may be considered as quickly as possible.

PCAOB International Inspections

When the Sarbanes-Oxley Act created the PCAOB, there were very few countries with similar auditor oversight bodies. Since that time, many countries have established PCAOB-like auditor oversight systems to inspect public accounting firms. The PCAOB's inspection program includes inspections of non-U.S. registered public accounting firms, but one of the more significant challenges facing the PCAOB is gaining access to certain non-U.S. public accounting firms and their audit work papers in order to perform inspections required by the Act. Access to non-U.S. firms and their audit work papers, particularly in the European Union, Switzerland, and China, has been hindered due to the PCAOB's lack of explicit legal authority to share information with its foreign counterparts and other issues related to the coordination of inspections with local authorities and the resolution of potential conflicts of law. As a result, the PCAOB has not been able to perform many of the required inspections of registered firms in those jurisdictions.

The PCAOB and the Commission share a belief that investors would benefit if the PCAOB were to obtain the ability to share information with its foreign counterparts. This information sharing would enhance the Board's ability to effectively oversee firms that audit multi-national public companies. I would like to thank Chairman Kanjorski and this Subcommittee for their leadership in including language in the House version of the regulatory reform bill that would allow the PCAOB to share certain information with audit regulators in other jurisdictions. In the meantime, the Commission will continue to work with the PCAOB and its foreign counterparts to evaluate whether an interim approach to information sharing can be developed pending a permanent legislative solution

PCAOB Oversight of Auditors of Broker-Dealers

An audit performed by a qualified independent public accountant is a powerful component of investor confidence and compliance. Broker-dealer audits have objectives beyond the financial statements that are critical to investor protection, even if these metrics are not directly apparent on the face of the balance sheet or income statement.

For example, an audit could reveal whether the broker-dealer satisfies Commission financial responsibility requirements, such as requirements relating to possession or control of securities and the segregation of customer cash.

It is important that audits of all broker-dealers be conducted by an auditor subject to the oversight regime of the PCAOB. Recent events, including highly publicized accounts of the role of broker-dealer auditors, have highlighted the need for this level of oversight. Clarifying the PCAOB's oversight authority with respect to auditors who perform audits of broker-dealers will improve the quality of broker-dealer audits and strengthen both investor protection and broker-dealer compliance.

The Board's current inspection program takes into account the size and complexity of each issuer when determining the scope of the inspection, and it will be capable of implementing a program for auditors of broker-dealers of varying size and complexity. This inclusion of a provision to clarify the PCAOB's oversight of auditors of all brokers and dealers is a significant improvement and this Subcommittee is to be commended for its leadership on this issue.

The Importance of Effective Internal Control over Financial Reporting

Since the enactment of the Sarbanes-Oxley Act, the Commission and the PCAOB have been committed to a Section 404 process that is both effective and efficient. To ensure confidence and accuracy in the resulting reporting, a company's books and records and internal controls need to be designed and operating effectively. This has been a staple of the federal securities laws since the Foreign Corrupt Practices Act of 1977. One of the objectives of Section 404 was to have companies publicly report on, and an auditor to attest to, the effectiveness of those controls.

Since 2004, filers with a public float greater than $75 million, representing a little over 50 percent of all public companies, have been required to include both a management's assessment of the effectiveness of its internal control over financial reporting and an auditor's independent opinion on such effectiveness. Since 2007, non-accelerated filers – generally those with a public float of less than $75 million – have been required to include only the management assessment. Under current Commission rules, and after significant reform and study, non-accelerated filers will be required to include an auditor's opinion on internal control over financial reporting in annual reports for fiscal years ending on or after June 15, 2010.

Conclusion

One of the most significant lessons from the recent financial crises was the same one that led to the philosophy of this country's commitment to securities regulation over 75 years ago. That is, when pressures are highest, and investor confidence has the greatest potential to be shaken by uncertainty, the importance of transparent, objectively audited financial reporting to investors, and an independent and objective system to establish standards for such reporting, are necessary and critical components to both short term and long term success.

