

**ACCOUNTING AND AUDITING OVERSIGHT:  
PENDING PROPOSALS AND EMERGING  
ISSUES CONFRONTING REGULATORS,  
STANDARD SETTERS, AND THE ECONOMY**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON CAPITAL MARKETS AND  
GOVERNMENT SPONSORED ENTERPRISES  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED TWELFTH CONGRESS  
SECOND SESSION

—————  
MARCH 28, 2012  
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Printed for the use of the Committee on Financial Services

**Serial No. 112-112**



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U.S. GOVERNMENT PRINTING OFFICE

75-084 PDF

WASHINGTON : 2013

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**Wednesday, March 28, 2012**

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

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Royce, Biggert, Hensarling, Neugebauer, Campbell, McCotter, Pearce, Posey, Fitzpatrick, Grimm, Dold; Waters, Sherman, Miller of North Carolina, Maloney, Perlmutter, and Donnelly.

Ex officio present: Representative Bachus.

Also present: Representatives Renacci and Capuano.

Chairman GARRETT. Good morning. Today's hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises is called to order. This morning's hearing is on accounting and auditing oversight.

We will begin with opening statements. And I will recognize myself for about 3 minutes.

We are here today to examine the accounting and auditing profession. And the hearing is aptly titled, "Accounting and Auditing Oversight: Pending Proposals and Emerging Issues Confronting Regulators, Standard Setters, and the Economy."

Accurate and reliable financial reporting to investors is obviously a key cornerstone to our Nation's capital markets. It is essential that investors have the appropriate information needed to make well-informed decisions on just where to invest their capital, as our Nation continues to recover from the recent financial crisis.

So we must work hard to restore the vitality to our markets and to foster an environment where American public companies can do what they do best, which is create jobs.

There are three broad areas that I want to explore in greater detail today with our great panelists here.

First, I would like to hear from the SEC where we stand with international convergence of accounting standards.

I know this is a top priority for many in the business community. I also realize that there is some disagreement between the large

and the small companies, as well as from different industries as to what the preferable outcome of convergence will be.

I am interested in discussing the steps that the Chairman and staff are taking to overcome these various obstacles, and how we can ensure that harmonization of these standards creates an atmosphere here in the United States where companies and investors have the best information possible.

Second, I look forward to learning more about the current process that FASB and GASB go through to develop their standards. And I agree that the integrity and the independence of the standard-setting process is basically essential, and that Congress should not legislate accounting standards.

I have seen some positive statements from the market participants about the improvement in the standard-setting process. And I appreciate that FASB and GASB balance that delicate line of listening to the business community's concerns, while also ensuring that there is an independent process in place.

Finally, I would like to discuss some of the PCAOB's current proposals and how and why these proposals came to pass.

I do think it is important to remind the PCAOB that it is not a policy-making entity. Congress and this committee are the policy-makers here. The PCAOB's job basically is to regulate and oversee the auditing profession.

So I am concerned about some of the recent activist-type proposals put forth by the PCAOB. And I agree with the Chamber of Commerce, where I was just speaking this morning as a matter of fact, and others, that believe that they may be engaged in—as someone called it—mission creep—crossing the threshold of audit regulation into an attempt to regulate corporate governance.

Specifically, the recent concept release on mandatory audit firm rotation is concerning.

What is the specific problem they are trying to solve here with that? What data are they examining? What kind of specific cost/benefit analysis is being done? What solutions will this lead to?

Too many times with many of our regulators, the policy outcome is predetermined before the work—that is hard usually to do—is determined and what the best solution should be.

So I would like to commend the gentleman from Pennsylvania, Mr. Fitzpatrick, for his legislation that would prevent the PCAOB from moving forward right now on its policies.

This hearing will serve as a legislative hearing for that proposal. And it is my hope that the subcommittee will consider this bill at the next possible markup.

So in conclusion, while I believe that those three areas, especially the concerns around the PCAOB, are the most pressing issues, I realize that there are many other issues that require further discussion. And I look forward to a constructive hearing this morning.

With that, I now yield 3 minutes to the gentlelady from California, and good morning.

Ms. WATERS. Good morning, and thank you, Mr. Chairman, for holding this hearing.

Investors in my district, including workers with investment and pension funds, have a strong interest in enhancing auditor independence. After all, it is the auditors who are supposed to reassure

investors that they can trust the financial reports of the companies they have entrusted with their lifesavings.

How we can achieve more auditor independence is obviously a subject for our debate. And I appreciate that the Public Company Accounting Oversight Board has put out its concept release on auditor rotation, and held public meetings last week to get this conversation started.

While I certainly think that we must explore ways to enhance auditor independence, I am interested in understanding the issue of mandatory auditor rotation more fully, whether it would work, or whether there might be better alternatives than mandatory rotation.

For example, should shareholders perhaps be allowed a proxy vote to determine if they would like to have mandatory audit rotation? Are there are measures that might increase professional skepticism more than rotation would?

However, even if stakeholders come to the conclusion that mandatory rotation is a good idea, I don't think anyone believes that it could come close to resolving all of the outstanding barriers to auditor independence. So I am eager to explore any other ideas brought forward by our witnesses today.

Finally, I would also like to note that I have been focused on ensuring that auditors are adequately and independent, and skeptical under the OCC and Federal Reserve's market servicing consent order process.

Under that process, banking regulators required servicers to hire auditors to investigate their foreclosure practices over the past few years, and to provide remediation to affected borrowers.

We found that auditors often have other lucrative engagements with the servicers they have been hired to investigate; perhaps creating a disincentive to find wrongdoing when it comes to looking at their foreclosure practices.

So along with Senator Menendez and some of my colleagues from the House, I have asked the GAO to look into this issue.

There are also other issues I hope we can get to today, including the role of audit committees, whether to make PCAOB disciplinary proceedings public, and certain accounting issues.

I look forward to hearing the testimony of our witnesses today.

Thank you. And I yield back the balance of my time.

Chairman GARRETT. Thank you.

The gentlelady yields back.

The chairman of the full Financial Services Committee, Chairman Bachus, is recognized for 2 minutes.

Chairman BACHUS. Thank you, Mr. Chairman, for convening this hearing.

I think it is important to have oversight of the SEC Office of Chief Accounting, the Public Company Accounting Oversight Board, and the Financial Accounting Standards Board.

There are several critical issues facing the accounting and auditing professions, their regulators, and their standard setters including the convergence of global accounting standards, mandatory audit firm rotation, and audit quality.

While we all agree that sound accounting and auditing play a critical role in the U.S. capital markets, regulatory overreach and

overly aggressive standard setting may disrupt the economy and limit job creation.

Regulatory overreach at least appears to be alive at the PCAOB. For example, the Board ignored what I consider flexibility provided in the Dodd-Frank Act to scale its oversight of auditors of broker-dealers, and instead imposed a one-size-fits-all exam program for all of these auditing firms.

Moreover, there are some at the PCAOB who feel that public companies should be required to rotate their audit firm. I have serious concerns about such a proposal because mandatory audit firm rotation would both increase the cost of auditing and decrease audit quality. And for that reason, I am not sure it is sound policy.

And no hearing on the accounting industry would be complete without a discussion of Sarbanes-Oxley, which will have its 10th anniversary in 4 months. As we approach that landmark, it is incumbent upon this committee to determine if Sarbanes-Oxley has been completely successful, and specifically, if Section 404(b) has been worth the cost.

Being from Birmingham where HealthSouth is located, obviously I know the value of good auditing. And I think Sarbanes-Oxley has probably resulted in avoiding a lot more HealthSouths and Enrons.

But particularly for small firms, the cost can be significant.

I thank the witnesses for your testimony.

And I thank you, Chairman Garrett, for holding this hearing.

I yield back the balance of my time.

Chairman GARRETT. Thank you.

The gentleman yields back.

Thank you, Mr. Chairman.

The gentlelady from New York is recognized for 2 minutes.

Mrs. MALONEY. Thank you.

And thank you, Mr. Chairman, and welcome to all the witnesses.

Oversight of the accounting industry is an important function of this committee. And I am so pleased that we have all of the accounting standard setters here with us this morning.

If we have an accurate and fair accounting system, then we have safety and soundness in our financial institutions. We have an oversight of how to be more effective in our government programs. And there are so many ways that an accurate accounting industry can contribute to the strength of our country.

We have also seen how if there are slack standards, we can end up with total economic disaster such as Enron and Tyco and others that led to the passage of Sarbanes-Oxley. And as we approach the 10th anniversary, I look forward to hearing your comments on how Sarbanes-Oxley is working or not working.

With the 404(b) exemption, we made permanent in Dodd-Frank an exemption for public companies under \$75 million, because of the cost, because many are start-ups, because of the need to have the right balance to allow them to grow without costly red tape.

I would like to hear whether you feel we got the right balance for exempting companies under \$75 million, and that have not been required to comply with 404(b). I am also interested in hearing more about proposals to make disciplinary proceedings public.

I understand the concern that the PCAOB has about firms dragging disciplinary proceedings. But I also want to hear whether

there is any concern that by making these proceedings public, we are necessarily harming the reputation of a firm before any official action is taken.

Personally, I don't think we should do so unless there is an official action.

I am also concerned about the cost and quality of audits. That is always a top concern, and one that I hear concerns, and about this thing about rotating of the oversight with the accounting firms.

I wonder whether there are other ways to boost auditor firm independence without putting an arbitrary requirement in there that might disrupt the relationship between the firm and the company it is auditing, and also the cost and quality effects that it has with the mandatory firm rotation.

So you have a big responsibility. If our audits are correct, then our economy and our private and public institutions are fair and honest and open, and hopefully thriving.

Congratulations on the work you do. And I look forward to your testimony.

Chairman GARRETT. The gentlelady yields back.

Mr. Fitzpatrick for 1 minute.

Mr. FITZPATRICK. Thank you, Mr. Chairman, for convening this important oversight hearing.

Our economy is in the midst of the slowest economic recovery since World War II. And what the American people need is for the economy to grow and for the private sector to create jobs.

What the people do not need is their own government getting in the way of that economic recovery or the private sector job creation.

For the last 15 months, this chamber and this committee has examined areas where regulations are stifling job growth and holding back our recovery. This hearing is consistent with that effort. And I thank the chairman for holding it.

According to the Small Business Administration, regulations cost our economy \$1.8 trillion annually. It is a very heavy burden on companies that we are looking to for job growth.

So when the Public Company Accounting Oversight Board issues a concept release for mandatory audit firm rotation, that elicits a negative response from almost 95 percent of the respondents in American companies from Krispy Kreme to Xerox to Coca-Cola. And they are unanimous in their opposition. I think that more than justifies a very, very careful examination.

We cannot afford to hamper job creation, and to lock up capital at this very fragile time.

So as we prepare to hear testimony today, I am curious to know what sort of cost/benefit analysis has been done or will be done.

And ultimately, I want to hear how this new regulation is going to help the economy and create jobs.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

Mr. Perlmutter is recognized for 1 minute.

Mr. PERLMUTTER. Thanks, Mr. Chairman.

And just sort of in response to my friend, Mr. Fitzpatrick, in the summer of 2008, the stock market was at about 12,500. By the end of the Bush Administration, 6 months later, it was at 6,500, a loss

of 6,000 points. It is \$1.3 billion per point, about \$7.6 trillion, \$25,000 for every man, woman, and child in America. And we were losing about 800,000 jobs a month.

We are now gaining about 200,000 jobs a month. We have doubled the stock market to about 13,000. We have had 23 months of job growth, and a doubling of the stock market.

And so allowing Wall Street or any financial markets to run pretty wild without regulation, without some responsibility through the accounting sector—and I am not throwing any disparagement towards you—but it is important to have reasonable regulation in place, because the cost of the loss that we suffered in the fall of 2008 was monumental. And we can't have something like that again.

Now I agree with Mr. Fitzpatrick in terms of, let us be reasonable. Let us make sure that we are not doing things that are just obstacles only for obstacle purpose, but have a real direction and a real effort in helping investors.

But we must have good accounting in this country so that investors and others feel protection, and a certainty and reliability of the system.

With that, I yield back.

Chairman GARRETT. The gentleman yields back.

I appreciate the reference to the Bush Administration.

Mr. PERLMUTTER. I thought you would like that.

Chairman GARRETT. Thank you.

Mr. Grimm is now recognized for 1 minute.

Mr. GRIMM. Mr. Chairman, thank you for holding this hearing, and I thank all of the witnesses for coming today to testify.

I think there are a lot of things that have contributed to the financial meltdown. And I certainly think that government intervention and the government's role cannot be left out of it when you are factoring in all the different things in the analysis.

But I certainly realize that job creation has to be at the top of the list. And whether the stock market is going up and down, I think there is a myriad of reasons why the stock market has doubled.

I don't think necessarily the accounting standards or what we are going to talk about in this hearing today is the reason. But I do know that stability, certainty, and the rule of law has always been an innate advantage for the United States.

And I think that preserving that, and making sure that everyone around the world who is going to invest understands our rules, and knows what they are going to be, not only today but tomorrow, will certainly help create jobs.

So I am looking forward to hearing your testimony today.

And with that, I yield back.

Thank you.

Chairman GARRETT. And the gentleman yields back.

Mr. Dold is recognized for 1 minute.

Mr. DOLD. Thank you, Mr. Chairman.

Historically, our capital markets have been the most transparent and the most efficient capital markets in the world.

And our accounting and auditing profession, along with the supporting balance regulatory framework, I believe, is an important reason for the historical success of our capital markets.

However, an increasingly interrelated global financial system and constantly changing economic circumstances puts significant pressure on our regulators and the Congress to make sure that the existing regulatory framework still makes sense, and that any necessary improvements are identified and implemented promptly.

After studying the proposals and considering the written testimony, and other expert resources, I am most concerned about two proposals that I believe have been rejected for good reason each time Congress considered them in the past: the mandatory audit firm rotation proposal; and the proposal to immediately make all Public Company Accounting Oversight Board allegations public without any due process and without any findings.

While I am always open to hearing counter arguments, these two proposals seem to me like solutions that are searching for non-existent problems, while creating a serious risk of inflicting severe, unnecessary, and actual harm on investors and other end-users.

In any event, all of these proposals raise important questions. And I look forward to hearing from my colleagues and from our witnesses today.

Thank you so much for being here.

Mr. Chairman, I yield back.

Chairman GARRETT. The gentleman yields back.

Do we have any other opening statements? Yes?

Mr. Royce is recognized for 1 minute.

Mr. ROYCE. The market is up, Mr. Chairman. But we still have fewer people in the labor force, fewer people out there working in jobs than we did 3 years ago.

And with the 10th anniversary of Sarbanes-Oxley coming up, I think the question for us—we all know what the end goal is. We are going to get the highest quality audits for public companies. That is the ambition.

The question is, how you do that in a reasonable way in terms of affordability, in terms of what is practical. What we happen to see is that we have something of an anchor on the creation of new corporate firms coming into the market.

We have fewer IPOs. We do have a consequence here. It is incumbent upon us to look at this tradeoff, and ask ourselves if we are taking actions that make it harder for this economy to get back on its feet.

Have we made it harder for new firms to create economic activity that employs Americans? Because at the end of the day, we have to ask ourselves how it is humanely possible to have figures that show so many people out of work, so much smaller participation in the American labor force after only 3 years.

What creates a circumstance where we have such a slow recovery?

And is part of it the overreach? The regulatory overreach is part of it. The regulatory cost is part of it, the impractical rules that we have put on our economic system.

Can we do something to get that balance so that the economy recovers more quickly?

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. The gentleman yields back.

And I think you are our final speaker, Mr. Renacci, for 1 minute.

Mr. RENACCI. Thank you, Mr. Chairman.

I want to thank you and the subcommittee for allowing me to sit in on this hearing this morning.

I realize most Members usually don't flock to hearings on accounting standards. But as a CPA, I believe the standards are the essential foundation for a sound and stable economy.

The reliability of a financial statement would allow businesses to access capital, markets to attract investors, and create jobs.

As lawmakers draft laws and propose regulations, we must remember that without uniform, consistent, and independent accounting standards, the accuracy of financial statements will deteriorate, making it more difficult for investors to invest, and companies to raise capital.

I want to thank the witnesses for being here today, and I look forward to hearing your testimony.

I am especially interested in hearing about FASB's latest efforts to coordinate international accounting standards, the progress of implementing the Dodd-Frank accounting provisions, and the PCAOB's proposal to mandate audit firm rotation.

Thank you again, Mr. Chairman, for allowing me to be here this morning. And I yield back.

Chairman GARRETT. And thank you. The gentleman yields back.

Thank you for being with us here today, and for all those people who are not flocking here, they obviously just do not know what they are missing, because today we have the SEC, the PCAOB, the FASB, and the GASB here, all here to testify on the first panel.

So I welcome you gentlemen, and gentlelady.

As all of you who have been here before know, we will recognize each of you for 5 minutes, and your complete written statements will be made a part of the record.

And so with that, Mr. Kroeker, good morning, and you are recognized for 5 minutes.

**STATEMENT OF JAMES L. KROEKER, CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)**

Mr. KROEKER. Good morning and thank you, Chairman Garrett, Ranking Member Waters, and members of the subcommittee.

I am Jim Kroeker, Chief Accountant of the Securities and Exchange Commission, and I serve as the principal advisor to the Commission on accounting and auditing matters.

I thank you for the opportunity to appear before you today, to testify on behalf of the Commission regarding current issues related to the accounting and auditing profession.

The reliability of financial reporting is critical to the confidence of the investing public. The objective of financial reporting is to provide information that is useful to providers of capital in their decision-making process.

This information must be neutral, reliable, and portray economic results in an accurate and faithful manner.

I am pleased to be on today's panel with individuals who have important roles in promoting high quality financial reporting.



I would like to summarize for the subcommittee some of what I view to be the principal current issues on this subject, beginning with accounting developments.

In February of 2010, the Commission issued a statement in support of efforts of the Financial Accounting Standards Board and the International Accounting Standards Board to converge U.S. GAAP with International Financial Reporting Standards, or IFRS.

This statement also directed the staff of the SEC to execute a work plan to evaluate issues relevant to a potential Commission consideration of incorporating IFRS for U.S. issuers.

With respect to convergence, the two Boards have continued to work diligently to complete their priority projects. Despite several successes, many challenges remain.

In addition, in response to concerns about the pace of standard setting, the Boards have extended several times the timetable for completion of these projects.

With respect to the work plan, the staff has expended substantial efforts towards its execution. To inform the Commission and the public of our progress, the staff has issued several progress reports and other papers.

At this point, we have completed what I believe to be the field work related to the work plan, and we anticipate publishing a final report in the upcoming months that will summarize our findings and observations in each of the areas of the work plan.

Moving on from international accounting standards, in recent years we have seen how important it is that financial regulation and accounting and auditing standards keep up with changes in the business environment.

In response, we have launched the Financial Reporting Series, an ongoing series of roundtables designed to examine emerging issues in financial reporting.

The inaugural roundtable was held in November of last year and discussed measurement uncertainty and its role in financial reporting.

Turning to auditing issues, this coming July will mark the 10th anniversary of the Sarbanes-Oxley Act. Despite the Act's many beneficial reforms, the PCAOB's inspection program continues to identify audit deficiencies of varying nature and severity, which may increase the risk of material misstatement in financial reports.

In response, the PCAOB is engaged in several efforts to enhance audit quality. It has undertaken efforts to identify and analyze further the underlying root causes of these audit deficiencies.

It has issued a concept release on auditor independence and objectivity, an important component of audit quality, that considers audit firm rotation, and it has issued a concept release on whether there should be changes to the information that auditors provide in their audit reports to investors.

Other jurisdictions, including the European Union, are currently considering these and other auditing reforms.

The PCAOB is working on a number of projects to update existing audit and quality control standards to reflect the lessons that it has learned from nearly a decade of audit firm inspections.

This type of project may have a direct positive impact on audit quality. My staff will continue to work closely with the PCAOB as it moves forward with these projects.

Finally, I would like to highlight two auditing areas related to the Dodd-Frank Act.

First, last summer the Commission proposed amendments to the financial reporting requirements for broker-dealers. And the PCAOB proposed new auditing and attestation standards that would apply to the audits of broker-dealers.

Both sets of proposals are still under consideration.

Second, the staff performed a study with respect to Section 404(b) requirements for issuers with market capitalization between \$75 million and \$250 million. This study was delivered to Congress last April.

To conclude, there is a substantial amount of activity in the accounting and auditing area. We will continue to work closely with the FASB and the PCAOB on these matters, guided by the Commission's mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation.

Thank you. And I would be pleased to address any questions.

[The prepared statement of Mr. Kroeker can be found on page 132 of the appendix.]

Chairman GARRETT. Thank you, and the gentleman yields back. Mr. Doty from PCAOB, welcome to the panel, and good morning. You are recognized for 5 minutes.

**STATEMENT OF JAMES R. DOTY, CHAIRMAN, PUBLIC  
COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)**

Mr. DOTY. Thank you.

Chairman Garrett, Ranking Member Waters, and members of the subcommittee, I am pleased to appear before you today. The PCAOB is focused on taking appropriate steps to improve audit quality and enhance protection of the investing public.

By law, all of the PCAOB's responsibilities are discharged under the oversight of the Securities and Exchange Commission.

Chairman Mary Schapiro, the Commissioners, and Chief Accountant Jim Kroeker have taken a deep interest in the PCAOB's work, and I am grateful for their support.

The Sarbanes-Oxley Act of 2002 requires the PCAOB to conduct a continuing program of inspections of registered accounting firms.

Our global network firm program covers the largest U.S. firms and approximately 190 of their foreign affiliates. In 2011, the PCAOB issued 344 inspection reports which included global firms, foreign affiliates, and smaller firms subject to PCAOB inspection.

During an inspection, PCAOB inspectors evaluate the design and effectiveness of a firm's quality control system, as well as the quality of the firm's work in the proportions of the audit selected for inspection.

The PCAOB has also continued its work to implement the Dodd-Frank Act which gave the PCAOB authority for inspection, standard setting, and enforcement for the audits of brokers and dealers registered with the SEC.

To this end, we have established a pilot inspection program for auditors of SEC-registered broker-dealers. This program will assess

compliance with existing auditing standards, all of which were set by the profession prior to the Dodd-Frank Act.

The pilot program is intended to help the Board determine the scope and elements of a permanent inspection program, including whether to exempt any public accounting firms such as the auditors of introducing brokers from inspection.

No firm's specific reports will result. But that should provide us valuable information needed to move forward with an intelligent permanent program.

We have also commenced a series of meetings with smaller firms that audit smaller broker-dealers, which we call forums on auditing smaller broker-dealers. These forums allow smaller firms to learn about the PCAOB's work and to provide their own insights and suggestions.

In addition to inspection authority, the Board has the authority to impose sanctions on registered firms and associated persons who have violated applicable laws and standards.

Under the laws that exist today, however, the PCAOB's disciplinary proceedings are nonpublic. This is not good for investors, not good for the auditing profession, and not good for the public at large.

I commend Congressman Westmoreland and Ranking Member Frank for bringing forward bipartisan legislation, H.R. 3503, to bring transparency to the PCAOB's disciplinary proceedings.

Turning to standards, the Sarbanes-Oxley Act also charges the Board with establishing audited and related professional practice standards. The Board has recently proposed new standards relating to communications with audit committees and related parties in transparency.

The Board has also recently issued two concept releases soliciting public comment on the auditors reporting model, and auditor independence, objectivity, and professional skepticism. The concept release on independence, objectivity, and professional skepticism included questions about the pros and cons of mandatory firm term limits.

These concept releases did not propose new auditing standards. Rather, they sought the public's views on particular matters so that the Board can better evaluate the need for future standard setting.

Just last week, the PCAOB held a 2-day public meeting on auditor independence, objectivity, and professional skepticism, at which 47 prominent leaders of the business world and academia offered their views.

This dialogue on auditor independence, objectivity, and professional skepticism was prompted by, among other things, concerns developed over the last 9 years of the PCAOB inspections of public company audits.

Concerns about auditors' skepticism have also been expressed by regulators in other countries. If this process results in the PCAOB proposing any rules—I emphasize "if"—and whether those would involve any form of audit rotation, term limits, or not, any such standards, any such proposed standards would be subject to further public comment and SEC approval.

I am certainly not wedded to any particular outcome. But I do believe that the PCAOB must continue to explore issues of such fundamental importance for the audit.

In conclusion, I appreciate the subcommittee's interest in this work. And I look forward to any questions you may have.

Thank you.

[The prepared statement of Mr. Doty can be found on page 87 of the appendix.]

Chairman GARRETT. And I thank you.

Ms. Seidman, you are now recognized for 5 minutes.

**STATEMENT OF LESLIE F. SEIDMAN, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)**

Ms. SEIDMAN. Good morning. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, my name is Leslie Seidman, and I am the Chairman of the Financial Accounting Standards Board, also known as the FASB.

The FASB is an independent private sector organization which operates under the oversight of the Financial Accounting Foundation and the Securities and Exchange Commission.

Since 1973, the FASB has established standards of financial accounting and reporting for nongovernmental entities, including both public and private businesses, and not-for-profit organizations.

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 nongovernmental entities.

GAAP is essential to the efficient functioning of capital markets. Investors, creditors, donors, and other users of financial reports rely heavily on relevant, comparable, and unbiased financial information.

Accounting standards are not intended to drive behavior in any particular way. Rather, they seek to present financial information so that financial statement users can make informed decisions about how best to deploy their capital.

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

We meet regularly with several advisory councils who advise us about emerging financial reporting issues, the practical implications of our proposals, and opportunities for improvement.

We also meet regularly with the staffs of the SEC, the PCAOB, and banking regulators as well as policymakers and their staff.

We recently added a project to reconsider the accounting for and disclosures about repurchase agreements, as a result of recent feedback obtained through these processes.

Broad consultation helps to identify unintended consequences, and to assess whether the benefits to users of improved information from our proposed changes outweigh the costs of the changes to preparers and to users.

The FASB recently completed several standard-setting projects to improve the transparency and overall usefulness of information provided in financial reports and to reduce complexity.

These projects include: new disclosures about a company's commitments to multi-employer pension plans; a simplified approach for determining whether a company's goodwill is impaired; and guidance to help creditors account for and disclose troubled debt restructuring.

The FASB also has a number of ongoing projects including its projects to improve and converge U.S. GAAP and International Financial Reporting Standards. We have already made substantial improvements on converged accounting standards in a number of areas, and are making progress on four remaining priority projects: revenue recognition; leasing; financial instruments; and insurance.

In all of these projects, we are making a significant effort to understand the perspectives of all of our stakeholders through public meetings, field visits, workshops, and the exposure of our proposals for public comment.

We have made a number of changes in response to the suggestions and concerns that have been expressed through these various means. For example, on our financial instruments project, we have modified our original proposal relating to loan accounting and impairment. And we are proposing new disclosures about liquidity risk that were suggested by investors.

In addition to our standard-setting activities, the FASB has recently made numerous process changes to improve our ability to understand and act upon private company concerns. We now have Board members with significant experience with private companies and staff dedicated to addressing private companies issues.

We have broadened our outreach activities to seek out and listen to private company practitioners, such as at dedicated roundtables.

In short, the FASB has taken these steps to understand private company perspectives in every standard that we set. The FASB is taking similar steps to enhance its consideration of the accounting and reporting needs of not-for-profit organizations.

Thank you for the opportunity to provide a brief overview of the FASB, and its priorities for this year.

My written testimony provides extensive information about our projects and activities.

I would be pleased to answer your questions.

[The prepared statement of Ms. Seidman can be found on page 169 of the appendix.]

Chairman GARRETT. Thank you for your testimony.

And finally, Mr. Attmore, you are recognized for 5 minutes.

**STATEMENT OF ROBERT H. ATTMORE, CHAIRMAN,  
GOVERNMENTAL ACCOUNTING STANDARDS BOARD (GASB)**

Mr. ATTMORE. Thank you.

Chairman Garrett, Ranking Member Waters, and members of the subcommittee, thank you for this opportunity to participate in today's hearing.

My name is Robert Attmore. I am the Chairman of the Governmental Accounting Standards Board and have served in that capacity since 2004.

Before joining the GASB, I was a deputy controller for the State of New York, and served as the New York State auditor.

Because this is the first time in the 27-year history of GASB that we have been invited to appear before Congress, I would like to briefly provide some background on our organization.

Sovereign state governments have the authority to establish accounting and financial reporting standards for themselves and their local jurisdictions. Before the GASB was created, State and local governments' accounting and financial reporting standards were established for over 50 years by the National Council on Governmental Accounting (NCGA).

In the wake of a financial crisis in the 1970s, State governments recognized the need for change. In order to adequately meet the needs of financial report users in the municipal bond market, State representatives determined they needed an independent national standard-setting body for State and local governments comparable to the Financial Accounting Standards Board.

State organizations working with the Financial Accounting Foundation (FAF), the American Institute of Certified Public Accountants, local government organizations, and the Government Accountability Office reached an agreement in 1984 to create the GASB, which began operations that year.

Today, all State governments follow financial reporting standards issued by the GASB.

The GASB was set up as an independent, private sector organization that establishes accounting and financial reporting standards for State and local governments in the United States. GASB was directed to adopt the existing NCGA standards, and then given the mission to establish and improve standards for State and local government accounting and financial reporting.

The mission is accomplished through a comprehensive and independent process that encourages broad participation, objectively considers all stakeholder views, and is subject to oversight by the FAF board of trustees.

Our proceedings are public and transparent. GASB's rules of procedure require that we circulate draft recommendations for public comment. We also hold numerous roundtable discussions and public hearings to solicit constituent views.

The GASB's work is accomplished with the seven-member board. As the chairman, I am the only full-time member of the board. The other GASB members serve on a part-time basis.

All board members have significant expertise in the issues facing State and local governments obtained through their prior work experience. The board is assisted by a 21-member staff.

In the past, the GASB was funded in a piecemeal, inadequate manner by voluntary contributions from States, local governments, the financial community, and sales of FAF publications. The Dodd-Frank Act established for the first time an independent stable source of funding for the GASB for which we say, thank you.

Over the years, GASB has issued 66 standards on a wide range of issues. Let me just mention two important projects on the GASB's current technical agenda.

The first is our pension accounting and financial reporting project. After extensive study, we have proposed several changes in the treatment of pensions, including new approaches to recognize pension expense.

We also propose bringing the net pension liability onto the face of an employer government's balance sheet. Our goal is to issue new standards for pensions in June of this year.

The second GASB project addresses economic condition reporting. This deals with financial projections for State and local governments.

GASB recently solicited public comments on a proposal that would call for State and local governments to provide projections of cash inflows, cash outflows, and total financial obligations for at least a 5-year period going forward.

We will be considering all the responses received for those proposals over the next several months.

Finally, the GASB could not achieve its mission without the strong support and oversight of the FAF board of trustees. This oversight assists us in maintaining our independence, and provides additional credibility to the robust public due process that the GASB follows when setting standards.

Thank you again, Mr. Chairman, for the opportunity to appear before the subcommittee. And I would be pleased to answer any questions.

[The prepared statement of Mr. Attmore can be found on page 60 of the appendix.]

Chairman GARRETT. Thank you, and welcome to the panel for the first time in 27 years.

Mr. ATTMORE. Thank you.

Chairman GARRETT. I will now recognize myself to begin the questioning.

And thanks to the panel.

We will start with Mr. Doty.

You may be familiar with the fact that I sponsored some legislation, it is before the committee, that would require the SEC and the PCAOB to do a cost/benefit analysis, and to identify the problem before the whole rule process begins. And I am sure you are familiar with that.

So looking at that issue in general, and then drilling down a little bit to the area that I referenced in my opening comments, and that you, I see, referenced in your discussion as well, the mandatory audit firm rotation.

Can you drill down a little bit and go beyond what you talked about as far as the panel that you discussed, with regard to any analysis that has been done on this, whether it is an economic analysis already, and if not already, what your plans are going forward?

What specific type of economic analysis has been or will be done? What sort of data would you be looking to collect? What has been or will be done? What sort of people will be doing that, economists or otherwise? How many have or will be done?

Can you just get into some detail on that particular area?

Mr. DOTY. Yes, sir.

Chairman GARRETT. Great, thanks, sir.

Mr. DOTY. Yes, sir.

First, we are at the concept stage. The concept release raised the issue of auditor independence because of the concern about the inherent conflict in the auditor's fee. This all comes out of a wide-

ranging international focus on whether the audit profession has an inherent conflict.

As you know, Congress originally, in considering this subject, did in fact institute audit partner rotation; they deferred the question of a firm rotation. The GAO took a look at it, and said we should wait a few years, and then look at it again.

We have in fact raised the concept release and asked people to consider what would be involved here, because it is a fact that nations around the world are rushing to adopt mandatory rotation in some cases in 5 and 6 years.

So we thought it was important to ventilate this subject.

Without talking about it, you are talking about auditor independence and the conflict of the fee in a—and ignoring the elephant in the room.

At any time, at any point that we get to a proposal for a standard, we will have considered in-depth the scaling, the proportionality, the purpose of the standard, whether the standard can be expected to engender the conflict—the conduct in an auditor that we expect, whether there are unintended consequences in the conduct of the auditor, scaling, proportionality.

And then, we think a post-implementation review is a part of any kind of analysis of the practicality and the cost of and the utility of a standard. And we do that.

We have done it. And if you look at our outstanding proposal on communications with audit committees on related parties, I think you will see that.

In this particular context, I think it is clear that we always have problems in the financial regulatory area, as the GAO notes. And many times, you cannot monetize or quantify either the costs or the benefits.

We will, I can assure the committee, be thinking as we move forward in this area of independence, with any standards that we are thinking of bringing in the independence area to address these issues of conflict—

Chairman GARRETT. Yes.

Mr. DOTY. —skepticism, independence, objectivity—

Chairman GARRETT. Right.

Mr. DOTY. —we will be thinking about the utility, the—

Chairman GARRETT. So—

Mr. DOTY. —and the cost/benefit of it.

Chairman GARRETT. Okay, so on that last point. I guess that is where—I get the point on scaling, proportionality, and the consequences.

In that analysis, once you—first of all, do you have a timeline as to when that will begin? When you do that, will you be bringing in an economist to be making that examination? And how many economists would be making that analysis?

So start there: when; who; and how many?

Mr. DOTY. Mr. Chairman, I can't tell you that we will be bringing a standard on mandatory audit firm rotation. At this point, we are a long way from any kind of decision on whether firm rotation should be proposed as a standard.



We are holding discussions on auditor independence and inviting a wide range of ideas on whether there is something we should be doing about independence—

Chairman GARRETT. And just—I only have about 3 seconds, and I try to abide by it pretty closely.

Other than the general consensus or general thought that this is an issue that should be looked at, was there any specific data that you had received from anyone to say, here is data that can show us that this is a problem area as opposed to anecdotal, this is just another topic area that we should be looking at?

Mr. DOTY. It is a very fair question. If you go back in our comments, the Board had—the Board’s inspectors in inspecting over the years, have found questions of skepticism, issues of whether auditor skepticism was present, whether professional independence was being compromised.

This is an area that crops up, recurs. It recurs in our findings over the years. It is not an isolated issue. It is not simply something that was raised without the basis in the—

Chairman GARRETT. And I will close it on this.

I think your comment was that we are not wedded to this outcome, so there is no preconceived notion as to—from where you personally sit or anybody else as far as the outcome here?

Mr. DOTY. Yes. In fact, Mr. Chairman, in the meetings of last week, I think one of the hallmarks of those meetings was that we heard a number of thoughtful comments on what could be done to enhance skepticism, to enhance the professionalism of auditors, but also to enhance the effectiveness of audit committees.

There is great interest among audit committees in working toward a more effective analysis of the audit function, and a more effective evaluation of the audit service they are getting.

That could come out of this very easily as a result.

Chairman GARRETT. I thank you, Mr. Doty.

I yield back and the gentlelady from California is recognized for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to start with Mr. Kroeker.

J.C. Flowers & Company, a private equity firm and a major MF Global shareholder, recruited Jon Corzine for the CEO job at MF Global.

Moreover, until MF Global’s failure, Mr. Corzine was an unsalaried operating partner at J.C. Flowers. David Schamis, a partner at J.C. Flowers, sat on the MF Global board, was deemed an independent director by the firm and was able to sit on the firm’s risk and audit committee.

So I am looking at all of these connections—many contend that the risk and audit committee at MF Global did not sufficiently push back against Corzine’s risk in sovereign debt trade.

While I am not trying to get into the specifics of this case, does MF Global teach us anything about how we can increase audit committee independence?

Yes, Mr. Kroeker?

Mr. DOTY. Ranking Member Waters—

Mr. KROEKER. Yes, again without commenting on any of the specifics, and I think consistent with Chairman Doty’s response of

what we heard in their 2 days of hearings yesterday on audit committee effectiveness is that there are areas where audit committees are probably—best practices with respect to audit oversight.

Part of that is understanding the nature of PCAOB inspections, how risk—financial reporting risk, how that relates to operational or business risk. PCAOB has a standard under consideration for finalization on auditors' communication with audit committees that helps provide that linkage between financial reporting risk and the audit committee's oversight role.

Ms. WATERS. Oh, and I am not so sure whether or not you—related to my concerns about the overlapping directorate here as it relates to those that I named that sat on both MF Global's and the relationship that Mr. Corzine had with J.C. Flowers, these connections I am concerned about.

What do you recommend?

Mr. KROEKER. Yes, and under existing requirements, again without commenting specifically on any individual registrant, the requirements to have an independent audit committee, I think, have strengthened that audit committee oversight role.

So I think, taking those requirements very seriously, that the audit committee members need to fulfill that independent role of the overseer of the audit process.

Ms. WATERS. Let me go to you, Mr. Doty.

Audit committees currently do not have access to PCAOB inspection reports which assess whether auditors approach their work with the required independence, objectivity, and professional skepticism.

Would this information be useful to audit committees?

Does the PCAOB need legislation in order to share inspection reports with audit committees?

Mr. DOTY. Ranking Member Waters, that is a good question.

Auditors, the auditor can of course waive or make this information available to an audit committee.

We cannot, under the statute. We cannot do it.

The auditor can choose to do it. But one of the remarkable things we heard over the last 2 days of meetings last week was an acute interest in audit committee members, mature and thoughtful people who sit on many audit committees and who want to see more of the detail that lies behind our published part one inspection reports.

So we believe that there is enhanced interest among audit committee members in understanding what our reports mean and what kind of detail is behind them. And we believe that there will be increasing interest on the part of audit committee members as an attribute of their being an effective monitor and evaluator of audit quality.

Ms. WATERS. So again, you think you need legislation?

Mr. DOTY. You would need legislation to authorize the Board to deliver it upon request of an audit committee member.

There was interest in audit committee members in meeting with the Board and having an exchange on that basis. And I think you would need legislation before we could reveal what is in the non-public portion of the report.

Ms. WATERS. Thank you.

Back to Mr. Kroeker, while I still have a few seconds.

Recently, the United Brotherhood of Carpenters Pension Fund and the Sheet Metal Workers Pension Fund have submitted a series of proposals to public companies recommending a shareholder advisory vote asking the companies to establish a policy of mandatory auditor rotation every 7 years.

To date, the SEC staff has issued no action letters to each of the companies stating it would not recommend enforcement action to the SEC if the companies omitted, the unions audit rotation proposal from its proxy materials.

Can you discuss the rationale for the SEC staff's decision on this issue?

Mr. KROEKER. Yes, and principally that is an issue that is handled by our Division of Corporation Finance and attorneys who look at the existing requirements for such proposals.

So I would be happy as well to get additional information.

But under the existing staff no-action guidance, there is an assessment made as to whether or not the request is a matter of—just to put it simply, in the ordinary course of business. And this has been a no-action process that works for many different types of proposals.

I am aware that proposals were brought forward with respect to auditor rotation and the staff's guidance was sought as to action, and the staff's conclusion was that no action would be recommended because it would be viewed as in the ordinary course of business activities.

Ms. WATERS. My time has been exhausted. I yield back the balance of my time.

Chairman GARRETT. Thank you.

Mr. Bachus is recognized.

Chairman BACHUS. Thank you.

Mr. Doty, in my opening statement I mentioned the audit firm rotation. And your statement, I think, basically is that we are only at the start of considering this. And we have made no decisions.

There seems to be at least a misinformed public who believes that you are well on your way to doing that. And I don't know why that is.

But, Mr. Garrett asked you if you had done a cost/benefit study. And I think you answered, well we are just at the start of the process.

But will that be a part of the process?

Mr. DOTY. Good question, Chairman Bachus.

It would be putting the cart before the horse.

Chairman BACHUS. Okay.

Mr. DOTY. To start evaluating costs and benefits of some form of rotation before you had any sense of whether you were going to go there or what it would be, the initial inquiry here is what should be done to enhance not only the perception of auditor independence which suffered in the financial crisis, but also the fact of auditor independence.

We are very aware of the pressures auditors are under.

Chairman BACHUS. Right.

Mr. DOTY. I personally, and I know members of the Board with me want the private auditing profession to survive. We want to see

a private auditing profession and not have audit become a public governmental function.

There is pressure on that at this point. And it derives, as I said before, from the questions of whether there are sufficient safeguards of objectivity, skepticism—

Chairman BACHUS. Right.

Mr. DOTY. —independence. One of the things you have to look at is the fact that in some cases companies have had the same auditor for a century—

Chairman BACHUS. I mentioned HealthSouth in my opening statement. And obviously, we all know accounting firms were under pressure, auditors if they wanted to keep the business, how closely did they look? I think skepticism is the right word.

And I think Madoff isn't about a public company. That auditor said that he just took everything at face value. And obviously, that had disastrous consequences.

Will you at least keep a dialogue open with us as you move along this, and give us your thought process and what you are finding, and keep us abreast of—

Mr. DOTY. We welcome the dialogue. And we want to be sure that we keep you informed of where these concepts and these proposals are moving.

And I would certainly tell you that the concepts on the changes in the reform, the audit reporting model, are moving toward a proposal. That enjoys a lot of support and input from the audit profession, from the users, from all sorts of sources of opinion.

We will be keeping you informed of that.

I would also simply volunteer the fact that we have no doubt that audit quality has improved since Sarbanes-Oxley.

Chairman BACHUS. Right.

Mr. DOTY. There is no question about that. Audit committees are the fulcrum of it. Audit committees are doing better.

Chairman BACHUS. I think I see evidence of that in The Wall Street Journal every day where people are questioning things.

And these are obviously issues that are tough to solve. That is why they are still issues.

Let me ask the SEC—you have a role in this.

Will you do a cost/benefit or an economic analysis of the effect? And I know it is hard to weight sometimes what is the cost of not having skepticism or an auditor question something. But it is hard to analyze what those costs are sometimes.

Mr. KROEKER. Those will be the—as Chairman Doty says, they are not anywhere close to that point. But those will be certainly if there was a proposal advanced, what would be the—

Chairman BACHUS. Of course if you made a proposal, we are going to go to that. And you hadn't done a cost/benefit analysis.

Mr. KROEKER. No, we will be looking in advance of that and working—

Chairman BACHUS. Okay.

Mr. KROEKER. —with the—

Chairman BACHUS. Let me switch gears for just a minute. I only have about 30 seconds.

Madoff, obviously it wasn't a public company. It was a private auditor. It was a two-man shop. They were regulated by the State. The broker-dealer was regulated by FINRA.

But the investment advisor was the SEC. Does the Board maybe feel like you ought to, that auditors of investment advisors should be more scrutinized to avoid a Madoff, which Dodd-Frank didn't address.

Mr. DOTY. We have not been—we don't inspect—

Chairman BACHUS. Oh, I know—

Mr. DOTY. —privately held—private—

Chairman BACHUS. Oh, I know.

Mr. DOTY. —hedge funds and their investment advisors that are neither SEC-registered brokers nor issuers.

Chairman BACHUS. Right.

Mr. DOTY. In the pilot program in the attempt to get to an intelligent rule, a standard that suits what Congress clearly wanted us to do, we will be looking at examinations and reviews. Reviews of the representations that broker-dealers make about their entitlement to the exemption, and the examination of the compliance with what they say in that.

We are hopeful that at the end of this process, we will be able to put in place a standard which will give the Congress and the public assurance that we have taken steps to prevent or detect the kind of fraud that Madoff perpetrated.