ICBA
INDEPENDENT COMMUNITY
BANKERS *of* AMERICA®

May 20, 2010

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Committee on Financial Services
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Washington, DC 20510

Dear Chairman Kanjorski and Ranking Member Garrett,

Thank you for your hearing on "Auditing and Accounting Standards: Pending Proposals and Emerging Issues." On behalf of the nearly 5,000 members of the Independent Community Bankers of America (ICBA), I take this opportunity to share our views on several issues of importance to us. ICBA respectfully requests that this letter be made part of the official hearing record.

The members of the ICBA bring the perspective of both preparers and users of financial statements. Community banks use financial statements as a key component of credit decisions and monitoring credit relationships with their small business customers. As we emerge from the financial crisis, it is appropriate to review accounting policies that have adversely impacted our ability to lend and serve customers, exacerbating the scarcity of credit that led to economic contraction and widespread unemployment. We have the opportunity now to recalibrate these policies in order to establish the conditions for future economic growth and forestall another devastating credit crunch.

ICBA's priority issues are discussed below.

Mark-to-Market Accounting

We urge that the FASB not move forward with its plans to apply full fair value accounting to the balance sheets of community banks.

ICBA has long held concerns about the use of mark-to-market or fair value accounting for community banks that are in the business of creating and holding illiquid assets.

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While they must hold some readily marketable securities for liquidity purposes, they are not generally in the business of creating or purchasing assets or liabilities for quick resale. They fund their operations primarily by deposits and hold small business, agricultural and even residential mortgage loans that are not readily marketable. We question how fair value measurements will provide a better understanding of illiquid agricultural loans held by a small bank in a rural area.

It is our view that full fair value accounting, applied to institutions such as community banks, is more likely to mislead investors and financial statement users than provide them a clear picture of financial condition. As the financial and credit markets faced extreme stress, fair value accounting only exacerbated the problems. While fair value accounting requires that assets be valued at the price they would receive in an orderly transaction at the time of measurement, too often investment and credit analysts have applied "fire sale" values, or assumed forced liquidations where there are no buyers in the market, in making their financial evaluations. This is alarming for financial institutions whose capital position—and continued survival—is dependent on these valuations. Frankly, mark-to-market accounting misses the mark – and both over-values and undervalues long-held illiquid assets.

We agree with the concerns expressed by the federal banking regulators in a letter dated October 17, 2008 to the Financial Accounting Standards Board regarding an expansion of the use of fair value accounting for financial instruments held by medium and smaller financial institutions. Measurement should be more closely tied to the way financial instruments generate earnings and cash flows, regardless of whether active markets for the instruments typically exist.

While FASB has taken some positive steps to clarify fair value measurements, in our view, more needs to be done to ensure a proper understanding of what fair value is and is not, and to ensure that it is being properly applied.

The limitations of fair value accounting extend to the financial statements of small businesses – the primary customers of community bankers. Community banks practice relationship lending that includes the personal guarantees of borrowers with whom the lender has a close, long-term relationship and other information that cannot be captured by accounting statements. Community bankers often choose to seek information directly from their borrowers, sparing them the significant cost of obtaining audited GAAP financial statements.

Accounting for Securitizations and Loan Participations

The recent accounting standard intended to provide transparency in securitizations and loan participations has disrupted the ability of agricultural lenders to provide seasonal credit to their borrowers through overlines. To stay within lending limits and capital constraints, community bank agricultural lenders have long used LIFO/FIFO loan participations to serve customers who draw on credit lines and periodically repay them.

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This legitimate, long-standing business practice has been put at risk by the new accounting standard, which will result in reduced credit to the agricultural sector. Accounting should reflect business operations, not direct them. ICBA urges FASB to reconsider the new accounting standard.

One Size May Not Fit All

We applaud the FAF, FASB and NASBA for establishing the Blue Ribbon Panel on Standards Setting for Private Companies and other initiatives to obtain the perspective of smaller companies and private companies in the standards setting process. It is critical for those bodies imposing standards and rules across the business sector to understand the implications—and potential for unintended consequences—on all types of financial statement users and preparers. We do not believe that one size fits all in all cases. The cost of accounting changes must be balanced with improved information and transparency. Providing more and more information and disclosures becomes an economic waste if it is not used or does not provide a clearer picture of business operations and financial condition.

SOX 404(b) Exemption for Small Public Companies

Section 404(a) of Sarbanes-Oxley requires a public company to include in its annual report management's assessment of the effectiveness of the company's internal control structure and procedures for financial reporting. Section 404(b) requires the company's auditor to attest to and report on management's assessment. While Section 404 is intended to prevent future accounting improprieties, the implementation of 404(b) has resulted in substantially greater than expected compliance costs, particularly for smaller public companies.

ICBA strongly supported the amendment to the Investor Protection Act (H.R. 3817) sponsored by Reps. Scott Garret (R-NJ) and John Adler (D-NJ) that would extend permanently an exemption from Sarbanes-Oxley Section 404(b) for companies with a market cap below $75 million. This provision is now part of the House regulatory reform bill (H.R. 4173).

Community banks and other smaller public companies have been disproportionately impacted by the auditing expense and the regulatory burden associated with SOX 404, so there needs to be a permanent exemption. The average community bank that is a small public company will save approximately $100,000 per year in auditing and regulatory expenses if this amendment becomes law. Community banks are already overburdened with all types of regulation so this exemption will go a long way towards easing their overall regulatory burden. We believe that the exemption level could safely be set at a market cap of $150 million in order to extend the benefit of regulatory relief to more small issuers without compromising financial statement integrity.

More SEC Guidance Needed

ICBA sees a need for more implementation guidance from the SEC to help financial statement preparers, auditors and examiners better understand the intent of accounting statements and guidelines and to foster more consistent application. In the recent past there have been misinterpretations, or unexpected interpretations of accounting guidance that caused problems for both standards users and standards setters. One notable example was the issue of Other than Temporary Impairments which was ultimately addressed when FASB revised its guidance.

We believe that the SEC should provide guidance more often and use greater transparency in communicating the guidance so it is disbursed broadly to the accounting and auditing industry and the public. This should be accomplished through timely public releases of guidance with prompt postings on the SEC website. We believe that a more transparent, broader disbursement of guidance will greatly help eliminate confusion as institutions and their auditors work to properly apply new accounting treatment.

Convergence to International Accounting Standards

ICBA is very concerned that in converging to international standards, smaller financial institutions and smaller businesses will be disadvantaged by standards better suited to the needs of international investors and complex companies that operate internationally. Users of the financial statements of small businesses and financial institutions generally do not need the same level of complexity in standards for transparency. Further, some standards are more difficult and burdensome for smaller institutions to implement, with implementation costs far outweighing benefits.

As policy makers plan the convergence to international standards, provisions must be made for small financial institutions and small businesses. A different schedule for implementation for these preparers may be appropriate.

Rapid Pace of Coming Accounting Changes

Community banks are not alone in their concern over the dramatic accounting changes that are coming over the next year. In May or June, we expect Exposure Drafts from FASB and the IASB on Financial Instruments, Fair Value Measurements, Consolidations, Revenue Recognition, Financial Statement Presentation, Financial Instruments with Characteristics of Equity, Insurance, and Leases. We expect these new standards to be implemented late this year or in the first half of next year.

It will be a substantial challenge for stakeholders to absorb and comment on the proposals and to understand and implement changes. Companies will need major accounting system changes, and staff, auditors and regulators will need significant training in a very short timeframe. The FAF and FASB themselves have noted that this level of standard setting activity is unprecedented. In the past, FASB has published at most four major standards in a year and had no more than three significant Exposure Drafts out for comment at one time. It will be hard for large corporations with large accounting departments to digest these changes. For community banks and small businesses with one or two staff accountants, it will be a daunting, costly task, a major distraction for management, and a disruption to business. We urge FASB to defer some of their Exposure Drafts and establish a workable pace so that small preparers have time to provide thoughtful input on proposals and to implement new standards with disrupting their businesses.

Eliminate Pro-Cyclicality in Accounting Standards

Accounting standards and guidance should not be pro-cyclical. Recent market conditions have demonstrated the pro-cyclical nature of mark-to-market accounting as declining values of financial instruments necessitated write-downs and sales, which in turn caused further write-downs and sales.

Current standards and guidance on allowances for loan and lease losses – directed at limiting management of earnings -- give financial institutions little ability to set aside reserves in good times to prepare for assumption errors and, more importantly, economic downturns. Yet, conservative community bankers (and often their examiners) see the need for more flexibility in this regard, as they are well aware of economic cycles and the challenge of absorbing losses and raising capital during an economic contraction when capital is needed most.