None of these are obviously foolproof, but we want to be conscious of the proportionality that Chairman Garrett referred to and I know you are interested in.

Chairman BACHUS. Sure. Thank you very much. I appreciate that.

Chairman GARRETT. Thank you, Mr. Chairman.

The gentleman from California is recognized.

Mr. SHERMAN. Ms. Seidman I want to commend you on this report to the blue ribbon panel on standard setting for private companies.

Without objection, I would like to make it a part of the record.

Chairman GARRETT. Without objection, it is so ordered.

Mr. SHERMAN. And I know that that there is some discussion in your shop of delay in writing another report—looks pretty good.

Mr. Doty, you have talked—I believe it was you who talked about smaller broker-dealers. And we saw this with Madoff where the accounting firm was obviously too small to have done the audit, if they chose to do an audit of Madoff, even if they had devoted 100 percent of all their efforts to that one client.

Standards for independents generally say that an accounting firm shouldn't have more than 5 or 10 or 15 percent of its revenue coming from one client.

Because even if you have just enough staff to service that one big client, if that one big client is half your business, then you are not so much independent as an appendix or an appendage.

What steps are you taking to make sure in dealing with these smaller auditing firms around the country, that they are big enough so that they can do the audit of the relevant broker-dealer and still have 90 percent of their resources available to handle other clients? In other words, that they are big enough not only

enough to do the job, but big enough to have other sources of revenue and be independent of the client.

Mr. DOTY. Congressman, you put your finger on an issue not simply for the auditors of broker-dealers, but for many of what we call the triennial firm, audit firms, the smaller audit firms.

Mr. SHERMAN. Please speak into the microphone.

Mr. DOTY. And we have inspected eight. We have selected eight of the broker-dealer auditors exclusively—auditors exclusively of broker-dealers that we inspected or we looked at with a mutual consent in 2011.

We will do two more this year, three more this year, probably—

Mr. SHERMAN. Mr. Doty, do you have standards or could—is it entirely legal for an accounting firm to get 30 percent of its revenue from a company and attest to their—excuse me—opine on their financial statement?

Mr. DOTY. It could be one of the indicia of independence and of capacity—

Mr. SHERMAN. So you have no—in a profession best known for focusing on numbers, you don't have a numerical standard?

Mr. DOTY. We think we would be precipitous to have established some kind of hard threshold at this point. But I would—

Mr. SHERMAN. So would 50 percent be enough, 60 percent, 80 percent?

Mr. DOTY. I think we would—

Mr. SHERMAN. Do you even know—

Mr. DOTY. —looking at firms—

Mr. SHERMAN. —when the broker-dealer files a statement with you, do you even know what percentage of the CPA firm's revenues come from that one client?

Mr. DOTY. Yes we do. We do look at that.

We look at—

Mr. SHERMAN. Is it on your form or do you look at it only in the 1 percent of the cases where you gather additional information?

Mr. DOTY. We—in all of our inspections of an audit—

Mr. SHERMAN. In all of your inspections, so 99 percent of these you don't inspect.

Mr. DOTY. But in every inspection that we do—

Mr. SHERMAN. Okay, why don't you ask for that information on every filing—

Chairman BACHUS. Mr. Chairman?

Chairman GARRETT. Yes.

Chairman BACHUS. I don't know that the witness is having an opportunity to respond to the—

Mr. SHERMAN. I will give you a chance to respond, Mr. Doty.

Why don't you ask that question for every filing?

Mr. DOTY. We get it—we do not ask for a general survey of firms to give us, in advance, an entire breakdown of their client revenue contribution. I believe I am right about that.

I will confirm that for you.

Mr. SHERMAN. Mr. Doty, if I can rephrase the question. Why don't you simply ask the firms when they submit the statement to indicate that that one client is less than 10 percent of 15 percent of their revenue, all the time, not just with the one tenth of 1 percent where you are able to conduct an investigation?

Mr. DOTY. It is certainly an idea that we should consider.

Mr. SHERMAN. Okay. And—

Mr. DOTY. —I don't—

Mr. SHERMAN. —the light is about to turn red.

I will say to Ms. Seidman, you have called upon me many times to defend the FASB's role in writing accounting standards, and the independence that the FASB has obtained.

And yet every time I have talked to the FASB about accounting for research, I get no theoretical support for a position. I am told, wait another decade. We will finally work something out with the Europeans. And in the meantime, there are tens of billions of dollars of research that isn't being done because we have accounting standards with no basis.

And I will ask you to respond for the record, unless the chairman wants to give me more time.

Chairman GARRETT. We will let that go to the record.

Mr. SHERMAN. Thank you.

Chairman GARRETT. And with that, I will go to Mr. Schweikert for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

This is one I want to try to get my head around on what accounting—what economic modeling, what else goes into it.

And some of this is sort of family folklore reaching way back when accounting recognition rules changed on installment sales. And some of that is, I think, the first time that was done was like 35 years ago, and then had multiple—and each time that happened, in the real estate industry people, particularly those who extended credit and had cascades of evaluations.

My understanding, Ms. Seidman, is that rules are in promulgation or being looked at in regards to how to recognize leaseholds. I would like to first understand, where is the rule going? What economic modeling has been done?

Is there differentiation made between credit tenant, long-term tenants, tenants who will—how are you modeling that?

And what potential do you see happening, as to how we book and value real estate across the country?

Ms. SEIDMAN. Thank you, Congressman.

First, let me just explain the project you are referring to is our joint project on lease accounting that we are conducting with the International Accounting Standards Board.

The primary purpose of the project was to respond to persistent concerns that we heard from investors and also regulators that material obligations of leases were not being reported on the balance sheets of lessees.

That is the primary purpose of the project.

We engaged in that because investors were trying to make adjustments themselves, to put those amounts on the balance sheets. So we are trying to take some cost out of the system and provide more useful information to investors.

With respect to where we stand in the process of it, we are currently working through the comments that we received on the first exposure draft which generally supported the proposal that longer-term leases would be recognized on the balance sheet.

There were concerns raised about complexity. And there are concerns that have been raised about the income statement treatment of that basic approach. So we are currently working through that.

We proposed some changes to the lessors accounting which is directly related to the question that you asked. We have been working through those issues, as well.

At this point, we have landed on a proportionate sale model for everything except real estate. We are planning to scope real estate out of the standard, and instead rely on a different standard that we are developing for investment properties.

Mr. SCHWEIKERT. Okay. Any sense where that is going?

And my reason is—I instantly can start to think of ways this gets gamed. If I am showing a concern saying, okay, here is a long term lease. We want to recognize that from the tenancy.

Now do you start doing 5 years with some type of rolling options?

At a way, so now, as the real estate owner, does it change the valuation of how you capitalize your real estate?

My fear is we are heading towards a mechanic—where the accounting standard may end up creating a certain level of game playing here, where most of us who have done evaluations and looked at REITs and those things, at least we sort of understand the mechanics right now.

Ms. SEIDMAN. Right.

Mr. SCHWEIKERT. Is my concern unfounded?

Ms. SEIDMAN. We would certainly try to make sure that there is no opportunity for arbitrage between the accounting standards or game playing as you said.

Mr. SCHWEIKERT. Some of it would just be the way you structured a lease. And therefore, if you did it for a certain amount of term with then a certain creatively written option, it would be recognized differently, wouldn't it?

Ms. SEIDMAN. Yes, the proposal would include provisions to enable people to form judgments about how to incorporate options in the estimation of the lease term, and then ultimately how the transaction is recorded.

Both of these standards are still under development. We have already agreed that we will send the leasing proposal out for comments again. So there will be an opportunity to provide further comments on it.

And we are just starting the process of looking at the comments we received on the investment property proposal, which is the one primarily related to real estate. And we got lots of substantive comments on it.

It is going to take us some time to work through them.

Mr. SCHWEIKERT. Aren't these pretty well disclosed also in the footnotes, though?

Ms. SEIDMAN. There are certain requirements to disclose minimum lease payments in the—

Mr. SCHWEIKERT. And duration, isn't that also in there?

Ms. SEIDMAN. The lease term, yes.

Mr. SCHWEIKERT. Okay.

Ms. SEIDMAN. But it is minimum lease payments rather than expected lease payments.



So what we are trying to do is have everybody perform similar calculations to take some of the work out of the hands of the investors.

Mr. SCHWEIKERT. Okay.

Mr. Chairman, thank you.

My only concern is that sort of law of unintended consequences that if we reach way back in time, we saw the devastation happen when we changed the installment sale rules.

Ms. SEIDMAN. Right.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Ms. SEIDMAN. May I just add that we do plan to conduct significant outreach with stakeholders to try to avoid any unintended consequences.

Chairman GARRETT. Thank you.

Mr. Miller is recognized for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

There has already been some discussion of concerns about a lack of independence for conflicts of interest by auditors. That is the reasoning behind the proposed requirement of retaining auditors.

But that seems to be a recurring concern.

It was a concern in Enron and those other scandals during that period. And the biggest auditing firms, the big four accounting firms, still have consulting firms that are affiliated that are as large, and as possible, as the accounting firm.

I know that there are some not some limitations on how much overlap there can be between the—consulting firms and the auditing firms.

But right now, the OCC and the Fed are both doing reviews of foreclosure practices by the bigger servicers that are all affiliates of the biggest banks. And both essentially have allowed the servicing firms to pick their own reviewers.

It appears from the engagement letters that had they made public that most of the reviews are being done by the consulting firms that are affiliated with auditing firms. And it certainly has raised some questions about conflict of interest.

Most notably for JPMorgan Chase, their affiliates that did servicing, they picked Deloitte. And a big part of their review will be mortgages that came to JPMorgan from Bear Stearns, which they acquired, and from Washington Mutual, which JPMorgan Chase acquired.

Deloitte was the auditor for Bear. And they are in fact a defendant in investor litigation for what went on at Bear and mortgage securitization. They are a defendant with Washington Mutual, also for the mortgages originated by Washington Mutual.

It seems like there is an ample disincentive for the auditing firm to find large problems with the mortgages originated by JPMorgan Chase, or now liabilities assumed by JPMorgan Chase, when they bought Bear and when they bought Washington Mutual.

There was an article in the American Banker earlier this month by Francine McKenna raising those questions. She has concerns about conflict, or certainly the appearance of conflict, or the lack of distance.

I have those concerns as well.

Do you all have those concerns?

And should this have happened? How should the rules be changed, if you think so?

Yes, sir?

Mr. DOTY. Congressman, first of all, you have highlighted the scope and complexity of the independence question.

Independence and skepticism are a state of mind. And part of the exercise that we are engaged in is to try to understand as much as we can about that.

I would have to say that with respect to the issue you put your finger on, it is an issue of another regulator's area of expertise and jurisdiction.

It is not part of our jurisdiction. It is part of the jurisdiction of the Federal banking regulators.

And I think in the McKenna article you are referring to, the appropriate official of the Office of the Comptroller of the Currency speaks to it, and speaks to the issue.

But I really would have nothing to add or nothing to comment on there. It is not my responsibility or the Board's responsibility to confront that issue in this particular case.

Mr. MILLER OF NORTH CAROLINA. I understand. I have heard that it is not my job response many times.

But it seems like it should be your job if an affiliate of an accounting firm is undertaking an investigation that may look at the work of the accounting firm with which they are affiliated.

Why is that not something that some of you will look at?

Would any of you look at that?

Mr. DOTY. We would in inspecting an engagement of any accounting firm. We would be concerned about business relationships with the affiliates of the accounting firm and the registrant or the issuer.

And we do look at, as I was saying to Congressman Sherman, the relative contribution of non-audit fees to the revenue of the firm when we do our annual inspection of the 10 largest firms.

Mr. MILLER OF NORTH CAROLINA. Anybody else? Mr. Kroeker, you have your hand on your button. Was it just a nervous twitch?

Mr. KROEKER. No, no, no.

As it relates to the independence of the financial statement auditor, which is really the jurisdiction that we have for registered public companies, we would certainly be taking a look at that issue.

It is a tenet of the independence rules that you can't audit your own work, and a tenet of the independence rules follows that you can't be independent if you have less than an objective sense of mind—that is, you are incented to come to a particular outcome.

So as it related to the financial statement audit, that would be squarely within our responsibility.

As it relates to any work that is done under a consent decree for the OCC or others, I don't believe it would fall within our jurisdiction.

Chairman GARRETT. The gentleman yields back.

Thanks for the answer.

The gentleman from Texas is recognized for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Doty, I may be confused about an earlier part of your testimony or actually an answer that you gave to Chairman Bachus. I

believe you said in response to a question of his that it is premature for a cost/benefit analysis.

Is that what I heard you say?

Mr. DOTY. You did.

Mr. HENSARLING. Okay, so implicitly that means you intend to conduct a cost/benefit analysis; the timing is simply wrong.

Is this what you are trying to say?

Mr. DOTY. Not to put too fine a point on it, but one would normally not conduct a cost/benefit analysis or indeed any kind of analysis of the kind you are talking about on a concept release.

It is when you get to the—if you got to the point of a proposal, and as I have said, we don't have a proposal outstanding—

Mr. HENSARLING. If I could, Mr. Doty, let me ask you this with respect to the concept release.

There is some reason you put it out. So I assume you assessed that there is a benefit to be derived by putting the concept release out.

You have identified some problem. You have proffered a solution.

So implicitly, aren't you telling us it is not premature to consider benefits, but it is premature to consider cost?

Mr. DOTY. The concept release, it is a fair question.

The concept release took note of the fact that there are other jurisdictions which are adopting term limits mandatory for all of the audits in their jurisdiction.

The Netherlands is one. India is moving in that direction. These are, in some cases, 5- and 6-year term limits. The E.U. is considering these proposals.

The concept release said we would be interested in the views of commenters on any of these proposals, but also what about terms of more than 10 years.

What about extended terms?

What about segments of the issuer market other than all?

I think that the concept release is very clear that we did not intend to suggest that we had reached some conclusion that all—

Mr. HENSARLING. Yes.

Mr. DOTY. —2,500—

Mr. HENSARLING. But let me speak of one conclusion. The GAO study, when they last looked at this, it appears they employed a cost/benefit analysis.

I am reading from their report: "GAO believes that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial cost and loss of institutional knowledge of the public company's previous auditor of record."

So it appears they used a cost/benefit analysis. Again, I am still a little curious as to what has changed since the GAO study that has caused this concept release to be put out?

What additional evidence is there?

It just seems like they may be putting that cart before the horse here. I am trying to—

Mr. DOTY. These are very fair questions.

The lapse of time—the GAO report was in 2004. It did direct us to take another look at it down the line.

The GAO report was tentative. It did not say that it would not. It offered the cautionary concern about cost. But it estimated—it was reporting an estimate it had received from others of a 20 percent jump that would cost 20 percent more.

Congressman, I think we have received a good deal of testimony, opinion, evidence that that number would be exaggerated, that in fact, firms change their auditors. They change their auditors all the time. And they don't experience a 20 percent jump in audit costs.

Audit costs have risen, but they haven't jumped through the period post-Arthur Andersen when firms have changed their auditors.

Mr. HENSARLING. Mr. Doty, I see my time is starting to wind down. I do want to get in a couple of other points.

I clearly have not had an opportunity to review all the responses to your concept release. I have been informed though that it is overwhelmingly negative. And in fact a majority of the investor community, who have sent you comments on record, are opposed to it.

Do you disagree with that characterization?

Mr. DOTY. First, it is helpful to us to know of 900 comment letters, there is very strong opposition to any kind of one-size-fits-all standard. And that is what the comment letters say, that they oppose a one-size-fits-all rule which is exactly what is being proposed in a number of foreign jurisdictions.

So that is a useful data point. It is a very important data point—

Mr. HENSARLING. If I could, as my seconds wind down, I know you don't have to be wedded to it, but are the majority of the comments from the investor community ostensibly those who would benefit from this mandatory auditor rotation? Have they opined negatively or positively?

Mr. DOTY. There is a large and representative segment of the CFO preparer community that is opposed to it. They are opposed to it—

Mr. HENSARLING. Thank you.

Chairman GARRETT. Thank you. Thank you.

The gentlelady from New York is now recognized.

Mrs. MALONEY. Thank you. Thank you for your testimony.

We are increasingly in a global economy and our firms are part of a global economy now. And I would like to hear some statements on how we are really merging the GAAP accounting principles with the International Financial Reporting Standards.

It seems like we should be trying to work together. It certainly would make it more efficient for our companies to interact in the global markets.

I would like to ask one specific question that really impacts the district that I represent. And that is, the G20 has urged FASB and the ISAB to converge GAAP and international standards. And as part of this convergent process, the FASB added a project to its agenda on accounting for the investment property.

As I understand it, FASB's investment property entities proposals relies on the type of entity that would determine whether investment property would be reported at fair value.

As I understand it, this proposal is inconsistent with the international standard that simply defines investment property as fair value and to report the property at its fair value.

And my question on this particular one is also to a larger sense why aren't we converging both and getting them to one standard? Why have two separate standards? Why can't we get together with GAAP and the international community?

But this is one specific example which then could probably explain the broader challenges of trying to mesh the two accounting standards that would make a more seamless and efficient international accounting standard for Americans' global businesses.

Ms. SEIDMAN. Congresswoman, I think that question is properly directed at me.

We indeed have a project on our agenda to consider putting in place a standard on investment properties. The reason we put it on the agenda was two-fold: first, it helps clarify what the scope of the leasing standard will be, because we are talking about leases of investment properties, for the most part; and second, to try and converge, if possible, with international accounting standards.

We certainly looked at the international standard as our starting point. The reason that we did not move forward with it was because it allowed an option for companies to decide whether to carry their investment properties at fair value or at cost.

And in very recent years, we have been urged by the SEC as part of their committee on improving financial reporting, and investors at large, to not allow choices in GAAP.

So we took the basics in the international standard and instead decided to try and develop a requirement for when certain types of investment properties should be carried at fair value.

Mrs. MALONEY. And where does it stand now?

Ms. SEIDMAN. We issued a proposal for public comment and the comment period just ended. We are in the process of conducting roundtables with stakeholders on it.

I will share with you that the IASB has indicated a willingness to consider the feedback that we have received on our proposal with a goal of eventually converging.

But this is a case of leapfrogging where we have entered into this narrow scope project for some very specific reasons with a broader goal of convergence ultimately.

Mrs. MALONEY. And how is convergence working in general across all accounting standards? Are you trying to make that one effort now or where does it stand?

That is one specific example, but generally in the whole accounting process, where does it stand?

Ms. SEIDMAN. Yes. We have been working on a number of projects that were agreed upon between the FASB, the SEC, and others which were representing the most significant opportunities for improvement and financial reporting, as well as the opportunities—

Mrs. MALONEY. It sounds like you are making good progress.

I would like to say that I think your profession is incredibly important, because if the private sector doesn't trust the financials, then they are not going to invest.

Public companies now pay firms to audit them. And as has been discussed in this committee many times at a basic level, this presents a conflict of interest and a potential barrier to auditor independence.

Are there any proposals either domestically or internationally to change this model of auditor compensation? And if so, what is it? My time has expired anyway.

Mr. DOTY. There are proposals that surfaced overseas, Congresswoman, that suggest that insurance funds should be created.

There are proposals that government funds should be established—that an independent government agency would employ, would select the auditor, negotiate, and determine the compensation.

I would have to say that I think that again rushes a process that is terribly important.

Audit committees have assumed since 2002 an increasingly independent and important role in selecting the auditor, negotiating the audit fee, and coming to terms with the scope of the audit. All of that has improved the audit.

And our outstanding proposal on communications with audit committees takes account of that. So we are not focusing a lot of attention on these alternative payor systems.

We were much more interested in knowing whether there was something in the concept release short of that kind of alternative payor alternative appointment process that would benefit independence.

Chairman GARRETT. I thank the gentleman.

And the gentlelady yields back.

Mr. Fitzpatrick is recognized for 5 minutes.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Mr. Doty, why did you decide to extend the comment period for entities to give testimony or write letters in connection with this rule?

Mr. DOTY. Good question. The 2 days of meetings we had last—the 2 days of public meetings and hearings included distinguished people such as Paul Volcker, John Bogle, and Don Nicolaisen. Their commentary is written. It is all on our Web site.

We felt it would be a good thing to allow other people to react to that and to get their comments in. The more information, the more comments we have, the better informed we are.

And a number of the comments—a number of the proposals or the—a number of the suggestions that came out of that meeting that we should consider were actually not suggestions that were encapsulated in the concept release. They were new.

So they deserve some consideration and comment.

Mr. FITZPATRICK. As I said in my opening statement, we are in a fragile economic recovery right now. We are looking to the private sector, including public companies, to get the private sector economy moving again, to get people back to work.

And so I think we need to be very careful as we impose new burdens, new regulations, and requirements upon them. And we listen very carefully to them, because everything that we do here in this town seems to dry up their capital that we are asking them to free up to get people back to work.

I have started printing out some of the comments. And I think I am about halfway through. This is half of them.

And following up on Mr. Hensarling's question, it seems like the overwhelming majority—and I have seen a number recently, maybe

as many as 95 percent of the comments that the Board is receiving on this concept are not just negative but overwhelmingly negative.

I pulled out a couple of them from my State of Pennsylvania. United States Steel has indicated the mandatory audit firm rotation will result in increased costs and inefficiencies and reduce audit quality with little if any added benefits.

A company called Koppers Holdings Incorporated, has said that mandatory audit firm rotation would cause higher costs and inefficiencies. A company will be required to invest substantial time, effort, and money each time it must select an educated new audit firm.

And finally, a little closer to my part of the State, AmerisourceBergen indicated, "We strongly oppose mandatory audit firm rotation for three primary reasons: number one, we believe that audit costs will increase significantly because new audit firm personnel will be required to invest time and educate themselves about the company, its operations, and business practices; number two, we don't believe there is evidence that audit firm rotation will work to improve audit quality—I thought this was interesting—; and number three, mandatory audit firm rotation will also indirectly increase the cost of our tax compliance.

"We use the same accounting firm for both audit and tax services work as permitted by and in accordance with the rules of the SEC to ensure that both audit and tax services are well coordinated and provided in an efficient manner.

"We believe that if we are required to use a new accounting firm for audit services, we would also need to use that firm for tax services."

And so, the great majority of companies are saying hold on, that the benefits are minimal, and the cost is potentially very significant.

I remember reading in one of these comments—I can't find it right now, that it might have been the GAO predicted that the increase in costs would be 20 percent.

I remember—was there a GAO study out there?

Mr. DOTY. That is what—the GAO study did recite that if that had been the estimate that some had.

I would tell you that there are people who would dispute the accuracy of that now—

Mr. FITZPATRICK. Do you dispute the accuracy—

Mr. DOTY. —7 or 8 years later—

Mr. FITZPATRICK. —of that?

Mr. DOTY. Sir?

Mr. FITZPATRICK. Have you disputed the accuracy of the 20 percent number?

Mr. DOTY. As I say, I have no basis for saying it is right or wrong now. But I—

Mr. FITZPATRICK. What do you believe—do you have an opinion?

Mr. DOTY. I have—we have been told by people who are in fact on audit committees and have engaged in the rotation of auditors for very substantial companies, that in fact audit rotation lowers the cost of the audit, reduces the fees that are charged, and lowers the cost to the company.

So there is conflicting testimony among people who are engaged in this process.

Mr. FITZPATRICK. And that is why, Mr. Doty—we really believe it is incredibly important to have it a good cost/benefit analysis done at the very beginning.

And so my question to you is, are you committed to doing a cost/benefit analysis? If so, when? Who is going to do it? And how is it going to be done?

Mr. DOTY. First, Congressman, the question arises because of the 2008 financial crisis in which people said auditors lost independence. They lost objectivity.

We do not have a proposal out for any kind of firm rotation. We are not committed to any particular approach to independence and objectivity. We are going to hear all of these comments.

And I assure you—

Mr. FITZPATRICK. But will you do a cost/benefit analysis before you begin pushing that concept?

Mr. DOTY. Before we came in with a proposal on mandatory firm rotation, we would be doing a very careful analysis of costs, unanticipated consequences, and benefits.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Chairman GARRETT. I thank you.

The gentleman yields back.

Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman, and I thank the committee for its indulgence and its courtesies.

I would like to shift a little bit from the panel to talk about an issue. I am the ranking member on the Oversight Subcommittee of the full Financial Services Committee, and we have been working for the last several months trying to figure out what happened with MF Global. I have no doubt that most of you have been, as well.

And in that time, for those of you—I am sure you all know. But we have \$1 billion missing. That \$1 billion belonged to investors, some big, many small, a lot of people hurt. And we are trying to figure out what happened.

I haven't reached any conclusions yet. The committee hasn't reached any conclusions.

But it is coming down to, in my opinion, three real possibilities here, or maybe some combination of these possibilities. One is possible criminal activity, which crimes happen everywhere. That is life. But the other one is also possibly the lack of true segregation and so-called segregated accounts, different issue, not an issue for you guys.

But the third item is potentially the language of FASB statement number 140, which attempts to define when a sale is a sale and how to treat a sale.

Now most Americans, I think you would find, they know what a sale is. If you sell it, you don't own it anymore. Someone else owns it.

The fact that we have to define a sale in a specific statement obviously answers the question that well, it is not always that way.

And I am not looking to lay blame here. But I need to be sure at this point—and as we speak, to my knowledge is at least six different agencies, both government and nongovernmental agencies,



giving serious review to this, including the SEC being one of the lead agencies, the CFTC, and others.

But I guess I need to know just for the record. Mr. Kroeker, I just want to be clear. I assume you are familiar with the SEC's review of the MF Global situation at the moment?

Mr. KROEKER. Yes.

Mr. CAPUANO. Okay.

And Mr. Doty, I am just curious, is the PCAOB involved with reviewing any of the rules or any of the appliance of those rules that might have been related to MF Global?

Mr. DOTY. Congressman, we shouldn't be commenting to you publicly on—

Mr. CAPUANO. I am not asking about the specific issue. But rules are rules that apply to others. And the reason there are rules is not for a specific investigation. I am not asking for a comment on that.

I am asking about any issue that you would read in the newspaper in theory would either result or not result in a self-review of what role might my group have had in this.

And did we do anything wrong? Or did we do anything wrong?

And not to say wrong, sometimes maybe we have to clarify something. That is all I am asking.

Is the PCAOB engaged in self-review, internal review, as to whether there can be any activities that you might be able to take to address whatever may have happened there?

Mr. DOTY. Yes, sir, we are constantly reviewing the existing audit standards with a view to determining whether there are areas where the audit standards can be improved—

Mr. CAPUANO. That is—and—

Mr. DOTY. —and how we do that—

Mr. CAPUANO. —and you have done it or you are currently doing it as it relates to potential issues that have been raised in the public domain, I might add, relative to MF Global?

Mr. DOTY. I wouldn't want to suggest that we have a view on what existing audit standards require for any currently problematic audits that are out—I think that would—

Mr. CAPUANO. That is—

Mr. DOTY. —be a mistake. But we are always looking at—we read the papers. We listen to what you all do here.

We are always concerned about whether our standards, whether we are looking ahead and thinking where our standards should be to guide auditors and to produce better audits to avoid—

Mr. CAPUANO. Yes.

Ms. Seidman, your agency?

Ms. SEIDMAN. Whenever a major financial reporting issue emerges, we take steps to try and evaluate whether there is an issue with the standard itself or whether there is a compliance issue with it.

Once we became aware of this situation, we did undertake steps to try and get to the bottom of that. Our outreach indicated that there was consistent interpretation of the guidance. But through our outreach, we also learned that market practices seem to have changed since the original standard was written in 1996.

And the nature of the change seems to be related to the types of securities that are involved in these arrangements. At the time the standard was written, it seemed to involve Treasury's and government agency's securities with very little credit risk.

Whereas now, we understand that a much broader range of securities—

Mr. CAPUANO. That is fair enough—

Ms. SEIDMAN. —are being used.

Mr. CAPUANO. Mr. Attmore, is your agency involved with any of these?

I am not sure that you would have a role in this.

Mr. ATTMORE. We do not have a role.

Mr. CAPUANO. I didn't think so.

The reason I ask is again, I only suspect, I am not looking for anybody to say, this is what we are doing on this case. That is inappropriate for this kind of a forum.

But I will tell you that you have a rule here that has already been amended, 140 is an amendment of 125, which was an amendment of a previous number. And I don't remember the previous number.

So it is clearly a rule that requires an ongoing review.

And I just need to be satisfied at the moment—maybe at a future time, I would like to know more—that at least all the agencies—and by the way, when you are doing all this, are you talking to each other? Because it is really not going to do any good for FASB to come up with a new rule if PCAOB and practitioners can't understand that one either.

You really have to be talking to each other. And I guess I would like to know, are you communicating with each other on this type of thing as to where you might want to go and what might be an appropriate way, so that you have one clear, unequivocal rule that every practitioner will be able to utilize in the same fashion?

Chairman GARRETT. And we will ask that they get back to you on that in writing, as the gentleman's time has—

Mr. CAPUANO. Fair enough.

Thank you very much, Mr. Chairman.

Chairman GARRETT. Thank you.

The gentleman from California is recognized.

Mr. CAMPBELL. Thank you, Mr. Chairman.

At Ford Motor Company back in the day, they used to call you a name based on what part of the company you came from.

If you came from accounting or finance, you were a "bean counter," right? And if you were from engineering and manufacturing, you were a "slide ruler." And if you came from sales and marketing, you were a "bozo."

I used to think "bean counter" was a pejorative until I heard them call a whole bunch of people "bozos," and then I was kind of happy about that.

As one of the three certified "bean counters" on the committee this morning, good morning.

I want to ask about something that Mr. Kroeker mentioned. And I think Ms. Seidman addressed tangentially a little bit.

But IFRS—and we are all talking about IFRS, and that IFRS is coming, and that we have to move in that direction.

And we have been—I was trained as an accountant back in the 1970s when principles-based accounting was a lot of what they taught you. And we have been moving away from that into rules-based accounting.

Ms. Seidman, you talked about a lot of the FASB things and how complex they are. The one on stock options being the most unbelievably byzantine complex thing I have ever seen in my life. And it is all a part of this rules-based accounting.

But if we go to IFRS, we are going to go back toward more principles-based.

My question is this: can we do that in this industry without having some tort reform or some aspect of—how can we do that with our legal system as it currently exists? Can we or can we not?

Anybody who wishes to answer that, I will be pleased to hear.

Yes, Mr. Kroeker?

Mr. KROEKER. I would be happy to answer that. My personal view is I think we can.

The SEC staff delivered to Congress a report on principles-based accounting standards coming out of Enron and other financial reporting scandals, some of which were really tied to what some have referred to as rules-based standards—that is, somebody was on one side of a 3 percent test.

And really the sense of that study was we need to move toward what we refer to as an objectives-based set of standards, broad objectives but sufficient application guidance, but not the detailed prescription that we have today.

And I think being on the good side of a judgment is a lot better than the wrong side of a bright line rule.

Mr. CAMPBELL. Okay.

But from a litigation standpoint, if there is a rule, even if the rule is a bad rule, that is not the fault of the person who followed the rule.

But if you are principles-based, which I personally much, much, much, much prefer, that means there is judgment involved. And judgment can always be second-guessed.

And so doesn't that create liability issues that are—that under a rules-based system—now I agree with you.

A principles-based system will give us a better outcome, give us better accounting. It will give us better financial statements, in my view and my estimation.

But the question is what—when people can second-guess things under our current—can we do that simultaneously and still have the accounting firm stay in business?

It seems like Ms. Seidman is jumping at the—

Ms. SEIDMAN. I think you are asking an excellent question. It is something that we live every single day working with our international counterparts where there is much more tolerance for the application of judgment.

And I will say much less severe consequences for someone questioning your judgment.

And so in our daily work with the International Accounting Standards Board, we have a tension every day about the U.S. stakeholders wanting a certain amount of specificity in the guidance, so that they have a sense that they are going to hit it down the fair-

way with good intentions; whereas internationally, they are much more comfortable having a broad principle expressed and not a lot of guidance.

To me, what we have been trying to do is provide enough application guidance so that there is an acceptable level of diversity, but at some point it becomes unacceptable. And we need to step in and provide some guidance.

So through our field work, we try and test how consistently do we think companies are going to be able to apply the standard without getting into excessive detail.

Mr. CAMPBELL. So how are we going to do—how are we going to move to—

Ms. SEIDMAN. Yes—

Mr. CAMPBELL. —more principles-based without—how do we deal with the other issue, with the litigation or the liability issue.

Ms. SEIDMAN. I do agree with you that it is a systemic issue.

But I will share with you that we hear from our investors as well, that they like to have a certain amount of consistency in the information being reported which lends itself to having some application guidance.

Mr. CAMPBELL. Mr. Kroeker?

Mr. KROEKER. I don't know which from a litigation standpoint is a better posture to be in, but we have so many rules in certain standards, that I understand the profession has a hard time in derivatives accounting when you get to the—highest to the lowest of actually understanding each rule.

So I am not convinced that we wouldn't be better off to have a principle where everyone understands the principle, and then makes those informed judgments.

Mr. CAMPBELL. Okay. I have more to ask but my time has expired.

Thank you, Mr. Chairman.

Chairman GARRETT. Indeed.

Mr. Perlmutter is recognized.

Mr. PERLMUTTER. I think I will start—you mentioned independence and objectivity as being sort of key to what an accountant and an auditor is trying to determine.

Are these good books or are these bad books? Are these numbers real or are they phony?

So just sort of going back to Mr. Fitzpatrick's line of questions, in 2008, where so many people lost so much, have you found that there wasn't objectivity, there wasn't independence exercised by accounting firms that come under your supervision?

Mr. DOTY. I don't think the failures in audit, whatever they may have been, have been fully explored, documented, and pinned down.

I would have to say that if you are asking do we have a clear electronic connection between some failure of independence and objectivity, and an obvious audit flow that led to the collapse of a major financial institution, I would say no, Congressman, we don't have that.

We don't have that.

What we do have, as I have said before, is a pattern that goes back beyond the—2008 in which inspectors do find failures of skep-

ticism and failure to perform necessary procedures, and perform a good audit under circumstances that suggest that they may be less than objective or less than independent.

Mr. PERLMUTTER. Well—

Mr. DOTY. So it is much more difficult—

Mr. PERLMUTTER. I see where Mr. Fitzpatrick is coming from. And you and I have had a chance to talk about this.

You don't want to have a cozy relationship between somebody, whether it is the regulator and the regulated company, or the auditor and the company. But auditors and accountants also need to know how the business is put together.

You are sort of—on the one hand, if you are always switching out auditors, they always have to learn about the company. And that doesn't make a lot of sense to me.

But there is this need for independence and not coziness, if you will. And so, I appreciate Mr. Fitzpatrick's questions, the cost/benefit analysis.

I don't know if you—the cost you use is \$25,000 per person in this country which was potentially lost between the summer of 2008 and the spring of 2009, or what the right cost/benefit analysis might be.

I will—just as I was sitting up here, maybe you rotate partners within the company if you are worried about having a new set of eyes. Obviously, you have thought about all of these things.

And so, I appreciate your concern. This rotation of auditing firms, I think, is probably too much, just from my point of view.

But I understand the value; you are trying to make sure there is independence and objectivity.

Now, the question about this principles-based versus sort of statutory or rules-based, when—let me step back and ask a more specific question.

With Madoff, using some kind of an accountant to hold the monies of the customers, does anybody disagree that if a broker-dealer or an investment advisor is holding somebody's funds, they ought to have a CPA or some kind of an independent accounting firm checking on the books of the investment advisor or the broker-dealer?

Mr. KROEKER. I agree they should.

Mr. DOTY. I concur.

Mr. PERLMUTTER. Because we want to make sure there is independence there as well. And—

Mr. DOTY. And independence was a problem of course in the Madoff case. It was an affiliated auditor.

Mr. PERLMUTTER. Okay.

I was thinking that whenever you all come and speak to us, it is a pretty dry subject. But then you start really digging into the weeds which is your responsibility when you look at the books and records of your businesses and the people.

If you don't take a good look, we can end up with lots of trouble.

So I just—you have been taking a little bit of heat from us up here. But we appreciate your service. And we obviously support the accounting industry in making sure that their customers, who they are reviewing, have good books so that the investors are protected.

So thank you, I yield back.

Mr. FITZPATRICK [presiding]. The Chair recognizes Mr. Renacci from Ohio for 5 minutes.

Mr. RENACCI. Thank you, Mr. Chairman.

Again, I want to thank all the witnesses for being here.

Mr. Attmore, Section 978 of Dodd-Frank established a permanent source of funding for the Government Accounting Standards Board by authorizing the SEC to require the financial industry's regulatory authority, FINRA, to collect these fees from its members.

If GASB had not received this Dodd-Frank funding source, would the future of GASB be comprised?

I figured I would bring you into the questioning.

[At this point in the hearing, there were some technical difficulties in the hearing room.]

Mr. ATMORE. [audio malfunction.]

Mr. RENACCI. So you are saying Section 978 has been successful for you?

Mr. ATMORE. [audio malfunction.]

Mr. RENACCI. Okay.

Mr. Kroeker in a written statement, you mentioned several SEC staff papers written in relation to the IFRS and its incorporation to U.S. GAAP.

One of these papers mentioned that diversity and application of IFRS presented challenges to the comparability of financial statements across countries.

How do you—how does the FASB and the ISAB plan to overcome these challenges in incorporating the IFRS into U.S. GAAP?

Mr. KROEKER. Part of the work that we are doing is really to inform the Commission as to whether to make a decision to incorporate. And so understanding the level of diversity in IFRS is important to that decision.

So no decision has been made as of yet.

But there are suggestions as we moved along that would say if there is an unacceptable level of diversity under IFRS, it really illustrates the need for a continuing strong role domestically for the Financial Accounting Standards Board (FASB), to assist both with identification of diversity, but then providing application guidance if needed if an incorporation decision was made, and sufficient guidance wasn't being provided internationally.

Mr. RENACCI. How will the convergence of international financial standards benefit the U.S. economy?

Mr. KROEKER. I think—first and foremost, it could benefit investors in making allocation decisions of their capital consistently across companies and across jurisdictions.

From a company's standpoint, that has a benefit to them because their competitors would then have consistent reporting that they do. For multinational corporations in the United States, we have heard from many of those that it would assist in a standard set of bookkeeping for them around the world.

But we have also heard plenty of challenges for those who aren't competing internationally for capital.

Mr. RENACCI. So do you think it will make capital markets more attractive to foreign issuers?

Mr. KROEKER. I haven't reached a conclusion on that yet.

Mr. RENACCI. Okay.

Ms. Seidman, what are your thoughts on if the FASB and the IASB also agree to one set of accounting standards? What happens if companies decide that they do not want to use IFRS?

And which accounting standards will they use?

Ms. SEIDMAN. The approach we have been taking so far is to work jointly on projects with the IASB that we would have concluded needed improvement in the United States anyway.

So in other words, the approach we are taking is to make improvements to U.S. GAAP that are consistent with the improvements that are being made by the International Accounting Standards Board.

So they are following U.S. GAAP. It just happens to be consistent with IFRS.

I think the big question is, how much further do we want to take this?

In other words, there are many, many pieces of U.S. GAAP that are not consistent with IFRS. And so, are we going to continue to do this or not?

That is really the crux of the matter that the SEC is looking at, and with very much of a cost/benefit perspective in mind.

Mr. RENACCI. So I know I am running out of time here.

But do you think U.S. GAAP will remain a valid set of accounting pronouncements?

Ms. SEIDMAN. Yes. We completely accept our responsibility to make sure that the standards that we set will continue to fulfill our mission, which is to make sure that investors have credible, complete, and transparent information regardless of what we are ultimately going to call it.

Mr. RENACCI. All right, thank you.

I yield back.

Mr. FITZPATRICK. At this point, I am going to ask unanimous consent to make three written statements a part of the record: one from the Mutual Fund Directors Forum dated March 28th; one from the Investment Company Institute dated March 28th; and one from the Property Casualty Insurers Association of America dated March 27th.

Without objection, they are a part of the record.

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.

So with that, this panel is dismissed with our appreciation for your time.

And we will ask that the second panel take their positions at the hearing table.

The second panel of this subcommittee hearing includes: Mr. Joseph Carcello, professor, department of accounting and information management at the University of Tennessee; Mr. Gary Karbureck, vice president and chief accounting officer at Xerox Corporation, on behalf of the Financial Executives International; Mr. Barry Melancon, president and chief executive officer of the American In-

stitute of CPAs; and Mr. Tom Quaadman, vice president, Center for Capital Markets Competitiveness at the United States Chamber of Commerce.

Your written statements, gentlemen, will be made a part of the record, and you will each be recognized for 5 minutes for an oral summary of your testimony, beginning with Mr. Joseph Carcello.

Sir?

**STATEMENT OF JOSEPH V. CARCELLO, PH.D., CPA, CMA, CIA, ERNST & YOUNG AND BUSINESS ALUMNI PROFESSOR; AND DIRECTOR OF RESEARCH—CORPORATE GOVERNANCE CENTER, THE UNIVERSITY OF TENNESSEE, KNOXVILLE**

Mr. CARCELLO. Congressman Fitzpatrick, Ranking Member Waters, and members of the subcommittee, thank you for giving me the opportunity to speak with you today about accounting and auditing oversight.

I have served as a professor at the University of Tennessee for approximately 20 years where I teach accounting, auditing, and corporate governance.

My remarks are also informed by my service on the PCAOB's investor advisory and standing advisory groups, both of which are outside advisory groups to the Board.

I will focus my remarks today on auditing oversight, particularly on three issues of concern to investors: internal control over financial reporting; public versus private nature of PCAOB enforcement proceedings; and audit firm rotation.

The Dodd-Frank Wall Street Reform and Consumer Protection Act exempts public companies with a market capitalization of less than \$75 million from Section 404(b) of the Sarbanes-Oxley Act. In addition, the Dodd-Frank Act requires the SEC to study whether to extend the exemption from compliance with Section 404(b) to issuers with a market capitalization below \$250 million.

I believe that expanding the number of public companies that are exempt from auditor reporting on internal control would ill-serve investors in the capital markets.

Over the last 5 years, a large body of empirical research has emerged that establishes the importance of effective internal controls and the benefits of auditor reporting on internal control.

The most compelling evidence on the value of auditor reporting on internal controls comes from a study by Bedard and Graham 2011. Bedard and Graham examine issuers with revenues of \$1 billion or less.

They find that one, auditors, rather than management, detect approximately 75 percent of the unremediated internal control deficiencies. As Bedard and Graham point out, "Importantly, this low level of client detection occurs when clients are aware that auditors will soon follow with their own tests."

Two, when managers detect the internal control deficiency, they tend to classify the deficiency as less severe, but auditors frequently override those classifications.

Three, a significant percentage of the internal control deficiencies in the control environment component and related to the revenue account are detected by auditor control testing. This is germane because fraud is often associated with control environment weak-



nesses and revenue is the account most typically misstated when fraud occurs.

Let me move on to public versus private nature of PCAOB enforcement proceedings.

I understand that Representative Lynn Westmoreland has introduced H.R. 3503, which would amend SOX to make PCAOB disciplinary proceedings public. I favor such legislation.

The most compelling argument for making PCAOB disciplinary proceedings public is that the nature of these proceedings is private if brought by the PCAOB, but public if brought by the SEC, even though the PCAOB is closely supervised by the SEC.

As former PCAOB Acting Chairman Dan Goelzer stated in his August 24, 2010, letter to Congressmen Frank and Bachus, "If the SEC were to bring the same case as the PCAOB, alleging the same violations, against the same auditor, the SEC's charges would be disclosed at the time the Commission instituted its proceeding. Any administrative trial would be open to the public."

Finally, on audit firm rotation, the PCAOB has outstanding a concept release on auditor independence and audit firm rotation. I understand that Representative Fitzpatrick is considering draft legislation that would prohibit the PCAOB from mandating audit firm rotation.

It is important to understand that the Board's release on this topic emanates from a concern that auditors currently exhibit an inadequate level of professional skepticism.

Without professional skepticism, audits are of little value.

I believe that there is sufficient evidence to legitimately question whether auditors are sufficiently skeptical.

The PCAOB's inspection process has found that at least one of the largest accounting firms uses the following language in a recent proposal to a prospective client: "Your auditor should be a partner in supporting and helping the company achieve its goals."

In addition, the PCAOB's inspection process continues to identify a sizable number of audit deficiencies. And these deficiencies are often related to inadequate profession skepticism.