This problem will only be exacerbated if FASB issues new accounting requirements to mark all loans to market, which will effectively eliminate the need for an allowance for loan losses. Except in the most liquid markets, fair value measurements for financial instruments require assumptions that may or may not be borne out. Our recent and continuing economic problems demonstrate the need to enable institutions to prepare ahead for the economic challenges.

Auditing

ICBA strongly supports an independent auditing profession to ensure that financial statements and disclosures truly reflect an institution's financial condition. Community banks and smaller companies, particularly those located in small towns and rural areas, do not have many options for auditing firms, directors and financial expert audit committee members. Regulations and other guidance for engaging outside auditors need to recognize this limitation. Community banks of all sizes should not be unnecessarily constrained from using their independent external auditors for internal audit work, consulting and certain other services.

In addition to these key accounting reform recommendations, Congress and bank regulators should consider advancing helpful measures, including:

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Extended Loan-Loss Amortization for Privately-Held Banks

Examiners are requiring banks to write down loans that are performing and whose collateral is likely to increase in the coming year. A similar policy in effect for agricultural lenders in the 1980s significantly mitigated the damage from the economic crisis of that era. Extended amortization would allow banks more leeway to work with struggling borrowers.

The Entire Amount of the ALLL Should Be Included as Part of Risk-Based Capital

Under the current risk-based capital rules, a bank is allowed to include in Tier 2 capital its allowance for loan and lease losses (ALLL) up to 1.25% of risk-weighted assets (net of certain deductions). Consequently, some community banks are now being downgraded based on capital inadequacy even though they have excess amounts of ALLL. The risk-based capital rules should take into consideration the entire amount of ALLL and not just the amount up to 1.25% of a bank's risk-weighted assets. This would encourage banks to reserve more and recognize the loss-absorbing abilities of the entire amount of the ALLL.

ICBA appreciates this opportunity to offer our views on current accounting and auditing issues of interest to our members. We're pleased to answer any questions you may have and to otherwise assist you in your oversight of this important area of public policy. Please contact Brian Cooney (brian.cooney@icba.org; 202/821-4423) if you need any further information.

Sincerely,
/s/
Stephen J. Verdier
Executive Vice President/Director of Congressional Relations

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June 4, 2010

The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
United States House of Representatives
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The Honorable Scott Garrett
Ranking Member
Subcommittee on Capital Markets, Insurance
and Government-Sponsored Enterprises
United States House of Representatives
Washington, DC 20515

The Honorable Lynn Jenkins
United States House of Representatives
Washington, DC 20515

Re: PCAOB Ombudsman Proposal

Dear Representatives Bachus, Garrett and Jenkins:

Thank you for your May 27, 2010 letter asking whether I support the creation of an ombudsman position within the Public Company Accounting Oversight Board. As your letter points out, this issue arises particularly in light of provisions in the House and Senate financial regulatory reform bills that would provide the PCAOB with new authority to oversee auditors of non-public broker-dealers, many of which are small and unfamiliar with the Board.

I support an ombudsman position within the PCAOB to act as a liaison between the Board and those affected by the Board's work. Legislation is not, however, necessary to create such a position. Even if the final financial regulatory reform legislation does not contain an ombudsman provision, I will recommend to the Board that it submit a 2010 budget amendment to the Securities and Exchange Commission requesting approval to establish an ombudsman position and to hire the first PCAOB ombudsman this year. The ombudsman would focus on outreach, education, and responding to inquiries and issues raised regarding the Board's work, particularly by smaller accounting firms and public companies, and would assume responsibility for existing Board activities in those areas. If Congress nonetheless decides to enact a statutory PCAOB ombudsman requirement, I have concerns with the current wording of Section 7609 of H.R. 4173 and request the opportunity to discuss those concerns with you or your staff.

Current PCAOB Broker-Dealer Auditor Outreach Efforts

It is important to note that, through various offices and initiatives, the PCAOB already spends considerable time and resources reaching out to and responding to questions from registered firms and others affected by the PCAOB's regulatory work. Consolidating these efforts and institutionalizing them through the creation of a dedicated office would support the Board's mission and be helpful to firms needing assistance in understanding and navigating the regulatory process.