Given that the PCAOB's mission is to protect the interest of investors and further the public interest in the preparation of informative and independent audit reports, exploring this issue is not only appropriate, not only is it within the clear mission of the Board as articulated by Congress, it is arguably the very mission of the Board and the reason the Board exists.

Thank you.

[The prepared statement of Professor Carcello can be found on page 79 of the appendix.]

Mr. FITZPATRICK. Thank you.

Mr. Kabureck from Xerox?

**STATEMENT OF GARY R. KABURECK, VICE PRESIDENT AND CHIEF ACCOUNTING OFFICER, XEROX CORPORATION, ON BEHALF OF FINANCIAL EXECUTIVES INTERNATIONAL (FEI)**

Mr. KABURECK. Thank you, Congressman Fitzpatrick, Ranking Member Waters, and members of the subcommittee for inviting me here today.

I am Gary Kabureck, chief accounting officer of Xerox Corporation. And today, I am representing the Financial Executives International (FEI), a leading international organization of senior financial executives.

I would like to discuss three items today of interest to our members: the PCAOB project exploring the merits of mandatory audit rotation; complexity in accounting standards; and, time permitting, to provide some perspectives in the concept of principles-based accounting.

Beginning with the subject of mandatory auditor rotation, the FEI has always supported the critical need for auditor independence and impartiality. There is no guarantee or evidence that mandatory rotation will increase auditor independence. However, it is clear that mandatory rotation will be costly and operationally disruptive.

There are many reasons financial statement preparers oppose a requirement to periodically rotate the company's auditors. My comments today will focus on practical operational implications and costs.

For the largest multinational corporations, realistically only the big four firms have the resources to effectively perform the audit.

I am on both sides of the table replacing auditors, and I can attest the process for selecting a new auditor in transitioning a new auditor will be lengthy and extremely costly for both the company and the new auditor.

It requires a significant amount of incremental time of company personnel at all levels to break in new auditors. And it is usually at least 3 years before the audit effort achieves the steady workflow state.

Company time and money are finite. Every hour and dollar spent on changing auditors is not available for the uses in the business or for return to investors.

Additionally, many multinationals have non-audit relationships, for example, consulting with one or more of the big four firms, which would need to be curtailed if such firm was to be the new auditor.

This leads to additional business disruption, to replace the firm in its non-audit capacity. Alternatively, companies may decide to never retain the big four firms to provide non-audit services, as one day that firm may need to become the new auditor.

Beyond the audit, this notion has consequences for the entire consulting industry.

The big four firms are not necessarily fungible as they vary in industry concentrations and expertise, geographic presence, and international reach, which potentially further limits the pool of selection of new auditors.

Many capital markets and merger and acquisition transactions extend over several periods. And under mandatory auditor rotation, there will be instances when one auditor is present at the beginning of the transaction and a different auditor is present at the end.

I can assure you this creates its own set of unique issues.

In summary, mandatory rotation is a draconian step and it is critical to keep in mind the actual project goals, which is to find

ways in which auditor independence, skepticism, and objectivity can be enhanced.

My second subject, complexity in accounting standards, is a significant issue for preparers of financial statements and their auditors.

Of course, some complexity is unavoidable and appropriate, but some can and should be avoided.

Unnecessarily complex accounting and disclosure requirements result in significant operating costs to financial statement preparers. It increases the risks of errors, mature weaknesses in these statements.

The FEI recommends that to the extent possible, new accounting standards should result in financial statements that reflect the company's business model.

We also believe the cost of implementation and compliance should receive greater prominence in the FASB's decision process.

The FEI does wish to recognize Chairman Seidman's efforts during the last 2 years she has chaired the FASB. In an effort to test the operational viability of potential new standards, the FASB has been conducting greater than ever outreach both in frequency and in visibility to its various constituencies.

Obviously, we encourage this path in the future.

One of the potential solutions, or at least partial solutions to complexity is my last subject: the call for great focus on principles-based accounting standards.

The FEI has long been a strong proponent of principles-based accounting and encourages the accounting standards setters to promulgate new standards with more emphasis on principles and less on detailed rules.

We have noticed the recent change by the FASB in this direction. But do note that old habits, for example the drafting of very detailed rules, are hard to break. And there remain many accounting standards on the books that include extensively detailed rules.

However, the effective principles-based accounting standards will require the acceptance of good faith application of judgment by all constituencies in the accounting, regulatory, audit, and user communities, and recognition that there may be slightly less comparability between companies in the future as local judgments may be different.

Thank you for your time today. And will be pleased to answer any questions.

[The prepared statement of Mr. Kabureck can be found on page 110 of the appendix.]

Mr. FITZPATRICK. Thank you, Mr. Kabureck.

Next, Mr. Melancon from the American Institute of CPAs.

**STATEMENT OF BARRY C. MELANCON, CPA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)**

Mr. MELANCON. Thank you, and good afternoon, Congressman Fitzpatrick, Ranking Member Waters, and members of the subcommittee. Thank you for having me today.

My name is Barry Melancon. I am a CPA, and president and CEO of the American Institute of Certified Public Accountants (AICPA).

I am pleased to be here to testify before you today about the profession's commitment to the public interests, its role in the global economy and capital markets, and the important services CPAs provide to U.S. businesses of all sizes.

The AICPA was established 125 years ago by the accounting profession to serve the public interests by fostering independence, objectivity, confidence, and the highest possible level of professionalism and ethical behavior.

To further that mission, we have identified five strategic initiatives geared toward the continuing improvement of our profession.

The first strategic initiative is attracting and retaining the best and the brightest people into the profession. The CPA profession recognizes that its principal asset is human capital. And the AICPA is making significant investments in ensuring that a vibrant and highly qualified number of professionals are attracted to the profession, and see the profession as a rewarding career.

The second initiative is ensuring the ongoing competency of the best and brightest in their respective roles. Many bodies are critical to the assurance—to assure the accuracy, transparency, and quality of financial reporting, including the AICPA, corporations, boards of directors, independent audit committees, CPA firms, and the regulatory community. The AICPA works to provide the ethical framework, training, and guidance that the CPAs as management and as auditors need to get it right.

Third, the AICPA promotes independent relevant financial reporting, auditing, and ethical standards. Standards of practice developed free of any special interests influences, but with input from all relevant stakeholders, are critical to the production of information that is meaningful to investors and other users of that information. The AICPA supports the ongoing independence of FASB and its activities to develop financial reporting standards for public companies.

More broadly, we support the development of one set of high quality global financial reporting standards. And we believe that international financial reporting standards, or IFRS, are best positioned to ultimately be that set of standards.

The fourth strategic initiative is developing and implementing innovative solutions to the increasingly complex issues and business environment that CPAs navigate skillfully. Accounting and auditing solutions need to keep pace with business activities in order to maximize the ability of the profession to perform at the highest levels and to keep abreast of complex global business transactions.

Nonfinancial information is becoming an increasingly integral tool to assess current and future business performance. Fraud detection and prevention will remain critical factors for both the financial statement preparer and auditor. Internal controls over financial and non-financial reporting are becoming much more important as well. And of course, technology solutions are critical.

The fifth strategic initiative is supporting robust but balanced regulation. The AICPA believes in a strong and balanced regulatory structure that protects the public but does not detract or

negatively impact quality reporting and auditing, and does not restrict the effective and efficient flow of capital.

The PCAOB is engaged in a number of projects which we support, including its concept release on auditors reporting model. There are two other projects about which we have some concerns.

Last August, the PCAOB issued a concept release on audit firm rotation. Sarbanes-Oxley delegated responsibility for overseeing the hiring and firing of external auditors to independent audit committees. We believe in the audit committee's authority and support strengthening its role, not undermining it.

If the PCAOB's release becomes a rule, it would present a clear example of unbalanced regulation by imposing significant strains on public companies and the audit profession, with little evidence that Sarbanes-Oxley is not working.

Last October, the PCAOB issued a proposed rule on improving the transparency of the audit which would require identification of the audit partner and certain other participants in the audit report. We have questioned whether the identification of this specific engagement partner in that report would improve audit quality and auditor accountability, and we have suggested an alternative that provides a more balanced approach. We appreciate the PCAOB's willingness to consider our suggestions.

I also want to note two recent rulemakings that we believe overlook the appropriate balance between regulation that protects the public, and regulation that overly burdens businesses and their auditors.

The first relates to audits of introducing broker-dealers and the inclusion in the PCAOB's interim inspection program. And the second relates to audits of pooled investment vehicles, which results in effectively excluding certain CPA firms from providing audit services.

We believe that regulations and the resources to implement those regulations should focus on where there is the greatest risk to the investing public.

Let me conclude my remarks by emphasizing that CPAs in all areas of the accounting profession, along with the AICPA, join you as we seek to advance a common mission of promoting the highest quality accounting and auditing services that are valuable to the public interest, and to the global capital market.

Thank you for the opportunity to present this testimony. And I would be pleased to answer your questions.

[The prepared statement of Mr. Melancon can be found on page 144 of the appendix.]

Mr. FITZPATRICK. Thank you.

The final witness is Mr. Quaadman from the U.S. Chamber of Commerce.

**STATEMENT OF TOM QUAADMAN, VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE**

Mr. QUAADMAN. Thank you, Representative Fitzpatrick and Ranking Member Waters.

I am Tom Quaadman with the U.S. Chamber of Commerce. And I think this hearing is appropriate the day after Congress passed the Jobs Act. The Jobs Act obviously was to spur IPOs.

But we also feel at the Chamber, that there is a significant outflow of public companies from the public marketplace itself, which is something that Congress should address. And we think this hearing is an important first step to do that.

Businesses need to have strong, clear, concise financial reports that accurately reflect economic activity.

Strong financial reports allow businesses to go out into the marketplace and raise capital. They allow them to identify counterparties for transactions, as well as determining what the needs and capabilities of the company are.

Standard setting is at the very head of that financial reporting process. Standard setting needs to be balanced and needs to have integrity. And the products that come out of the standard-setting process itself need to be done through thoughtful deliberation—masquerades as financial reporting will in fact drive investors and businesses out of the public marketplace.

FASB, we believe years ago, had a problem with the standard-setting process that was unbalanced, was not receiving the appropriate input. That fair value accounting was actually a symptom of that problem.

However, under the leadership of Jack Brennan with the Financial Accounting Foundation, and with Leslie Seidman of FASB, we think they have developed strong lines of communication that have allowed for the convergence projects to move forward in a very thoughtful way.

The PCAOB, in our view, does have a very, very important role in the financial reporting process. However, currently we believe that they are misguided in their priorities and that they are actually engaged in mission creep.

Sarbanes-Oxley was very clear in delineating lines of demarcation that corporate governance would reside either with State corporate law or with the SEC. The PCAOB was given jurisdiction over the regulation of auditing itself.

In a series of concept releases and proposals that the PCAOB is currently looking at, they are crossing the threshold into corporate governance. Those include: the concept release on auditor independence which has rotation; audit committee communications; revisions to the audited financial statements; and apparently coming soon, the need for auditors to review and pass judgment on executive compensation.

The reason why rotation is such an important issue—and I think why there has been such important discussion on it today, this as proxy access in its own way, has been around for decades.

Yet there has been universal opposition to rotation.

Congress, in debating Sarbanes-Oxley, specifically declined to include rotation. The GAO in looking at the issue twice decided that rotation was not appropriate and that it would increase costs.

The majority of investors who have commented on the concept release have opposed rotation. All the businesses that have commented on the concept release have opposed rotation. And there are academic studies that oppose it as well.

But in the justifications we have heard about the need to consider rotation, the PCAOB has failed to provide any inspection evidence as to why this should be considered.

Furthermore, the concept release and the statements, including this morning by Chairman Doty, have said that audit quality standards today are better than they were 10 years ago.

So the question is, what is the need? The more fundamental question is, why is it the role of the government to tell a business what vendors they should or should not use.

We think not. We think that the draft bill that you have put forward, Mr. Fitzpatrick, actually delineates the lines that Sarbanes-Oxley stated.

We have a 12-point plan, outlined in our testimony, that has a number of provisions we think would improve reporting, including Chairman Garrett's SEC accountability bill, that would have FASB and the PCAOB have to abide by the Administrative Procedures Act as well as any advisory groups through FACA.

They will in fact allow—force the arbiters of transparency to be transparent. We think that the PCAOB should have a business advisory group.

And finally, Congressman Miller had an amendment in the Financial Regulator Reform bill to create a financial reporting forum that would have allowed the regulators—FASB, the PCAOB, investors, and businesses—to get together on a periodic basis to identify problems in financial reporting as well as to prioritize appropriate projects.

We think that these are all issues that Congress should look at. And I look forward to taking any questions.

[The prepared statement of Mr. Quaadman can be found on page 158 of the appendix.]

Mr. FITZPATRICK. Thank you. Thank you, Mr. Quaadman.

I want to follow up on your testimony in connection with what you referred to as “mission creep” within the Board.

As we all know now, the PCAOB has this concept release mandate auditing firm rotation. Yet, I believe they also acknowledge that audit quality has increased post Sarbanes-Oxley. So it has gotten better.

In addition, this concept release also states that there is no data from PCAOB's inspections that were shown to demonstrate the need for firm rotation, and also that the GAO studies have estimated that rotation—GAO says that it will cost 20 percent.

Some say more.

Why do you believe that the PCAOB is continuing to expend resources on this concept release at this point?

Mr. QUAADMAN. Part of the justification we have heard is that this is being considered internationally and there has been discussion about that today.

A couple of points on that. One is the Netherlands is about the size of New Jersey.

The E.U.—and there has been discussion about auditor rotation or changes to the audit model, they say we need to move forward on this because the United States is considering this.

And if you actually look at China, in China they are talking about rotation. But they are talking about it in a way that you

would actually force Chinese companies after a period of time to rotate out of global firms into Chinese-only firms. And that might be a problem because it could actually be protectionist in measure.

What is also troubling, I think, as well was that Chairman Doty has stated to the press that “This is an issue we will be working on a year from now.”

If you look at the state of audit standards today, most audit standards today predate Sarbanes-Oxley.

So why is the PCAOB engaged in this process using these resources where there is no justification for moving forward or for the consideration when there are other more important issues that they should be working on?

Mr. FITZPATRICK. What are some of those issues in your—

Mr. QUAADMAN. As I said, reviewing audit standards is one.

The SEC 5 years ago, in 2008, before the financial crisis, had an advisory committee that actually issued a number of different proposals on how to reduce financial restatements, including the use of materiality for investors.

That has sat on the shelf. And I think it is a question Congress should ask the chairman: why aren't they moving forward on the ability to reduce restatements?

Mr. FITZPATRICK. Mr. Kabureck what are some of the operational challenges that companies would face if mandated to rotate their firms such as being proposed?

Mr. KABURECK. I can think of several in the time I have. Let me talk in the context.

Most multinational companies probably would have independence issues with three of the big four firms.

In my company, we would. We have outsourced internal audit. Another firm does work that will be constituted tax law. Still another does joint go-to-market services for us.

So if you had to—as a big four—we would need a big four firm. If we had to go to one of the other big four, is—they would—the independence issue that they would have would have to be remedied.

So for example, take an internal audit. We would have to bring it back in-house, which would encompass finding new people who are willing and qualified to do auditing. Or you would have to move it to still another firm. You lose the institutional knowledge that that outsourced internal auditor has.

And then you don't want to have a break in internal audit while you are transitioning from the old firm until you have the new arrangement. That would not be a good thing either.

So I could go on and on. But basically, this example is that the services that these vendors are providing would have to stop. There are at least nine enumerated prohibited services that exist today.

And the major corporations use the other big three firms that sent their auditor for them regularly.

Mr. FITZPATRICK. So you are suggesting that if your corporation were required to switch auditing firms that you may be limited to only one to go too?

Mr. KABURECK. You would—at the moment, there would be independence issues with all three. Some task would have to stop by one or the others.



And you could—I used the internal audit as an example because it—but the law—but the big four firm that does some international tax work for us that would be more—can—would—here would be considered practicing tax law, that would have to stop. And they are doing a very good job if it over there.

So you are going to have to replace your tax attorney abroad. And so it is a—something else changes besides just the auditor.

Mr. FITZPATRICK. Mr. Melancon, you had talked briefly about the importance of these firms being able, and the companies being able, to attract quality auditors.

Given what Mr. Kabureck just indicated, you are now limited to perhaps one company to transfer to. What does that do to the sort of migration of auditors between company and auditors and different auditing firms?

Mr. MELANCON. The human capital issue is real.

One of the things in all this discussion about auditor rotation that wasn't brought up today, that I think is very important, it goes to your point, Congressman, is that Sarbanes-Oxley actually in—passed—part of its law required the lead partner and the concurring partner to rotate every 5 years, which was addressing the issue of that different look.

But at the same time, not going to the point that Gary mentioned which was related to the audit firm rotation itself.

And we tend to sort of bypass that. But even that provision requires huge human capital aspects within a firm because of the difficulties of those particular issues.

If you go to a much greater extent, there will be disruption, serious disruption within the firms as well as within the corporations as he just mentioned.

Mr. FITZPATRICK. Mr. Kabureck, this question of audit committees within public companies, my understanding of those audit—the committees are independent. They have a job to do. Their job is to understand the importance of the audit. How it occurs. How many individuals are there day-to-day within the company?

And that is an appropriate role in a public company for that audit committee.

What essentially is being proposed is that the Federal Government through one of its agencies' Boards is now going to sort of reach into—not just mandate audit firm rotation, but essentially usurp the proper role of an audit committee within a public company.

Can you expand on that?

Mr. KABURECK. Certainly. As I understand it, the PCAOB proposal, if it was to become the requirement, to mandatory rotate audit firms, it absolutely is usurping a Board governance, more specifically audit committee governance responsibility.

Going towards local solutions to local issues would seem to me, and I think to my colleagues in FEI, is that companies, boards of directors, more specifically their audit committees, their best position is to understand when is the right time, if ever, to reconsider changing auditors and to challenge the auditors, even just to rebid it just to get fees down.

But it would seem to me that every company situation is different. Every audit situation is different. So the FEI believes that is best left to companies and their boards of directors.

Mr. FITZPATRICK. I now recognize the ranking member, Ms. Waters, for 5 minutes.

Ms. WATERS. Thank you very much.

I would like to thank all of our witnesses for being here today.

I have to say that I am a little bit concerned about the tremendous opposition to the rotation concept.

We have just gone through a subprime meltdown that basically almost destroyed our economy. And we have found that there were many individuals, agencies, organizations that played a role in the demise almost of our housing market, which negatively impacted our entire economy.

And yet this very, very strong opposition to rotation just seems as if there is not a lot of understanding about auditing, rating agencies, etc., etc.

I want to go back to our first witness here, and ask about—under Sarbanes-Oxley's Sections 302 and 906, CEOs and CFOs must sign certification attesting to the internal controls of the corporation they are recording every year in.

If as a CEO, or if a CEO or CFO attests that those certifications are accurate, and if they are not, they could face civil and criminal penalties. Have these certifications been effective in improving the quality of financial reporting?

Could you help me with this, Mr. Carcello?

Mr. CARCELLO. Yes, as you point out, Representative Waters, under Sections 302 and 906, the CEO and the CFO have to certify as to the accuracy of the financial statements.

There has been both anecdotal and empirical research. We have talked earlier today about costs and benefits.

I would refer this committee to numerous studies that have documented the benefits associated with that certification. So it does seem to have helped.

I believe, although we haven't talked extensively about this today, one of the reasons that the PCAOB has proposed a requirement for the audit partner to be identified in the audit report is if those certifications have provided benefits on the part of preparers, public identification of the audit partner may provide comparable benefits on the audit side of the house.

Mr. Kabureck, do you agree?

Mr. KABURECK. With respect to the 302 and 906 certifications, I think they have increased the quality of and the liability of financial reporting.

I am also a signing officer for quarterly and annual filings.

The CEO and CFO rely upon internal processes, which I lead, to give them comfort and assurance that the statements that we are releasing comply with GAAP and the relevant laws and so on.

So I think 302 and 906 certifications have been an improvement from the pre-Sarbanes-Oxley practices.

Ms. WATERS. What you are saying suggests that audit partners should be required to sign off on the audit reports they issue as proposed by PCAOB, and as is the case in the E.U, Australia, Korea, and other countries?

Mr. KABURECK. No, if the question is directed to me, and I don't know if FEI has a position on it. I personally support the audit partners name being disclosed and associated with the audit, either by signature or by in the text in the 10-K.

Ms. WATERS. Let me turn to the U.S. Chamber of Commerce.

I have been reading some news reports that basically talk about a clash between you and—as they refer to it, our top watchdog. You have been very, very vocal. As a matter of fact, you have demanded that Mr. Doty back up from this idea of rotation.

Why are you so adamant that rotation is the wrong way to go, and that the concept should not even be considered?

Mr. QUAADMAN. Sure. Thank you for the question.

As you know, we can't control what reporters write. But we strongly believe in the internal controls in Sarbanes-Oxley. We strongly believe in independent audit committees. And actually, rotation has been considered over decades and been rejected.

Our concern is that rotation is going to neuter independent audit committees. And in fact, that there are other things that the PCAOB could be working on.

Ms. WATERS. You mentioned cost. And I think cost was mentioned several times.

What do you mean? And what is the difference?

And how much increase in cost do you anticipate that rotation would cost?

Mr. QUAADMAN. I think there are costs that—in a couple of ways.

First off, in any rulemaking that a Federal agency does, they have to engage in a cost/benefit analysis. In fact, the President's Executive Order last year on regulatory reform enhanced what should be the economic analysis scrutiny that agencies should engage in.

We think that both FASB and PCAOB should do that. Because one, you have to identify problems, and two, you have to try and look at alternative solutions, and what the costs and benefits to those may be.

FASB and PCAOB do not provide a public cost/benefit analysis as does the SEC.

I think the proxy access decision from last year was very instructive in that. And furthermore, what the court also talked about there is that if a regulator has a predetermined outcome in mind when they begin a process, that is something that the court is going to strike down.

So if you have an agency such as the PCAOB, despite the fact that 92 percent of the comment letters oppose the concept release saying we are going to be working on this issue a year from now, we really have to wonder if they have crossed the line of having a preconceived outcome in mind.

Ms. WATERS. I am way past my time. And I thank you very much, Mr. Chairman.

By the way, proxy access was my addition to Dodd-Frank.

Mr. QUAADMAN. I am very much aware of that.

Mr. FITZPATRICK. I recognize Mr. Campbell for 5 minutes.

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

I know there is lots of talk about firm rotation. And I have feelings on that too.

But I am going to go back to the line of questioning that I had earlier, with the earlier panel. And I don't know if you were all here.

I want to try and elicit perhaps a little more specific responses from you all, who I think maybe have a little more flexibility to do so.

Let me tell you what I think. And you tell me if you think I am full of garbage or you agree with some of it or not, or whatever.

But what I think is that IFRS is a good thing. From a harmonization standpoint, we need to go in that direction.

I think principles-based accounting is a good thing. And that we ought to move in that direction.

But under our current litigation system, if we do that, we won't have a big four accounting firms. We may not have a big one accounting firm, because it is too easy in a principles-based system to second-guess a judgment call that turns out to be wrong at the time perhaps it was made.

And that we need some now—people shouldn't go without punishment for making bad—for making mistakes.

But that we need some kind of system that allows us to use—make more judgment calls, have harmonization with world accounting principles, have a much better system of accounting statement. But not basically be setting up the situation where we have a big one which is not going to enable us to meet Sarbanes-Oxley, or Dodd-Frank, or any of the other requirements that have been passed by this Congress over the past decade.

Somebody talk to me.

Mr. Melancon?

Mr. MELANCON. Thank you, Congressman.

I think that first off, your line of reasoning is very sound. We would agree with you that the IFRS is the ultimate end game here. And that getting to a global set of standards that are used around the world from accounting is a good thing for investors worldwide, and U.S. investors who are investing in foreign companies as well.

The premise of your discussion is really about principles-based versus rules-based. And we see in America, obviously in many instances outside of the—accounting, issues of significant rules because of the environments that you are in today.

And what we have said is that to move to IFRS, it requires the entire system to move. It requires for instance where you use professional judgment, there has to be reasonable protection that this thought of 20–20 hindsight or second-guessing reflects the professionalism that people bring to that particular standpoint.

I think it applies to companies. I think it applies to auditors. And I think it applies to audit committees and everyone else in that particular process.

It is very important that when people use and deploy reasonable, rational, professional approaches, and come to a reasonable answer, that the system does not allow that to be second-guessed with the emergence of facts 2, 3, 5, 8, or 10 years later that would say, you did wrong in that particular circumstance

Because it is only natural then if that is the case, the people in that system will say, then give me rules to comply with. And I think that is what has driven where we are today.

Mr. CAMPBELL. Dr. Carcello, I think you were the next most anxious.

And then we will get to you—

Mr. CARCELLO. Thank you, Congressman.

In terms of a principles-based system, and your argument for that, reasonable people can disagree. But let us take your premise as a given.

In order to get better accounting, the role of auditors will become even more important, because management will be given more judgment.

But others here seem to oppose efforts to improve auditor independence and skepticism, whether rotation is the answer or not, that is a different question.

But there is a legitimate concern, as expressed by virtually everyone who testified last week, if you go read the statements, as it relates to auditor independence and skepticism. In my opinion, those positions are not consistent.

In terms of litigation reform, I would point out for the benefit of the Members here, let us not forget that in 1995, this Congress passed a Private Securities Litigation Reform Act. Let us not forget that in—

Mr. CAMPBELL. Authored by my predecessor, Christopher Cox.

Mr. CARCELLO. Yes. That is right.

In 1998, this Congress passed the Securities Litigation Uniform Standards Act to prevent an end run around Federal jurisdiction by going to the States.

And let us not also forget that in the last 15 years, there has been a series of Supreme Court decisions that have substantially weakened the ability of third parties to sue outside parties, starting with the Central Bank of Denver, the Stoneridge, to Morrison to Janus.

Mr. CAMPBELL. Okay. I want to make sure that Mr. Quaadman has a chance.

Mr. QUAADMAN. No, Mr. Campbell, I think you have really sort of highlighted what the third rail is with IFRS.

We support IFRS. We support a global system. We have raised the same issues with the SEC about the stresses of the litigation system here in the United States.

I think that is quite frankly one of the reasons why the SEC, and Jim Kroeker in particular, are taking the time that they are to try and get there because they also recognize the same issue.

I also want to agree with you as well that a principles-based system is the right way to go.

And just one small example with the convergence projects, where we have had a very sharp difference of opinion, is actually on lease accounting. And one of the areas where we have a very sharp difference of opinion is this notion that you have to frontload all the expenses, which doesn't seem to make sense.

Yet, that has a direct impact on the bottom line for companies.

So we think that a principles-based system will allow for adjustments that won't have such harmful consequences.

Mr. CAMPBELL. Okay, thank you. And my time is up.

I will just say on that that I—a lot of these rules-based systems, I have looked at—and not taking anything away from the FASB. They are doing what they have to do under the circumstances.

But I can put together scenarios under which the outcome is completely wrong. And everybody understands it is completely wrong, because you can't make a rules-based system that covers all potential scenarios.

But yet that is what we are doing. And it is—and I—many of these pronouncements I have to agree, I look at them and go, this is just wrong.

They—certain things you—if it looks like a duck, quacks like a duck, and acts like a duck, it is a duck. And if it doesn't, it is not.

And at some point we need to go back to that system.

I appreciate your indulgence, Mr. Chairman.

Mr. FITZPATRICK. I recognize Mr. Sherman for 5 minutes.

Mr. SHERMAN. Thank you.

Mr. Melancon, the Public Company Accounting Oversight Board has urged us to amend Sarbanes-Oxley to make PCAOB disciplinary proceedings public unless the Board orders otherwise.

Currently, those proceedings are not public until and unless the PCAOB decides to refer the case to the SEC for criminal prosecution.

What do you think of the Public Company Accounting Oversight Board's proposal to amend Sarbanes-Oxley?

Mr. MELANCON. Congressman, being a CPA, you know all CPAs would be in favor of making sure the highest quality is there. And certainly dealing with people who have performed inadequately is a part of that process.

However, Sarbanes-Oxley built a system that addresses actually the two aspects that are most important here: the ability to address bad actors; but also the ability for the professional's reputation to be protected through a reasonable process in which their professional judgment—to Congressman Campbell's previous question—can be aired out in that particular process.

And that is the reason for that first layer of confidentiality with the PCAOB. The PCAOB is not a government agency. And as a result, it has certain exemptions from other activities that other government agencies must abide by, which includes Sunshine and Administrative Procedures Act and the like.

And so what the system actually provides is that you have a mechanism with the PCAOB in which you have, yes, a confidential process for a while.

And an ability at any time, not just at the end of the process, but at any time that the PCAOB if they believe there is an egregious situation, where the public is at risk, or if someone, quite frankly, is gaming the system, that they can make an immediate referral to the SEC, which of course then affords that investigation all of the transparency that is being called for.

And so what we actually have in the construct of what is there today is a system that tries to balance, as my testimony talks about, balance regulation, both of those imperative in the process.

Mr. SHERMAN. So you think this committee got it right on this issue when we passed the original version of Sarbanes-Oxley.

I would like to move to another issue and that is the PCAOB issued its concept release on auditor independence and audit firm rotation. They received, I believe, 600 comments, and 96 percent of them opposed that rotation.

Tell me what it would mean to the cost of the audit and the quality of the audit if we went to mandatory rotation.

Mr. MELANCON. A lot of people have been talking about cost today. And it is—and I am sure Gary would agree with this.

There is not only the external cost changing an audit firm which includes familiarity with the business, which is a big component of these very complex global organizations. But also the internal cost to the business itself in dealing with a different set of individuals in that capacity.

There is also a cost overall to the system. There would be a process that would be going on where different firms would be constantly being reviewed by—or considered by different public companies, some 15,000 or so of those.

That in itself consumes activity.

The premise of this discussion is about professionalism, and independence, and skepticism. And my friend, Dr. Carcello, at the end said, people here don't seem to be very concerned about that.

We are absolutely concerned about that.

But the question becomes, as rotation addressed those particular concerns—I travel all over this country. I can tell you, auditors today are under more scrutiny and more pressure and more aspects to do it right, both internally from their firms, from the regulatory process, from independent audit committees, and the like.

And so there is a high degree of skepticism. And Chairman Doty, in fact, testified that audit processes are better today.

Now, we all agree we should be working on things to improve. But we don't really believe that this is the way to go.

We believe improving audit committees, getting them more equipped to ask the right questions of auditors about independence and skepticism. All of those things will add to improvements in the process without sort of taking a very direct approach like mandatory rotation.

And I want to make one final point.

I think it is very critical to understand that there are other places around the world. And Chairman Doty referenced that, that are talking about this.

But we are the deepest, most significant capital market in the world. And it would be very unfortunate if our discussion about that topic, even if it doesn't lead to a rule, would imply to others that that is a direction outside the United States that they should go, which would have the same type of detrimental effect on the profession.

Because these are global—for the most part, global companies, global audits that are going on, and it is teams around the world that are involved in these particular processes.

Mr. SHERMAN. And finally, I would point out that one part of the oversight of the profession is if the firm screws up, they are going to get sued, and not for just a few million dollars.

I yield back.

Mr. FITZPATRICK. I recognize Mr. Perlmutter for 5 minutes.

Mr. PERLMUTTER. Thanks, Mr. Chairman.

And it is interesting that in the Congressmen you have facing you, you have two lawyers and two accountants. So that is who enjoys this kind of conversation, I guess.

Mr. SHERMAN. Actually, I am both.

Mr. PERLMUTTER. Oh and then—yes. So he has two stripes on his epaulet.

But no, I appreciate the testimony. I thank you for—and Noah who works with my office, Noah Marine, and you Mr. Melancon educated me on what is in Sarbanes-Oxley, that there is a refreshing or a new set of eyes every so often.

And for me, that is sufficient.

At the end of the day, I have to believe either accountants are professionals, or they are not. They either know what they are doing or they are bums.

The business needs from the officers to the investors to the bankers to the lenders to the counterparties, as you suggested, rely on good information, good financial information.

And if we did a rotation, a mandated rotation with these giant companies, for them to get up to speed, it just hasn't made sense to me in the conversation. Especially now, knowing that under Sarbanes-Oxley there is a requirement within the firm to bring in a new set of eyes, just to make sure that it isn't too cozy.

So I appreciate that. There has been a metamorphous I would say to my friend, Mr. Campbell, over time.

Back in the 1970s, there was a business judgment rule. But there were mistakes made. And there—the common law and the law equity came into play.

And ultimately, there were losses. There were judgments. And we kept getting more and more specific with—either with statues or rules to provide safe harbors.

Now if we are going to go back to principles-based, it is not going to—what his idea of a bad judgment might be—I might say was a really bad judgment.

So, we are in this pickle between having the safe harbor for those that are trying to interpret financial records versus wait a second, the business has the right to make a judgment in this respect.

So I did have a specific question rather than just a conversation about this.

Mr. Melancon, you talked about now having to deal with non-financial information.

What did you mean?

Mr. MELANCON. Congressman, I think the world of business reporting, I will call it and not just financial reporting is rapidly evolving.

And this Congress has certainly had debate on Section 404(b) and the internal controls.

I think that if we were here 10 years from now talking about what is it that the information that investors have, that business decisionmakers are having as it relates to companies, it is going to be much more expansive, much more real time, much more complex than it is today.

And what controls are about is about building processes around that whole information flow.



If you think about better decision-making and protections, which is what obviously this whole process is about from a systems standpoint, clearly businesses are reporting on broader sets of information.

There are pilots going on around the world for instance. And there is something called the International Integrated Reporting Council which all of the large networks are working on, in which companies are looking at a broader information footprint, not just the financial statements, financial statements plus, so information about how sustainable the business process is; in other words, their supply chains, and the ability for the company to survive as a going concern as an example.

The key indicators that are important for management and the Boards to be measured on by investors as to what is really driving value in the organization.

And those types of things require an information system that people who see the outputs of those can rely on that information.

Mr. PERLMUTTER. But let me—

Mr. MELANCON. And so, that is the broader footprint.

Mr. PERLMUTTER. My time is about up.

So let us say on the supply chain, does an auditor these days, or somebody and maybe, Professor, you could answer, do you guys have to opine on whether the supply chain is shaky or not shaky or if there is a tsunami in Japan, it is going to—Toyota here in the United States is going to have trouble. You don't have to go that far, I hope.

Mr. MELANCON. No, not today. But the fact of the matter is, again, that when we look at information that is used for the decision-making set, there is evolution to those broader footprints today.

And as I said, there are pilots that are going on around the world. Not so much in the United States, that is exactly related to that particular concept of a broader set. Not to the maybe a myopic point that you might be thinking, but the broader strategic and critical performance indicators that are necessary for us to understand how a business is operating.

Mr. PERLMUTTER. Thank you.

Thanks, Mr. Chairman.

Mr. FITZPATRICK. The gentleman yields back.

With that, the questions are concluded.

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.

So with that, I want to express our appreciation to the members of the panel for your service here today.

And this hearing is adjourned.

[Whereupon, at 1:00 p.m., the hearing was adjourned.]



# **A P P E N D I X**

March 28, 2012



Testimony of  
Robert H. Attmore, Chairman  
Governmental Accounting Standards Board

Before the

U.S. House of Representatives Financial Services Subcommittee On  
Capital Markets and Government Sponsored Enterprises

Accounting and Auditing Oversight: Pending Proposals and Emerging Issues  
Confronting Regulators, Standard Setters and the Economy

March 28, 2012

Chairman Garrett, Ranking Minority Member Waters, and Members of the Subcommittee, thank you for this opportunity to participate in today's hearing. My name is Robert Attmore. I am the Chairman of the Governmental Accounting Standards Board (GASB) and have served in that capacity since 2004. Before joining the GASB, I was a Deputy Comptroller for the State of New York and served as the N.Y. State Auditor. Before joining the State in 1979, I worked for Deloitte, a major public accounting firm.

Because this the first time in the 27-year history of the GASB that we have appeared before Congress, I would like to briefly provide some background on our organization. The GASB was set up as an independent private-sector organization that establishes accounting and financial reporting standards for state and local governments in the United States. The GASB operates under the auspices of the Financial Accounting Foundation (FAF) which has oversight authority for both the GASB and the Financial Accounting Standards Board (FASB).

Individual sovereign state governments have the authority to establish accounting and financial reporting standards for themselves and their local jurisdictions. Before the GASB was created, state and local government accounting and financial reporting standards were established for over 50 years by the National Council on Governmental Accounting (NCGA) and its predecessors. In the wake of a financial crisis in the 1970s, state governments recognized a need for change. In order to adequately meet the needs of financial report users in the municipal bond market, state representatives determined they needed an independent, national, standards-setting body for state and local governments comparable to the FASB. State organizations, working with the FAF, the American Institute of Certified Public Accountants, local government organizations, and the Government Accountability Office, reached an agreement in 1984 to create the GASB, which began operations that year. Today, all state governments follow GASB standards.

The GASB is recognized by state and local governments, resource providers, the accounting industry, and the capital markets as the official source of generally accepted accounting principles (GAAP) for state

and local governments. Tribal governments in the United States and United States territories also have chosen to follow the GASB pronouncements. While recognized as an authoritative standard setter, the GASB does not have enforcement authority. Compliance with GASB's standards, however, is enforced through the laws of many individual states and through the audit process, when auditors render opinions on the fairness of financial statement presentations in conformity with GAAP.

#### **GASB's Mission and Guiding Principles**

The mission of the GASB is to establish and improve standards of state and local governmental accounting and financial reporting that will:

- Result in useful information for users of financial reports, and
- Guide and educate the public, including issuers, auditors, and users of those financial reports.

The mission is accomplished through a comprehensive and independent process that encourages broad participation, objectively considers all stakeholder views, and is subject to oversight by the FAF's Board of Trustees.

GASB publications note that external financial reporting assists in fulfilling government's duty to be publicly accountable and that such reporting is used to assess accountability and to make economic, social, and political decisions. Those publications also identify the primary users of state and local government financial reports as those:

- To whom government is primarily accountable—its citizens
- Who directly represent the citizens—legislative and oversight bodies
- Who finance government or who participate in the financing process—taxpayers, other governments, investors, creditors, underwriters, and analysts.

Sometimes government administrators also are users of financial reports; whether they are considered primary users depends on whether they have ready access to internal financial information.

To accomplish its mission, the GASB acts to:

- Issue high-quality standards that improve the usefulness of financial reports based on the needs of financial report users and on the underlying concepts set out in the GASB's conceptual framework
- Keep standards current to reflect changes in the governmental environment
- Provide guidance on implementation of standards
- Consider significant areas of accounting and financial reporting that can be improved through the standards-setting process
- Improve the common understanding of the nature and purposes of information contained in financial reports.

The GASB develops and uses concepts to guide its work of establishing standards. Those concepts provide a frame of reference, or conceptual framework, for resolving accounting and financial reporting issues.

The GASB's work on both standards and other communications, including concepts, is based on research conducted by the GASB's technical staff and others. The GASB actively solicits and considers the views of its various stakeholders on all accounting and financial reporting issues. The GASB's activities are open to public participation and observation under the "due process" procedures mandated by its Rules of Procedure.

In establishing standards and concepts, the GASB exercises its judgment after research, public due process, and careful deliberation. It is guided by these principles:

- To be objective and neutral in its decision making and to ensure, as much as possible, that the information resulting from its standards is a faithful representation of the effects of state and local government activities. Objective and neutral mean freedom from bias, precluding the GASB from placing any particular interest above the interests of the many who rely on the information contained in financial reports.
- To weigh carefully the views of its stakeholders in developing standards and concepts so that they will:

- a. Meet the decision-making needs of the users of government financial reports, and
  - b. Gain general acceptance among state and local government preparers and auditors of financial reports.
- To establish standards only when the expected benefits to be derived exceed the perceived costs. The GASB strives to determine that proposed standards (including disclosure requirements) fill a significant need and that the costs they impose, compared with possible alternatives, are justified when compared to the overall public benefit.
  - To consider the applicability of its standards to the separately issued general purpose financial statements of governmentally owned special entities. The GASB is aware of the unique and distinguishing characteristics of the government environment, which may require different standards from those used by similar private-sector entities. However, it specifically evaluates similarities of special entities and of their activities and transactions in both the public and private sectors, and the need, in certain instances, for comparability with the private sector.
  - To bring about needed changes in ways that balance the desire to minimize disruption of accounting and financial reporting processes with the need for information in financial reports to communicate effectively to users. The GASB establishes reasonable effective dates and transition provisions when new standards are introduced.
  - To review the effects of past decisions and interpret, amend, or replace standards when appropriate.

The GASB also works to educate the public, including financial statement preparers, auditors, and users, about its standards and the information those standards require governments to present in their financial reports. In order to encourage broad public participation in the standards-setting process, GASB standards and other communications are issued only after completion of extensive and rigorous public due process.

#### **Board Members and Staff**

The GASB standards and other communications are established by a seven-member Board whose members are selected by the Trustees of the FAF. The Chairman serves on a full-time basis with the remaining six members devoting approximately one-third of their time to GASB



activities. The Board holds face-to-face public meetings every six weeks. Those meetings generally are held over a three day period. Due to the part-time nature of the Board, the face-to-face meetings are supplemented by half-day public teleconference meetings that are generally the third week after the face-to-face meeting.

In addition to me, the current Board membership is as follows:

**William W. Fish** (term expires 2016) joined the GASB on February 1, 2012.

**Michael H. Granof** (term expires 2015) began serving as a member of the GASB on July 1, 2010.

**David E. Sundstrom** (term expires 2014) began serving as a member of the GASB on July 1, 2009.

**Jan I. Sylvis** (term expires 2017) began serving as a member of the GASB on July 1, 2007.

**Marcia L. Taylor** (term expires 2015) joined the GASB on July 1, 2005.

**James M. Williams** (term expires 2012) joined the GASB on July 1, 2002.

The Board members are supported by 17 technical and 4 administrative staff. The technical staff is drawn from the preparer, audit, and user communities from around the United States. As discussed below, the staff conducts basic research, and prepares papers and proposals that set forth issues to be deliberated by the Board members in public meetings.

#### **Why Different Standards for State and Local Governments?**

Accounting and financial reporting standards designed for the government environment are essential because governments are fundamentally different from for-profit businesses in several important ways. Their purpose is different, in that governments provide public services rather than seek to generate wealth for business owners, and the way they are financed is very different. For example, businesses receive revenues from a voluntary exchange of perceived equal values between a willing buyer and seller; whereas, governments obtain resources primarily from the required payment of taxes, and the specific taxes paid by an individual taxpayer often bear little

direct relationship to the value of services received by that taxpayer. Furthermore, the information needs of the variety of users of government financial statements are different from the needs of the users of nongovernmental financial statements. For example, governmental accounting and financial reporting standards aim to address the need for information to help stakeholders assess how public resources are acquired and used, whether current resources were sufficient to meet current service costs or whether some costs were shifted to future taxpayers, and whether the government's financial position and its ability to provide services improved or deteriorated from the previous year.

### **GASB Due Process**

The GASB's due process activities are described in its published Rules of Procedure. The GASB's stringent due process activities are designed to encourage broad public participation in the standards setting process. These activities promote timely, thorough, and open study of financial accounting and reporting issues by the preparers, auditors, and users of financial reports. For many of the issues it addresses, the GASB:

- Appoints an advisory task force of outside experts
- Studies existing literature on the subject (including pronouncements previously issued by the Federal Accounting Standards Advisory Board (FASAB), FASB, and the International Public Sector Accounting Standards Board and conducts or commissions additional research if necessary
- Publishes a discussion document for public comment setting forth the issues or concerns being addressed and possible solutions
- Broadly distributes an Exposure Draft of a proposed standard for public comment
- Conducts public hearings and user forums on its due process documents.

Significant steps in the process are announced publicly. The GASB's meetings are open for public observation and a public record is maintained. The GASB also is advised by the

Governmental Accounting Standards Advisory Council (GASAC), a 30-member group appointed by the FAF Trustees that represents a wide range of the GASB's stakeholders.

Transcripts of public hearings, letters of comment and position papers, research reports and other relevant materials on projects leading to issuance of pronouncements become part of the Board's public record and are available for inspection. To encourage public comment, discussion documents and Exposure Drafts are made available for download on the Internet. Single printed copies also are available without charge during the comment period to all who request them. Final pronouncements are distributed when published through GASB subscription plans or may be purchased separately.

### **GASB Funding**

The Sarbanes-Oxley Act of 2002 provided an independent, stable source of funding for the FASB. An adequately funded independent private-sector standard setter also is essential for the state and local government environment and the municipal securities market. Although states essentially delegated their authority for prescribing accounting and financial reporting standards for state and local governments to the GASB (under the oversight of the FAF) in 1984, the GASB has been funded in a piecemeal, inadequate manner by voluntary contributions from states, local governments, the financial community, and through sales of FAF publications since its inception.

The recent financial and economic crisis has demonstrated the urgency to ensure full disclosure and transparency in the municipal securities market. The municipal securities market is a key component of our nation's capital markets. The Federal Reserve Board has estimated the size of the municipal securities market at \$3.7 trillion with over 50,000 issuers as of September 30, 2011. GASB has an essential role in this market by issuing high-quality, independently established governmental accounting standards that provide a foundation for financial reporting that investors can rely on to make informed investment decisions.

The municipal securities market is largely a retail market. According to a June 2011 Federal Reserve Board statistical release, approximately 51% of the \$3.7 trillion municipal securities market is held by individual investors and an additional 22% is held by mutual funds. As such, these securities are not only critical to financing infrastructure and other government needs, they are important to American investors seeking safe state and local government investments.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (WSRA) became law. §978(a) of the WSRA empowers the U.S. Securities and Exchange Commission (Commission) to require a national securities association to establish a reasonable annual accounting support fee adequate to fund the annual budget of the GASB to ensure high-quality state and local governmental accounting and financial reporting standards. As a result, the Commission directed the Financial Industry Regulatory Authority, Inc. (FINRA) to establish a reasonable accounting support fee and related rules and procedures to provide a sustainable funding mechanism to support the efforts of the GASB. On February 23, 2012, the Commission issued an order granting approval of FINRA's proposed rule change establishing a GASB Accounting Support fee.

Securing an independent funding source for the GASB is a tremendous milestone in the Board's history and represents the far-reaching recognition by the municipal capital markets of the importance of transparent financial information and the important role that GASB plays in fostering high-quality financial accounting and reporting. I am grateful to Congress for recognizing the need for this secure and independent funding source for the GASB.

#### **Current GASB Activities**

Accounting and financial reporting is in a state of continual improvement. At any one time, the GASB has four to six major projects on its current technical agenda and two to four more limited

scope projects that focus on practice issues. In addition, there are usually four to six projects where initial research is being conducted by the staff. During the past year, the GASB has focused its efforts on four major projects:

- Postemployment Benefits—pension accounting and financial reporting and reporting of other postemployment benefits, including retiree healthcare
- Economic condition reporting: financial projections
- Financial guarantees
- Government combinations

The following is a summary of activities to date associated with these four projects and major issues identified by the GASB in each of those projects.

#### **Postemployment Benefits Project**

##### **Pension Accounting and Financial Reporting**

The Board currently is considering improvements to existing standards of accounting and financial reporting for pension benefits by state and local governmental employers and by the trustees, administrators, or sponsors of pension plans. One objective of this project is to improve the transparency of financial reporting, in regard to the financial effects of employers' commitments and actions related to pension benefits. This objective would include improving the information provided to help financial report users assess the degree to which *interperiod equity* has been achieved. Another objective of this project is to improve the *usefulness* of information for decisions or judgments of relevance to the various users of the general-purpose external financial reports of governmental employers and pension plans.

This project follows a research project initiated by the Board in January 2006 to gather information regarding how effective the standards established for pension accounting and financial reporting—Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans*

*and Note Disclosures for Defined Contribution Plans*, and Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*—have been in providing decision-useful information. The research project was conducted, in part, as a result of the Board’s commitment to periodically reexamine its standards. The research project provided an opportunity to review how state and local governments and pension plans applied the requirements of Statements 25 and 27 and how financial reporting reflected the transactions and events affecting pensions from the issuance of those standards in 1996. In 2008, the Board concluded that, based on the results of this research, additional improvements should be considered. The Board has drawn upon the work of various standards setters for the pension project, including the FASB and GASB.

Since the project was added to the current technical agenda, the Board has issued the following due process documents to solicit constituent feedback:

- Invitation to Comment, *Pension Accounting and Financial Reporting*—which was issued in March 2009
- Preliminary Views, *Pension Accounting and Financial Reporting by Employers*—which was issued in June 2010
- Exposure Drafts, *Accounting and Financial Reporting for Pensions* and *Financial Reporting for Pension Plans*—which were issued in June 2011

The Board held multiple public hearings for each of the documents as part of its extensive due process. In addition, the Board conducted a field test with financial statement preparers in late 2011 to assist the Board in identifying the costs associated with the pension proposals and potential implementation issues. The Board also held three financial statement user forums in October 2011 to further identify and understand the perspectives of financial statement users regarding the anticipated benefits from the pension proposals.

The Board is currently in the process of again deliberating its tentative decisions based on the feedback to the proposals that were included in the employer Exposure Draft. The GASB proposed that generally a government (the employer) that provides pension benefits to its employees is responsible for the net pension liability and would report it in its financial statements.

A total pension liability is measured based on actuarially-calculated methods using assumptions that are consistent with the American Academy of Actuaries' Actuarial Standards of Practice, unless otherwise specified by the GASB. The total pension liability less amounts held in a qualifying pension trust, which generally are measured at fair value, equals the net pension liability. The measurement of the total pension liability is based on projecting future benefits payments, discounting those benefits to a present value, and attributing the present value of the projected benefits to appropriate service periods (past, present, and future).

Based on the career-long employer/employee relationship that is being measured, the GASB has proposed to continue the current practice of incorporating expectations of future employment-related events and cost-of-living increases into the projections of benefit payments.

As long as plan assets related to current employees, retirees, and their beneficiaries are projected to be sufficient to make the projected benefit payments for those individuals, governments would discount projected benefit payments using a long-term expected rate of return on plan investments. For some governments, however, there will be a point at which the plan assets are no longer projected to be available to be invested long term and, therefore, would not be sufficient for paying benefits to current employees, retirees, and their beneficiaries. The GASB believes that from point forward, the projected benefit payments take on attributes that are similar to other forms of debt. In this circumstance, governments would incorporate into the calculation of the discount rate a tax-exempt, high-quality municipal bond index rate to reflect that future benefit payments are not expected to be made from earnings on long-term investments.

The GASB also has proposed that all governments use a single actuarial cost method for attributing the present value of projected benefits to past, present, and future periods that is known as entry age, and to apply that method as a level percentage of payroll.

The effects of changes in the net pension liability resulting from service cost, interest cost, benefit changes, and projected earnings on plan investments should be recognized in pension expense in the period of the change. Changes in the net pension liability due to differences between expected and actual experience with regard to economic or demographic factors, and the effects of changes of assumptions about future economic and demographic factors for all employees and retirees, should be recognized in pension expense over the average expected remaining service lives of all employees and retirees using a systematic and rational, closed-period method. Differences between projected and actual plan investment earnings should be recognized in pension expense over a closed five-year period, in a systematic and rational manner.

The Board is expected to complete its deliberations on the proposed pension standards in the summer. New pension Statements would then be issued assuming that no significant changes are made to the prior proposals (which would result in the reexposure of new proposals).

#### **Other Postemployment Benefits**

In addition to the pension accounting and financial reporting project, the Board also has a companion project that addresses other postemployment benefits (OPEB), including retiree healthcare benefits. Since the issuance of the OPEB recognition standards in 2004, state and local governments, for the first time, have been required to disclose the extent of their retiree healthcare obligations in the notes to their financial statements. This new project will reexamine the measurement and recognition provisions related to those OPEB obligations. Deliberations on this project are scheduled to restart in July 2012.

#### **Economic Condition Reporting: Financial Projections**

The objective of this project is to consider what guidance, if any, should be provided for additional information about a government's economic condition. The project examines the usefulness of indicators of economic condition and its related components. This project also includes consideration of the information financial statement users identified as necessary to assess the risks associated with a government's intergovernmental financial dependencies.



The GASB's research indicates that users of financial reports are interested in understanding a governmental entity's *past* economic condition—and thus how the governmental entity arrived at its current status—with an eye toward assessing a governmental entity's *future* financial viability or fiscal sustainability. In other words, based on existing information, users seek to assess a governmental entity's *ongoing* ability to raise revenue, to deliver services, to issue debt, and to meet its obligations and commitments as they become due—the capacity to *sustain* or improve its financial status. Fiscal sustainability is the forward-looking aspect of economic condition. The GASB has tentatively defined fiscal sustainability as a government's ability and willingness to generate inflows of resources necessary to honor current service commitments and to meet financial obligations as they come due, without transferring financial obligations to future periods that do not result in commensurate benefits.

The current technical agenda project was begun in 2010 and in October 2011, the Board issued its Preliminary Views, *Economic Condition Reporting: Financial Projections*. The Preliminary Views presents the Board's current tentative views on what it believes are the most fundamental issues associated with the reporting of financial projections and related narrative discussions that will assist users in assessing a governmental entity's economic condition. The Board's intent is to obtain comments from constituents before developing more detailed proposals for potential new standards.

The Board's preliminary view is that projections of the following information for each of the next five years are necessary to assist users in assessing a governmental entity's fiscal sustainability:

- Cash inflows and cash outflows, with explanations of the known causes of fluctuations in cash inflows or cash outflows
- Financial obligations, including bonds, pensions, other postemployment benefits, and long-term contracts, with explanations of the known causes of fluctuations
- Annual debt service payments (principal and interest)

A narrative discussion of a government's major dependencies on other governments to provide its services also would be included.

Similar to guidance that is currently effective for the federal government based on standards established by the FASAB, financial projections would be (1) based on current policy, (2) informed by historical information, and (3) adjusted for known events and conditions that affect the projection periods. Assumptions employed in making projections would be (1) consistent with each other and with the information used as the basis for the assumptions and (2) comprehensive by considering significant trends, events, and conditions. Disclosure of key assumptions would be required.

It is important to note that projections based on current policy do not represent a forecast or a prediction of the most likely outcome. Financial projections may be based upon assumptions regarding changes in social, economic, and demographic events and conditions that are inherently subject to uncertainties. Therefore, a cautionary notice would precede the displayed financial projections and related narrative discussions advising readers that actual results may vary from the financial projections reported.

The Board plans to hold public hearings on these preliminary views in late March and April before again beginning deliberations based on constituent feedback later this spring.

#### **Financial Guarantees**

The objective of the financial guarantees project is to establish additional guidance regarding the recognition and disclosure of financial guarantees made and received by state and local governments.

The GASB staff's research indicates that financial guarantees are primarily associated with commitments related to debt issued by other governmental units, not-for-profits, and in certain cases for-profit organizations. The guarantees, however, may take other forms, including statutory commitments. The current economic environment has resulted in a level of financial

stress that has touched most organizations, resulting in financial guarantees that have been made or received in the past that are now coming to light. Currently, generic and specific accounting and financial reporting guidance for these transactions derives from multiple sources, to the extent it exists. There is no single, comprehensive source of guidance for these guarantee transactions. Due to the heightened importance of these guarantees and the potential for them to result in claims, the Board believes that it is important to establish clear recognition and disclosure requirements.

Since the project was added to the current technical agenda in April 2011 the Board has reached several tentative conclusions that it plans to expose for public comment later this year. These tentative conclusions include proposals related to measurement and recognition standards.

For guarantees extended for which qualitative factors indicate that it is more likely than not an indemnification payment will be made, the amount of the liability should be measured using a cost accumulation approach. An Exposure Draft is scheduled to be issued in June 2012 for public comment.

#### **Government Combinations and Disposals of Government Operations**

The primary objective of the current government combinations project is to consider the financial reporting requirements for government combinations that are accomplished through annexation, consolidation, acquisition, shared service arrangements, or by other means. This project includes the analysis of government combinations that have taken place in both the general governmental area (for example, city/county consolidations and consolidated school districts) and the business-type activities area (for example, healthcare organizations). In addition, the project addresses certain devolution (spin-off) issues; for example, accounting for a library district that was formerly a department in a primary government.

Until now, governments have accounted for mergers, acquisitions, and other combinations by analogizing to accounting and financial reporting guidance intended for the business environment, generally APB Opinion No. 16, *Business Combinations*. This proposed Statement would provide accounting and financial reporting guidance for combinations that would be specifically relevant to the governmental environment. This proposed Statement also would

improve the decision usefulness of financial reporting by requiring that relevant disclosures be made by governments about combination arrangements in which they engage and for disposals of government operations.

The project was added to the current technical agenda in December 2010. Since that date, the Board has reached tentative conclusions that were exposed for public comment earlier this month. These tentative conclusions include:

- Government combinations are identified by whether governments and other entities or their operations are transferred to (a merger or transfer of government operations) or purchased (an acquisition) by a government and the services associated with an entity or operation will continue after a government combination has occurred.
- Carrying values would be used to measure the assets and liabilities in a government merger or transfer of government operations. Measurements of assets acquired and liabilities assumed in an acquisition generally are to be based upon their acquisition values.

#### Other Projects

In addition to these four major projects that were addressed herein, the Board has other projects on its current technical agenda and projects on its research agenda. A list of all GASB projects, along with a projected due process timetable is presented in Attachment A. Additional information on all GASB projects can be found at the GASB's website, [www.gasb.org](http://www.gasb.org).

#### **Conclusion**

In conclusion, the GASB has made significant progress over the past 27 years, but there is still much left to do. With continued oversight by the FAF, a robust public due process that encourages and values broad participation from all GASB constituents, and dedicated Board members and staff, the GASB is up to the challenges that lie ahead.

Thank you again Mr. Chairman for the opportunity to appear before the Subcommittee.

**Attachment A****GASB Current Technical Agenda: Overview (As of 3/15/12)**

<b>Project</b>	<b>Issued</b>		<b>To Be Issued</b>		
	<b>ITC/PV</b>	<b>ED</b>	<b>DPD/PV</b>	<b>ED</b>	<b>Final</b>
<b>Major Projects:</b>					
Conceptual Framework— Recognition and Measurement Approaches	6/11	—	—	4Q12	2Q13
Economic Condition Reporting: Financial Projections	11/11	—	—	4Q12	3Q13
Fair Value Measurement and Application	—	—	—	1Q13	4Q13
Financial Guarantees	—	—	—	2Q12	1Q13
Government Combinations	—	3/12	—	—	4Q12
Postemployment Benefit Accounting and Financial Reporting— Other Postemployment Benefit Accounting and Financial Reporting	—	—	—	3Q13	2Q14
Pension Accounting and Financial Reporting	3/09 6/10	6/11	—	—	2Q12

**GASB Current Technical Agenda: Overview (As of 3/15/12)**

Project	Issued		To Be Issued		
	ITC/PV	ED	ITC/PV	ED	Final
<b>Practice Issues:</b>					
Comprehensive Implementation Guide—					
Annual Update	—	—	—	—	3Q12
Mid-Year Supplement	—	—	—	—	1Q13
User Guides—Update	—	—	—	—	2Q12

ED—Exposure Draft  
 Final—Statement, unless otherwise noted  
 ITC—Invitation to Comment

PV—Preliminary Views  
 RED—Revised Exposure Draft  
 RFR—Request for Response  
 TB—Technical Bulletin

**Research Projects**

Electronic Financial Reporting
Fiduciary Responsibility
GAAP Hierarchy
Leases

Statement of Joseph V. Carcello, Ph.D., CPA, CMA, CIA  
Ernst & Young and Business Alumni Professor  
Director of Research – Corporate Governance Center  
University of Tennessee, Knoxville

**Testimony before the Capital Markets and Government Sponsored Enterprises  
Subcommittee of the House Financial Services Committee on “Accounting and Auditing  
Oversight: Pending Proposals and Emerging Issues Confronting Regulators, Standard  
Setters, and the Economy”**

Chairman Garrett, Ranking Member Waters, and other members of the Subcommittee, thank you for giving me the opportunity to speak with you today about accounting and auditing oversight. I have served as a professor at the University of Tennessee for approximately 20 years, where I teach accounting, auditing, and corporate governance. In addition to my teaching and research, my remarks are informed by my service on the PCAOB’s Investor Advisory and Standing Advisory Groups, both of which are outside advisory groups to the Board. Moreover, I have performed two coauthored studies for COSO that examine fraudulent financial reporting in the United States between 1987 and 2007.

I will focus my remarks today on auditing oversight, and will focus on six issues of concern to investors.

**Internal Control over Financial Reporting**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) exempts public companies with a market capitalization of less than \$75 million from Section 404(b) of the Sarbanes-Oxley Act (SOX). Section 404(b) requires the issuer’s external auditor to audit and issue an opinion on the effectiveness of the issuer’s internal controls over financial reporting. In addition, the Dodd-Frank Act requires the SEC to study whether to extend the exemption from compliance with Section 404(b) to issuers with a market capitalization below \$250 million.

I believe that expanding the number of public companies that are exempt from auditor reporting on internal control would ill-serve investors and the capital markets. Over the last five years, a large body of empirical research has emerged that establishes the importance of effective internal controls and the benefits of auditor reporting on internal control (see Schneider, Gramling, Hermanson, and Ye (2009) for a review of this literature). Ashbaugh-Skaife, Collins, Kinney, and LaFond (2008) find that issuers reporting material internal control deficiencies have lower quality accruals (accrual quality is a frequently-used metric used to evaluate the quality of financial reporting). In addition, issuers who remediate (fix) these internal control deficiencies experience an increase in accrual quality, whereas issuers who do not remediate the control deficiencies do not experience an improvement in accrual quality. Second, auditors’ internal

control opinions have real effects in the managerial labor market. Li, Sun, and Ettredge (2010) find a positive relation between the auditor concluding that an issuer's internal controls are ineffective and turnover of the CFO. More importantly, when the auditor concludes that internal controls are ineffective, these issuers are more likely to hire a replacement CFO with better qualifications and, for these firms, internal control is likely to improve in the future.

The most compelling evidence on the value of auditor reporting on internal control comes from a study by Bedard and Graham (2011). Bedard and Graham examine issuers with revenues of \$1 billion or less. They find:

- Auditors, rather than management, detect approximately 75% of the unremediated internal control deficiencies. As Bedard and Graham point out, "Importantly, this low level of client detection occurs when clients are aware that auditors will soon follow with their own tests."
- When managers detect the internal control deficiency, they tend to classify the deficiency as less severe, but auditors frequently override those classifications.
- A significant percentage of the internal control deficiencies in the control environment component and related to the revenue account are detected by auditor control testing. This is germane because fraud is often associated with control environment weaknesses and revenue is the account most typically misstated when fraud occurs (Beasley, Carcello, and Hermanson 1999; Beasley, Carcello, Hermanson, and Neal 2010).

Finally, any decision to exempt smaller public companies from auditor internal control testing under Section 404(b) ignores the ample evidence that internal control problems are often most serious in smaller public companies. Doyle, Ge, and McVay (2007) find that issuers with more serious (entity-wide) control problems are generally smaller and younger. Audit Analytics (Whitehouse 2011) reports that larger public companies, which are subject to auditor reporting on internal control, experienced a 5.1% decline in restatements for non-GAAP reporting from 2009 to 2010, whereas those public companies not subject to auditor reporting on internal control experienced a 13.8% *increase* in restatements during the comparable time period. Finally, those companies charged with financial statement fraud by the SEC tend to be relatively small (Beasley, Carcello, and Hermanson 1999; Beasley, Carcello, Hermanson, and Neal 2010). As Bedard and Graham (2011) conclude, "... the recent exemption of Section 404(b) for smaller U.S. public companies could result in failure to fully realize potential improvements in financial reporting quality in that sector of the market." Given the weight of the empirical evidence on the efficacy of auditor involvement in testing and reporting on internal control, exempting more issuers from such auditor involvement seems adverse to the interests of investors and the capital markets.



**Public vs. Private Nature of PCAOB Enforcement Proceedings**

I understand that Representative Lynn Westmoreland (R-GA) has introduced H.R. 3503 that would amend SOX to make PCAOB disciplinary proceedings public. I favor such legislation, as I believe that the existing non-public nature of PCAOB disciplinary proceedings does not serve investors or the capital markets. Under current law, PCAOB disciplinary proceedings against auditors and audit firms are non-public until the proceedings are settled or adjudicated. This structure provides an incentive for firms, particularly large firms, to litigate PCAOB enforcement actions because during the litigation process, including any subsequent appeal to the SEC, the existence and nature of the PCAOB enforcement action remains undisclosed to investors, companies, audit committees, and other capital market participants. More perniciously, during this entire time, the accountant or firm that is the subject of the PCAOB enforcement action is permitted to continue issuing audit reports on public companies, regardless of the seriousness of the charges being litigated.

It is important to understand that even if PCAOB disciplinary proceedings are made public, substantial protections remain for parties that may be subject to these proceedings. The Board only commences disciplinary proceedings after an extensive *nonpublic* (my emphasis) investigation, involving document production and on-the-record testimony. Moreover, the evidence gathered by the Board's Division of Enforcement and Investigations is presented to the Board, and it is the five Board members who must vote to commence a disciplinary proceeding. Given that two of these five Board members are CPAs, two are securities attorneys who have spent much of their career representing companies and auditors, and one is a former Congressional staff member, accountants who may face disciplinary proceedings would clearly appear to be facing a "jury of their peers."

The most compelling argument for making PCAOB disciplinary proceedings public is that the nature of these proceedings is private if brought by the PCAOB but public if brought by the SEC, even though the PCAOB is closely supervised by the SEC. As former PCAOB (acting) Chairman Dan Goelzer stated in his August 24, 2010 letter to Congressmen Frank and Bachus:

If the SEC were to bring the same case as the PCAOB, alleging the same violations, against the same auditor, the SEC's charges would be disclosed at the time the Commission instituted its proceeding. Any administrative trial would be open to the public. If there were an appeal to the Commission and an oral argument, the public could attend. The ability – or inability – of the Commission's staff to prove its charges would be a matter of public record.

**Audit Firm Rotation**

The PCAOB has outstanding a Concept Release on auditor independence and audit firm rotation (PCAOB 2011a). I understand that Representative Michael Fitzpatrick is considering draft legislation that would prohibit the PCAOB from mandating audit firm rotation. The PCAOB has

not proposed audit firm rotation. Nonetheless, this is obviously a controversial PCAOB Concept Release, as evidenced by the fact that the Board has received more than 600 comment letters on the Release.

Before discussing the relative merits of mandatory firm rotation, it is important to understand that the Board's release on this topic emanates from a concern that auditors currently exhibit an inadequate level of professional skepticism. Without professional skepticism, audits are of little value. I believe that there is sufficient evidence to legitimately question whether auditors are sufficiently skeptical. First, in a study of how issuers choose audit firms, Fiolleau, Hoang, Jamal, and Sunder (2009) find: (1) there is significant management control in the selection of the external auditor (also see Cohen, Krishnamoorthy, and Wright (2010) for similar evidence), (2) auditors are required to provide references from senior officers of current and past clients, and repeatedly demonstrate responsiveness and commitment to the prospective client's management, and (3) there is extensive price competition, where one audit firm offered a bid materially below the previous year's audit fee. Based on this research, audit committees appear somnolent and captured by management. Management seems to want compliant and cheap auditors, and to know how to get them. Investors are an afterthought. And the behavior of auditors was the most discouraging of all – so eager to obtain new clients that the auditor talks about the client during the proposal process using the client's own code words among other potentially problematic behaviors. Second, the PCAOB's inspection process has found that at least one of the largest accounting firms used the following language in a recent proposal to a prospective client: "Your auditor should be a partner in supporting and helping [the issuer] achieve its goals ..." (PCAOB 2011a). I chair the audit committee for a mid-size governmental entity, and we recently solicited proposals for our external audit. A national CPA firm that bid on the engagement used similar language about partnering with the governmental entity. Third, the PCAOB's inspection process continues to identify a sizable number of audit deficiencies, and these deficiencies are often related to inadequate professional skepticism (Ferguson 2012). In my view, any serious observer of the accounting profession needs to be concerned about the current level of professional skepticism exhibited by auditors.

Given that the PCAOB's mission is "to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports", exploring this issue is not only appropriate – not only is it within the clear mission of the Board as articulated by Congress -- it is arguably the very mission of the Board and the reason the Board exists.

Notwithstanding the importance of improving professional skepticism, I think it is an unresolved question as to whether mandatory audit firm rotation would improve skepticism and, if so, the optimal structure for implementing a mandatory rotation regime. The academic literature is mixed on the benefits of mandatory rotation. Bazerman (2012) favors fixed contract terms for audit engagements. Moore (2012) and Kaplan (2012) both support audit firm rotation. In an experimental study, Arel, Brody, and Pany (2006) find that auditors in a rotation regime make more independent judgments than auditors in a regime where tenure is not limited. In an

archival study, Harris and Whisenant (2012) study the effects of implementing mandatory rotation in three foreign countries (Italy, South Korea, and Brazil). They generally find improved audit quality after the introduction of mandatory auditor rotation, but audit quality appears lower in the last year of the previous auditor's tenure and the first year of the successor auditor's tenure. Conversely, Ghosh (2012) points out that audit quality is correlated with audit firm industry expertise, and that audit firms will have less incentive to specialize by industry if limits on auditor tenure are introduced. Moreover, Ghosh concludes, based on a review of the literature, that the majority of extant studies find that long auditor tenure is not problematic. In addition, Jenkins (2012) also is concerned that mandated auditor rotation might result in decreased use of industry-specialist auditors, which he believes will result in a decline in audit quality.

The relative merits of audit firm rotation are complex and deserve careful study. The PCAOB appears to be proceeding slowly and cautiously in examining this topic – i.e., the Board has only released a concept document (essentially a discussion document), the Board just completed two full days of hearings on this topic and appears committed to having more hearings, and no Board member appears to have prejudged the final outcome. A prudent course is to let the PCAOB continue to examine the issue of auditor independence and professional skepticism, including potential solutions, under the active supervision of the SEC, without interjecting Congressional action into the process.

Previous attempts by Congress to micro-manage standard setting in accounting and auditing have generally been failures (e.g., Congress' interjecting itself into the discussion of stock option accounting). For example, the proposed bill introduced by Representative Fitzpatrick, although less than one page in length, is potentially flawed. The proposed bill would prohibit the PCAOB from requiring public companies to use specific auditors. PCAOB Auditing Standard No. 5 (AS5) already requires an issuer to use the same auditor to audit the financial statements and internal control over financial reporting. This requirement in AS5 could be interpreted as the Board requiring an issuer to use a specific auditor. Eliminating this AS5 requirement would likely make audits more expensive and less effective.

In the interest of brevity, I will only briefly touch on the last three issues.

#### **Nature of the Audit Report**

The PCAOB has outstanding a Concept Release on potential changes to the auditor's report (PCAOB 2011b). The current audit report is a standard three-paragraph report that is essentially identical for the overwhelming majority of all public companies. As a result, notwithstanding the significant fees associated with external audits, many investors view the information content of the standard audit report as lacking (Blake et al. 2011). The PCAOB's Concept Release discusses four alternatives: (1) supplementing the audit report with more information about the audit and the issuer's financial statements, (2) requiring an expanded use of emphasis-of-matter

paragraphs, (3) requiring auditor reporting on information outside the financial statements, and (4) clarifying certain language in the auditor's report.

I believe, as do two-thirds of the PCAOB's Investor Advisory Group (IAG), that the standard audit report is currently deficient as a communication vehicle, and that the audit report needs to be supplemented with more information about the audit and the issuer's financial statements. Based on a survey of institutional investors conducted by a sub-group of the IAG, we believe that the additional information needed by investors includes: (1) the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment, (2) disclosure of areas of high financial statement and audit risk and how the auditor addressed these risk areas in planning and conducting the audit, (3) discussion of unusual transactions, restatements, and other significant changes in the financial statements, and (4) discussion of the quality, not just the acceptability, of the issuer's accounting policies and practices.

#### **Audit Partner Identification**

The PCAOB has outstanding a Proposed Rule (PCAOB 2011c) that would, among other changes, require the identification of the name of the audit partner in the audit report. Notwithstanding that engagement partners are required to *sign* the audit report throughout the European Union, Australia, Korea, and many other countries, the PCAOB's more modest proposal to simply identify the engagement partner by name is largely opposed by the public accounting profession (although there is some corporate support for this proposal). I agree with the Board that identifying the engagement partner would enhance accountability and transparency. In addition, research that I have conducted finds that audit quality improved in the United Kingdom after partners were required to sign the audit report (Carcello and Li 2012).

#### **Related Parties and Significant Unusual Transactions**

The PCAOB has recently released a Proposed Rule (PCAOB 2012) on related parties and significant unusual transactions. Given that related party transactions and significant unusual transactions are often associated with fraudulent financial reporting (Beasley, Carcello, and Hermanson 1999; Beasley, Carcello, Hermanson, and Neal 2010), I support this proposed PCAOB rule. Moreover, the PCAOB's Proposed Rule would require auditors to read and understand compensation practices of the issuer's senior management. Given that compensation-related incentives are often tied to fraudulent financial reporting (e.g., Feng, Ge, Luo, and Shevlin 2011), requiring the auditor to have a better understanding of the financial incentives that management may have to misstate the financial statements is prudent.

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Statement of James R. Doty  
Chairman  
Public Company Accounting Oversight Board

at a Hearing on

Accounting and Auditing Oversight: Pending Proposals and Emerging  
Issues Confronting Regulators, Standard Setters and the Economy

Before the

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

2128 Rayburn House Office Building  
March 28, 2012



Statement of James R. Doty  
Chairman  
Public Company Accounting Oversight Board

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

Thank you for the opportunity to appear before you today on behalf of the Public Company Accounting Oversight Board ("PCAOB" or "Board") to testify on the work of the PCAOB.

I appreciate the Subcommittee's continued interest in high quality audits for public companies and SEC-registered broker-dealers. Further, on behalf of the PCAOB, I commend the Committee's members, Representative Westmoreland and Ranking Member Frank, for bringing forward bipartisan legislation, H.R. 3503, to bring transparency to the PCAOB's disciplinary proceedings. Transparency would enhance the PCAOB's effectiveness – as well as public confidence in the PCAOB's oversight and in the auditing profession's credibility as a relevant participant in the capital markets – by permitting the Board to disclose its disciplinary proceedings, and I encourage the Congress to pass it.

**I. Introduction**

Public securities markets provide a reliable funding mechanism for American – and, increasingly, foreign – businesses. More than half of American households invest their savings in securities to provide for retirement, education, and other goals. Our economy is resilient, even in the face of the recent financial crisis, in part because millions of savers continue to be willing to invest in business enterprises to fuel growth, growth that results in more workers, more savings and more investment. This cycle promotes economic wealth, but it relies on the system of accurate financial disclosures by public companies to the investors who entrust capital to them.

As Chairman of the PCAOB, I believe that the PCAOB, and the accounting firms that we oversee, play a critical role in enabling markets to provide investors with reliable information upon which to make their own investment decisions. The financial audit is the linchpin for investor confidence in that information, and a reliable audit is one led by an auditor that is independent, objective, and skeptical, and applies the diligence needed to meet PCAOB standards.

If investors lose confidence in financial reporting, they will demand prohibitively high returns as a condition of investing or they may withdraw from the capital 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 or fraud that, if left uncorrected, may result in the misallocation of capital, business failures, and job losses.





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The PCAOB is focused on taking appropriate steps in its inspection and enforcement programs in order to improve audit quality and enhance protection of the investing public. The PCAOB is also using information gained in inspections and investigations, along with information received from investors, audit committee members, auditors and others, to improve auditing and related professional practice standards.

The PCAOB is a non-profit, independent institution designed to bring expertise and a variety of perspectives to the task of setting appropriate standards and overseeing the practice of auditing public companies and SEC-registered broker-dealers. This independence is critical for the Board to fulfill its Congressionally mandated mission of protecting the interests of investors. By law, all of the PCAOB's responsibilities are discharged under the oversight of the U.S. Securities and Exchange Commission ("SEC"). Chairman Mary Schapiro, the Commissioners, and Chief Accountant Jim Kroeker have taken a deep interest in the PCAOB's work, and I am grateful for their support and for the strong working relationship they have fostered between our organizations.

## **II. Current PCAOB Activities and Priorities**

### **A. Inspections**

The Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") requires the PCAOB to conduct a continuing program of inspections of registered accounting firms. There are currently 2,398 accounting firms registered with the Board. The Board's statutory inspection authority relates to audits of issuers, brokers, and dealers. The Board does not inspect firms that perform no such work, although many such firms have chosen to register.

During an inspection, the PCAOB assesses the firm's compliance with applicable laws, rules and professional standards. As part of an inspection, PCAOB inspectors evaluate the design and effectiveness of a firm's quality control system as well as the quality of the firm's work in the portions of audits selected for inspection.

Registered firms that issue audit reports for more than 100 issuers are required to be inspected by the PCAOB annually. In 2011, the PCAOB inspected 10 such firms. As part of these inspections, PCAOB inspectors examined portions of more than 340 audits performed by these firms.

Registered firms that issue audit reports for 100 or fewer issuers are, in general, inspected at least once every three years. At any time, the PCAOB may also inspect any other registered firm that plays a role in the audit of an issuer, and the PCAOB has a practice of inspecting some firms in that category each year. The PCAOB inspected



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203 firms in these categories in 2011, including 42 non-U.S. firms located in 15 jurisdictions. In the course of those inspections, PCAOB staff examined portions of more than 485 audits.

#### **1. Inspections of Public Company Audits.**

PCAOB inspections of public company audits are handled in one of two programs. First, we have a global network firm program. Second, we have a program covering the other registered firms located in the U.S. as well as non-U.S. firms not covered in the global network firm program.

Our global network firm program covers inspections of the largest U.S. firms and approximately 190 of their foreign affiliates, which participate in the audits of issuers that file financial statements with the SEC.

Each registered firm in a global network of firms is a separate legal entity that is subject to the same frequency of inspections as any other registered firm. Substantial portions of the audits of many of the largest U.S. companies are performed by affiliated network firms, including firms we cannot inspect due to resistance by local authorities.

The selection of issuer audits for review is influenced by a number of factors. The selection can be based on the risk that an issuer's financial statements could be materially misstated; characteristics of the particular issuer or its industry; the audit issues likely to be encountered; considerations about the firm, a particular practice office or an individual partner; prior inspection results; or other factors.

The PCAOB prepares a report on each inspection and makes portions of that report publicly available, subject to statutory restrictions on public disclosure. The Board issued 344 inspection reports in 2011.

If an inspection report includes criticisms of or identifies potential defects in a firm's system of quality control, those criticisms are initially kept nonpublic, as required by the Act. The firm has 12 months from the issuance of the inspection report to address the criticisms to the Board's satisfaction. If it does so, the criticisms remain nonpublic. If it does not do so, then, subject to the firm's right to seek SEC review of the Board's determination, the Board publicly discloses those criticisms.

As a matter of law, the full reports on inspections are nonpublic although certain parts of the reports are public. Inspectors have identified a concerning number of deficiencies in successive inspection cycles for the largest firms, and at times on those firms' largest engagements. While our 2011 inspection cycle is not yet complete, our inspectors' preliminary results show that the number of deficiencies identified continues to be high relative to earlier years.



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The PCAOB's second inspection program focuses on the smaller registered firms (i.e., firms that audit 100 or fewer issuers) that are not members of a network covered in our global program. Currently approximately 600 such domestic firms and 75 non-affiliated, foreign firms are subject to triennial inspection.

In 2010, the PCAOB established an Office of Outreach and Small Business Liaison, to focus on outreach to auditors of the small business community. This office serves as a point of contact for anyone with questions about the PCAOB's activities. It also assists in identifying areas where information related to the PCAOB's work may not be well understood.

In addition, for several years, the PCAOB has conducted a series of meetings with auditors from smaller, unaffiliated firms that lack the resources of the large, networked firms but nevertheless can bring significant expertise to bear for investors in the vast array of small public companies. These meetings, called the Forum on Auditing in the Small Business Environment, are day-long events designed to allow auditors in smaller firms to learn about the PCAOB's work, to provide their own insights and suggestions, and to ask questions about PCAOB activities, including inspections and new auditing standards and guidance.

The format of these forums promotes an open dialogue among PCAOB representatives and forum participants. In 2011, 762 people attended small business forums held in seven cities. The PCAOB plans to hold seven more such forums in 2012.

## **2. Pilot Program for Inspections of Broker-Dealer Audits.**

In 2011, the PCAOB continued its work to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which gave the PCAOB authority for inspection, standard setting and enforcement for the audits of brokers and dealers registered with the SEC.

On June 14, 2011, the Board adopted a temporary rule that provides for an interim inspection program for firms that perform audits of the financial statements of brokers and dealers.

The interim inspection program allows the Board to assess registered public accounting firms' compliance with current laws, rules, and standards in performing audits of the financial statements of brokers and dealers. As part of this program, information will be gathered to help guide the Board's decisions about the scope and elements of a permanent inspection program, including whether to differentiate between classes of brokers and dealers; whether different inspection schedules would be appropriate with respect to firms that only audit certain types of brokers and dealers;



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and whether to exempt any public accounting firms from inspections related to their audits of broker and dealers.

The SEC approved the temporary rule on August 18, 2011. By year-end, the PCAOB had inspected eight firms and examined portions of 19 audits of brokers and dealers.

The PCAOB does not expect to issue firm-specific inspection reports as part of the interim inspection program. Instead, to keep the public informed, the Board will annually publish a report describing the progress of the interim program. The first such annual progress report is expected to be issued in August 2012.

After gaining valuable insight through the interim inspection program and analysis of broker-dealer characteristics, I anticipate that the Board will then carefully consider whether there should be exemptions from the permanent program, including for auditors of brokers that do not receive or hold customer funds.

Further, in an effort to provide information to and seek the views of auditors of brokers and dealers, the PCAOB in 2011 inaugurated the Forum on Auditing Smaller Broker-Dealers, drawing 321 attendees in Jersey City, NJ, and Huntington Beach, CA. The PCAOB plans four additional such forums in 2012 in Chicago; Houston; Jersey City; and San Diego.

#### **B. PCAOB Access to Non-U.S. Registered Firms**

Public companies, whether located in the U.S. or abroad, access U.S. capital markets by complying with certain U.S. legal requirements, including the requirement to periodically file audited financial statements with the Securities and Exchange Commission.

Under the Sarbanes-Oxley Act, the auditor of financial statements – whether a U.S. auditor or a non-U.S. auditor – must be registered with the PCAOB, and the PCAOB must regularly inspect the firm to assess its compliance with U.S. laws, rules and professional standards in connection with those audits. As of Dec. 31, 2011, 908 non-U.S. accounting firms were registered with the PCAOB.

The PCAOB has conducted inspections in 37 non-U.S. jurisdictions since non-U.S. inspections began in 2005. In 2011, the PCAOB reached cooperative agreements with auditor oversight authorities in the United Kingdom, Canada, Switzerland, Norway, Japan, Taiwan, Israel, Dubai and the Netherlands.

These cooperative agreements generally provide a basis for cooperation in the oversight, including inspections and investigations, of firms subject to the jurisdiction of



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both parties to the agreement. Many of the PCAOB's cooperative agreements also permit the PCAOB to exchange confidential information with its non-U.S. counterparts, under authority granted to the PCAOB by the Dodd-Frank Act.

The PCAOB in 2011 remained unable to conduct inspections of registered firms in certain European Union member states and China, due to asserted restrictions under local law or objections based on national sovereignty. Due to the position taken by the authorities in China, the PCAOB also was prevented from conducting inspections of registered firms in Hong Kong to the extent that their audit clients had operations in China. Discussions with local oversight authorities in Europe and China continue.

While we work on negotiating access, the PCAOB has issued staff audit practice alerts and other reports to keep auditors and the public apprised of audit risks presented in non-U.S. audits. Specifically, the PCAOB has issued two staff audit practice alerts relating to (i) appropriate use of non-U.S. auditors and related risks that should be addressed,<sup>1</sup> and (ii) audit risks identified in emerging markets.<sup>2</sup> In addition, in March 2011, the PCAOB issued a research note on trends and risks related to reverse merger transactions involving companies from the China region.<sup>3</sup>

### C. Enforcement

The Board has broad authority to impose sanctions on registered firms and associated persons that have violated applicable laws and standards. Disciplinary cases that have become public recently have focused on audit failures related to both U.S. and non-U.S. companies traded in U.S. markets; failures to follow standards on quality control and auditing; and auditors' failures to comply with the Board's processes and rules.

For example, in 2011 the PCAOB announced a settlement with five India-based affiliates of PricewaterhouseCoopers, for their audits of Satyam Computer Services.

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<sup>1</sup> PCAOB Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (July 12, 2010).

<sup>2</sup> PCAOB Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets* (Oct. 3, 2011).

<sup>3</sup> PCAOB, *Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: January 1, 2007 through March 31, 2010* (March 14, 2011), available at [http://pcaobus.org/News/Releases/Pages/03152011\\_ResearchNote.aspx](http://pcaobus.org/News/Releases/Pages/03152011_ResearchNote.aspx).



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This followed the extraordinary public statement of Satyam's then-Chairman that the company had reported inflated profits over several years and was showing on its balance sheet more than \$1 billion in non-existent cash and bank balances. The SEC, in an order in its proceeding against the auditors, noted that the fraud was accomplished through the company's use of fictitious invoices, bank statements, and bank confirmations. The Satyam audit was a high profile example of auditors failing to exercise professional skepticism.<sup>4</sup> Their deficient audit procedures contributed directly to their failure to uncover the Satyam fraud.<sup>5</sup>

Also, just last month, the Board issued another settled disciplinary order against one of the largest registered accounting firms. In this order, the Board censured Ernst & Young LLP ("E&Y"), imposed a \$2 million civil money penalty against the firm, and sanctioned four of its current and former partners for violating PCAOB rules and standards.<sup>6</sup>

This order related to three E&Y audits of Medicis Pharmaceutical Corporation and a consultation stemming from an internal E&Y audit quality review of one of the audits. Specifically, the company's initial basis for establishing its sales returns reserve conflicted both with U.S. generally accepted accounting principles ("GAAP"), and with the firm's internal accounting guidance that addressed revenue recognition for sales with rights of return. Rather than appropriately addressing this material departure from GAAP, E&Y and its personnel wrongly decided in an internal consultation that another flawed rationale supported the company's existing accounting. The company ultimately corrected its accounting for its sales returns reserve and filed restated financial statements with the SEC as a result.

In another recent settled matter, the Board revoked a firm's registration, and barred two of its partners, for violations of quality control and auditing standards,

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<sup>4</sup> Under PCAOB standards, "professional skepticism" is an attitude that includes a questioning mind and a critical assessment of audit evidence. See AU 230.07.

<sup>5</sup> In addition to censuring the firms, the Board (i) levied a \$1.5 million fine, (ii) barred the firms from taking on any new SEC issuer work for 6 months, and (iii) ordered them to retain an independent monitor to oversee development of quality control improvements ordered by the Board. The SEC brought a simultaneous proceeding against the firms under Rule 102(e), including a \$6 million penalty.

<sup>6</sup> See In the Matter of Ernst & Young LLP, Jeffrey S. Anderson, CPA, Ronald Butler, Jr., CPA, Thomas A. Christie, CPA, and Robert H. Thibault, CPA (Feb. 8, 2012).



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including in audits of two China-based reverse merger companies, and for failing to cooperate in the investigation and in an inspection.<sup>7</sup>

There is also a significant body of cases that focus on firms' failure to cooperate with the PCAOB's inspection or enforcement programs. For example, in two other settlements last year, the Board barred two audit personnel at a large firm, including the engagement partner on the relevant audit, for improperly creating, backdating, and adding documents to audit work papers shortly before a PCAOB inspection.<sup>8</sup>

The PCAOB closely coordinates its enforcement efforts with the SEC, including on China audit firm matters. 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.

### **III. New Audit Standard-Setting Initiatives**

The Sarbanes-Oxley Act charges the Board with establishing auditing and related professional practice standards for audits of public companies and SEC-registered broker-dealers, and the Board has followed a transparent and fair process for doing so. The Board uses information that it learns in its inspections and from other sources to evaluate the need for changes in auditing standards. In developing new standards, the PCAOB casts a wide net to seek advice from various interested people and groups on ways to improve audits.