As you know, in December 2008, the SEC discontinued the exemption from PCAOB registration previously applicable to accounting firms that audit the approximately 5,000 SEC-registered broker-dealers. The termination of the exemption meant that auditors of non-public broker-dealers with calendar year-ends had to register with the PCAOB before those broker-dealers filed their 2009 financial statements with the SEC, or by March 1, 2010. As a result, more than 500 additional audit firms have registered with the Board.

Addressing the needs of this wave of new registrants required extensive outreach by the PCAOB and close coordination among the Board, the SEC, and the Financial Industry Regulatory Authority. Well before the filing deadline, we worked with the SEC and FINRA to identify auditors potentially subject to the registration requirement. In addition to contacting many of those firms directly, the Board's staff posted on our website information, including frequently asked questions and their answers, about registration process and timing. FINRA posted similar information on its website, and the SEC also issued staff FAQs on broker-dealer audits. The Board's Registrations staff also worked with individual firms, as necessary, to respond to questions and to assure that firms understood the registration process.

For the past six years, the PCAOB has conducted a series of forums on auditing in a small business environment at various locations around the country. Attendance at these events is limited to smaller audit firms and, in some cases, their small public company clients. To date, the PCAOB has held 41 such forums in 19 cities. Over 3,500 people have participated in these events, which are provided at no cost to attendees. During the 2009 small business forums, Board members and staff explained the need for broker-dealer auditors to register and answered questions.

Appointment of an Ombudsman

Both the House and Senate financial regulatory reform bills contemplate that Board oversight of broker-dealer auditors will expand. If that occurs, the same type of outreach and assistance will need to be made available to these firms in anticipation of new standards setting, inspection, and other regulatory processes. The appointment of an ombudsman would provide a focal point for the provision of that assistance.

In addition, I believe that a PCAOB ombudsman should not be limited to assisting auditors of non-public broker-dealers. A PCAOB ombudsman would also act as a liaison between the PCAOB and any PCAOB-registered public accounting firm or any other person or entity affected by the PCAOB's regulatory activities, including broker-dealers and public companies the audits of which may be selected for PCAOB inspection. In general, the ombudsman would serve as a contact for anyone who, as a result of the Board's regulatory activities, may be having difficulties dealing with the Board. He or she would also have responsibility for responding to inquiries and providing information about Board activities.

For those reasons, I intend to recommend that the Board appoint such an ombudsman, whether or not a requirement for a PCAOB ombudsman is enacted as part of the financial regulatory reform legislation. In order for this to take place in time to assist broker-dealer auditors with the expected transition to PCAOB inspection and oversight, this recommendation would be implemented by the Board's submitting a 2010 budget amendment to the SEC. The amendment would provide for the hiring of the first PCAOB ombudsman this year.

Section 7609 of H.R. 4173

Should Congress nonetheless decide to require the appointment of a PCAOB ombudsman, I have concerns about the current wording of Section 7609 of H.R. 4173. I would request that the Board's staff have the opportunity to discuss those issues with your staff in the hope that they could be addressed during the work of the Conference Committee.

PCAOB
Public Company Accounting Oversight Board

In general, I am concerned that this section could be read to go beyond the traditional role of an ombudsman as a liaison between the regulator and regulated. Instead, the language as currently drafted could allow the ombudsman to become involved in substantive accounting or auditing issues that arise between companies and their auditors, or even in commercial disputes between auditing firms and their clients over fees and other matters. Among other things, such involvement could delay the SEC reporting process, to the detriment of public investors, while the ombudsman attempts to obtain the detailed knowledge of facts and circumstances necessary to facilitate resolution of technical accounting or auditing issues. Further, many of these issues are likely to involve questions of the application of accounting principles. PCAOB ombudsman involvement in resolving such questions could therefore create conflicts between the Board's jurisdiction and that of the SEC. Finally, I am also concerned that Section 7609 fails to make clear – as the comparable provision creating the bank regulators' ombudsmen does – that it does not affect the PCAOB's authority to take enforcement or supervisory action.

* * *

Thank you for your continued leadership on this important issue and your support for the Board's mission of protecting the interests of investors. We would be glad to discuss these concerns with you or your staff, and we look forward to continuing to work with you as this process moves forward.

Sincerely,

Daniel L. Goelzer

Daniel L. Goelzer
Acting Chairman

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