The Board's actions are informed by meetings and dialogue with investors, auditors, representatives of public companies and members of the academic community, among other ways through its Standing Advisory Group. Further, the Board holds roundtable discussions and other public meetings to deepen its dialogue with commenters and other interested parties. The Board also works closely with the SEC on the development of standards and monitors the work of accounting standard setters, such as the Financial Accounting Standards Board, for developments that may affect auditing.

PCAOB standards are rules of the Board. To adopt or change them, the Board uses a notice-and-comment process similar to the process used by federal agencies and other standard setters, under which the Board proposes standards for public comment before adopting new or amended standards in a public meeting. All Board standards must be approved by the SEC before they can become effective.

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<sup>7</sup> See *In the Matter of Chisholm, Bierwolf, Nilson & Morrill, LLC, Todd D. Chisholm, CPA, and Troy F. Nilson, CPA* (Apr. 8, 2011).

<sup>8</sup> See *Peter C. O'Toole* (Aug. 1, 2011); *Darrin G. Estella* (Aug. 1, 2011).



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In the past year, the Board has engaged in a number of projects related to auditing and related professional practice standards:

- The Board proposed a new auditing standard, *Related Parties*, and amendments to certain PCAOB standards regarding significant unusual transactions, intended to enhance auditing procedures in areas that have, at times, been used to engage in fraudulent financial reporting.
- The Board also proposed amendments intended to improve the transparency of public company audits by requiring the disclosure of the engagement partner's name in the audit report and the disclosure of other independent public accounting firms and other persons that took part in the audit.
- The Board repropose a new auditing standard, *Communications with Audit Committees*, and related amendments that are intended to enhance the relevance and quality of the communications between the auditor and the audit committee.
- The Board proposed auditing and attestation standards that would apply to the audits of SEC-registered brokers and dealers and to the supplemental information accompanying audited financial statements.
- Finally, the PCAOB issued two Staff Audit Practice Alerts in 2011 – one intended, as discussed above, to increase auditors' awareness of risks when performing audits of companies with operations in emerging markets, and the other to assist auditors in identifying matters related to the economic environment that might affect the risk of material misstatement in financial statements.

These projects, as well as the Board's planned future standard-setting projects, are described in Appendices 1 and 2, respectively.

In addition, the Board has recently issued two concept releases, soliciting public comment on possible changes to PCAOB standards affecting two major areas of audit practice: (i) the auditor's reporting model, and (ii) auditor independence, objectivity and professional skepticism, including mandatory term limits, or rotation, for auditors of companies traded in U.S. markets. These concept releases did not propose new auditing standards. Rather, they sought the public's views on particular matters so that the Board can better evaluate the need for future standard-setting. To this end, the PCAOB held a roundtable on the auditor's reporting model in September 2011.





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Further, the PCAOB recently held a public meeting on auditor independence, objectivity and professional skepticism.<sup>9</sup> Forty-seven panelists appeared at the two-day public meeting, offering varied perspectives as investors, senior executives and audit committee chairs of major corporations, chief executive officers of audit firms, academicians and other interested parties. The PCAOB plans to hold additional such meetings around the country, in an effort to obtain public comment from a wide and diverse set of interested parties on this important topic.

#### **IV. Pending Legislative Proposals**

##### **A. Providing Public Transparency to PCAOB Disciplinary Proceedings**

The Subcommittee's invitation letter invited comment on H.R. 3503, introduced by Congressman Westmoreland and co-sponsored by Committee Ranking Member Frank to make the PCAOB's disciplinary proceedings public.

Under the Sarbanes-Oxley Act as it exists today, the PCAOB's disciplinary proceedings are nonpublic, unless the Board finds there is good cause for a hearing to be public *and* each party consents to public hearings.<sup>10</sup> The auditors and audit firms charged with violating applicable laws, rules or standards have little incentive to consent to opening the case against them to public view, and in fact, none have ever done so.

PCAOB disciplinary proceedings remain nonpublic even after a hearing has been completed and adverse findings made by a disinterested hearing officer, if the auditors and firms do not consent to make the proceedings public and opt to appeal. In addition, unlike the authority the Securities Exchange Act of 1934 provides the SEC in its administrative proceedings, the PCAOB has no authority, while litigation is pending, to issue temporary cease-and-desist orders in appropriate cases, to prevent threatened violations or harm to investors or the public interest.

Continued litigation postpones – often for several years – the day on which the public learns that the PCAOB has charged the auditor or firm, the nature of those charges, and the content of adverse findings. This secrecy has a variety of unfortunate consequences.

First, the public is denied access to important information regarding PCAOB cases. During the course of the proceeding, investors, audit committees, and other

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<sup>9</sup> The agenda and a webcast of the meeting are available at [http://pcaobus.org/News/Events/Pages/03212012\\_PublicMeeting.aspx](http://pcaobus.org/News/Events/Pages/03212012_PublicMeeting.aspx).

<sup>10</sup> See Sarbanes-Oxley Act, Section 105(c)(2).



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interested parties are kept in the dark about a respondent's alleged misconduct – no matter how serious. Even after the Board has found sufficient cause to initiate formal proceedings and a disinterested hearing officer has found that the alleged violations occurred, the matter may still remain unknown to the public at least until the case is appealed to the Commission. As a result, investors are unaware that companies in which they may have invested are being audited by accountants who have been charged, even sanctioned, by the Board. For example, during the nonpublic proceedings regarding Gately & Associates, the firm issued 29 additional audit reports on public company financial statements between the commencement of the Board's proceeding and when the Board was able to make its charges public, which was not until the Commission affirmed the Board's decision to expel the firm from public company auditing.<sup>11</sup>

Second, respondents have an incentive to litigate Board cases, regardless of whether they believe they will ultimately prevail. Contesting the allegations allows respondents to continue with their public company audit practice without any disclosure to clients or investors of the Board's charges for as long as the litigation is ongoing. In the Gately & Associates matter, over two years elapsed between the filing of the Board's case and the Board's publication of the sanctions. During that time, the firm continued its public company audit practice.

Third, the public cannot properly evaluate the Board's enforcement program. During the course of a PCAOB disciplinary proceeding no investor, no other auditor, no audit committee, no member of the media is entitled to know what conduct the Board considers to merit discipline, whom the Board has charged, and what issues are being litigated. As a result, the public is uninformed about the level of activity in the Board's enforcement program and how the Board uses its enforcement resources.

If the SEC were to bring the same case as the PCAOB, alleging the same violations, against the same auditor, the SEC's charges would be disclosed at the time the Commission instituted its proceeding. Any administrative trial would be open to the public. If there were an appeal to the Commission and an oral argument, the public could attend. The ability – or inability – of the SEC's staff to prove its charges would be a matter of public record.

The SEC determined more than twenty years ago that its disciplinary proceedings against accountants and auditors should be public. In the 1980s, the SEC faced the same problem as now confronts the Board. SEC disciplinary hearings

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<sup>11</sup> See In the Matter of the Application of Gately & Associates, LLC and James P. Gately, SEC Release No. 34-62656 (August 5, 2010). The number of opinions issued was obtained from Audit Analytics.



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involving accountants and auditors were private until 1988, when the Commission amended its rules to make the hearings presumptively public.<sup>12</sup> The reasons cited by the SEC for the change included:

- Virtually all other administrative proceedings brought by the SEC (including those against brokers, dealers, investment advisers, and public companies) and all SEC injunctive actions are public,
- Private proceedings create incentives for delays,
- The public and audit professionals are interested in timely disclosure of the standards used to commence disciplinary proceedings (the public and other auditors have a legitimate interest in learning, on a timely basis, the facts and circumstances that have led to the institution of proceedings), and
- Public proceedings are more favored in the law than closed-door proceedings.

These same reasons support the need for public PCAOB disciplinary proceedings. The Board, however, unlike the SEC, lacks the authority to make its proceedings public through a change to its rules. This state of affairs is not good for investors, for the auditing profession, or for the public at large. Investors would be best served by similar transparency in PCAOB disciplinary proceedings.

#### **B. March 21 Discussion Draft**

The Subcommittee's invitation letter also invited comment on a discussion draft of potential legislation that would amend Section 103 of the Sarbanes-Oxley Act to prohibit the PCAOB from requiring public companies to use specific auditors or require the use of different auditors on a rotating basis.

The Board, of course, has not proposed mandatory audit firm rotation. Rather, as described above, the PCAOB is engaged in a deep and wide-ranging public dialogue about ways to enhance the independence, objectivity and professional skepticism of public company auditors. The Board initiated this discussion by issuing a concept release, which asked not only whether others agree or disagree that the Board should focus on this issue, but also sought specific ideas for improving independence, objectivity, and skepticism, including the possibility of rotation. This dialogue was prompted, among other things, by concerns developed over the last nine years of the PCAOB's inspections of public company audits. It was also prompted by the

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<sup>12</sup> SEC Release No. 34-25893 (July 7, 1988); 53 FR 26427 (July 13, 1988).



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Government Accountability Office's statutorily required 2003 report on mandatory audit firm rotation, which noted the significant implementation issues that would be associated with mandatory audit firm rotation and concluded that the PCAOB and the SEC would need more time and experience to evaluate whether term limits are necessary to preserve auditor independence.<sup>13</sup>

With the benefit of nearly a decade of inspections, the Board has begun that evaluation. As the Board's concept release states –

Since its creation, the Board has conducted hundreds of inspections of registered public accounting firms each year. These inspections provide the Board with a unique insight into the state of the audit profession and the conduct of public company audits. Based on this insight, the Board believes that the reforms in the Act have made a significant, positive difference in the quality of public company auditing. Yet, as described below, the Board continues to find instances in which it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional skepticism.<sup>14</sup>

The PCAOB is not alone in its concern over the number of deficiencies found in inspections and the larger questions that arise from these findings. Similar concerns have been expressed by regulators in Canada, Germany, the U.K., the Netherlands, Australia and elsewhere.<sup>15</sup> As the Canadian Public Accountability Board recently

<sup>13</sup> See U.S. General Accounting Office, *Required Study on the Potential Effects of Mandatory Audit Firm Rotation* (2003), at 5.

<sup>14</sup> See PCAOB Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation* (Aug. 16, 2011). Pursuant to the Sarbanes-Oxley Act, the details of the PCAOB's inspections are subject to a broad confidentiality restriction such that they may not even be shared with Congress. Sarbanes-Oxley Act, Section 105(b)(5). Last Congress, the House Financial Services Committee unanimously approved an amendment offered by then-Representative Adam Putnam (R-FL) to amend the Act and allow the Board to do so, but that provision has not been enacted.

<sup>15</sup> See Audit Oversight Commission, *Report on the Results of the Inspections according to § 62b WPO for the Years 2007-2010*, at 3 (Apr. 6, 2011) (Germany):

In general the inspection findings . . . show that there is still room for improvement in terms of the audit quality, according to the AOC.

This particularly applies in view of the auditor's indispensable professional scepticism towards statements made by the audit client. In this respect



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reported in a summary of worldwide inspection findings, “[i]nsufficient Professional Skepticism . . . is undoubtedly the most common finding – that auditors are too often accepting or attempting to validate management evidence and representations without sufficient challenge and independent corroboration.”<sup>16</sup> Based on such concerns, the European Commission also is considering reforms to enhance auditor independence.

In light of these findings and related developments, the PCAOB has solicited ideas and begun a vigorous, substantive and constructive debate on the best ways to achieve greater auditor independence, objectivity and professional skepticism. Part of this debate has involved bringing interested and experienced parties together for in-depth discussions. As previously mentioned, the PCAOB just last week held a two-day

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the inspections showed indications in some cases that the audits had not been conducted with the necessary professional scepticism, especially in the audit fields which were exposed to increased risks in the context of the financial market and economic crisis and consequently required particular professional scepticism on the part of the auditor.

See also U.K. Professional Oversight Board, *Audit Inspection Unit 2009/10 Annual Report*, at 4 (July 21, 2010) (stating that “[f]irms sometimes approach the audit of highly judgmental balances by seeking to obtain evidence that corroborates rather than challenges the judgments made by their clients” and that “[a]uditors should exercise greater professional scepticism particularly when reviewing management’s judgments relating to fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern”); Netherlands Authority for the Financial Markets, *Report on General Findings Regarding Audit Quality and Quality Control Monitoring*, at 13-14 (Sept. 1, 2010); Australian Securities & Investment Commission, *Audit Inspection Program Public Report for 2009-2010*, at 13-14 (June 29, 2011); Canadian Public Accountability Board, *Enhancing Audit Quality: Report on the 2010 Inspections of the Quality of Audits Conducted by Public Accounting Firms*, at 3 (April 2011); Federal Audit Oversight Authority, *Activity Report 2010*, at 23 (Feb. 14, 2011) (Switzerland).

In addition, the Canadian Public Accountability Board just last month issued a Special Report on Auditing in Foreign Jurisdictions, in which the CPAB “found a lack of professional skepticism when auditors were confronted with evidence that should have raised red flags regarding potential fraud risk.” Canadian Public Accountability Board, *Auditing in Foreign Jurisdictions: CPAB Special Report*, at 1 (Feb. 2012).

<sup>16</sup> See Canadian Public Accountability Board, *Auditing in the Decade Ahead: Challenge and Change*, Audit Quality Symposium Pre-Reading Materials, at 36 (2011).



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public meeting at which the PCAOB heard from forty-seven participants. We plan to hold additional meetings around the country over the course of the next year or so.

During this dialogue, I have been struck and encouraged by auditors' heightened self-awareness that the world is changing and that a new look at measures to maintain the relevance and reliability of audits is warranted. Most accounting firms appear to appreciate that the profession is evolving and that additional enhancements to auditor independence, objectivity and professional skepticism are needed.

As an independent standard setter, the PCAOB has brought people with a variety of viewpoints together to explore this critical issue in greater depth. If this process results in the PCAOB proposing any rules – whether they involve term limits or not – they will be subject to further public comment and SEC approval.

For these reasons, I encourage the Subcommittee to respect the decision made by Congress to entrust these judgments to the independent standard-setting process of the body charged with examining public company audits and, based on that examination, considering what improvements are needed in those audits to protect investors and further the public interest.

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In conclusion, I appreciate the Subcommittee's interest in the work of the PCAOB and I look forward to working with you in the future. I would be happy to answer any questions.



## APPENDIX 1 – RECENT STANDARD-SETTING ACTIVITIES

### Proposed Standards and Amendments

#### *Audits of SEC-Registered Brokers and Dealers*

The Dodd-Frank Act gave the PCAOB the authority to oversee auditors of SEC-registered brokers and dealers, including authority to set standards and rules for audits of brokers and dealers.

The SEC decides what parts of the financial reports filed by registered brokers and dealers should be audited by PCAOB-registered accounting firms and the standards that should be used in conducting those audits. In June 2011, the SEC proposed to amend its rules to require that certain audit and attest reports be prepared by PCAOB-registered auditors using standards established by the PCAOB. On July 12, 2011, the Board proposed attestation standards for auditors tailored to the SEC proposed rule amendments. The Board also proposed a standard for audits of supplemental information accompanying audited financial statements that would apply to audits of brokers and dealers and audits of issuers. The deadline for comments on the proposed PCAOB standards was Sept. 12, 2011. Further action on the Board's proposals is dependent on the SEC's adoption of the proposed amendments to its rules.

#### *Audit Transparency*

The audit report is typically an investor's primary source of information about the audit. Usually a single page, the report provides general information about how every audit must be conducted, states that the audit complied with applicable standards, gives the firm's opinion on the company's financial statements or internal control over financial reporting, and includes the signature of the firm that issued it. While the report provides useful information—the opinion, primarily—it tells the reader little about the key participants in the audit.

On Oct. 11, 2011, the Board proposed amendments to its standards that would improve the transparency of public company audits by requiring that audit reports disclose the name of the engagement partner as well as the names of other independent public accounting firms and other persons that took part in the audit. The amendments would also require registered public accounting firms to disclose the name of the engagement partner for each audit listed on the firms' annual reports filed with the PCAOB. The deadline for comments on the proposed amendments was Jan. 9, 2012.



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#### *Communications with Audit Committees*

On Dec. 20, 2011, the Board repropoed a new auditing standard, *Communications with Audit Committees*, and related amendments. The standard is intended to benefit investors by establishing requirements that enhance the relevance and quality of the communications between the auditor and the audit committee.

The Board originally proposed the auditing standard in March 2010. Interest in the proposed standard prompted the Board to reopen the comment period and host a roundtable discussion with representatives of audit committees, investors, auditors, issuers and others.

The repropoed standard incorporates comments and suggestions received; reflects information that is aligned with the Board's new risk assessment standards that took effect in 2011; and adds a requirement to communicate information about significant unusual transactions. The repropoal also provides commenters with an opportunity to comment on the standard in relation to the audits of brokers and dealers. The deadline for comments was Feb. 29, 2012.

#### *Auditing Related Party Transactions*

Related party transactions often involve difficult measurement and recognition issues that not only can lead to errors in financial statements but also, in some cases, have created opportunities for fraudulent financial reporting and the misappropriation of assets. Studies have shown that such transactions have played a recurring role in financial failures, from those that led to the Sarbanes-Oxley Act to those recently alleged in certain emerging market companies. Significant transactions that are outside a company's normal course of business present similar issues. On February 28, 2012, therefore, the Board proposed a new standard, *Related Parties*, as well as amendments to certain PCAOB auditing standards to assist auditors in detecting and addressing the audit risks associated with related parties and other unusual transactions. The comment period expires May 15, 2012.





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### **Concept Releases**

#### *Auditor's Reporting Model*

Auditors, as a result of performing required audit procedures, often have significant information regarding a company's financial statements and the audit of such financial statements. Although that information is not reported in the standard auditor's report to the financial statements users, the information might be useful to investors and other financial statement users.

On June 21, 2011, the Board issued a concept release to seek public comment on potential changes to the auditor's reporting model based on concerns of investors and other financial statement users.

The concept release raised for consideration several alternatives for the auditor's reporting model that could increase its transparency and relevance to financial statement users. The alternatives include a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the auditor's view of the company's financial statements (an "Auditor's Discussion and Analysis"); required and expanded use of emphasis paragraphs in the auditor's report; auditor reporting on other information outside the financial statements; and clarification of certain language in the auditor's report. The concept release noted that the identified alternatives are not mutually exclusive and that other alternatives may exist.

The concept release was preceded by several discussions with the PCAOB's Standing Advisory Group and Investor Advisory Group, in addition to extensive outreach by PCAOB staff in 2010 and early 2011. The staff presented the findings from that outreach to the Board at an open meeting March 22, 2011, and the Board approved the concept release June 21, 2011. The Board solicited further comment at a roundtable on Sept. 15, 2011, with participants representing investors, other users and preparers of financial statements, audit committee members, academics and auditors. The deadline for comments on the concept release was Sept. 30, 2011.

#### *Auditor Independence and Audit Firm Rotation*

An audit has value to financial statement users because it is performed by a competent third party who is viewed as having no interest in the financial success of its audit client. Investors should be able to take comfort in the fact that



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independent professionals have performed required procedures and have a reasonable basis for the audit opinion.

Questions persist, however, about whether more can and should be done to enhance auditor independence, objectivity and professional skepticism. As a result of PCAOB inspections, the experience of other audit regulators and concerns expressed by investors, the Board issued a concept release Aug. 16, 2011, seeking public comment on a variety of possible approaches to improving auditor independence, objectivity and professional skepticism.

One possible approach is mandatory audit firm rotation, which would limit the number of consecutive years a registered public accounting firm could serve as the auditor of a public company.

The release sought comments on, among other things, whether a rotation requirement would risk significant cost and disruption and how mandatory rotation would serve the Board's goals of protecting investors and enhancing audit quality. The Board also sought comment on whether other measures could meaningfully enhance auditor independence.

The deadline for comments was Dec. 14, 2011. The Board also held the first of several public meetings to obtain further comment last week, on March 21 and 22. The Board reopened the comment period in connection with the public meeting, until April 22, 2012.

#### **Staff Audit Practice Alerts**

The PCAOB publishes Staff Audit Practice Alerts to highlight new, emerging or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. The PCAOB issued two alerts in 2011 in response to events in emerging markets and in the global economic environment that exposed possible threats to the reliability of some companies' financial statements and heightened the need for vigilance on the part of auditors.

#### *Audit Risks in Certain Emerging Markets*

On Oct. 3, 2011, the PCAOB issued Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets*, to increase auditors' awareness of risks when performing audits of companies with operations in emerging markets.



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The alert was prompted by disclosures of possible improprieties in financial reporting by companies based in certain large emerging markets in Asia and observations from the Board's oversight activities. The practice alert focuses on risks of misstatement due to fraud that auditors might encounter in audits of companies with operations in emerging markets—risks that also may be present in companies in developed markets.

Conditions and situations indicating heightened fraud risk include discrepancies between a company's financial records and audit evidence obtained from third parties; auditors' difficulties in confirming cash and receivable balances; and the recognition of revenue from contracts or customers whose existence cannot be corroborated.

#### *Risk in the Current Economic Environment*

On Dec. 6, 2011, the PCAOB issued Staff Audit Practice Alert No. 9, *Assessing and Responding to Risk in the Current Economic Environment*, to assist auditors in identifying matters related to the economic environment that might affect the risk of material misstatement in financial statements and, therefore, require additional audit attention.

The alert updated Staff Audit Practice Alert No. 3, issued in December 2008, in light of global economic conditions and new risk assessment standards that took effect for audits in 2011. The alert directs auditors' attention to considering the impact of economic conditions on the audit; auditing fair value measurements and estimates; considering a company's ability to continue as a going concern; and auditing financial statement disclosures.



## APPENDIX 2 – FUTURE STANDARD SETTING PLANS

Among the auditing issues on the Board's standard-setting agenda are those dealing with:

*Specialists.* The Board is considering possible revisions to the standard on the auditors' use of specialists to strengthen requirements related to certain aspects of specialists' work, such as the auditor's evaluation of the work of a specialist.

*Part of the audit performed by other auditors.* In many public company audits, the accounting firm issuing the audit report does not perform 100 percent of the audit procedures. This may be especially common in, but not limited to, audits of companies with operations in more than one country. In these situations, audit procedures on or audits of the company's foreign operations are performed by other accounting firms or other participants in the audit not employed by the auditor. The Board is considering possible revisions to its standards to strengthen requirements regarding the work performed by the various auditors participating in the audit.

*Assignment and documentation of firm supervisory responsibilities (failure to supervise).* The Sarbanes-Oxley Act authorizes the PCAOB to impose sanctions on registered public accounting firms and their supervisory personnel for failing to reasonably supervise associated persons. To assist its oversight, the Board is considering possible rulemaking or standard setting that would require firms to make and document clear assignments of the supervisory responsibilities that should already be part of any audit practice. The Board sought comment on rulemaking concepts related to supervision in a release issued Aug. 5, 2010.

*Fair value measurements.* The Board is evaluating potential revisions to the PCAOB standards on fair value measurements and other accounting estimates.

To assist in its evaluation, the Board formed the Pricing Sources Task Force in March 2011. This group of investors, financial statement preparers, auditors and representatives of pricing services and brokers met three times in 2011 to discuss the valuation of financial instruments that are not actively traded and the use of third-party pricing sources to value such instruments.

*Going concern.* The Board is considering possible revisions to the auditing standard on the auditor's evaluation of a company's ability to continue as a going concern. Among other things, the Board is considering how to enhance the auditor's evaluation process and the usefulness of the auditor's communication to investors regarding going concern uncertainty.



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*Confirmation.* The Board is considering possible revisions to the proposed standard, *Confirmation*, that would update and expand the requirements related to the auditor's use of confirmations. Confirmations are the direct communications between an auditor and a third party about a particular item affecting a company's financial statements. The standard was proposed July 13, 2010.

*Quality control.* The Board is in the process of evaluating potential revisions to its quality control standards, including the SEC Practice Section standards.

*Codification of PCAOB standards.* The Board is considering a potential framework of organization and codification of its auditing standards.

*Subsequent events.* The Board is also considering possible revisions to the auditing standards related to events or transactions that occur subsequent to the balance-sheet date.

Prepared Testimony to the Subcommittee on Capital Markets and Government  
Sponsored Enterprises

By Gary R. Kabureck  
Vice President and Chief Accounting Officer, Xerox Corporation  
On Behalf of Financial Executives International  
March 28, 2012

I would like to begin by thanking Chairman Garrett, Ranking Member Waters and the members of the Subcommittee on Capital Markets and Government Sponsored Enterprises for inviting me today to discuss a number of current issues and matters affecting the state of the U.S. accounting and auditing professions. Today I am representing Financial Executives International (FEI) – a leading international organization of senior financial executives. I am the chairman of the FEI's subcommittee on relations with the Financial Accounting Standards Board (FASB). For the last 11 years I have been Chief Accounting Officer of Xerox Corporation, a \$23 billion multinational corporation which operates in over 160 countries. The perspectives I will share with you today will be from the perspective of a financial statement preparer.

The accounting and auditing professions are large, dynamic and crucial to the smooth and efficient functioning of our economy and its capital markets. Like any large profession the list of current issues under consideration for change is long - as it should be – reflecting: the professions' continuous efforts for improvement; emerging issues and current needs of financial statement users; and reflection on the continuing applicability and on-going value of past decisions.

There are three subjects I would like to discuss with you today – they are:

- Mandatory Rotation of Auditing Firms
- Complexity in Accounting Standards
- Principles Based Accounting Standards

**Mandatory Rotation of Auditing Firms**

**Key messages:**

- The FEI recognizes and has always supported the critical need for auditor independence and impartiality however there is no guarantee that mandatory rotation of auditing firms will increase auditor independence and thus result in higher quality audits which is the primary goal. However it is clear that mandatory rotation will be costly and operationally disruptive.

- There are many reasons the financial statement preparer community opposes any requirement to periodically rotate a company's external auditors. This presentation focuses on practical operational implications and costs.
- For the larger multinational corporations (MNCs) realistically only the Big 4 firms have the global resources to effectively perform the audit.
- The process for selecting a new auditor and transitioning in a new auditor will be extremely costly for both the company and the new auditor. Company time and money are finite – every hour and dollar spent on changing auditors is not available for other uses in the business or return to investors.
- Many MNCs have non audit relationships (i.e. consulting, valuation, internal auditing, etc.) with one or more of the Big 4 firms which would often need to be curtailed if such firm was to be selected as the new auditor. This leads to additional business disruption to replace that firm in its non audit capacity. Alternatively, companies may decide to never retain a Big 4 firm to perform non-audit services as one day that firm may become the new external auditor.
- As big as they are the Big 4 firms are not necessarily fungible. They vary in industry concentrations and expertise, geographic presence and international reach which may limit the potential for selection as a new auditor.
- Many complex capital markets and M&A transactions may extend over several periods with one auditor present at the beginning and another present at the end. This creates it own set of costs and complications.

**Discussion:** The preparer community has been closely following this issue and is virtually unanimously opposed to any regulations which would require the mandatory rotation of a company's independent auditors. This Committee has or may hear the detailed pro and con arguments in favor or opposed to auditor rotation.

My objective today is to describe what some of the disruptive effects on a company's operations would be if periodic auditor rotation became a requirement. As I will discuss the financial, operational and cost implications are significant.

- For large multinational corporations (MNCs) realistically only the Big 4 firms have the capacity to perform a quality global audit in accordance with the standards of the PCAOB. This means there are only three potential alternatives when a MNC needs to change auditors. Contrast that to say the number of large banks or law firms who may be available for a given service.
- In some instances it is possible that there would not even be 3 of the Big 4 available. Each of these firms have varying industry expertise and

geographic presences and there are degrees of industry concentration within them. Thus the practical number of choices for new auditor selection may be less than 3.

- The Big 4 firms have enormous global capabilities and their non-audit practices place them among the largest consulting firms in the world. They each bring to the table a vast array of non-audit financial and other consulting services which most MNCs use in some capacity. The business issue is that many of these services (nine are enumerated in regulation) are prohibited from being performed by a company's audit firm – generally as an impairment to independence.
- For example implementing computer processing systems is a competency each of the Big 4 have. Systems projects often occur over several years. When an audit rotation interval comes up the Big 4 firm involved in the systems project would likely be ineligible to become the next auditor. What does a company do as there are no good choices:
  - Do not hire the Big 4 firm to do the system project in the first place even if it is otherwise highly qualified and cost effective?
  - During the middle of the systems project replace the Big 4 firm with another vendor and hope the vendor transition is seamless?
  - Limit the new auditor selection to only 2 of the Big 4?
- Another business disruptive example involves a company's internal audit function. Many MNCs – including my own – have outsourced internal auditing to a Big 4 firm other than their auditor. Internal audit outsourcing is a large line of business for many audit firms however it is a prohibited service for the external auditor to perform for his audit client. As with systems vendors, a company is only left with poor choices:
  - Select the firm with the internal audit contract to be the new external auditor, terminate their internal audit relationship and change the internal audit outsourcer to another major accounting firm;
  - Bring the internal audit function in house but in doing so a company would have to establish a new department and then identify and train qualified internal finance staff to do the function;
  - Leave the internal audit function where it is outsourced and limit new auditor selection to only 2 of the Big 4.
- There are many other examples that could be cited however it is very likely that most MNC's retain at least a few of the Big 4 firms to perform professional services that would be prohibited to be done by the external audit firm.
- Capital markets transactions and major acquisitions are complicated, big dollar business critical transactions with significant amounts of capital and risk often present. Often these transactions will span several quarters from launch to closing including over a fiscal year end. What happens if during the course of a lengthy transaction the required audit rotation interval occurs – i.e. one Big 4 firm is present at the beginning but another signs off at closing? This is a hugely important issue and concern. In



these circumstances extensive and complicated coordination between the predecessor and successor auditors is required. Both audit firms would have to concur on all significant accounting and auditing matters and a protocol to share audit findings would need to be developed. There would result in otherwise unnecessary costs (i.e. different firms signing comfort letters to underwriters, consents and expertization in registration statements, subsequent events reviews, different auditors signing off on different years in the financial filings, etc.). Capital markets and M&A transactions are frequently costly and complex and a required auditor change during the life of one would be an unwelcome and costly event.

- For large companies the process for new auditor selection is lengthy and expensive. For a MNC it may be necessary for the prospective auditor to visit several locations and commit to extensive due diligence in order to assess a company's internal controls, nature of records, operational matters affecting the audit etc. in order to prepare a meaningful proposal to become the new auditor. For a company's management it may have to repeat this process with several firms. Once the bids are in, extensive senior management time is necessary to evaluate them, conduct interviews and presentations. During this process the company's audit committee would need to become engaged, conduct their own interviews, evaluate management's assessments, etc. before finally selecting the new auditor. Much of this work would occur while the outgoing auditor is present and wrapping up his final year on the engagement.

The institutional knowledge the predecessor auditor has is lost when that firm leaves the engagement as it is not transferable to the new auditor. Thus, once the new auditor is selected management must commit extensive support time to assist the new firm in learning all the financial details about the client. It is easy for first year audit time to exceed by 50% or more the steady state effort and it may take several years to get to the steady state.

In summary, requirements to mandate the periodic rotation of auditing firms will have significant operation consequences and cost increases to the companies they audit. The above examples are among the more significant implications however there are many more that can be enumerated.

### **Complexity in Accounting Standards**

#### **Key messages:**

- Complexity in accounting standards, including the related disclosure requirements, is a significant issue for the preparers of financial statements.
- Some complexity is unavoidable and appropriate but some can and should be avoided.
- Unnecessarily complex accounting standards results in significant operating costs to preparers.
- To the extent possible, new accounting standards should result in financial statements which reflect a company's business model.
- Cost of implementation and ongoing compliance should receive greater prominence in the FASB's decision process for new standards.
- The FASB currently conducts extensive outreach when developing new accounting standards and the FEI strongly encourages such be continued in perpetuity. The FEI wishes to recognize Chairman Seidman's efforts during the almost two years she has chaired the FASB. In an effort to test the operational viability of potential new standards the FASB has been conducting greater than ever outreach – both in frequency and visibility – to its various constituencies including the preparer community.

**Discussion:** The complexity of many accounting standards is a matter of significant importance and concern to the preparers of financial statements, the senior management of their companies and to the audit community. Unnecessarily complex accounting standards almost certainly result in increased operational and audit costs for financial statement preparers and increase the potential for financial statement errors. The FEI has long been a proponent of improvements to financial accounting to address investor needs and works very closely with the FASB in a continuous dialogue regarding the development of new accounting standards and in the ongoing evaluation of existing standards. To be sure, some complexity is inevitable and the complex nature of some transactions can only be properly addressed by complex accounting standards. There are many root causes behind the complexity in accounting standards including (but not limited to):

- Culturally the US tends to be a rules based society so it is logical that accounting standards also contain a large rules based element.
- The FASB and its predecessor standards setters have historically been guided by an overarching goal of achieving consistency and comparability in the recognition, measurement and presentation of transactions between different companies. Thus a tendency towards detailed rules and a 'one size fits all' approach in the promulgation of new standards.

- Building on the preceding point, in an effort to achieve consistency new accounting standards released over the last few decades have tended to be very detailed in trying to provide guidance for many lower level implementation issues and variants found in practice.
- The cost of compliance with new accounting standards has frequently not been a significant factor in the establishment of new standards. In this context 'cost' means the internal operating costs to develop new procedures and information systems and the ongoing costs of compliance including internal staff time and external audit fees.

While the FASB's mission is to enhance the decision usefulness of accounting information for investors and other users of financial statements, the FEI strongly recommends that new standards should also be developed with due consideration of the preparer community's operational capability in a cost-effective manner. Stated differently, improvements to accounting standards and cost effective, less complex new requirements need not be mutually exclusive. FEI recommends to the extent reasonably possible new accounting principles:

- Be developed considering the business models of the affected companies;
- Recognize that companies are different from each other – even than those in the same industry – such that it is reasonable to assume that similar transactions may be accounted and presented differently but still produce decision useful financial statements;
- Recognize that there will be occasions when there is more than one equally reasonable and decision useful alternative accounting treatment for a given type of transaction or event;
- Increase the weighting that cost of implementation and compliance receives in the FASB's decision process;
- Allow for reasonable flexibility in the transition rules for the initial adoption of new accounting principles;
- Minimize unnecessary complexity even at the expense of permitting some variations in practice – see next section below on Principles Based Accounting Standards.

### **Principles Based Accounting Standards**

#### **Key Messages:**

- The FEI has long been a strong proponent of principles based accounting and encourages the accounting standards setters to promulgate new standards with more emphasis on principles and less on detailed rules and implementation guidance.
- The FEI has noticed a recent change by the FASB in this direction but notes that old habits (i.e. drafting very detailed guidance) are often hard to

break and there remain many accounting standards on the books that include extensively detailed rules.

- Unnecessary complexity and higher compliance costs tend to be by-products of rules based accounting standards.
- Principles based accounting standards will require (1) the acceptance of good faith application of judgment by all constituencies in the accounting, reporting and auditing communities and (2) recognition that there may be slightly less comparability between companies in the future as local judgments may be different.

**Discussion:** FEI has been a strong proponent for principles based accounting for many years. The question often comes up – what’s the difference between rules based accounting and principles based accounting? The simple answer involves the level of detail provided by standards setters such as the FASB and IASB. Rules based accounting standards always begin with basic principles but then expand from there. Rules based standards frequently attempt to provide guidance for as many transaction variants and combinations and permutations as have been identified by the staff as existing in practice. The high level objectives for detailed rules are generally laudable – consistency in practice, implementation guidance, detailed standards to audit against, etc. Although most interested parties in the accounting and auditing communities regularly profess to be supporters of principles based accounting the reality is that after several decades of primarily rules based new standards it is difficult to quickly change philosophical direction. FEI has noticed the winds of change appear to be gathering and strongly encourages the direction. However old habits are always a challenge and there are many, many standards on the books with heavy detailed rules content.

Some of the drawbacks of rules based accounting principles include:

- Complexity is definitely increased as the final accounting standards are much longer and frequently it is not always clear which individual rule applies in a given situation because:
  - All possible variations in practice cannot be covered by detailed rules
  - Detailed rule making tends to invite exceptions.
  - Precise and detailed rules offer the opportunity for transaction structuring around and between individual rules.
  - The ability to apply judgment is often limited.
  - Costs of implementation and ongoing compliance will frequently be higher because it may be more difficult to apply detailed rules than higher level principles.
  - Detailed rules and resulting complexity increase the chance of error and restatement.
- It generally takes longer for standard setters to finalize new accounting standards if for no other reason than the mere length of the final document and level of details provided.

- Detailed rules based standards often detract from the basic, high level goals of the new accounting standard.

While FEI recognizes that some level of detailed rules are inevitable and appropriate, we strongly recommend that the future direction of accounting standards setting stay primarily focused on promulgating principles and resist, to the extent possible, the historical urge for extensive rules. Effective deployment of a principles based accounting system may require certain changes in practice such as:

- Acceptance by all constituents that good faith judgment will play a greater role in the future recognition, measurement and auditing of transactions
- Acceptance by all constituents that in a principles based system there will be some variations in practice – frequently in timing as opposed to overall end results - but the reduction in complexity and lower compliance costs will be offsetting benefits.
- There may be slightly less comparability of financial statements between companies because local judgments may be different.
- A standard or framework for how to apply and assess judgment may need to be developed by accounting, auditing or regulatory bodies.

In summary, there are many benefits to principles based accounting standards but they do come with the potential for slightly less consistency in practice and the need for a greater role in good faith judgments by all involved parties.

\* \* \* \* \*

I would be pleased to take questions from the members of the Subcommittee and would be available at a later date to discuss in greater detail any of the matters reviewed today.


**fei**

 financial executives  
 international

COMMITTEE ON CORPORATE REPORTING

December 14, 2011

 Office of the Secretary  
 Public Company Accounting Oversight Board  
 1666 K Street, N.W.  
 Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No.37

Dear Board:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to share its views on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Release No. 2011-006, "Concept Release on Auditor Independence and Audit Firm Rotation" ("the Release"). FEI is a leading international organization of senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

Although we support the Board's efforts to evaluate ways to enhance auditor independence, objectivity and professional skepticism, and improve overall audit quality, we oppose mandating audit firm rotation. We believe there is a lack of empirical evidence to support the Board's hypothesis that mandatory audit firm rotation will improve auditor independence, objectivity and professional skepticism, and that there are other ways to enhance these areas. Our opposition is primarily based upon the potential negative impacts to audit quality, especially around the time of a rotation, the anticipated increase in overall audit costs that will likely result from such a requirement, and operational challenges in connection with identifying successor auditors upon a rotation. We recommend that any changes to enhance auditor independence, objectivity and professional skepticism should potentially be part of a holistic approach that further enhances the role of the audit committee in overseeing the independent auditor. We are also concerned that mandatory audit firm rotation would lead to significant operational challenges due to the limited number of audit firms with the industry experience and international presence required to perform audits for large multi-national issuers. Lastly, we are concerned that mandatory audit firm rotation would be a drastic measure impacting hundreds of registrants to address concerns that appear to be arising in only a limited number of audit inspections.

#### ***Risks to Audit Quality***

An audit firm accumulates knowledge of its audit client over an extended period of time. We believe there is a distinct and important difference between (i) the minimum level of knowledge of a company and its control environment that the auditor is required to obtain in order to conduct an audit in accordance with the standards of the PCAOB and (ii) the level and depth of such knowledge that is built and accumulated over time. Extensive experience

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with a company drives an appreciation for historical transactions and trends as well as an understanding of an issuer's control environment. An audit firm develops a deep understanding of an issuer's accounting policies, procedures, processes and information systems through experience over time. As this knowledge base grows, the audit firm is far better able to challenge management's judgments and assumptions that underlie significant accounting estimates and other complex accounting and disclosure determinations.

An audit firm must climb a steep learning curve in the early years of an audit relationship with a new client, especially on large multi-national company audits where the audit work may be performed by several audit firm offices and/or member firms. It could easily take several years before an audit firm has developed a deep level of knowledge of the company. During these early years of the audit relationship, we are concerned that an auditor's lack of in-depth knowledge of the company and its history may adversely affect audit quality. The potential risks relate to new auditor's difficulty challenging management's assumptions and judgments due to the auditors' limited knowledge of the company, its history and industry. Although detection risk is inherent within the auditing model, a more mature relationship between the external audit firm and the company significantly mitigates the risk. The audit firm's specific experience with the company provides a greater foundation from which the auditor can assess the company's conclusions and to formulate their own professional judgments. Additionally, some academic studies suggest that auditors with longer tenure demonstrate increased audit quality, including the 2002 study by Geiger and Raghunandan (Geiger, Marshall A. and Raghunandan, Kannan, Auditor Tenure and Audit Reporting Failures, *Auditing: A Journal of Practice & Theory*, Vol. 21, No. 1, March 2002). Geiger and Raghunandan's analysis found that there was an adverse correlation between the propensity of audit failures and audit firm tenure, resulting in significantly more audit failures during the early stages of the audit relationship.

Specifically related to the notion that in some instances audit firms with a long-standing tenure could lack objectivity and professional skepticism, we believe the current five year rotation period imposed on the lead and concurring review audit partners adequately addresses these concerns. In our members' experiences, the engagement partners typically possess a broad understanding of the general business, industry specific and unique risks facing the company, and are the audit team members who maintain the closest relationships with the executive management of the company. However, our members see the greatest levels of in-depth knowledge of the company's policies, procedures and information systems reside with the experienced staff audit team members (e.g., managers, senior associates) as they perform the majority of the detailed audit procedures. We believe that the current mandatory rotation of the engagement partners coupled with the established company knowledge retained throughout the remainder of the audit engagement team allows for both a fresh perspective and depth of knowledge that is necessary to perform a high quality audit. In fact, we believe that longer audit tenure and mandatory partner rotations exemplify the combination of experience and independence necessary to achieve the desired level of objectivity and professional skepticism. Furthermore, there is no clear evidence that longer audit firm tenure adversely impacts an auditor's independent mindset and objectivity.

#### ***Increased Costs***

We also believe that any mandatory audit firm rotation will likely result in increased audit costs. These increased costs will be both direct financial costs and indirect costs associated with lost time and productivity. The 2003 GAO study estimated an increase of 17% in audit fees as a result of a mandatory audit firm rotation requirement (Government Accountability Office, 2003, Required study on the potential effects of mandatory audit firm rotation). Our members' experience suggests audit firms currently absorb (i.e., do not bill to the client) much of the first-time non-recurring costs associated with a new audit engagement. We are

concerned that a mandatory firm rotation will change the marketplace dynamic such that more of these costs are billed to the audit client. We do not believe that it is in the best interest of the investors to burden them with these increased expenses without specific understanding of direct benefits from these costs.

We expect that companies will be significantly impacted by the lost productivity amongst various levels of a company's organization as a result of a mandatory audit firm rotation. Certain of our members have recently undertaken a voluntary change in audit firms and have directly experienced significant lost productivity as a result of the time necessary to educate the new audit firm's personnel on the company's background, control environment, accounting practices and information systems.

There also will be significant costs involved in changing the audit firm at various subsidiaries around the world where statutory audits are required. In most cases, our members seek to use the same audit firm that audits their consolidated financial statements to also perform any required statutory audit work in foreign subsidiaries. This is done for a variety of reasons, including managing the overall coordination and effectiveness of such arrangements as well as overall cost considerations. For many companies, this would mean not just a change in the auditor at the parent company level, but also the auditor at all such subsidiaries. We believe this introduces substantial additional costs into the audit process without a proven benefit to investors or the public interest.

#### ***Operational Challenges***

We are also concerned that significant operational challenges will arise under a mandatory audit firm rotation requirement due to companies' limited options when selecting a successor audit firm. These limitations may arise due to concerns with certain geographic requirements, sufficient industry expertise and potential independence considerations.

Practically speaking, most of our members would need one of the Big 4 audit firms to perform the audit due to the overall size and complexity of the engagement. Further, the potential audit firms would need to have a deep understanding of and experience with their industry and have an international presence appropriate to meet the needs of the consolidated audit and various statutory audits. These complexities result in significant limitations to the population of potential audit firms who possess the size, international presence and overall expertise to meet the demands of our members' audit requirements.

With an already limited audit firm pool from which to choose due to size and industry expertise of the audit firm, we are also concerned with the impact that independence would have on mandatory audit firm rotation in regards to identifying a potential successor audit firm. Currently, most of our members use one of the Big 4 audit firms to perform the audit, while also utilizing one or more of the remaining Big 4 firms to perform non-audit services the auditor is prohibited from performing (i.e., valuation services or internal audit outsourcing). In these circumstances, our members' audit committee's could find themselves with very few, if any, options that would not also involve changing a non-audit service provider. If audit firm rotation were required, many of our members would undoubtedly find themselves in a situation where they would have to rotate a Big 4 firm out of the non-audit services space in order to establish their independence and thus eligibility to perform the audit. This rotation must be completed well before the time of mandatory rotation, which would further constrain and complicate the selection process of the new audit firm as well as cause a significant disruption to management's processes as some of these services could take a significant period of time themselves to transition and likely result in increased costs.



The pervasiveness of these limitations would be a significant hurdle that all large, international issuers would be forced to address. The compounded nature of these limitations realistically reduces the number of audit firms who could adequately perform the audit, while causing an unnecessary disruption to management's processes.

#### ***Audit Committee Corporate Governance***

We are concerned that mandatory audit firm rotation will preclude audit committees from effectively fulfilling one of their chief governance responsibilities. Currently, audit committees select the audit firm that they believe best meets the company's and investors needs. Further, audit committees have the right to implement a change in audit firms at any time and have exercised this right when they considered it appropriate to do so. We believe that the audit committee is in the best position to determine who will perform the audit and when it is appropriate to make a change in audit firms and that mandatory audit firm rotation significantly impedes the exercise of this discretion. For example, an audit committee may be forced to make a decision which is not in the best interests of investors by having to change audit firms in the middle of a complex business development transaction, registration statement or spin-off which could delay the transaction and put investors at greater risk.

#### ***Other Actions to Consider***

With respect to the Board's initiatives regarding the enhancement of audit quality, we believe that there are other potential solutions that could achieve the desired goals without mandating an audit firm rotation model. These include the expanded distribution of inspection comments to the issuer's audit committee and more timely distribution of formal PCAOB inspection results.

The audit committee's oversight role directly includes the responsibility to oversee the overall quality of the audit and audit firm including assessing independence, objectivity and professional skepticism. To further improve this aspect of audit committee governance, a natural first step would be to enhance the information available to the audit committee for use in their assessment of the audit firm. While we recognize there may be limitations under the laws and regulations that exist today, one alternative solution is for the PCAOB to revise the auditor's required communications with the audit committee to include its firm's inspection results, including, where applicable, any audit engagement-specific results. We believe audit committees are generally effective in their oversight of the audit firms and believe that this additional knowledge, specifically related to the effectiveness of their audit firm and team, would allow audit committees to more proactively address any potential audit quality concerns. Ultimately, it is in our best interest and the interest of investors to promote full and effective communication between audit committees and audit firms, and this information would be useful in the audit committee's ongoing assessment of the audit firm's effectiveness. We also recommend that the PCAOB consider enhancements to the auditor's required communications to the audit committee that address additional matters specifically related to the audit firm's objectivity and professional skepticism exercised throughout the audit.

While the PCAOB has made progress in issuing their inspection reports more rapidly following the completion of inspection fieldwork, we encourage the PCAOB to continue to refine its reporting process so that inspection reports could be issued sooner after completion of fieldwork. For example, a recent inspection report for an annually inspected firm was issued in November 2011 following completion of fieldwork in November 2010, under which the covered audits were presumably for fiscal 2009 year-ends. We believe that a more timely delivery of the Board's inspection results to auditors and the investing public


following completion of fieldwork could provide important information to audit committees and further enhance ongoing efforts to increase audit quality.

In summary, we do not support a mandatory audit firm rotation requirement and believe the PCAOB should continue its research into other potential initiatives to improve auditor independence, objectivity and professional skepticism and, ultimately, audit quality.

\* \* \* \* \*

We appreciate the Board's consideration of these matters and welcome the opportunity to discuss any and all related matters. If you have any questions, please contact Lorraine Malonza at (973) 765-1047 or [lmalonza@financialexecutives.org](mailto:lmalonza@financialexecutives.org).

Sincerely,



Loretta V. Cangialosi  
Chair, Committee on Corporate Reporting  
Financial Executives International

cc: Martin F. Baumann, Chief Auditor and Director of Professional Standards



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January 30, 2012

Mr. J. Gordon Seymour  
Secretary, Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC. 20006-2803

PCAOB Rule Making Docket Matter No. 037 – Concept Release on Auditor Independence and Audit Firm Rotation

Dear Sirs:

In my capacity as a member of the Standing Advisory Group (SAG) and as the Chief Accounting Officer of Xerox Corporation I am pleased to have the opportunity to provide my comments and suggestions on the PCAOB's recent Concept Release "Auditor Independence and Audit Firm Rotation" (Release No. 2011-006). Xerox Corporation is a multinational organization with operations in 160 countries and annual revenues of approximately \$23 billion. Our audit fees, exclusive of non-recurring items and non audit services, have approximated \$20 million in recent years. We fully support the PCAOB's stated objectives for this Concept Release of strengthening auditor independence, objectivity and skepticism. These principles have long formed the basis of modern auditing and financial reporting and are critical to ensuring the integrity of an independent audit. However we at Xerox strongly disagree with any final rule making which will require the mandatory rotation of a company's auditors. We believe such a requirement will not result in improved auditor independence, objectivity or skepticism and there are numerous cost-beneficial ways, far short of auditor rotation, that can enhance achievement of these objectives. The PCAOB's own research and the research of others does not make a compelling case in support of mandatory auditor rotation. Further we note the Concept Release itself acknowledges that there are important company and investor benefits to long term audit relationships. Lastly, mandatory auditor rotation usurps a responsibility of a company's audit committee and will result in unnecessary costs and business disruptions. This letter will conclude with several suggestions on other means to potentially enhance auditor independence, objectivity and skepticism

My detailed comments and recommendations follow:



### Recent Enhancements to Auditing Standards Make Mandatory Auditor Rotation Unnecessary

The Sarbanes-Oxley Act has already resulted in significant enhancements to auditor independence and overall audit quality. The creation of the PCAOB with its audit firm registration process, deep inspection program and effective enforcement activities by itself represents a significant improvement from previous practice. As impressive as the PCAOB's activities and accomplishments have been to date, it is worth noting your organization is relatively young and the full positive impact of PCAOB activities is most likely still emerging.

Early in the PCAOB's existence the managerial reporting and external auditing on the effectiveness of internal controls over financial reporting (ICFR) became a reality for most corporations beginning in 2004. The positive impacts of ICFR are unmistakable. As reported in the Audit Analytics December 2011 report "Auditor Tenure, Financial Officer Turnover and Financial Reporting Trends" during the 6 years ended in 2010 material weaknesses in the Russell 1000 companies steadily dropped from 8.2% of companies in 2005 to 0.8% in 2010. Likewise for the same study group, in 2005 131 of the Russell 1000 companies reported restatements however that number had declined to 31 by 2010. Similar results are observed when the Russell 2000 companies results are included. The conclusion is that for 12,000 audits over the research period restatements and material weaknesses have steadily improved which must indicate that overall financial statement reliability has been improving.

In 2010 the PCAOB issued several new auditing standards on assessing engagement audit risk and, in 2009, a major standard expanding the role of the engagement quality reviewer (the 'EQR' or as more commonly known the concurring partner). Additionally, at this time there exists several important standards development projects which, when finalized, will undoubtedly increase auditor independence, objectivity and overall audit quality. These projects include the auditor's reporting model and auditor communications with audit committees among others.

One of the often expressed concerns about auditor independence (or lack thereof) is (was) the temptation for audit firms to actively solicit non audit services from audit clients such that the auditor may have become so financially dependent on non-audit fees, so much so that that audit independence, objectivity and skepticism were compromised. This important concern was also addressed by the PCAOB and SEC several years ago when nine (9) prohibited services by a company's auditor were enumerated. These significant restrictions on allowable non audit services has gone a long ways towards addressing the ability of auditing firms to become financially dependent on non-audit fees from audit clients. Proxy statement disclosures of fees paid to auditors is extensively studied and widely reported on. It is very apparent that



over the last decade non audit services provided to audit clients has been severely curtailed. In addition, many companies have adopted governance policies limiting non audit services to de-minimus amounts.

Lastly, we believe the current five year rotation requirement for the lead audit partner and the EQR effectively results in a 'fresh look' at the audit client every few years. In addition, for larger accounts the major audit firms have a practice of having a second headquarters audit partner assigned adding another check and balance on the lead audit partner. In comparison to earlier rules, after rotating off it is much more difficult for the lead audit partner to re-engage in the near term with his or her former audit client. The net result is that today a process is in place to continually ensure partner level transitions which can and does increase overall auditor objectivity and skepticism.

In light of all these impressive accomplishments – the benefits of some are just emerging - I recommend the Board refrain from the drastic step of mandatory auditor rotation until substantial evidence is available that conclusively establishes the aforementioned are materially ineffective.

#### Mandatory Auditor Rotation will Increase Risks to Audit Quality

While the stated objectives of this Concept Release are to enhance auditor objectivity, independence and skepticism these objectives represent tactical goals in support of the Board's overarching objective which is to improve overall audit quality. We believe that mandatory rotation of auditing firms will most likely result in lower – not higher – overall audit quality.

Institutional knowledge is a valuable asset – one that is not capable of being sold or transferred from one entity to another. It is obtained the old fashioned way – by the sustained hard work of many professionals over a long period of time. One of the primary reasons a company, or more importantly its audit committee, values long term audit relationships is this institutional knowledge as it enables the auditor to bring the proper resources to the audit at the right place and time. Learning curves are steep and costly. The Concept Release itself notes that most audit failures occur early in a new auditor's tenure. There is a big difference between a new auditor having the minimum knowledge of a company and its control environment required to conduct an audit in accordance with the standards of the PCAOB and an effective audit which is planned and executed by an incumbent auditor with full knowledge of the company, its financial processes, culture, business objectives, etc.

With respect to transitioning institutional knowledge, there is an enormous difference between a lead partner or engagement team within a firm transitioning audit knowledge to another audit partner in the firm versus the information that is required to be communicate between predecessor and successor audits under



current standards. It seems very logical that within a firm there will be an orderly and effective transition policy and protocol versus what may be expected between different audit firms. We believe the current practices of mandatory partner rotation, EQR reviews and National Office reviews and consultations are sufficient to preserve auditor independence, objectivity and skepticism. If, despite many objections to the contrary, the Board decides to require mandatory auditor rotation, as a prerequisite the Board will need to vet new standards with respect to required communications and transitional support between predecessor and successor auditors.

Audit services for multinational corporations can rarely be met other than a Big 4 firm. It is important to note that the Big 4 are not fungible. They each have varying strengths (and weaknesses) in terms of geographic reach, industry expertise, local presence, etc. It is possible in a given industry that only 2 of the Big 4 have the relevant firm wide expertise. In this scenario the situation would effectively result in a duopoly and industry participants would merely rotate back and forth between 2 firms. Does this accomplish much?

One last point on audit quality and risk, while most observers seem to agree the risk of audit failure is highest in the early years of a new auditor's tenure, I submit there is an equal risk of audit failure late in the auditor's tenure as well because the existing audit firm can naturally be expected to move its best people assigned to the audit to other clients of the firm.

#### Appointment and Removal of Auditors is Properly an Audit Committee Responsibility

Under Section 301 of the Sarbanes-Oxley Act, the audit committee of a public company is responsible for managing the relationship with the company's independent auditor including appointment, compensation, retention and oversight. Mandating auditor rotation would circumvent this external director governance responsibility and compromise the audit committee's ability to effectively engage, oversee and terminate an audit firm. For U.S. public companies, all audit committee members must be independent directors who are knowledgeable about a company's business, internal controls, financial policies and external reporting requirements. Because of this unique role, we believe a company's audit committee is best positioned to determine the circumstances under which an incumbent audit firm should be replaced. It is important that an effective working relationship exists between a company's audit firm and the audit committee; the requirement for periodic rotation is inconsistent with this objective. Audit committees do have the right to terminate an audit relationship at any time deemed appropriate and, as is public record, it is not infrequent that this right is exercised. When an audit termination occurs, SEC has Form 8-K disclosure requirements requiring both the company and the terminated firm to report on the circumstances of the dismissal.



Assuming the PCAOB persists, despite the strong objections of many commentators, to require mandatory auditor rotation there will inevitably be many instances where a change in auditors compelled by regulation would not be in the interest of the company or its investors and such a change would not be otherwise contemplated. For example, a very complex M&A transaction, a major business re-organization or transformation, a material capital markets action, etc. may span several quarters and be in process over a fiscal year end when there is a change in the external audit firm before the event in question is finalized. This will create significant challenges for, and between, management, the predecessor auditor and the successor auditor and require complicated and otherwise unnecessary coordination of activities. The list of potential complications is long but includes the obtaining of consents, subsequent events reviews by the predecessor auditor, carrying forward prior year audit reports on earlier year but still live financial statements, concurrence between the two auditing firms on all material matters of accounting and auditing significance, etc. We strongly encourage the Board to field test and evaluate the real world implications of requiring the rotation of audit firms at sub optimal times and the difficult position audit committee members will find themselves in these circumstances.

Mandatory Auditor Rotation will Permanently Increase Costs and Result in Unnecessary Business Disruption without Commensurate Benefits

Virtually all comment letters have noted the significant increase in audit costs that mandatory auditor rotation will cause. We agree with those observation and would like to offer some additional perspectives which have not been as frequently raised in the comment letters to date:

Monetary amounts aside, the PCAOB needs to address the question, and concern, as to exactly how the audit firms will source the increased workload? I have been on both sides of changing auditors both as an auditor and as a preparer. Many commenters have observed that it is at least four (4) years into a new audit engagement before the audit effort settles into its ongoing level. Consider this plausible scenario: In year 1 of a new audit there is a 50% increase in assigned hours over the steady state; in year two - 30% and year 3 - 10% before year 4 achieves normal go forward level of efforts. Extrapolating this using the European Union proposal of a 6 year rotation plan, there is a 15% permanent increase in audit hours so presumably on average each auditing firm will need 15% more staff. Extrapolating using a 10 year rotation plan results in 9% permanent increase in staffing requirements. With respect to the demand for accounting skills, every analysis I have seen indicates that the demand for accounting talent will grow by ~5% or more for the foreseeable future. So, the obvious question in need of an answer is 'where will all these future accountants come from?'



There will be significant burdens and hidden costs with respect to the rotational selection process itself – on management, the audit committee and the audit firms. The process for changing auditors, similar to the process for changing other major vendors, would commonly use an RFP process. Due diligence materials would need to be prepared; interviews with prospective auditors would need to occur; the audit firms would need to consider their bids and identify the engagement partner and senior audit team. For a multinational corporation the size of Xerox this process would be lengthy - the mere task of visiting numerous global locations and obtaining an understanding of accounting processes and internal control effectiveness would be immense and expensive. Senior management and the audit committee would need to divert significant time to reviewing and assessing competing bids and final interviews. After the new firm was selected, there would then need to be a major coordinating effort between the predecessor and successor firms. The company's internal accounting and other finance organizations would see an exponential increase in staff time to adopt to a new auditing firm and to familiarize the new auditors with the company. All of this unnecessarily drives up operating costs and diverts important managerial and outside director time for no commensurate benefit.

For virtually all major corporations, realistically only the Big 4 firms can perform the audit. Xerox, like most major companies, routinely utilizes the consulting and other non-audit services capabilities of the remaining Big 4 firms. Many of these services would constitute prohibited services if performed by our external auditors. Further, even if not an expressly prohibited service, many companies from time to time will use these same firms to perform other non-audit and consulting services which current governance practices would tend not to award to a company's audit firm. The Big 4 firms have immense global presence and vast business support capabilities. Mandatory audit rotation would be a disservice to investors because one of the practical implications is that the at least some non-audit service capabilities of the other Big 4 firms would no longer be available to companies.

Multinational companies globally operate through subsidiaries most of which will have statutory audit requirements. It is not uncommon for corporations the size of Xerox to have hundreds of statutory audit reports each year. For purposes of the US GAAP and GAAS audit only a handful would typically be significant with the remainder being primarily local compliance efforts. Many companies have a policy of requiring all statutory audits to be performed by the parent company's auditor. In order to minimize business disruption, companies would have to choose – leave the local incumbent statutory auditors in place when the parent company rotates the incumbent Big 4 auditor or transition dozens to hundreds of local audits to the new Big 4 firm which may not otherwise be necessary to enable the US GAAP and GAAS audit. As the PCAOB deliberates the notion of mandatory auditor rotation the implications on statutory audits should not be underestimated.





#### Evidence in Support of Mandatory Auditor Rotation is Neither Sufficient nor Compelling

The Concept Release accurately notes that the issue about mandatory auditor rotation has been around for a long time and I agree it is time to conclusively address the subject and (presumably) conclude the costs and risks far outweigh the benefits. Many comment letters have noted the conclusion of the 2003 GAO Report, commissioned as part of the Sarbanes-Oxley Act, to study and report on the potential effects of requiring mandatory audit firm rotation. The conclusion, as you are aware, states that "mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality."

It does not appear staff or other independent research to date has established a definitive correlation between audit failures and the length of the audit relationship. It is important to observe that the Board defines audit failures as situations where documented audit evidence is either insufficient, or categorically does not, provide the proper support the audit report. Financial statement users on the other hand would likely define audit failures in terms of restatements which, as discussed on page 2 of this letter, are infrequent and declining. It is critical for this project to reconcile these two very different theories.

I recommend that staff research on the incident rates of audit failures be conducted to categorize the nature of audit failures by: auditor competence and training, lack of industry expertise; occurring in the early years of a new audit relationship; audit firm size no longer adequate for a growing client; and lastly by lack of auditor independence, objectivity or skepticism. Lastly, this research should not be limited to audits supervised by the PCAOB – it is only in the last year that the PCAOB (as part of the Dodd Frank Act) achieved control over the audits of broker-dealers and as we all know too well some of the most spectacular audit failures in recent years (e.g. Madoff Securities) involved audits not subject to the PCAOB's procedures.

#### Potential Strategies for Enhancing Auditor Independence, Objectivity and Skepticism

The considerable Board and staff effort which would be required to attempt finalizing a rule requiring mandatory auditor rotation would be far better used in developing new auditing standards and other policy positions consistent with the Concept Release's primary objective of enhancing auditor independence, objectivity and skepticism. I believe considerable progress can be made towards the objective in a much more cost-beneficial and practical manner than the draconian step of requiring mandatory auditor rotation. I have listed below a number of suggestions for your consideration:



- The PCAOB should refine its inspection process such that its firm inspection reports are issued more timely. For example, in November of 2011 an inspection report of a major firm was issued for field work completed in November 2010 for the calendar year 2009 audits. Using this example, by the time the year end 2011 audits are completed, fully 40% of the engagement partners from the 2009 audits will have rotated off the engagement diminishing the effectiveness of the inspection findings. A more timely delivery of inspection results to the investing public would be beneficial.
- PCAOB inspection reports for the specific engagements reviewed should be made available to the audit committees of the companies audited. Many comment letters have recommended this. Transparency is always key to effectiveness as the 'light of day' (or the potential therefore) tends to bring out the best in people – in this case an audit engagement partner would clearly not want it to be communicated to his or her client that the PCAOB had concerns with how the engagement was conducted. We want to second the comment letters from many audit committee members who have also recommended these reports be made available because an inspection report would be invaluable to the audit committee's oversight of the audit function.
- Several professional groups I am associated with have discussed the merits of revising audit committee membership requirements to include a 'financial accounting' or 'financial auditing' expert – which is a different skill set from today's required 'financial expert'. This letter is not advocating this becomes a requirement but merely that the subject is worthy of PCAOB and SEC staff research.
- At several SAG meetings we have discussed 'audit quality indicators' – what they are, how they would be measured and how they would be used. To my knowledge no consequential further actions have to date occurred. I recommend this become a formal staff project and when finalized they become a part of the PCAOB inspection procedures and, to the extent any inspection report is engagement specific, it be shared with the related audit committee.
- Finalize the current major PCAOB projects on revising the auditor's reporting model and required communications with audit committees and allow sufficient time for these standards to be in force and then measure their effectiveness. While many commenters, including as you will recall myself, disagreed with many of the more expansive requirements of these proposals I anticipate that both projects will be completed with at least some modification from current requirements. These should be allowed reasonable time to work in practice and their effectiveness evaluated.
- Finalize the requirement to publicly disclose the name of the lead engagement partner – either by a personal signature on the audit report or by other disclosure means. This issue has been discussed many times at SAG and other PCAOB forums and is a common practice outside the



United States. Publicly personalizing the engagement partner's name with the audit report and related annual report can only serve to increase the engagement partner's focus on the quality of the audit.

Summary

We strongly disagree with any notion of requiring mandatory audit firm rotation no matter what the rotational interval may be. Such a requirement holds a very real possibility for an overall decrease in audit quality and will result in a permanent increase in cost and business complexity that is not justified by the evidence at hand. As discussed, the numerous PCAOB and SEC pronouncements and regulations of recent years are having a positive effect on external reporting casting further doubt on the need to mandate auditor rotation. We remain very supportive of the Board's efforts to continue enhancing auditor independence, objectivity and skepticism by less draconian, more cost effective means and, as we have in the past, are prepared to provide the Board whatever assistance we can.

\* \* \* \* \*

Thank you for the opportunity to provide these comments for your consideration on this important project. Please do not hesitate to contact me if you have any questions or comments about the contents of this letter.

Yours very truly,

A handwritten signature in cursive script that reads "Gary R. Kabureck".

Gary R. Kabureck

c: M. Baumann, Chief Auditor and Director of Professional Standards, PCAOB

**Testimony Concerning Accounting and Auditing Oversight: Pending Proposals and  
Emerging Issues Confronting Regulators, Standard Setters, and the Economy  
by**

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

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

**March 28, 2012**

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

I am Jim Kroeker, Chief Accountant of the Securities and Exchange Commission. I serve as the principal advisor to the Commission on accounting and auditing matters. I thank you for the opportunity to appear before you today to testify on behalf of the Commission regarding current issues related to the accounting and auditing profession.

**Importance of Reliable Financial Reporting**

The reliability of financial reporting is critical to 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. Information provided to participants in our capital markets must be neutral, reliable, and portray economic results in an accurate and faithful manner. Just as important, participants must have confidence that this is in fact the case.

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 are directly linked to our system's ongoing commitment to high-quality, accurate financial reporting. This

commitment provides investors with confidence, helping to minimize the cost of capital from uncertainty or suspicion as to an issuer's economic fundamentals and prospects.

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 filed with the Commission. The federal securities laws also mandate an independent audit of public company financial statements according to specified standards by qualified professionals in order to provide assurance as to the faithfulness and integrity of the information presented.

Two entities under the Commission's oversight have key roles in the financial reporting process. The first is the Financial Accounting Standards Board, or FASB, whose accounting and financial reporting standards the Commission has recognized as "generally accepted" for purposes of the federal securities laws. The second is the Public Company Accounting Oversight Board, or PCAOB, which is responsible for overseeing the audit of public companies that are subject to the securities laws. I am pleased to be on today's panel with Leslie Seidman, the Chair of the FASB, and Jim Doty, the Chair of the PCAOB. I also am pleased to be on this panel with Robert Attmore, Chairman of the Government Accounting Standards Board, or GASB.

Today, a confluence of factors—from the financial crisis to the decade-long effort to converge U.S. GAAP with International Financial Reporting Standards, or IFRS—has produced a significant volume of activity in the accounting and auditing areas. My office—the Office of the Chief Accountant, or OCA—works closely with the FASB and the PCAOB on these matters.

I would like to summarize for the subcommittee some of what I view to be the principal current issues.

#### **Current Accounting Developments**

The SEC continues to focus significant attention on two aspects of accounting. The first is the Commission's consideration of whether, and if so how, to incorporate IFRS into the financial reporting system for U.S. issuers. The second, and critically related to the first, is the ongoing efforts of the FASB and the International Accounting Standards Board, or IASB, in their efforts to converge U.S. GAAP and IFRS.

##### *Global Accounting Standards*

The Commission has previously stated its conceptual support for a single set of high-quality, globally-accepted accounting standards. This position advances the dual goals of improving financial reporting within the United States and reducing country-by-country disparity in financial reporting, which in turn facilitates cross-border capital formation and helps provide investors with the comparable and material information they need to make informed decisions about investment opportunities. Of course, having a single set of high-quality standards is not in itself enough to achieve these benefits. Investors must also have confidence in the standard-setting body and that the standards will be consistently applied and robustly enforced both within and across jurisdictions. And we recognize that there are many factors and challenges that need to be considered in pursuit of this objective.

The Commission has engaged in significant efforts to determine how to advance the goal of a single set of high-quality globally-accepted accounting standards, including through

considering whether to incorporate IFRS into the U.S. financial reporting system. In February 2010, the Commission issued a statement in support of the FASB's and IASB's ongoing convergence efforts, and also directed the Staff to execute a Work Plan to evaluate issues relevant to a potential Commission consideration of incorporating IFRS for U.S. issuers.

The Work Plan includes the following areas for staff study:

- The sufficiency of the 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;
- The independence of international accounting standard-setting for the benefit of investors;
- Investor understanding and education regarding IFRS;
- The U.S. regulatory environment that would be affected by a change in accounting standards;
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies; and
- Human capital readiness.

The Staff at this point has completed what I would consider the "field work" related to the Work Plan. In executing the Work Plan, we have sought input from U.S. investors, issuers, regulators, auditors, and other constituents; evaluated financial statements of foreign companies that assert compliance with IFRS; and researched the experiences of other jurisdictions that have incorporated IFRS into their financial reporting systems.

To inform the Commission and the public of our progress, the Staff has issued several reports and papers. The first report, published in October 2010, was a comprehensive status update on the Staff's Work Plan performance and planned next steps. This report also followed

two public requests for comment, one specifically related to issues that may impact investors, such as their knowledge of and preparedness for IFRS, and one specifically related to issues that may impact public companies, such as compliance with contractual arrangements and regulatory requirements.

In the second paper, published in May 2011, the Staff sought public input on a possible method of incorporation of IFRS. This possible method previously had not been described in as much detail as other potential approaches. It contemplated establishing an endorsement protocol whereby the FASB would incorporate existing IFRSs into U.S. GAAP over an extended transition period, while also incorporating any new or newly-amended IFRSs into U.S. GAAP. The paper also described and sought feedback on potential benefits and risks that may be associated with such an approach. The staff received over 100 thoughtful and productive comment letters in response to this paper.

The third and fourth staff papers were released in November 2011, and both relate to the Staff's work in considering the sufficiency of development and consistency of application of IFRS. The first of these papers provided a summary of the status of the FASB-IASB convergence projects and an analysis of the Staff's comparison of the written text of U.S. GAAP to that of IFRS. In comparing the two sets of standards, the paper noted many similarities in the overarching principles, but also noted examples of differences, including many differences in the detailed text. The second of these November papers analyzed recent annual financial statements of approximately 180 companies (including both SEC registrants and companies that are not SEC registrants) that assert that their financial statements are prepared in accordance with IFRS. This paper notes two general themes: first, across topical areas, the transparency and clarity of the financial statements reviewed could be enhanced through improved disclosures; and second,



diversity in the application of IFRS presented challenges to the comparability of financial statements across countries and industries.

We anticipate publishing a final staff report in the upcoming months that will summarize our findings and observations for each of the areas of the Work Plan.

### *Convergence*

Another critical component in evaluating whether to incorporate IFRS into the U.S. financial reporting system is the outcome of the FASB-IASB joint convergence projects. The Commission in its 2010 statement expressed support for the Boards' efforts and noted the importance of completing such convergence projects according to the Boards' then-current work plan as part of the Commission's consideration of incorporating IFRS. The convergence efforts also demonstrate that the United States is committed to considering changes to our accounting standards in conjunction with the IASB in areas where both Boards have acknowledged that both sets of standards are in need of improvement.

The FASB and the IASB have worked together since 2002 to improve and converge U.S. GAAP and IFRS. In 2006, the FASB and IASB developed a joint project plan (commonly referred to as the Memorandum of Understanding) that identified those standards perceived to be most in need of improvement. The Boards set out to develop new comprehensive standards to address those topical areas. By June 2010, the Boards had achieved some successes, but many challenges remained, and stakeholders were expressing concerns that the rapid pace of standard setting made it difficult for them to provide meaningful, high-quality comments on draft standards. The Boards therefore reprioritized their agenda and modified their joint standard-

setting timetable. The Boards made further adjustments in November 2010 and April 2011, again in response to stakeholder concerns.

Despite rigorous efforts by the Boards, including monthly joint meetings, the timetable for completing the priority projects has been gradually extended, from June 2011, to the end of 2011, and now into 2012 to allow for sufficient time to complete deliberations on certain projects and to allow for re-exposure of draft standards for public comment on other projects.

The Board's current priority convergence projects include the accounting requirements in three areas: financial instruments, revenue recognition, and leases.

#### **Financial Reporting Series**

In recent years, we have seen repeatedly how important it is that financial regulations and accounting and auditing standards keep up with changes in the business environment. To assist in the early identification of risks related to, as well as areas for potential improvements in, the reliability and usefulness of financial information provided to investors, OCA launched the Financial Reporting Series on November 8, 2011.

The Series is intended to be an ongoing series of roundtables designed to provide a thorough and balanced examination of emerging issues in financial reporting. The roundtables will include a cross-section of capital markets participants, including investors, preparers, auditors, and others, to discuss their individual views. The FASB and the PCAOB also will participate as observers.

The topic of the inaugural roundtable was measurement uncertainty in financial reporting. Measurement uncertainty exists when values are computed based on judgments about unknown

future events. The concept of measurement uncertainty touches on many issues important to investors, preparers, and auditors alike.

#### **Current Auditing Developments**

Let me now turn to auditor and PCAOB oversight. In 2011, the Commission appointed three new board members to the PCAOB, including Chairman Doty. Last month, the Commission appointed a fourth new board member, Jeanette Franzel, to replace the last founding PCAOB board member, Dan Goelzer, whose second term had ended.

##### *Audit Quality*

This coming July will mark the tenth anniversary of the Sarbanes-Oxley Act of 2002. With the financial crisis looming large in our memories, we also must not forget the crisis of confidence in the audit profession caused by the accounting scandals of just over a decade ago. The Act created the PCAOB, strengthened the role of audit committees, and focused management and auditors on the importance of internal controls. Now there are important issues being debated about what the auditor should audit, how the auditor should communicate its results to investors, and whether the auditor is sufficiently independent and objective.

In this environment, both we and the PCAOB are continuing to devote substantial attention to these issues. The PCAOB's inspection program continues to identify audit deficiencies of varying nature and severity. While the presence of an audit deficiency does not necessarily mean that the related financial reporting contains material undetected errors, it may increase the risk of material misstatement in that reporting. The PCAOB has undertaken efforts

to identify and analyze further the underlying causes of audit deficiencies in developing its inspection reports.

*PCAOB Standard-Setting Projects*

Another important component of audit quality is auditor independence and objectivity, and there are considerations being debated both here and abroad in this area. In August 2011, the PCAOB issued a concept release soliciting comment on new standards for auditor independence and audit firm rotation.

Mandatory firm rotation has been explored in the past. For example, the subject of firm rotation was debated in the development of the Sarbanes-Oxley Act. The eventual Act required audit partner rotation and requested a study of possible firm rotation by the U.S. Government Accountability Office. In its report, the GAO expressed the belief that mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality considering the additional financial costs and the loss of institutional knowledge of a public company's previous auditor of record. The GAO also stated that several years' experience with implementation of the Sarbanes-Oxley Act's reforms would be necessary in order to adequately evaluate whether further enhancements or revisions, including mandatory audit firm rotation, may be needed.

The PCAOB's comment period on the concept release closed in December of last year. Many important issues that require careful consideration were raised in the more than 600 comment letters received by the Board. The PCAOB also last week held two days of public meetings on the concept release. My staff will work with the PCAOB as it continues its deliberation on auditor independence, objectivity, and professional skepticism.

Other jurisdictions are currently considering mandatory firm rotation along with other auditing reforms. The European Commission, for example, has released a proposal for audit market reform that includes mandatory firm rotation and encouragement of joint audits. In addition to reinforcing auditor independence and professional skepticism, the stated objectives of the proposal include promoting competition among audit providers.

Another project the PCAOB has undertaken is the consideration of the usefulness or relevance of the audit report to investors. In this vein, the PCAOB is actively considering whether there should be changes to the information the auditor provides in the audit report to investors. This is another topic that is also being considered in other jurisdictions as well as our own. Questions being explored include: (1) what, if any, additional information about the audit or the related financial reporting should be included in the audit report; (2) should the scope of the audit be expanded; and (3) should there be additional disclosure regarding participants in the audit, such as the engagement partner and other audit firms that have performed work in the audit? The PCAOB issued a concept release and a proposal last year on these ideas, and my staff will continue to work with the PCAOB as it moves forward with these projects.

In the meantime, the PCAOB is undertaking a significant amount of very important work to update existing audit and quality control standards to reflect the lessons it has learned from nearly a decade of audit firm inspections. Many of the PCAOB's standards are still "interim" standards that the Board adopted in 2003. There is increasing focus on the need for significant progress on updating the interim standards that directly address audit performance, which may have a direct positive impact on audit quality. The PCAOB's standard-setting agenda includes a number of active projects related to some of the interim audit performance standards, including auditing fair value measurements, the use of specialists by auditors, the use of the work of other

audit firms, and firm quality control standards. In addition, last month the PCAOB issued for public comment a proposed auditing standard on related party transactions. Finally, the PCAOB recently received a number of comments on its re-exposed standard related to auditor communications with audit committees, which it intends to finalize later this year and submit to the Commission for approval.

*Dodd-Frank Considerations*

I'd like to address briefly two other areas related to auditing, both related to the Dodd-Frank Wall Street Reform and Consumer Protection Act. These are the expanded PCAOB authority over audits of brokers and dealers, and the audit requirement over an issuer's internal control over financial reporting.

First, the Dodd-Frank Act granted the PCAOB explicit oversight authority over audits of brokers and dealers registered with the Commission. Last June, the Commission proposed amendments to the financial reporting requirements for brokers and dealers. Among other things, the proposed amendments are intended to facilitate the ability of the PCAOB to implement its oversight of auditors of broker-dealers, and to eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually registered as, investment advisors. Last July, the PCAOB proposed new auditing and attestation standards that would apply to the audits of broker-dealers. Both sets of proposals are still under consideration.

Second, Section 989G of the Dodd-Frank Act amended Section 404 of the Sarbanes-Oxley Act to provide that smaller companies (specifically those that are not "accelerated filers" or "large accelerated filers" under Commission rules) are exempt from the requirement in Section 404(b) that an independent auditor attest to, and report on, the issuer's assessment of its

internal control over financial reporting. The Dodd-Frank Act also mandated a study with respect to Section 404(b) requirements for issuers with a market capitalization between \$75 and \$250 million. That study was delivered to Congress in April 2011. It recommended maintaining the existing investor protections of Section 404(b) for this category of issuers and encouraging activities that have the potential to improve further both the effectiveness and the efficiency of the evaluation of internal controls. One of these activities is the plan by the Committee of Sponsoring Organizations, or COSO, to review and update its internal control framework, which is the most common framework used by management and the auditor alike in performing assessments of internal control over financial reporting. COSO exposed a draft of its updated framework for public comment; the comment period closes on March 31.

**Conclusion**

In sum, there is a substantial amount of activity in the accounting and auditing space. We will continue to work closely with the FASB and the PCAOB on these matters, guided by the Commission's mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. Thank you, and I would be pleased to address any questions.



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**WRITTEN TESTIMONY OF BARRY C. MELANCON, CPA  
ON BEHALF OF THE  
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**

**BEFORE THE  
SUBCOMMITTEE ON CAPITAL MARKETS  
AND GOVERNMENT SPONSORED ENTERPRISES  
HOUSE FINANCIAL SERVICES COMMITTEE  
U.S. HOUSE OF REPRESENTATIVES**

**HEARING ON ACCOUNTING AND AUDITING OVERSIGHT:  
PENDING PROPOSALS AND EMERGING ISSUES CONFRONTING  
REGULATORS, STANDARDS SETTERS AND THE ECONOMY**

**March 28, 2012**



**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**

**TESTIMONY OF  
BARRY C. MELANCON, PRESIDENT AND CEO  
BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS  
AND GOVERNMENT SPONSORED ENTERPRISES  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES**

**HEARING ON ACCOUNTING AND AUDITING OVERSIGHT:  
PENDING PROPOSALS AND EMERGING ISSUES CONFRONTING  
REGULATORS, STANDARDS SETTERS AND THE ECONOMY**

Good morning Chairman Garrett, Ranking Member Waters and members of the Subcommittee. My name is Barry Melancon and I am a CPA and president and CEO of the American Institute of Certified Public Accountants ("AICPA"). I am pleased to be able to testify before you today about "Accounting and Auditing Oversight: Pending Proposals and Emerging Issues Confronting Regulators, Standards Setters and the Economy." I will address the CPA profession's commitment to the public interest, as well as the important services CPAs provide to U.S. businesses of all sizes and to investors and the profession's role in the global economy and global capital markets.

This year, the AICPA celebrates its 125<sup>th</sup> anniversary. The AICPA was established by the accounting profession to serve the public interest by fostering independence, objectivity and competence, the highest possible level of professionalism and ethical behavior. Our mission is to provide our members with leadership, information and resources to enable them to provide valuable services in the highest professional manner to benefit the public, employers, investors and clients.

The world was very different in 1887 when the AICPA began than it is today. Businesses were simpler entities that focused on local markets and customers. Financial instruments were limited to hard currency and paper checks. And the Securities and Exchange Commission ("SEC") would not be established for another 47 years.

It's not an exaggeration to say that virtually everything CPAs do and how they do it has changed since then; the capital markets and business activity around the

globe have become more complex. What has not changed, however, is the commitment the AICPA and the profession made in 1887 to ensure the highest levels of quality and professionalism, unimpeachable ethics, objectivity and a healthy degree of skepticism, and financial reporting and auditing that meets the investment community's need for transparency and expert analysis.

The AICPA is the world's largest association representing the accounting profession, with nearly 377,000 members. AICPA members represent many areas of practice, including business and industry, public practice, government, education and consulting. CPAs work in accounting firms that range from sole proprietors in small towns supporting Main Street businesses, to large firms with thousands of employees supporting multinational entities with operations worldwide. CPAs are business owners, CEOs and CFOs and serve in other key decision-making roles in companies, from the Fortune 100 to small businesses, throughout America.

The AICPA sets ethical standards for the profession and U.S. auditing standards for audits of private companies, non-profit organizations and federal, state and local governments. It develops and grades the Uniform CPA Examination and offers specialty credentials for CPAs who concentrate on personal financial planning; fraud and forensics; business valuation; and information technology.

The AICPA works to ensure that CPAs have the skills, tools and information necessary to address the complicated accounting, tax and auditing questions they face every day. Our members are required to exercise sound professional judgment as they practice, regardless of whether the beneficiary will be investors, lenders, employers, employees, taxpayers or an unknown third party.

Of critical importance to the AICPA is that the profession fulfills its commitment to lead as our business community, its financial reporting needs and the needs of investors and other users of business information continue to evolve in a rapidly changing environment.

To that end, we've identified five strategic initiatives where we devote significant resources toward the advancement of the profession. We believe it is critical to create an environment that attracts the best and brightest from each generation to join and remain in the profession, to assure the quality of the services performed and to promote innovation for the future.

The first strategic initiative is attracting and retaining the best and the brightest people into the profession.

The CPA profession recognizes its principal asset is human capital and the AICPA is making significant investments in creating a vibrant and highly qualified supply. Our research tells us that the baby boomer generation will be retiring at an alarmingly high rate, over 10,000 every day for the next 19 years, and that professions will be competing with each other to attract the best and the brightest. Our goal is to create an environment where the millennial generation is attracted to and continues to see the accounting profession as a rewarding profession where individuals can collectively make a difference in their communities, businesses and the economy.

The AICPA engages students through our **Start Here, Go Places** website, which is focused on high school and community college students. The site allows students to explore broad possibilities from small business start-ups to Fortune 100 companies.

We know that enrollment at community colleges is reaching an unprecedented level, but resources available to accomplish a transfer to a four-year institution continue to be challenged. To serve these needs, the AICPA, in partnership with other associations and state CPA societies, has taken critical steps to help students and educators at two-year colleges enhance the pathway to four-year schools.

To continue providing university accounting students and CPA candidates with a clear roadmap to navigate the educational and licensure process and become successful CPAs, the AICPA launched its community-based website, **ThisWayToCPA.com**. Since the website's launch, more than 27,800 have joined this community, which features CPA role model profiles, recent CPA candidate exam diaries and state licensure requirements.

**ThisWayToCPA.com** hosts scholarship applications and the **Legacy Scholars Program**. About 80 percent of the 2011 - 2012 class of AICPA Legacy Scholars represents students from ethnically diverse backgrounds. During the fall semester, Legacy Scholars' community service and outreach efforts reached over 4,600 individuals.

Because we believe there is an impending shortage of accounting PhD faculty, which are a necessary and integral part of the accounting profession supply chain, the AICPA established the **Accounting Doctoral Scholars Program**. With financial commitments exceeding \$17 million, the program's goal is to increase the current

doctoral pool by 120 PhDs by 2016. This program should also increase the availability and quality of accounting programs across the country.

The AICPA has established the **Fellowship for Minority Doctoral Students** to ensure that PhDs from minority populations are provided the resources to participate as we work toward creating a more ethnically diverse profession. Recognizing the need for ethnically diverse role models, the AICPA is enhancing its focus on diversity under the newly established **AICPA National Commission on Diversity**.

Aligning with the recommendations of the **Advisory Committee on the Accounting Profession for the US Treasury Department**, the AICPA works to address the future of accounting education through the efforts of the Pathways Commission. The Commission's goal is to provide ongoing strategies to enrich accounting education processes. The AICPA stands ready to support and implement the forthcoming recommendations.

The second initiative is ensuring the ongoing competency of the best and the brightest in their respective roles.

What may be most familiar to the Subcommittee is the fact that the AICPA develops and maintains the **Uniform CPA Examination** ("Examination"), which establishes the entry point for CPAs into the profession and is designed to assure a competency baseline for the best and the brightest. Examination content development is a major AICPA effort, involving sixty full-time AICPA staff and hundreds of CPA volunteers who spend literally thousands of hours every year on the development of new examination questions. A constant flow of new questions is necessary to maintain the currency, vitality, and credibility of the CPA Examination – which remains a critical entry point for professionals who serve the public in a wide swath of roles, from the CFO to the auditor to the tax preparer.

CPAs serve in many key decision-making roles, including those who work in business and industry. For example, over 42 percent of our members practice as management accountants—those CPAs on the front line every day making decisions about their businesses. Management is responsible for the preparation of financial information and therefore a CPA in business or industry is the gatekeeper who is responsible for the preparation of high quality financial statements. It is critical that CPAs have the skills and tools to "get it right." This includes a steady moral compass, a healthy eye for skepticism, the knowledge to apply professional judgment, and the technical accounting resources to apply his or her craft, including enhanced understanding of financial reporting standards. The AICPA's role is to

provide the ethical framework, training and guidance so that the preparer is best positioned to "get it right." We do this through the development and issuance of training materials (e.g., conferences, continuing education) and publications (e.g., industry accounting guides, checklists, comparison tools).

The auditor provides an opinion on financial statements that are the responsibility of management to prepare. Auditing involves complex procedures designed to provide the auditor with sufficient evidence so that the auditor has reasonable assurance, which is a high but not absolute level of assurance, that his or her opinion is correct.

CPA firms and the AICPA commit significant resources to training and educating auditors in order to "get it right." Examples of our areas of focus are training and guidance materials in auditing standards and audit methodology, the development of skills necessary for fraud detection and how to apply professional skepticism and judgment and education in unique industries and areas of specialization, such as auditing fair value calculations or testing information technology controls.

One of the keys to quality is the structure that firms have in place to internally support and monitor their audit engagement teams. For example, the major accounting firms and the AICPA provide practitioners with access to specialists in accounting and auditing on a daily basis. These consultations help promote accounting and audit effectiveness as well as consistency in the application of standards. Internal review, monitoring and inspection of audit engagements are also key components of assuring that the firm has complied with all appropriate professional standards.

Further, external quality monitoring via peer review and Public Company Accounting Oversight Board ("PCAOB") inspection provide the final layer of oversight, designed to provide investors with confidence that the auditor has the skills, education and procedures in place to assure that the audit meets the appropriate professional standards and can be relied upon.

As part of the AICPA's commitment to audit quality, we have established audit quality centers, so that we can provide CPAs with focused tools and resources to meet the ongoing challenges of a vibrant and changing environment. Our **Governmental and Employee Benefit Plan Audit Quality Centers** focus on enhancing the performance of the CPA firms that audit the many thousands of entities that receive federal assistance, including governments, not-for-profits and certain for-profits and that participate in over 80,000 employee benefit plans, such as 401(k), pension and health and welfare plans subject to the Employee Retirement Income Security Act.

In addition, five years ago the public company auditing profession established the **Center for Audit Quality**--an independent organization affiliated with the AICPA, whose sole mission is to improve the quality of and confidence in public company audits--which has been a leader in the profession, dedicated to enhancing investor confidence and public trust in the global capital markets.

Third, the AICPA promotes independent, relevant financial reporting, auditing, and ethical standards.

Standards of practice, developed free of any special interest influences but with input from all relevant stakeholders, are critical to the production of information that is meaningful to investors and other users of business information.

Accordingly, the AICPA supports the ongoing independence of the Financial Accounting Standards Board ("FASB") in its activities to develop financial reporting standards for public companies. More broadly, we support the development of one set of high quality global financial reporting standards, and we believe that International Financial Reporting Standards--or IFRS--are best positioned to be that set of standards. The accounting profession strongly encourages the SEC to make a decision soon on next steps with respect to IFRS incorporation into U.S. GAAP.

The AICPA was an early supporter of international convergence of accounting standards and has fully supported the incorporation of IFRS into the U.S. financial reporting framework. There is no choice: uniform international standards are critical. Multinational companies are chartered in different countries and the AICPA is convinced that investors will benefit if issuers around the world prepare financial statements using a common set of high quality, globally accepted and consistently applied and enforced financial reporting standards.

Along these lines, we would also suggest the PCAOB consider utilizing International Standards on Auditing--ISA--as a basis for U.S. public company auditing standards.

Finally, the AICPA's mission includes promoting the highest possible ethical standards. It sanctions members who do not follow the standards that we have set and that we believe are essential to the proper professional performance of a CPA.

The fourth strategic initiative is developing and implementing innovative solutions to the increasingly complex issues and business environment that CPAs navigate skillfully for their clients and employers.

Accounting and auditing solutions need to keep pace with business activities in order to maximize the ability of the profession to provide value-added services. Standards for financial reporting are critical to the equation and non-financial information is becoming an increasingly integral tool to assess current and future business performance. Measurement of natural resource use and replenishment is a good example of the kind of issue the profession is confronting.

How these important measures are reported and whether there should be independent reporting and assurance on those measures is an emerging discussion topic within the business community.

Internal control has always been an integral part of reliable financial reporting, and Sarbanes-Oxley focused renewed attention on its importance. We believe that robust internal control over financial reporting is critical to every organization, regardless of size. Further, testing financial reporting control effectiveness and reporting on controls to some extent should be required in every audit. The AICPA continues to believe that there should be no additional exemption for existing issuers from section 404(b) of Sarbanes-Oxley.

Use of technology is a given and it is one of the critical tools companies utilize to manage their businesses. We believe it is important for users of business data to have meaningful and usable information to help them make investing decisions. While not demanded yet, we believe that users will seek a common format on the source data that ultimately results from financial statements and we are on the frontlines to support the advancement of such a format.

**EX**ensible **B**usiness **R**eporting **L**anguage ("XBRL") is an electronic data format standard that is already opening doors by allowing users of financial information to drill down into financial statements and other business reports. XBRL is a royalty-free, international information format designed specifically for these purposes, which allows users to automatically consume and analyze the data. We strongly believe the broader application of the XBRL data standard across reporting streams would create tremendous efficiency gains and enable more sophisticated and timely analysis. The creation of new tools to leverage these data standards will magnify this potential exponentially.

Looking to the future, the AICPA and the profession are working to integrate key non-financial data with financial reporting measures to provide one integrated meaningful report. We started this work nearly 10 years ago with the creation of the **Enhanced Business Reporting Consortium** and are now collaborating with the **World Intellectual Capital Initiative** and the **International Integrated Reporting Council** to advance this initiative.

We are also looking at the best ways to develop assurance of this data via activities related to data standards, information integrity and system reliability which addresses the privacy, security and confidentiality of information in addition to other criteria.

Finally, we recognize that preventing and detecting fraud remains a significant challenge for all members of the “financial reporting supply chain”—company management, boards of directors, audit committees, internal auditors and external auditors. While company management has primary responsibility when it comes to preventing and detecting fraud and the financial statement audit is designed to provide reasonable assurance that material fraud will be detected, all members of the supply chain should work together to leverage their complementary and interconnected duties. Of great importance in mitigating the conditions leading to fraud is the tone at the top, skepticism and strong communication. A critical part of the profession's work, headed by the Center for Audit Quality, is the formation of an **Anti-Fraud Collaborative Partnership** with a number of other financial associations. The partnership is engaged in a number of projects aimed at improving our collective ability to deter and detect financial reporting fraud.

The fifth strategic initiative is supporting robust but balanced regulation.

Robust, balanced regulation is the final component of the strategic equation.

The profession is subject to several layers of regulation. State boards license and regulate CPAs at the state level. Several agencies regulate CPAs at the federal level depending on the area of practice, including the SEC and the PCAOB.

The AICPA believes in a strong and balanced regulator for the public company audit profession and supports robust regulation of the profession in a manner that protects the public, but does not detract from, nor negatively impact, quality



reporting and auditing and does not restrict the effective and efficient flow of capital.

There are several current issues that should be noted in a discussion of robust and balanced regulation:

1. A strong and balanced regulator for the public company audit profession. The AICPA and the profession communicate regularly with the SEC, PCAOB, FASB and Governmental Accounting Standards Board (“GASB”) to provide useful and relevant information about the profession and to make sure that the profession’s views are considered as part of these organizations’ deliberations. Through our members’ expertise and the information and data we have compiled, we formally comment on proposals and informally consult with these entities, to help them fully understand the implications of what they are considering and ultimately develop meaningful and balanced regulation and standards.

During its entire history, the AICPA has consistently worked closely with Members of Congress, regulators, the accounting standards-setting bodies and ad hoc federal task forces and committees, to assure balanced regulation of the profession.

2. PCAOB Rulemaking. The PCAOB is currently engaged in a number of projects and is to be commended for the manner in which it is approaching them. For example, before issuing the concept release on possible changes to the auditor’s reporting model, the PCAOB held open forums as well as private meetings with a wide variety of stakeholders, including auditors, audit committee members and investors, to help shape the ideas presented in the concept release. This is a good example of how a strong and balanced regulator acts to promote the public interest.

3. PCAOB Concept Release on Firm Rotation. In August 2011, the PCAOB issued Release No. 2011-006--*Concept Release on Auditor Independence and Audit Firm Rotation*—focusing on various recommendations, including the periodic, mandatory rotation of an audit firm, to improve auditor independence, objectivity and skepticism. Sarbanes-Oxley delegated responsibility for overseeing the financial reporting process, including the hiring and firing of the external auditor, to independent audit committees. Audit committees, which take this responsibility seriously and have the requisite skills, fiduciary knowledge and experience, are the appropriate and balanced approach to the auditor’s ongoing engagement and retention. We believe in the audit committee’s authority and support efforts to strengthen the role of the audit committee, not undermine it.

Interestingly, the PCAOB's release acknowledges that there is little evidence linking audit firm tenure to audit failures or a lack of independence, objectivity and professional skepticism by the auditors. The release also recognizes that mandatory audit firm rotation would represent a significant change in practice and would increase costs and cause disruptions for companies and external auditors.

Of the roughly 600 comment letters received by the PCAOB, 94 percent were against mandatory audit firm rotation, including that of the Government Accountability Office ("GAO"), which stated the PCAOB "does not provide compelling evidence that the root cause of the audit quality issues [it has found] is related to a breakdown in auditor independence." GAO also stated, "Even if the PCAOB could clearly establish that a lack of independence or objectivity is causing audit quality problems, it is unclear that such a problem would be prevented or mitigated by a mandatory audit firm rotation requirement." Finally, it's important to note that more than 200 letters were sent to the PCAOB by audit committees during the original comment period, and not one supported rotation.

Given the significant costs and disruption, the lack of evidence linking engagement tenure to audit quality, and, most importantly, the risk that mandatory rotation is actually a detriment to audit quality, we oppose mandatory firm rotation. We do however support the review underway to further enhance both the role of the auditor and of the audit committee in ways that enhance the quality of information provided to investors. We believe this is a much more beneficial and fruitful area on which to focus.

Should the PCAOB's Concept Release become a proposal which is adopted, it would represent a very clear example of unbalanced regulation. It would impose significant strains on the audit profession and the public company business community with no evidence that the Sarbanes-Oxley formula, which assigned authority to hire and fire the auditor to the independent audit committee, is not working in a way that protects the public interest.

4. Transparency of PCAOB Enforcement Proceedings. The PCAOB also has urged Congress to amend Sarbanes-Oxley and make its enforcement proceedings public. To that end, the "PCAOB Enforcement Transparency Act of 2011," which has been introduced in both the House and the Senate, would

make PCAOB hearings and all related notices, orders, and motions, open and available to the public unless otherwise ordered by the Board.

PCAOB enforcement proceedings currently are confidential under Sarbanes-Oxley, because Congress understood that auditors belong to a profession in which a good reputation is essential and publication of *unproven* charges may end an individual auditor's career or audit firm's existence. Congress created a special confidentiality regime for PCAOB enforcement proceedings because of that concern and because the PCAOB is not part of the government and thus is not subject to the procedural due process requirements imposed on government agencies pursuant to the Administrative Procedures Act.

Most assuredly, the AICPA and the accounting profession want to eliminate bad actors from the profession. The stain from one affects all. But there needs to be an appropriate balance of the rights of the accused and due process for someone unjustly accused.

Transparency of PCAOB disciplinary matters is appropriately addressed under current law, by the PCAOB's authority to refer matters to the SEC when it determines that public disclosure is necessary to protect the public interest. The SEC has the authority to make its investigations public. In other words, the PCAOB has existing statutory authority to address these public policy concerns; thus we believe that amending Sarbanes-Oxley is unnecessary.

5. Transparency of Audit Partners. In October, 2011, the PCAOB issued a proposed rule--*Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards and Form 2*" that would require identification of the audit partner and certain other independent firms and participants along with the percentage of hours worked in the audit report.

We have appropriately questioned the PCAOB on whether the identification of the engagement partner in the audit report will improve audit quality and auditor accountability and have expressed concerns about increased liability to, and safety of, the individual audit partner. We suggested an alternative that identifies the audit partner in firms' annual reports to the PCAOB (Form 2) rather than the audit report in SEC Form 10-K.

The profession also supports providing additional information to investors to enhance the understanding of the auditor's role and responsibilities and the audit process, including certain information regarding the use of other firms in the

audit. We have suggested 1) a higher threshold for disclosure, such as 10 percent or 20 percent participation which aligns with existing FASB, SEC and PCAOB guidance and 2) using ranges to indicate participation as opposed to requiring disclosure of precise participation percentages.

We hope the PCAOB will consider this more balanced, but still robust approach.

I also want to note two recent regulatory rulemakings where we believe the PCAOB and the SEC have adopted rules that overlook the appropriate balance between regulation that protects the public and regulation that overly burdens businesses and their auditors.

The first relates to audits of non-public, not-clearing, non-custodial (known as “introducing”) broker dealers and the second relates to audits of pooled investment vehicles (“PIV”).

Congress explicitly gave the PCAOB in the Dodd-Frank Act the authority to determine which nonpublic broker-dealer auditors should be part of an expanded regulatory structure that includes PCAOB auditor oversight and inspection. Rather than tailoring its approach to those broker-dealers that pose the greatest risk, the PCAOB has adopted an interim rule requiring that all auditors of nonpublic broker-dealers be registered and inspected.

We believe that regulations—and the resources to implement those regulations—should focus on where there is greatest risk to the investing public and that auditors of non-public introducing broker-dealers do not pose that risk and, therefore, should not be subject to PCAOB oversight and inspection.

The second issue involves amendments to the SEC’s custody rule. In its custody rule, the SEC determined that all PIVs must be audited by independent public accountants “subject to regular inspection by” the PCAOB. However, some CPA firms that previously have specialized in PIV work do not audit public companies and, therefore, cannot be subject to PCAOB inspection. This regulation denies those CPA firms the ability to continue to audit their PIV clients, which are not publicly-traded companies. We do not believe it appropriate for the SEC to effectively ban an otherwise qualified firm from conducting this work through its rules.

Another area of continuing discussion in the policy arena is the requirement for auditors to attest to a public company's internal controls over financial reporting under section 404(b) of Sarbanes-Oxley.

The Dodd-Frank Act made the exemption from this auditor attestation requirement permanent for public issuers with market capitalizations of less than \$75 million. In recent months, there have been multiple proposals to raise this exemption for larger companies and/or to provide an on-ramp for new public companies. While we oppose exemptions to Sarbanes-Oxley section 404(b) for existing issuers, we appreciate Congress' effort to promote capital creation for small businesses through the more focused approach of the IPO on-ramp legislation.

As I mentioned earlier, effective internal controls are an integral part of an entity's financial reporting system. The U.S. Government Accountability Office has recognized this concept and requires auditors of entities subject to an audit under Generally Accepted Government Auditing Standards to issue a report identifying weaknesses in internal control over financial reporting that were noted during the financial statement audit.

Let me complete my remarks by reiterating the CPA profession's foundation of commitment to the public interest, our history of objectivity, independence and integrity and as well as the important services CPAs provide to U.S. businesses of all sizes and to investors and the profession's role in the global economy and global capital markets.

The U.S. retains the most sound and credible financial reporting in the world and I am here to assure you that CPAs in all areas of the accounting profession, along with the American Institute of CPAs, join you as we seek to advance a common mission of promoting the highest quality accounting and auditing services that are valuable to the public interest and to the global capital markets.

Thank you for the opportunity to testify today.



100 Years Standing Up for American Enterprise  
**U.S. CHAMBER OF COMMERCE**

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# Statement of the U.S. Chamber of Commerce

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**ON: "Accounting and Auditing Oversight: Pending Proposals and Emerging  
Issues Confronting Regulators, Standard Setters and the  
Economy"**

**TO: The Subcommittee on Capital Markets and Government Sponsored  
Enterprises**

**DATE: March 28, 2012**

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The Chamber's mission is to advance human progress through an economic,  
political and social system based on individual freedom,  
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance -- is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Chairman Garrett, Ranking Member Waters and members of the Capital Markets and Government Sponsored Enterprises subcommittee. My name is Tom Quaadman, vice president for the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce. The Chamber is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector and region. I appreciate the opportunity to testify before the Subcommittee today on behalf of the businesses that the Chamber represents, which are investors themselves in our economy.

We are here to discuss the current issues facing the accounting profession and accounting and auditing standard setting.

Effective financial reporting and internal controls are an important priority for the U.S. Chamber of Commerce and one of the reasons why the Chamber established the Center for Capital Markets Competitiveness in 2007. In order for businesses to grow over the long-term they need to be able to access capital in financial markets domestically and abroad. The conveyance of reliable and relevant financial information to investors is an important part of that capital formation process.

Similarly, businesses are investors and active market participants themselves. Companies must mitigate risk through derivatives transactions and raise cash to ensure continuity of operations and accommodate growth. As active participants in the debt and equity markets, companies, like other investors, must have access to reliable and relevant financial data that facilitates efficient analysis and decision-making.

Therefore, the work of the Financial Accounting Standards Board ("FASB"), Public Company Accounting Oversight Board ("PCAOB"), and the Securities and Exchange Commission ("SEC") to ensure usable, reliable, and relevant financial reporting are critical to our free enterprise economy.

If the United States is to create the 20 million jobs that it needs to revive the economy over the next decade, financial reporting must play its crucial role of accurately, reliably and efficiently reflecting relevant economic activity. Some advances have been made in improving accounting and auditing standards. But unfortunately, over the last two decades, we have also seen ill conceived initiatives. Some of these were not just bad policy. They were efforts to redirect accounting and auditing standards to advance agendas rather than providing investors and businesses with useful information.



Dialogue between regulators, the accounting and auditing professionals who prepare financial data and the investors who use and rely upon it—including American business—is critical to keeping changes and refinements to auditing and accounting standards on track toward serving their vital purpose. The Fair Value accounting crisis was brought about, in part, by a lack of communication between FASB and the business community. A lack of dialogue deprived FASB of useful information and critical facts. Consequently, this led to flawed standards that prevented financial reports from realistically measuring economic activity.

In this context, the Fair Value accounting crisis was merely a symptom of a larger communications problem—one for which we think FASB has taken efforts to correct through regular and meaningful dialogue with stakeholders. However, we are concerned that the PCAOB is currently facing a similar communications challenge.

To elaborate, we have worked with Financial Accounting Foundation Chairman Jack Brennan and FASB Chairman Leslie Seidman to facilitate continuous on-going communications regarding standards development and other issues of importance to accounting. I believe that these communications have been helpful and fruitful during this critical phase of the FASB convergence projects with the International Accounting Standards Board (“IASB”). The objective is not to create standards that pick winners or losers in our free enterprise system, but rather to insure that the standards are reflective of real world activities and provide investors and other users of financial reports with the relevant, reliable and useful data needed to make informed decisions and compete on a level playing field.

Are all of our concerns addressed in these communications? Of course not. Are there bumps in the road? Yes. For instance, we believe that a reversal by FASB and IASB of current lease accounting standards could dramatically spike costs for companies and weaken a leasing market worth trillions of dollars. Yet, we continue to work with FASB to solve the problem. By giving stakeholders their voice in the process, FASB has developed a level of trust that insures a collaborative partnership to share relevant facts to inform the development of standards. This benefits everyone and ensures that the evolution of accounting and auditing standards remains focused on its specific role in our system of free enterprise.

The dramatic improvement in communications with the Financial Accounting Foundation and FASB has made the convergence projects less contentious than they could have been and facilitated world class standards that can help advance capital formation globally. This benefits businesses, investors, and our economy. The increased communication efforts and process to solicit input, facts, and feedback can

serve as a model for the PCAOB in improving its processes and the deployment of the resources at its disposal—the majority of which come from public companies.

This is important because the PCAOB appears to have embarked on an agenda that is leading far afield from its specific, but important, mandate to regulate auditors. For example, the concept releases on mandatory audit firm rotation and auditor discussion and analysis have the Chamber concerned that the PCAOB is engaged in mission creep. It is leaving the realm of audit regulation and crossing the threshold of regulating corporate governance, a subject area that has been left to state corporate law and the Securities Exchange Commission. Moreover, the PCAOB should clarify that their recent proposal for auditors to understand executive compensation is for risk assessment rather than trying to regulate corporate governance.

Let's take a look at the history of mandatory audit firm rotation debate:

- Congress, in debating Sarbanes-Oxley, explicitly declined to enact provisions requiring mandatory firm rotation;
- The General Accounting Office has twice reviewed and rejected the need for mandatory firm rotation;
- Academic studies have demonstrated that mandatory firm rotation may harm companies through higher costs and increased incidence of undetected fraud;
- The PCAOB has failed to provide information through the inspections process demonstrating a need for mandatory firm rotation;
- Over 90% of commenter's to the concept release have opposed the concept of mandatory firm rotation; and
- The majority of investors commenting on the concept release also opposed mandatory firm rotation.

The PCAOB's failure to demonstrate any need for mandatory firm rotation – much less a rationale that outweighs the cogent and consistent concerns raised about it by investors, businesses and government entities that have rejected the concept leads us to question why valuable resources, time, and monies are being spent on this project. They can be better deployed for many other worthwhile endeavors. Indeed, statements that this issue will be worked on a year from now open the PCAOB to

potential criticism that a predetermined objective exists even if there is no record to support it. A similar zeal to reach a result in the absence of supporting facts or analysis caused the D.C. Circuit Court of Appeals to vacate the SEC's proxy access rule.

Such a result is neither good for the PCAOB nor for financial reporting as a whole.

Last month we wrote to the PCAOB and SEC with concerns that the PCAOB does not have enough dialogue with the business community, and we have proposed the creation of a Business Advisory Group to work with the PCAOB from the outset along the lines of the dialogue that now exists with the FAF and FASB. Such dialogue can prevent concept releases being opposed by 92% of the comments submitted and allow a more constructive focus on workable standards tied to the PCAOB's mission. A wide range of input and discussion can only enhance the ability of the PCAOB to prioritize issues within its purview and address them in a thoughtful and balanced manner.

Other innovations, which we will discuss in greater detail, such as the use of a cost benefit analysis can also assist the PCAOB and stakeholders in determining the importance of issues and the efficacy of proposed solutions in relation to the costs and burdens they impose.

To summarize, for the past twenty years we have seen financial reporting move from one crisis to the next. Numerous studies have been conducted with solutions seldom implemented. Standards have been written, not to reflect economic activity, but in search of a holy grail of purity that is simply unobtainable and sometimes counterproductive to good and lawful economic activity. During this time we have seen:

1. A steady decline in the listing of public companies in the United States; and
2. American companies eschewing the traditional form of public company financing and consciously avoiding the American capital markets to raise capital through private markets.

Despite these indications of serious problems, financial reporting policies in the United States are still the best in the world. But our competitive advantage as the preferred destination for capital formation is eroding. We cannot wait to address the issues and correct the problems if we want to ensure our capital markets remain efficient and attractive for years to come.

The following are among the reforms that need to be taken to retain our primacy:

- **Financial Reporting Forum:** A FRF should be formed and made up of the SEC, FASB, PCAOB, financial regulators, investors (broadly defined), and businesses and its mission should be to identify and propose solutions to problems before they reach the crisis stage. This will also provide a mechanism to allow for appropriate coordination amongst regulators and input from investors and businesses. Congressman Gary Miller had an amendment to create an FRF that became a part of the House passed financial regulatory reform bill. The Miller amendment was stripped out by the Dodd-Frank Conference Committee.
- **Materiality for Investors:** The SEC, FASB, and PCAOB should develop standards of materiality for investors, as well as the scope of outreach to the investor community. This will provide perspective on various accounting and auditing issues such as the need for restatements on the one end, while framing the picture for input on the front end of standard setting.
- **PCAOB, FASB, and Regulator Coordination:** A formal, ongoing, and transparent dialogue should be created to consider the auditability of accounting standards. This would allow for the auditing of accounting standards to work in conjunction with standard development. It would also provide for the identification and resolution of issues that arise in practice. A similar process should be created to ensure that regulators have an understanding of standards and that different entities are not working at cross purposes. The era of “not my problem” needs to end.
- **Administrative Procedures Act and Federal Advisory Committee Act:** Recognition should be made that both FASB and PCAOB can have an enormous impact on the economy. Accordingly, FASB and PCAOB should abide by the same rules of procedure as required by the Administrative Procedures Act. In its standard setting activities, it should be required to consider the effects of its proposals “on efficiency, competition and capital formation” as the SEC is required to do and provide meaningful cost-benefit analysis so that it is mindful of the downstream effects of its proposals. Additionally, any advisory groups FASB and PCAOB form should be balanced in representation, open in process and follow the mandates for transparency and open deliberation reflected in the FACA.

- **Formal Pre and Post Implementation Review by FASB:** Standards should be field tested and put through a rigorous process to identify unintended consequences both before and after implementation. This process should include the following:
  1. Establishing a nine month period, following the finalization of the convergence projects, for FASB and IASB to work with all financial reporting stakeholders to identify transition issues and issue an implementation plan;
  2. Establishing an Implementation Issuer Advisory Group made up of large cap, mid cap, and small cap public companies and appropriate private company representation to advise FASB and IASB on the transition issues and implementation plan;
  3. Holding a series of roundtables, in conjunction with the appropriate regulators, for all stakeholders to have a voice in identifying issues and developing an implementation plan;
  4. Committing to procedural transparency through adherence to the Administrative Procedures Act and the cost-benefit analysis required for significant rulemakings, as well as disclosure policies established by U.S. financial regulators in the wake of the Dodd-Frank Act rulemaking;
  5. Consulting with appropriate financial regulators; and
  6. Developing a formal implementation and post-implementation process as proposed by CIFIR.
  
- **PCAOB Business Roundtables and Formation of Business Advisory Group:** In the coming weeks the Chamber and other trade associations will call upon the PCAOB to hold a roundtable and form a business advisory group to understand the role of companies as investors and their views on enhancing audit quality and other issues under the PCAOB's purview. Such a group should be transparent and follow the standards of FACA.
  
- **PCAOB Audit Advisory Group:** To provide for current, relevant expertise in the standard setting process and facilitate the identification and resolution of

issues that arise in practice, the PCAOB should form an audit advisory group composed of public company auditors.

- **Cost Benefit Analysis:** In developing accounting and auditing standards, FASB and PCAOB must conduct a cost benefit analysis for investors and businesses before moving forward with a proposal. Standards should also show a justification for market efficiency and capital formation.
- **Less Reliance on Prescriptive Rule Making:** Hand-in-hand with the appropriate use of judgment is avoiding a system that is overly prescriptive in the formulation and application of standards and rules. The danger of an ever increasing number of rules and regulations by which audit firms are required to operate and auditors are required to apply has a danger of limiting the perspective of audit firms and auditors by displacing the application of principles and the exercise of judgment. This has the potential to create a system that has a one size fits all approach and check the box mentality that is at odds with the ever evolving dynamics of change inherent in our economy
- **Global Standards:** The SEC, FASB, and PCAOB should work towards the convergence of accounting and auditing standards to create a global system that will benefit investors from around the world. This convergence must create quality standards and should not adhere to a strict timeline to achieve that goal. Additionally, the SEC, and the Administration should continue efforts to achieve the international recognition of inspections.
- **Liability:** It should be recognized that large, medium, and small audit firms are needed, just as our economy needs large, medium, and small financial institutions. However, the unique aspects of the industry and the potential for catastrophic failure because of liability require a serious effort at liability reform, as has been accomplished in other jurisdictions or for other industries here in the United States.
- **Ban Mandatory Audit Firm Rotation and keep the PCAOB focused on its mission:** This is not a matter of auditing regulation. This is a matter of corporate governance outside of the PCAOB's realm. Congress should stop this effort in its track and refocus the PCAOB on its core mission.

The Chamber believes that these reforms would have dramatic benefits and provide a resiliency that was lacking during the financial crisis. All stakeholders would have the ability to provide input to FASB and PCAOB in an open and transparent

manner. Standards would be improved and accounting and auditing would be on the same page. The same would be true of the regulators who, with the standard setters, would have a better feel for the overlap and interplay of seemingly disparate yet interconnected disciplines.

Finally, let me discuss the Chamber's positions on H.R. 3503 (the "Westmoreland Bill") and the draft bill banning mandatory firm rotation ("the Fitzpatrick Bill"). We have serious concerns regarding the Westmoreland bill on public disciplinary proceedings. First, the current system is one commonly used for regulatory proceedings—it is the same system that the Federal Elections Commission uses for alleged campaign finance violations. Second, these proceedings affect the auditor and the company. Inappropriate disclosures regarding disciplinary proceedings will impact the equity value of a company, harming shareholder value for investors and a business's capital base. We believe in strong even-handed enforcement and would like to have further discussions with Congress to achieve this goal.

The Chamber supports independent standard setting, however we believe that recent proposals on mandatory firm rotation, audit committee communications and proposals on an auditor discussion and analysis and executive compensation clearly are outside the bounds of audit regulation and entering corporate governance as discussed before. The Fitzpatrick bill reaffirms the line of demarcation, as established in Sarbanes-Oxley, that the PCAOB's jurisdiction is limited to that of an audit regulator, while corporate governance and executive compensation reside with the SEC or state corporate law.

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Auditors would be empowered to use their best judgment to impose integrity and accountability into the system. Global standards and cross-border cooperation will increase the ability of investors to understand a global marketplace, and for regulators to better provide for safety and soundness.

If we want to have transparent financial disclosures, the regulators and standard setters need to be transparent themselves. They need to focus on disclosures that are relevant and rational, and useful to investors, including business. The Chamber urges you to:

- Mandate more rational and efficient procedures at the standard setting bodies with a particular emphasis on improving their transparency and accountability;

- Keep these entities focused on their narrow, but important roles. Do not permit them to become overlapping and redundant bureaucracies that perpetuate a bloated administrative state that stifles the creative energies of its citizenry with excessive red tape;
- Empowering the stakeholders of these entities by ensuring they can engage in meaningful dialogue and get reasoned analysis to support new accounting and auditing standards;
- Address the ominous and growing liability issues that threaten the depth of our auditing and accounting professions.

All of these reforms are critical next steps to aligning financial reporting policy with America's economic prosperity in the 21<sup>st</sup> century economy.

As you move forward to make these reforms, recognize that the purpose of the financial reporting system is not to eliminate all risk from economic endeavors. Risk is inherent in our free enterprise system. It is a necessary element for innovation and the growth opportunities our economy needs to thrive. While we can try to strengthen the system, we must recognize that rational and enforceable financial reporting policies are designed to help stakeholders evaluate risks through the many different perspectives they may have of it. Such a system properly conceived as a means to an end and not as an end in itself will help spur long-term economic growth and job creation, and the Chamber is willing to work with any and all parties to make that a reality.

I will be happy to take any questions that you may have.





**Testimony of**

**Leslie F. Seidman, Chairman**

**Financial Accounting Standards Board**

**before the**

**U.S. House of Representatives Financial Services Subcommittee**

**on Capital Markets and Government Sponsored Enterprises**

**Accounting and Auditing Oversight: Pending Proposals and Emerging Issues  
Confronting Regulators, Standard Setters and the Economy**

**March 28, 2012**

**Introduction**

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

My name is Leslie Seidman and I am the Chairman of the Financial Accounting Standards Board (FASB or Board). I would like to thank you for this opportunity to participate in today's important hearing.

As the Subcommittee examines current issues facing accountants and auditors, I thought it would be helpful to outline for you the manner in which accounting standards are developed. In doing so, I would like to begin by providing a brief overview of the FASB and its parent organization, the Financial Accounting Foundation (FAF). I also want to explain the FASB's robust due process and how we remain accountable to our stakeholders. As you requested, I have summarized some recent guidance promulgated by the FASB as well as several of our pending projects, including our disclosure framework project and our convergence projects with the International Accounting Standards Board (IASB). Finally, I would like to highlight some of the changes that we have made to our process to better understand and respond to the issues of private companies and not-for-profit organizations.

**The FASB**

The FASB is an independent private-sector organization that operates under the oversight of the FAF. For nearly 40 years, 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.

U.S. 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. In today's dynamic financial markets, the need for integrity, transparency, and objectivity in financial reporting is increasingly critical to ensure the strength of U.S. capital markets and provide investors with accurate and timely information.

In 2002, Congress enacted the Sarbanes-Oxley Act, which included provisions protecting the integrity of the FASB's accounting standard-setting process. The legislation provided the FASB with an independent, stable source of funding. The legislation mandated an ongoing source of funding for the FASB from annual accounting support fees collected from issuers of securities, as those issuers are defined in the Sarbanes-Oxley Act.

It is important to note that although the FASB has the responsibility to set accounting standards, it does not have authority to enforce them. Officers and directors of a company are responsible for preparing financial reports in accordance with accounting standards. Auditors provide an opinion as to whether those officers and directors appropriately applied accounting standards. The Public Company Accounting Oversight Board (PCAOB) is charged with ensuring that auditors of public companies have performed an audit in accordance with generally accepted auditing standards, which include an auditor's analysis of whether a public company has complied with appropriate accounting standards. The SEC has the ultimate authority to analyze whether public companies have complied with accounting standards.

#### **The Mission of the FASB**

The FASB's mission is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports. That mission is accomplished through a comprehensive and independent process that encourages broad participation, objectively considers all stakeholder views, and is subject to oversight by the FAF's Board of Trustees.

We recognize the critical role that reliable financial reporting plays in supporting the efficient functioning of the capital markets. Robust financial reporting increases investor confidence, which in turn leads to better capital allocation decisions and economic growth. Accounting standards are not intended to drive behavior in a particular way; rather, they seek to present financial information so that financial statement users can make informed decisions about how to best deploy their capital.

Today, as the U.S. economy continues to recover from the financial crisis and recession, the FASB remains committed to ensuring that our nation's financial accounting and reporting

standards provide investors with the information they need to confidently invest in the U.S. markets.

To accomplish its mission, the FASB acts to do the following:

1. Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency
2. Keep standards current to reflect changes in methods of doing business and changes in the economic environment
3. Consider promptly any significant areas of deficiency in financial reporting that might be addressed through the standard-setting process
4. Improve the common understanding of the nature and purposes of information contained in financial reports.

As it works to develop accounting standards for financial reporting, the FASB is committed to following an open, orderly process that considers the interests of the many who rely on financial information. Because we understand that the actions of the FASB affect so many stakeholders, we are steadfastly committed to ensuring that the decision-making process is independent, fair, and objective.

#### **The Standard-Setting Process**

An independent standard-setting process is paramount to producing high-quality accounting standards, since it relies on the collective judgment of experts, and it is informed by the input of all interested parties through a thorough, open, and deliberative process. The FASB sets accounting standards through processes that are open, accord due process to all interested parties, and allow for extensive input from all stakeholders. Such extensive due process is required by our Rules of Procedure, set by the Board within the parameters of the FAF's bylaws. Our process is similar to the Administrative Procedure Act process used by federal agencies for rulemakings but provides far more opportunities for interaction with all interested parties. In fact, in recent years, we have significantly expanded our ability to engage with stakeholders in a variety of ways.

The FASB's extensive due process involves public meetings, public roundtables, field visits or field tests, liaison meetings and presentations to interested parties, and the exposure of our proposed standards for public comment. The FASB videocasts its Board meetings and education sessions on its website to make it easier for stakeholders to observe our decision-making process. The FASB also creates podcasts and webcasts to provide short, targeted summaries of our proposals and new standards so that people can quickly assess whether they have an interest and want to weigh in. We also have been proactively reaching out to meet with stakeholders, including a wide range of investors and reporting entities, to discuss our proposals to help us to assess whether the proposals will lead to better information as well as to assess the related costs. Those interactive meetings allow the FASB and its staff to ask questions to better understand why a person holds a particular view, which can accelerate the identification of issues and possible solutions.

The FASB proactively meets with stakeholders, including a wide range of investors, auditors, and reporting entities, to identify implementation issues with existing standards. Those meetings with stakeholders help us to assess whether U.S. GAAP is providing useful information and also to assess the related costs.

The FASB conducts outreach on a frequent and regular basis with its numerous advisory groups. The primary role of advisory group members is to share their views and experience with the Board on matters related to practice and implementation of new standards, projects on the Board's agenda, possible new agenda items, and strategic and other matters.

In addition to the FASB's advisory groups, the Emerging Issues Task Force (EITF or Task Force) assists the FASB in improving financial reporting through the timely identification, discussion, and resolution of financial accounting issues relating to U.S. GAAP. The EITF also was designed to promulgate implementation guidance for accounting standards to reduce diversity in accounting practice on a timely basis. The EITF assists the FASB in addressing implementation, application, or other emerging issues that can be analyzed within existing U.S. GAAP. Task Force members are drawn from a cross section of the FASB's stakeholders, including auditors, preparers, and users of financial statements. The chief accountant or the deputy chief accountant of the SEC attends Task Force meetings regularly as an observer with

the privilege of the floor. The structure of the EITF is designed to include persons in a position to be aware of emerging issues before they become widespread and before divergent practices become entrenched.

The FASB also meets regularly with the staff of the SEC and the PCAOB. Additionally, since banking regulators have a keen interest in U.S. GAAP financial statements as a starting point in assessing 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 accounting developments.

In short, the FASB actively seeks input from all of its stakeholders on proposals and processes and we are listening to them. Wide consultation provides the opportunity for all stakeholder voices to be heard and considered, the identification of unintended consequences, and, ultimately, broad acceptance of the standards that are adopted. The Board's wide consultation also helps it to assess whether the benefits to users of improved information from proposed changes outweigh the costs of the changes to preparers and others.

The FASB Chairman's Reports for all four quarters of 2011, which enumerate the FASB's technical activities, its education and communication activities, and its various forms of outreach with stakeholders, are provided as Attachment 1.

#### **Oversight of FASB**

The FASB's accountability derives from oversight at two levels. First, the Board is overseen by the independent Board of Trustees of the FAF. Organized in 1972, the FAF is an independent, private-sector, not-for-profit organization. The FAF exercises its authority by having responsibility for oversight, administration, and finances of the FASB and its sister organization the Governmental Accounting Standards Board (GASB). The FAF also has responsibility for the following:

1. Selecting the members of the FASB, the GASB, and their respective Advisory Councils
2. Overseeing the FASB's and the GASB's Advisory Councils (including their administration and finances)

3. Overseeing the effectiveness of the FASB's and the GASB's standard-setting processes and holding the Boards accountable for those processes
4. Protecting the independence and integrity of the standard-setting process
5. Educating stakeholders about those standards.

Second, the FASB also is subject to oversight by the SEC with respect to standard setting for public companies. The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For nearly 40 years, the SEC has looked to the private sector to set accounting standards. In 2003, the SEC issued a Policy Statement, *Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, which reaffirms its longstanding relationship with the FASB.

Additional information about the FASB and the FAF can be found in the 2010 Annual Report of the FAF, which is available on the FAF website.

#### **FASB Activities**

One of the significant challenges facing our financial reporting system is the need to improve the transparency and overall usefulness of reported financial information to investors and other users of financial reports and reduce complexity. The FASB is addressing this challenge in a number of ways. First, the FASB has completed several projects to improve information provided in financial reports. Second, the FASB continues its work to improve accounting requirements in several areas, including its convergence projects to improve U.S. GAAP and International Financial Reporting Standards (IFRS) and narrow the differences between the two. Third, the FASB has made numerous process changes to improve its ability to understand and act upon private company concerns and the not-for-profit sector. Fourth, the FASB is working on a disclosure framework project intended to increase the utility of information disclosed in the financial statements. Lastly, the FASB continues to enhance the *FASB Accounting Standards Codification*<sup>®</sup> (Codification), which is the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities, and the XBRL (eXtensible Business Reporting Language) U.S. GAAP financial reporting taxonomy.

**Recently Completed Standard-Setting Activities**

The FASB recently completed a number of amendments to U.S. GAAP through the issuance of Accounting Standards Updates (Updates) to improve accounting and disclosure requirements. Some of the changes affect how companies recognize and present certain transactions in their financial statements and other changes enhance footnote disclosures.

1. **Participation in multiemployer plans to be disclosed.** Previous accounting guidance required a company to disclose only its historical contributions made to multiemployer pension plans. The FASB introduced new disclosure requirements to increase awareness of a company's commitments and risks involved with participating in multiemployer pension plans.<sup>1</sup> The new disclosures improve transparency into how a company's future cash flows might be affected by its participation in a multiemployer pension plan.
2. **Qualitative assessment allowed for goodwill impairment test.** Goodwill impairment testing affects a large number of companies. Previous accounting guidance required companies to calculate the fair value of a business as part of a two-step goodwill impairment test. The FASB simplified the impairment test by introducing an initial qualitative assessment.<sup>2</sup> Under that simplified approach, a company is not required to calculate the fair value of the business unless that company determines that it is more likely than not that the fair value of the business is less than its carrying amount.
3. **Presentation of other comprehensive income (OCI) is enhanced.**<sup>3</sup> All companies that report items of OCI will be affected by this change. OCI items may no longer be presented in the statement of stockholders' equity. Instead, OCI will be presented after net income in either a single statement of comprehensive income or in two separate but consecutive statements.

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<sup>1</sup> FASB Accounting Standards Update No. 2011-09, Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80): Disclosures about an Employer's Participation in a Multiemployer Plan.

<sup>2</sup> FASB Accounting Standards Update No. 2011-08, Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment.

<sup>3</sup> FASB Accounting Standards Update No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income.



4. **Amendments made to fair value measurement requirements.** The amendments result in common fair value definitions and disclosure requirements in U.S. GAAP and IFRS.<sup>4</sup> Among other things, the amendments clarify that a reporting entity should disclose quantitative information about inputs used in certain fair value measurements.
5. **Offsetting of derivatives, financial assets, and financial liabilities.**<sup>5</sup> To facilitate comparison between companies that use U.S. GAAP versus companies that use IFRS, the FASB and the International Accounting Standards Board (IASB) issued common disclosures about derivative contracts and other financial instruments. The new disclosures will require (a) both gross and net information about instruments and transactions eligible for offset in the balance sheet and (b) information about instruments and transactions subject to master netting arrangements or similar arrangements.
6. **Additional guidance about troubled debt restructurings.** Given the recent economic downturn, the volume of debt restructured by creditors has increased. The FASB issued additional guidance to help creditors to determine whether debt restructurings constitute troubled debt restructurings, which are subject to impairment guidance and supplemental disclosure requirements.<sup>6</sup>
7. **Insurance companies—change in the accounting for deferred acquisition costs.** Certain costs incurred by insurance entities qualify as deferred acquisition costs and can be capitalized in the acquisition of new and renewal insurance contracts rather than expensed when incurred. Under the amendments, fewer costs qualify as deferred acquisition costs; costs associated with the successful acquisition of a contract are now the only acquisition costs eligible for deferral.<sup>7</sup>
8. **Change in how effective control is determined for repurchase agreements.** Under previous guidance, a company had to consider the extent of collateral maintained in its assessment of whether a repurchase agreement should be accounted for as a sale or

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<sup>4</sup> FASB Accounting Standards Update No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.

<sup>5</sup> FASB Accounting Standards Update No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*.

<sup>6</sup> FASB Accounting Standards Update No. 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*.

<sup>7</sup> FASB Accounting Standards Update No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*.

secured borrowing. The FASB concluded that the criterion pertaining to an exchange of collateral should not be a determining factor when evaluating the accounting for a repurchase agreement. As a result, some repurchase transactions will be reported as secured borrowings rather than as sales.<sup>8</sup> That change will affect leverage and expense ratios.

A list of recent Updates issued by the FASB is provided as Attachment 2.

**Ongoing Standard-Setting Activities**

The FASB has a number of ongoing projects to improve accounting and disclosure requirements in several areas, including its projects to improve U.S. GAAP and IFRS and narrow the differences between the two.

The current Technical Plan for all of the FASB projects underway (joint and standalone) is provided as Attachment 3.

**Convergence Activities with the IASB**

The FASB has long supported the goal of developing high-quality, comparable global accounting standards based on the 2002 Norwalk Agreement and the 2006 Memorandum of Understanding (MOU) (as updated in 2008).

The MOU reflects the decision by the FASB and the IASB, with concurrence of the SEC and the European Commission, that their resources should focus on developing converged and improved standards in those areas in U.S. GAAP and IFRS that were most in need of improvement. To that end, the FASB and the IASB have substantially converged accounting standards in a number of areas including business combinations, noncontrolling interests, fair value measurements, borrowing costs, segment reporting, stock compensation, and nonmonetary exchanges.

However, significant differences remain, and the FASB and the IASB are working together and making progress on the four remaining priority projects (revenue recognition, leasing, financial

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<sup>8</sup> FASB Accounting Standards Update No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*.

instruments, and insurance). In areas in which we have not yet reached converged solutions, we are reviewing the differences to see if further convergence can be achieved.

While the FASB is committed to working at a deliberate pace to develop improved, converged, and sustainable standards, it is equally committed to making sure that the standards result in improved financial information for investors and that companies and auditors understand the new requirements and can implement them in an orderly manner. Those proposed standards go to the core of a company's operating metrics, and the FASB is committed to ensuring that stakeholders have ample opportunities to comment on proposed changes and identify possible implementation issues before the standards are finalized. The four priority convergence projects are described below.

#### ***Revenue Recognition***

In November 2011, the FASB and the IASB issued a revised Exposure Draft<sup>9</sup> of a comprehensive principle and application guidance for when and how to recognize revenue. The revised Exposure Draft reaffirms the principle for revenue recognition from the first Exposure Draft (issued June 2010) but, based on the feedback we received, we made changes that were aimed at reducing complexity and adding clarity to the basic concepts. The Boards decided to reexpose the revised proposal for public comment as a quality control measure because revenue is such an important indicator of performance for virtually every company around the world.

The FASB has taken a number of steps to inform stakeholders about the revised proposal. The FASB website contains a webcast explaining the major provisions, a webcast answering frequently asked questions, and a reference tool comparing current requirements with the proposed requirements and highlighting the industries that would be affected.

Since the issuance of the revised Exposure Draft, the FASB also has been conducting extensive outreach meetings with stakeholders around the globe to help them understand the proposal and the changes that we intend to help them formulate their views. We have a number of roundtables planned in locations around the world to discuss feedback on the proposed changes. We also

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<sup>9</sup> Proposed FASB Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*, and IASB Exposure Draft, *Revenue from Contracts with Customers*.

have a simple electronic feedback form on the website, which is ideal for targeted feedback on a narrow point or an overall statement in which you agree with the proposal or in which your previous concerns have been addressed.

The Boards expect to begin joint redeliberations in the second quarter, with a goal of completing those discussions by the end of the year. However, that timing depends on the nature of the feedback we receive and how long it takes to work it through. Based on the current plan, we expect to issue a converged new standard in the first quarter of 2013.

### *Leasing*

The Boards were urged to consider changes to existing accounting standards on leasing for a few reasons including (1) the feedback from investors that significant lease obligations were not being reported on the balance sheet, (2) the complexity of the existing guidance, and (3) to converge the guidance in U.S. GAAP and IFRS. In August 2010, the Boards issued an Exposure Draft<sup>10</sup> proposing that the rights and obligations relating to leases be reported on a company's balance sheet. For the last several months, the FASB and the IASB have been jointly considering the feedback we received on that original Exposure Draft. Based on that feedback, the Boards have already decided to make (a) numerous changes to the original proposal, which largely address issues relating to complexity, and (b) clarifications of the scope of the proposed standard. The Boards have reaffirmed their decision that the rights and obligations relating to leases belong on the balance sheet, which has been widely supported by investors.

However, the Boards have continued to receive feedback indicating concerns with the income statement effects resulting from the proposed right-of-use model. Many stakeholders, including preparers and some investors, do not view certain types of leases as being similar to a purchase and financing of part of an asset. Both Boards are trying to work through those concerns. The Boards have asked the staff to conduct outreach to evaluate the decision usefulness and operability of two alternative approaches before they decide how to proceed. Leasing is a very pervasive transaction, and we want to make sure that we have carefully considered the concerns that have been raised before we move forward with another Exposure Draft.

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<sup>10</sup> Proposed FASB Accounting Standards Update, *Leases (Topic 840)*, and IASB Exposure Draft, *Leases*.

On the lessor side, the Boards also have revisited the conclusions in the first Exposure Draft to address the concerns that had been raised. We decided to apply a proportionate sale model for all leases except leases of investment property, which would be excluded from the scope. However, given the potential changes being considered for lessees, the Boards asked the staff to explore whether there should be symmetrical accounting for lessors, which could have implications for the Board's previous decisions for lessors. The staff will gather input on those issues, and we expect to continue our discussions with the IASB in May 2012.

This additional analysis will extend the timetable on leasing by a few months. If the Boards reach a decision in May 2012, then we would expect to conclude our discussions in the second quarter, with a revised Exposure Draft in the third quarter of 2012. During the comment period, the Boards plan to conduct additional outreach with investors and a wide range of companies that lease property and equipment. The purpose of the outreach is to help people understand the revised proposal, gain an understanding of the expected costs of implementation, and to gather additional input from investors and other users of financial statements about whether the resulting information is useful in their decision making. At this point, we would anticipate a final standard in mid 2013.

#### *Accounting for Financial Instruments*

The financial instruments project aims to provide a more timely and fulsome description of a company's involvement in financial instruments. The project addresses how to (1) classify and measure financial instruments, (2) account for impairments (loan loss provisioning), and (3) improve reporting of hedging activities. The Boards' overall objective is to simplify, improve, and converge the accounting for financial instruments. Differing timetables and priorities led the FASB and the IASB to develop separate proposals. The IASB issued final guidance on classification and measurement (IFRS 9, *Financial Instruments*) as well as separate proposals on impairment and hedging, while the FASB issued a comprehensive Exposure Draft in May 2010.<sup>11</sup>

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<sup>11</sup> Proposed FASB Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instrument and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*.

**Classification and measurement of financial instruments**

The May 2010 FASB Exposure Draft on financial instruments proposed a much greater use of fair value measurement for financial instruments than exists under current accounting guidance or under IFRS 9. The feedback that the FASB received on that proposal indicated that the vast majority of investors, reporting entities, and other stakeholders did not think that fair value was the most appropriate measurement attribute for some financial instruments in the balance sheet. They suggested various ways to enhance the information through a more robust impairment approach and expanded disclosures, particularly for loans. Based on that feedback, in its deliberations to date, the FASB has tentatively decided that at least some assets should qualify for cost accounting based on the characteristics of the instrument and the entity's business strategy in holding them.

In November 2011, the IASB decided to consider making limited modifications to IFRS 9. That decision gives the Boards an opportunity to try to narrow the differences with the tentative classification and measurement model that the FASB has been developing. The Boards began joint discussions at their February 2012 meeting, and plan to continue those joint discussions over the next few months.

**Impairment of financial instruments**

The FASB and the IASB initially proposed different impairment models, but are now developing a joint approach to credit impairment based on variations of their previous proposals. This joint approach is based on expected losses and is more forward looking than the current incurred loss approach. Under this joint approach, companies would recognize losses as a loan deteriorates based on supportable information (for example, past events, current conditions, and reasonable and supportable forecasts) that is consistent with externally available information and considered relevant in measuring the credit impairment allowance. (Under current U.S. GAAP, an impairment loss is not recognized until it is *probable*.)

The joint staff team continues to perform extensive outreach to determine whether the approach is operational. The current plan is to complete joint deliberations on impairment in the second

quarter of 2012 and issue a converged Exposure Draft in the second half of 2012. Based on that timetable, we would expect to finalize the new impairment requirements in the first half of 2013.

**Hedging**

The FASB plans to consider whether to expand its evaluation of hedge accounting issues following the joint discussions of classification and measurement issues.

**Risk disclosures about financial instruments**

In response to significant investor feedback on the FASB's May 2010 Exposure Draft on financial instruments, the FASB has developed new disclosure requirements about liquidity and interest rate risk. The FASB plans to expose those proposed disclosure requirements in the second quarter of 2012.

***Repurchase Agreements***

Current accounting guidance and current transaction structures result in most repurchase agreements being accounted for as secured borrowing transactions with only certain types of transactions being accounted for as sale transactions. Those are repurchase agreements involving the return of a security that is different from the security originally transferred and repo-to-maturity transactions.

Concerns about the accounting for repo-to-maturity transactions had not been raised in the past, even when the FASB previously considered certain aspects of the accounting for repurchase agreements, as recently as 2010. However, in late December 2011, the FASB was made aware of concerns about the accounting for repo-to-maturity transactions. In January 2012, the staff in the SEC's Office of the Chief Accountant and the staff at the FASB began evaluating those concerns. The FASB staff commenced outreach activities with various stakeholders to better understand current practices related to repo-to-maturity agreements. Our outreach indicates that market practices have changed over the years since this accounting guidance was established (in 1996). For example, while historically, repurchase agreements involved mostly U.S. Treasury and agency securities, the range of debt instruments has broadened to include other types of debt securities, which may be less creditworthy and consequently affect how those transactions operate and how investors consider the risks associated with them.

Accordingly, on March 21, 2012, the FASB added a project to its agenda to reconsider the accounting and disclosure guidance for repurchase agreements and similar transactions. In keeping with our due process procedures, we will hold a series of public meetings to deliberate the issues raised and expose a proposed standard for public comment. Subject to nature of our deliberations and the feedback we receive, we expect that a final standard could be issued in 2012.

### ***Insurance***

The FASB and the IASB have been working together to develop a converged global standard on accounting for insurance contracts. In general, the Boards are developing a model that would reflect current estimates of the amount necessary to fulfill an insurance obligation. However, we have not reached consistent conclusions about several elements of the model. There is a strong desire for a global standard on insurance, and the Boards are undertaking an effort to gain a deeper understanding of the decisions taken by each Board to identify potential opportunities to resolve differences. Once we have worked through some of those issues, we will evaluate the prospects for further convergence and decide how to proceed.

The FASB and the IASB are at different points in the process on the insurance contracts project. The FASB is developing its first Exposure Draft, whereas the IASB has already issued an Exposure Draft, *Insurance Contracts*. We currently estimate that we will conclude our major technical discussions in the second quarter of 2012, with a FASB Exposure Draft in the second half of 2012. The IASB will determine whether to reexpose the changes they made during redeliberations.

### ***Further Convergence of International Standards***

Many stakeholders, including leaders of the G-20 nations and the SEC, have called for the FASB and the IASB to continue efforts to converge accounting standards in key areas. On May 26, 2011, the SEC Staff issued a paper titled, *Exploring a Possible Method of Incorporation* under the SEC's *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers*. The SEC Staff Paper described an approach to incorporation colloquially referred to as "Condorsement". The FAF Board of



Trustees and the FASB Board members carefully considered the proposed approach and the comments made by U.S. stakeholders to the SEC about the approach. In November 2011, the Chairman of the FAF, on behalf of the Board of Trustees, submitted a letter to the SEC supporting an incorporation approach with some recommended modifications and clarifications intended to address the concerns that were raised by many who offered comments to the SEC Staff.<sup>12</sup>

*Private Company Accounting*

Privately held companies remain very important to the FASB in achieving its mission. The FASB recently has made numerous process changes to improve its ability to understand and act upon private company concerns. For example, the FASB did the following:

1. Welcomed the FAF's appointment of a Board member with a private company preparer background and another Board member with significant experience investing in and auditing private companies
2. Assigned private company liaisons to each project team to better provide input on how proposed changes to U.S. GAAP would affect private companies
3. Held roundtables comprised only of private company stakeholders to discuss proposed changes to U.S. GAAP
4. Increased participation in conferences targeting private company stakeholders
5. Developed an electronic feedback form to enable stakeholders to more easily respond to proposed changes to U.S. GAAP
6. Increased the use of webcasts and podcasts about proposed changes to U.S. GAAP to increase awareness of our activities and encourage participation.

In addition, the FASB has increased its face-to-face interactions with its nonpublic advisory groups, the Small Business Advisory Council (SBAC) and the Private Company Financial Reporting Committee (PCFRC). The SBAC focuses on increasing the opportunities for small business community members (both public and private) to share their ideas, knowledge, and

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<sup>12</sup>Brennan, John J., Letter to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, November 15, 2011. <http://www.sec.gov/comments/4-600/4600-158.pdf>.

experience with the FASB, as well as with the other group members. The PCFRC represents privately held business entities and focuses on how standard setting affects day-to-day technical activities and procedures from a cost/benefit perspective.

The FASB has taken these steps to make private company concerns an integral part of every standard-setting deliberation it undertakes. The process changes noted above have led to recent changes in accounting standards on goodwill impairment<sup>13</sup> and disclosures about multiemployer pension plans.<sup>14</sup> In addition, we have two projects underway that focus on private companies. The first is to ensure that we have a common understanding of when differences are appropriate for private companies versus public companies in U.S. GAAP. We have heard a wide range of views—at one end, the perspective that “significant changes are required” and at the other end, the view that “there should be no differences in recognition and measurement.”

To try to build consensus on this core issue, the FASB staff has been developing a decision-making framework that will describe a number of the distinguishing characteristics of private companies and then suggest how those characteristics might affect the various types of accounting and disclosure issues that we typically address. The staff has been working with a resource group of private company professionals to vet these ideas, and our plan is to issue a draft framework in the second quarter for public comment.

A related issue is the definition of a private company. The FASB recently added a project to clarify the definition for a few reasons. First, it will help establish which entities have specific attributes that would potentially warrant a difference in reporting. Second, we plan to address a number of practice issues that have emerged over the years, including some recent changes in legislation about filing requirements for various types of entities. And third, there are a number of existing definitions of a nonpublic entity in U.S. GAAP, and we see an opportunity to reduce complexity in that area.

In addition to the FASB’s efforts, the FAF Board of Trustees has taken a number of steps to address private company concerns. Most recently, the trustees developed a plan to establish a

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<sup>13</sup> Update 2011-08.

<sup>14</sup> Update 2011-09.

Private Company Standards Improvement Council (PCSIC).<sup>15</sup> The public comment period for the trustees' proposed plan ended on January 14, 2012. The trustees conducted four roundtables and other forms of outreach across the country this year and will make a final decision after reviewing and considering public input.

#### *Not-for-Profit Accounting*

The FASB has a long-standing commitment to the not-for-profit sector as part of its standard-setting process for U.S. GAAP. Over the years, the FASB has addressed the accounting and reporting needs of the sector, both for transactions that are unique to the sector (for example, contributions received) and for transactions that it has in common with public and private business enterprises (for example, employee postretirement benefit obligations). The FASB has staff dedicated to advising the Board and other staff members on issues pertinent to the not-for-profit sector and communicating with members of the sector. To reinforce and broaden such consultation and communication, the FASB created a Not-for-Profit Advisory Committee (NAC) in 2009. The NAC serves as a standing resource for the FASB in obtaining input from the not-for-profit sector on existing guidance, current and proposed technical agenda projects, and longer term issues affecting those organizations.

With the help of the NAC, the FASB will reexamine existing standards to improve the way donor restrictions are considered in the presentation of net assets and to provide more relevant information about a nonprofit's liquidity, financial performance, and cash flows. The FASB plans to start discussing those issues in the second quarter of 2012. FASB staff also will be conducting research about best practices followed by nonprofits to "tell their story" about their financial health and the overall effectiveness of their organizations. The EITF also is currently working to address two accounting issues unique to the not-for-profit sector.

#### *Disclosure Framework*

Stakeholders have expressed concerns about disclosure overload or, often, disclosure ineffectiveness. In response to those concerns, the FASB has added a disclosure framework

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<sup>15</sup> Financial Accounting Foundation, *Plan to Establish the Private Company Standards Improvement Council*, October 4, 2011. See Attachment 4.

project to its agenda. We have been working to develop a framework to identify what information is most informative to users of financial statements. The framework would guide the Board in future decisions about disclosure requirements, but it also would provide a guide for companies on how to exercise discretion, to make the information presented most relevant at any point in time.

The second objective is to seek ways to better integrate information provided in financial statements, Management Discussion & Analysis (MD&A), and other parts of a reporting entity's financial reporting package. The intention is to promote meaningful communication and avoid repetition wherever possible. The desired results are an increase in the utility of the information disclosed and a net reduction in volume.

The FASB is working cooperatively with a few European standard-setting bodies and with the assistance of a U.S.-based resource group. We currently expect to issue a discussion document for public commentary in mid 2012. We plan to review existing disclosure requirements as well, but will consider the feedback on the proposed framework first.

***FASB Accounting Standards Codification®***

In 2009, the FASB officially launched 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 multiyear effort to make the U.S. GAAP literature more accessible and user friendly. Instead of U.S. 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.

With the launch of the Codification, the FASB is no longer adding numbered Statements, Interpretations, FASB Staff Positions, and the like to U.S. GAAP but, rather, is issuing Updates that contain amendments to the relevant sections of the Codification.

The new system significantly reduces the amount of time and effort required to research accounting issues, mitigates the risk of noncompliance with standards through improved

usability of the literature, provides accurate information with real-time updates as new standards are released, and assists the FASB with the research efforts and literature amendments required during the standard-setting process.

To monitor the effectiveness of the Codification, the Codification system allows users to submit content feedback. In addition, the FASB meets with stakeholders to discuss concerns about the Codification and recently solicited feedback via a user survey. The FASB staff reviews feedback on the Codification in an ongoing manner and the Board periodically issues technical corrections to update the Codification to address feedback received.

#### *U.S. GAAP Financial Reporting Taxonomy*

The U.S. GAAP Financial Reporting Taxonomy is a list of computer-readable tags in XBRL that allows companies to label precisely the thousands of pieces of financial data that are included in typical long-form financial statements and related footnote disclosures. (XBRL is a standard for tagging business and financial reports to increase the transparency and accessibility of business information by using a uniform format.) The tags allow computers to automatically search for and assemble data so those data can be readily accessed and analyzed by investors, analysts, journalists, and the SEC staff. The FASB's development of the taxonomy is investor-focused and its use has increased substantially over the past few years. As a result, the FASB is continually striving to understand how the information is used by investors and other users and has initiated some mechanisms such as the FASB Taxonomy Advisory Group (made up of analysts, data aggregators, accounting firms, service providers, and preparers) to advise it on these matters. The FASB also launched an online review and comment system to make it easier for stakeholders to submit comments on the U.S. GAAP Financial Reporting Taxonomy.

#### **Conclusion**

Thank you for the opportunity to provide a brief overview of the FASB and its many pending projects and initiatives. I would be pleased to answer any questions.

Attachments:

1. The FASB Chairman's Reports for 2011
2. List of ASUs issued by the FASB since January 1, 2011
3. Current Technical Plan for all of the FASB projects underway (joint and standalone)
4. Financial Accounting Foundation, *Plan to Establish the Private Company Standards Improvement Council*, October 4, 2011.

REPORT OF THE FASB CHAIRMAN  
TO THE FINANCIAL ACCOUNTING FOUNDATION  
January 1, 2011 through March 31, 2011

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**ITEM 1: TECHNICAL ACTIVITIES**

**BOARD AND STAFF ACTIVITIES**

- a. Final Document Issued:
1. Accounting Standards Update No. 2011-01, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20* (issued January 19, 2011).
- b. Exposure Documents Issued:
1. Proposed Accounting Standards Update, *Balance Sheet (Topic 210): Offsetting* (issued January 28, 2011). Comment deadline: April 28, 2011.
  2. Supplementary Document, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Impairment* (issued January 31, 2011). Comment deadline: April 1, 2011.
  3. Discussion Paper, Invitation to Comment—*Selected Issues about Hedge Accounting (including IASB Exposure Draft, Hedge Accounting)* (issued February 9, 2011). Comment deadline: April 25, 2011.
- c. From time to time, the FASB issues Accounting Standards Updates to amend the nonauthoritative portions of the *FASB Accounting Standards Codification*® (such as the nonauthoritative SEC content). No such Updates were issued this quarter.
- d. No new projects were added to the Technical Agenda.
- e. An agenda request to add a project to the Technical Agenda on the definition of a nonpublic entity was considered but declined.
- f. No projects were removed from the Technical Agenda.
- g. Outreach Activities—Public Roundtable Meetings. The FASB held the following public roundtable meetings:
1. Four public roundtable meetings were held to discuss the Exposure Draft on Leases. One of those roundtable meetings, held in Chicago, was composed solely of nonpublic company participants.
- h. Outreach Activities—Meetings of FASB Standing Advisory Groups:

1. Financial Accounting Standards Advisory Council (FASAC) meeting. Seven Board members and several FASB staff members met with FASAC in March to discuss the Board's projects on Accounting for Financial Instruments, Revenue Recognition, and Leases. Participants also discussed their views about issues that the FASB should consider in setting its future agenda, once it completes the current priority projects.
  2. Investors Technical Advisory Committee (ITAC) meeting. Five Board members and several FASB staff members met with ITAC in an open meeting in January to discuss the Board's projects on Leases and Accounting for Financial Instruments and the Discussion Paper on Effective Dates and Transition Methods. Participants also discussed the need for a potential future FASB project on the Accounting for Pensions.
  3. Not-for-Profit Advisory Committee (NAC) meeting. Two Board members and several staff members met with NAC members in an open meeting to discuss the definition of public and private entities, the reporting model for not-for-profit organizations, the Board's projects on Revenue Recognition and Leases, and other matters of interest.
- i. Outreach Activities—Other Consultations with Stakeholders:
1. National Association of College and University Business Officers (NACUBO). Five Board members and several staff members met in an open meeting with representatives of the NACUBO's Accounting Principles Council in January. Participants discussed what readers of higher education financial statement want to know, focusing on both public and nonpublic entities. Participants also discussed the Board's projects on Accounting for Financial Instruments, Revenue Recognition, and Leases, as well as feedback on the classification requirements for net asset by not-for-profit organizations.
  2. Chartered Financial Analysts Institute (CFA). Five Board members and several staff members met in an open meeting with representatives of the CFA's Corporate Disclosure Policy Committee in February. Participants discussed individual and cross-cutting issues on the priority projects. Participants also discussed the Board's projects on Disclosure Framework, Effective Dates and Transition Methods, Financial Statement Presentation, Loss Contingencies, and Investment Properties.
  3. Three FASB members met privately with representatives from the Campaign for Quality Construction (CQC) and the Mechanical Contractors Association of America (MCAA) to discuss the ongoing project on Disclosures about an Employer's Participation in a Multiemployer Plan.
  4. Two FASB members met privately with representatives from the National Council of Real Estate Investment Fiduciaries (NCREIF) to discuss the ongoing project on Investment Properties.



- j. Other significant project-specific outreach activities:
1. Offsetting financial assets and financial liabilities—representatives of the FASB participated in over 25 calls and other meetings with various groups of investors, preparers, and auditors.
  2. Revenue recognition—the project team continued their targeted outreach program to obtain feedback throughout the redeliberations process. The staff met with various companies and industry organizations including representatives from the entertainment and media, aerospace and defense, engineering and construction, technology, software, pharmaceutical and biotechnology, and financial services industries.
  3. Financial statement presentation—representatives of the FASB meet privately with the Investment Company Institute working group.
  4. Goodwill impairment—representatives of the FASB participated in calls with a number of preparers, users, and auditor groups.

COLLABORATION WITH THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

- a. The FASB and the IASB held multi-day joint Board meetings in January, February, and March using their video-conferencing capabilities and a three-day face-to-face joint Board meeting in London in February and Norwalk in March.
- b. FASB staff participated in IASB Board meetings to discuss technical issues on the Boards' various joint projects.
- c. FASB members participated in joint Board advisor meetings on Revenue Recognition, and Insurance.
- d. The FASB and the IASB held joint education sessions on Revenue Recognition, Leases, and Insurance.
- e. Two FASB Board members and staff participated in a public meeting of the Leases Working Group (Norwalk).
- f. An FASB Board member and staff participated in a public meeting of the Leases Working Group (London).
- g. FASB staff participated with IASB staff in conducting outreach on the projects on Impairment and Offsetting Financial Assets and Financial Liabilities.
- h. The FASB and IASB directors met periodically to discuss technical and administrative matters.

OTHER INTERNATIONAL ACTIVITIES

- a. Two FASB Board members, the technical director, and several staff members met with representatives of the Accounting Standards Board of Japan to discuss progress on their shared goal of convergence. The Boards also discussed the projects on Accounting for Financial Instruments, Revenue Recognition, Leases, and the issues surrounding the interest rate on the measurement of liabilities.
- b. The FASB sponsored the National Standard Setters two-day meeting and dinner in New York. The FASB chairman, an FASB Board member, and the FASB technical director participated in the meeting.
- c. The FASB chairman, the FAF chairman, and the FAF CEO met with representatives of the European Commission, EFRAG, the U.S. Treasury, and the U.S. Ambassador to the E.U. to discuss progress on the convergence projects and other matters of mutual interest.

XBRL ACTIVITIES

The FAF is responsible for the ongoing maintenance of the taxonomy applicable to public issuers registered with the SEC. The FAF has delegated those maintenance responsibilities to the FASB.

- a. On January 18, 2011, we posted the 2011 U.S. GAAP Financial Reporting Taxonomy (UGT) to the FASB website. The SEC officially adopted the 2011 UGT on February 28, 2011, making it available for use by public issuers registered with the SEC.

EDUCATIONAL WEBCASTS AND PODCASTS DELIVERED

1. 2011 Chairman's Outlook for the FASB (January webcast)
2. XBRL 2011 Taxonomy Overview (February webcast)
3. The FASB's Supplementary Document on Impairment (January podcast)

SPEECHES DELIVERED

The following is a list of speeches delivered during the 1<sup>st</sup> quarter of 2011:

- AAA Financial Accounting & Reporting Section—Midyear Meeting
- CFA Institute—Cayman CFA Society
- CFA Institute
- Corporate Directors Forum
- CT Society of CPAs (CSCPA) Not-for-Profit Committee Meeting
- Deloitte Trueblood Seminar
- FEI Central Florida Chapter
- FEI Tampa Chapter

- FEI Philadelphia Chapter
- FEI Committee on Corporate Reporting
- Financial Services Roundtable
- Florida State University College of Business
- Investor Roadshow (CLSA sponsored)
- LTA Committee Conference
- National Association of Regulatory Utility Commissioners
- National Society of Accountants for Cooperatives Roundtable
- NCFE Legal, Tax & Accounting Conference & NSAC Conference
- New York State Society of CPAs (NYSSCPA) Higher Education Conference
- NYSSCPA Annual Not-for-Profit Conference
- Northwestern Law School's 38<sup>th</sup> Annual Securities Regulation Institute
- Pathways Commission
- Public Company Accounting Oversight Board (PCAOB) Annual Inspections Training
- Standard & Poor's Accounting Conference
- United States Chamber of Commerce, Center for Competitiveness
- University of Wisconsin, Arthur Andersen Center School of Business.

#### **PROFESSIONAL DEVELOPMENT—FASB STAFF AND BOARD**

- a. The following professional development sessions were presented to the Board and staff:
  1. Bank Regulatory Capital, presented by Steven P. Merriett, Assistant Director and Chief Accountant—Supervision for the Federal Reserve Board's Division of Banking Supervision and Regulation, and R. Ryan Richards, Senior Supervisory Financial Analyst for the Federal Reserve Board's Division of Banking Supervision and Regulation.
  2. XBRL in 2011, presented by Louis Matherne, FASB Chief of Taxonomy Development; Christine Tan, FASB XBRL Project Manager; Adrian Hong, FASB XBRL Technical Research Assistant; and David Shaw, FASB XBRL Technical Research Assistant.
  3. Conducting Interviews for Research, presented by Dean Mead, GASB Research Manager.
  4. Effective Writing, presented by Mary Huydic, FASB Editor.

#### **ITEM 2: ADMINISTRATIVE MATTERS AND STRATEGIC ACTIVITIES**

- a. All Board members attended the January FAF Trustees meeting.
- b. In March, the FASB launched live video-webcasting of its education sessions.

**ITEM 3: WASHINGTON ACTIVITIES**

- a. Members of Congress, their staffs, and the Administration were informed about the activities of the FASB through various meetings and other forums, including:
1. The FASB chairman and FASB staff and FAF staff provided the Treasury Assistant Secretary for International Markets & Development with a conference call update on convergence, offsetting, and hedging.
  2. An FASB Board member and FAF staff met with the PBGC Director and senior staff to brief them on the FASB's Multi-Employer Plan Disclosure Exposure Draft.
  3. An FASB Board member and FAF staff met with Senate HELP Committee and Senate Finance Committee staff to brief them on the FASB's Multi-Employer Plan Disclosure Exposure Draft. In addition, FASB and FAF staff conducted a conference call with Senate staff members of the HELP Committee to answer questions on the proposed disclosure requirements in the Multi-Employer Exposure Draft.

**ITEM 4: ADDITIONAL COMMUNICATIONS ACTIVITIES**

- a. The FASB issued the following press releases/media advisories:
1. 1-10-11: Susan M. Cospser Named Technical Director of the Financial Accounting Standards Board
  2. 1-14-11: Financial Accounting Foundation Appoints Daryl E. Buck and R. Harold Schroeder to the Financial Accounting Standards Board
  3. 1-14-11: MEDIA ADVISORY: FASB to Host January 25 Webcast, *2011 Chairman's Outlook on the FASB* with Leslie F. Seidman
  4. 1-19-11: MEDIA ADVISORY: Registration Is Now Open for January 25 Webcast, *2011 Chairman's Outlook on the FASB* with Leslie F. Seidman
  5. 1-28-11: IASB and FASB Propose to Align Balance Sheet Netting Requirements—*Differences in IFRS and US GAAP Offsetting Requirements to Be Eliminated*
  6. 1-31-11: IASB and FASB Propose Common Solution for Impairment Accounting—*Boards Jointly Address Fundamental Aspect of Financial Instruments Accounting*
  7. 2-9-11: FASB Discussion Paper Seeks Input on Issues about Hedge Accounting
  8. 2-11-11: Representatives of the Accounting Standards Board of Japan and the Financial Accounting Standards Board Meet to Discuss Global Convergence
  9. 2-14-11: FASB to Host February 24 Webcast, *XBRL 2011 Taxonomy Overview*
  10. 2-17-11: The Financial Accounting Foundation Reappoints Thomas J. Linsmeier to a Second Term on the FASB
  11. 2-22-11: MEDIA ADVISORY: Register Now for February 24 Webcast, *XBRL 2011 Taxonomy Overview*

12. 3-1-11: MEDIA ADVISORY: 2011 US GAAP Financial Reporting Taxonomy Adopted and Supported by SEC Effective February 28, 2011
  13. 3-7-11: Financial Accounting Foundation Announces Live Video Webcasting of FASB Education Sessions
  14. 3-17-11: Financial Accounting Standards Board Announces Joint FASB/IASB Public Roundtable Meetings on Proposed Standard on Offsetting
- b. The FASB issued “FASB in Focus” documents during the month of January for the Exposure Draft on Offsetting of Financial Assets and Liabilities and the Supplementary Document on Impairment of Financial Assets.
  - c. In January, Leslie Seidman was interviewed by Ellen Heffes of *Financial Executives Magazine* for an in-depth profile of the new FASB chairman.
  - d. On March 3, Leslie Seidman participated in an interview conducted by Matt Lamoreaux for the *Journal of Accountancy*. The interview covered a broad array of topics regarding the new chairman’s priorities for the FASB in 2011 and beyond.
  - e. The following student groups visited the FASB for tours:
    - a. Creighton University—January 5, 20 students
    - b. University of New Hampshire—March 10, 30 students
    - c. Texas A&M Fellows—March 16, 13 students
    - d. Champlain College—March 30, 15 students

#### **ITEM 5: GASB LIAISON ACTIVITIES**

- a. GASB meeting minutes were sent to the FASB directors.
- b. The GASB RTA director and the FASB P&S director held monthly meetings and met quarterly with the FASB and GASB chairmen.
- c. The GASB staff distributed a draft of the preliminary views document, *Recognition of Elements of Financial Statements and Measurement Approaches*, to the FASB for review.
- d. The FASB staff distributed the following drafts for GASB’s review:
  - Accounting Standards Update, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*
  - Accounting Standards Update, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirement in U.S. GAAP and IFRS*
  - Accounting Standards Update, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*
  - Accounting Standards Update, *Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors*
  - Proposed Accounting Standards Update, *Balance Sheet (Topic 210): Offsetting*

- Proposed Accounting Standards Update, *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment*.

REPORT OF THE FASB CHAIRMAN  
TO THE FINANCIAL ACCOUNTING FOUNDATION  
April 1, 2011 through June 30, 2011

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**ITEM 1: TECHNICAL ACTIVITIES**

**BOARD AND STAFF ACTIVITIES**

- a. Final Documents Issued:
1. Accounting Standards Update No. 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring* (issued April 5, 2011)
  2. Accounting Standards Update No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements* (issued April 29, 2011)
  3. Accounting Standards Update No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (issued May 12, 2011)
  4. Accounting Standards Update No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* (issued June 15, 2011).
- b. Exposure Document Issued:
1. Proposed Accounting Standards Update, *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment* (issued April 22, 2011). Comment deadline: June 6, 2011.
- c. From time to time, the FASB issues Accounting Standards Updates to amend the nonauthoritative portions of the *FASB Accounting Standards Codification*® (such as the nonauthoritative SEC content). No such Updates were issued this quarter.
- d. No new projects were added to the technical agenda.
- e. No projects were removed from the technical agenda.
- f. The FASB and the IASB decided to reexpose their revised proposals for a common revenue recognition standard.
- g. The FASB chairman, a Board member, and the FASB technical director met with representatives from the Clearing House to provide a technical update on current priority projects.
- h. The FASB technical director had periodic calls with the PCAOB and SEC in planning the financial reporting series.

i. Outreach Activities—Meetings of FASB Standing Advisory Groups:

1. Financial Accounting Standards Advisory Council (FASAC). Seven Board members and several FASB staff members met with FASAC in a June public meeting to discuss critical aspects of standard-setting success in four areas: high-quality financial reporting standards, outreach to stakeholders during the standard-setting process, transition to forthcoming final accounting standards, and education about and implementation of forthcoming final accounting standards. Participants also discussed their views about cross-cutting issues related to accounting for acquisition costs and complexity in financial reporting.
2. Investors Technical Advisory Committee (ITAC). Three Board members and several FASB staff members met with ITAC in an April closed meeting to discuss the projects on accounting for financial instruments, balance sheet—offsetting, leases, and revenue recognition. Participants also discussed potential risk disclosures related to an entity’s involvement in financial instruments and provided feedback about the information provided through the enhanced credit quality disclosure requirements that went into effect at the end of 2010.
3. Small Business Advisory Committee (SBAC). Seven Board members and several staff members met with SBAC members in a May public meeting to discuss private company financial reporting, goodwill impairment assessments, education about forthcoming final standards, and key decisions in the projects on revenue recognition, leases, and accounting for financial instruments.
4. Private Company Financial Reporting Committee (PCFRC). Six Board members and several staff members met with PCFRC members in a May public meeting to discuss projects on goodwill impairment, leases, accounting for financial instruments, hedge accounting, revenue recognition, investment properties, and the Board’s consideration of effective dates and transition methods.
5. Each of the Not-for-Profit Advisory Committee (NAC) subgroups (Reporting Financial Performance, Telling the Story, and Liquidity and Financial Health) held a series of closed meetings to begin the development of proposals for discussion at the September 2011 meeting of the full NAC. Representatives of all three subgroups met in June to update each other on their progress and direction. Several FASB staff members participated in those closed subgroup meetings.

j. Outreach Activities—Other Consultations with Stakeholders:

1. Financial Executives International Committee on Corporate Reporting (CCR). Seven Board members, the FASB technical director, the FAF chairman, the FAF president and CEO, and an FASB staff member met with CCR in June to discuss the Committee’s views on the SEC staff paper on IFRS, the status of the FASB-IASB Memorandum of Understanding, the FAF’s post implementation review, and the FASB’s projects on disclosure framework, accounting for financial instruments, leases, and revenue recognition.



2. ABA Accounting Committee. Two Board members met in a closed meeting with representatives of the ABA's Accounting Committee in May.
  3. Leaseurope and the US Equipment Leasing and Finance Association (ELFA). One Board member discussed lessor accounting in a May conference call with Leaseurope and ELFA members.
  4. The FASB chairman, the FAF chairman, and the FAF president and CEO met privately with ABA President Frank Keating to discuss matters of mutual interest.
- k. Other significant project-specific outreach activities:
1. Insurance Contracts—Representatives of the FASB met in closed meetings with over 60 users via small group roundtables or individual calls.
  2. Insurance contracts—A Board member and staff participated in a closed half-day Property/Casualty Insurance roundtable meeting sponsored by Deloitte & Touche and attended by approximately 15 property/casualty insurers.
  3. Insurance contracts—Three Board members participated in a closed FASB-sponsored workshop meeting with preparers (insurers, investment bankers, etc.) and audit firms regarding the accounting for various types of guarantees.
  4. Financial Guarantees Workshop—Three Board members and the FASB technical director participated in a closed workshop meeting with representatives from various companies to discuss the accounting for financial guarantees.

COLLABORATION WITH THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

- a. The FASB and the IASB and staff held multi-day joint Board meetings using their video-conferencing capabilities and a three-day face-to-face joint Board meeting in London.
- b. Four FASB Board members and the FASB technical director attended an open meeting of the Leases Working Group in London.
- c. Three FASB Board members and the FASB technical director attended an open meeting of the Insurance Working Group in London.
- d. The FASB and the IASB held public roundtable meetings on balance sheet—offsetting in London, Singapore, and Norwalk.
- e. The FASB and the IASB held joint education sessions on revenue recognition and leases.
- f. The FASB and IASB directors met periodically to discuss technical and administrative matters.

OTHER INTERNATIONAL ACTIVITIES

- a. The FASB chairman and another FASB Board member met with the European Financial Reporting Advisory Group (EFRAG) to discuss potential collaboration of their respective projects to develop a Disclosure Framework. Two FASB staff members attended the May 2011 EFRAG Technical Experts Group meeting in Brussels, Belgium, with the objective of collaborating with EFRAG to issue a discussion paper on a Disclosure Framework in the fall of 2011.

XBRL ACTIVITIES

The FAF is responsible for the ongoing development and maintenance of the taxonomy applicable to public issuers registered with the SEC. The FAF has delegated these responsibilities to the FASB.

- a. On June 14, 2011, the FASB launched a new Taxonomy Online Review and Comment System. This new system provides greater transparency for users of eXtensible Business Reporting Language (XBRL) and makes it easier for stakeholders to submit comments on the U.S. GAAP Financial Reporting Taxonomy. The Taxonomy Online Review and Comment System allows Taxonomy users to review and provide direct input on the Development Taxonomy being updated and maintained by the FASB XBRL team.

ITEM 2: EDUCATION AND COMMUNICATIONSEDUCATIONAL WEBCASTS AND PODCASTS DELIVERED

- a. The first two webcasts with CPE credit were held in June:
  - 1. IN FOCUS Webcast: FASB Update for Nonpublic Entities—June 17, 2011
  - 2. IN FOCUS Webcast: How to Use the XBRL 2011 US GAAP Financial Reporting Taxonomy—June 22, 2011.
- b. The FAF Post-Implementation Review Process—May 20, 2011. The FASB chairman participated in a live FAF webcast explaining its post-implementation review process.
- c. April 2011 podcast—The FASB chairman discussed the April 2011 Progress Report on FASB/IASB MOU projects.
- d. April 2011 podcast—An interview with the FASB chairman and the IASB chairman regarding the timeline for completing the convergence program.
- e. April 2011 podcast—An FASB Board member and staff discussed testing goodwill for impairment proposals.
- f. May 2011 podcast—An FASB Board member discussed FASB Accounting Standards Update No. 2011-04, *Fair Value Measurement (Topic 820): Amendments*

*to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.*

- g. June 2011 podcast—An FASB Board member discussed the just-issued final Accounting Standards Update on the presentation of comprehensive income.

#### SPEECHES DELIVERED

FASB Board members or staff delivered speeches during the 2<sup>nd</sup> quarter 2011 at the following conferences and events:

- American Council of Life Insurers
- AICPA National Conference on Employee Benefit Plans
- AICPA's NFP Expert Panel
- AICPA Webcast – MOU Update: A U.S. Perspective
- Appraisal Institute Investment Property Accounting Standards
- Baruch College 10th Annual Financial Reporting Conference
- CFO Magazine Core Concerns Conference
- CEASA/CARE Conference
- Chartis Global Finance Leadership Conference
- College of William & Mary, Mason School of Business, Excellence of Financial Reporting Conference
- Compliance Week Annual Conference
- Deloitte & Touche 2011 Professional Practice Directors Meeting
- Deloitte IFRS
- FICPA Accounting & Auditing Conference
- J. H. Cohn LLP – CFO Breakfast Roundtable Accounting Update
- Massachusetts Society of CPAs 42<sup>nd</sup> Annual Accounting & Auditing Conference
- Moody's Insurance Executives' Conference
- Morgan Stanley Insurance Conference –Accounting Controversies: Understanding the Divergent Views
- National Rural Utilities Cooperative Finance Corporation (NRUCFC or CFC) Workshop: Cooperative Accounting
- National Society of Accountants for Cooperatives
- NIRI Annual Conference
- Northern Lights Regional Council of the Institute of Management Accountants Annual Seminar
- OSCPA Not-for-Profit Conference
- PCIAA – PCI Global Financial Issues Seminar
- Practising Law Institute (PLI) Audit Committee Workshop 2011
- Property Casualty Insurers Association of America
- RC Knox Symposium at University of Hartford
- SEC Financial Reporting Institute Conference (USC)
- SEC Institute's 26<sup>th</sup> Midyear SEC Reporting Conference
- Southern Connecticut State University Accounting Society Annual Banquet
- Standard & Poor's 27<sup>th</sup> Annual Insurance Conference
- University of Tulsa, Collins College of Business
- University of Washington Eighth Annual Financial Reporting Conference

- XBRL International Conference, Brussels

**ITEM 3: ADMINISTRATIVE, PROCEDURAL, AND STRATEGIC ACTIVITIES**

a. Administrative Matters:

1. In June, the FASB launched a series of live educational webcasts that will provide CPE credit to qualifying participants.
2. All Board members attended the May FAF Trustees meeting.
3. The FASB launched the Nonpublic Entities portal on its website, designed to enable stakeholders to more easily find information on the FASB's activities.

b. Procedural Matters:

1. In connection with the goodwill impairment project, the FASB piloted a new electronic constituent feedback form that is intended to make it faster and easier for stakeholders to provide comments about proposals.

c. Professional Development—FASB Staff and Board

The following professional development sessions were presented to the Board and staff:

1. Analyzing Financial Statements of Insurance Companies presented by Doron Nissim, Ernst & Young Professor of Accounting & Finance, Columbia School of Business. This session described accounting issues in the insurance industry that users find particularly relevant.
2. Lunch and Learn: Seven Steps to Financial Fitness presented by Gillian Anderson, director of the Fairfield County Chapter of the Foundation for Personal Financial Education.
3. Successful Leaders in Today's Business Environment (the first of the FAF Leadership Series) presented by Jack Brennan, chairman of the Financial Accounting Foundation. The objective of this session was to provide the FAF, FASB, and GASB staff with a better understanding of what makes a good leader and how those traits can be used to find success outside the workplace.
4. Excel Workshop presented by Tracy Farr, FASB postgraduate technical assistant. This session covered how to reconfigure data, how to manipulate data, and advanced methods of using or combining formulas to analyze data. At the end of the session, participants were able to work more efficiently and effectively in Excel.
5. The Conceptual Framework Project: An Overview presented by Jim Leisenring, FASB senior advisor. In this session, Mr. Leisenring discussed the history of the

Conceptual Framework, including the issues it was intended to address and the reasons why early Board members thought establishing a framework was important.

- d. Professional staff attended the following external conferences:
1. The 10th Annual Financial Reporting Conference at the Robert Zicklin Center for Corporate Integrity, Baruch College, NY
  2. SEC Institute Mid-Year Reporting Forum.

**ITEM 4: WASHINGTON ACTIVITIES**

- a. An FASB Board member, the FASB technical director, and FAF staff met with the U.S. Department of Labor Assistant Secretary of Employee Benefits Security Administration (EBSA) and the EBSA Chief Accountant to provide an update on the FASB multi-employer proposal.
- b. Members of Congress, their staffs, and the Administration were informed about the activities of the FASB through various meetings and other forums, including:
1. FASB and FAF staff presented updates on convergence and the leases project to the FEI Committee on Government Business.
  2. The FAF/FASB/GASB hosted the annual FAF Trustee reception and dinner in Washington, DC in May that was attended by several Members of Congress and senior Administration officials. The keynote speaker for the dinner was SEC Chairman Shapiro.
  3. The FASB chairman, FASB Board members, the FASB technical director, and FAF staff met in closed meetings with the Federal Reserve Board Chairman and Governors, members of the Senate Banking Committee and House Financial Services Committee, and Members of Congress (House and Senate) to update them on FASB initiatives, especially convergence.
  4. An FASB Board member, the FASB technical director, and certain FAF staff met with the Labor Assistant Secretary for EBSA and CFO for EBSA to update them on the multi-employer disclosure project.
  5. The FASB chairman appeared before the Senate Banking Committee, Subcommittee on Securities, Insurance & Investment to testify on the role of the accounting profession in preventing another financial crisis.

6. An FASB Board member, the FASB technical director, and certain FAF staff met with Congressman Sherman's Legislative Assistant to discuss present and past accounting requirements for research and development costs.
7. An FASB Board member, the FASB technical director, and FAF staff met with the U.S. Chamber of Commerce Leases Coalition to brief the coalition on status of the leases project.
8. The FASB chairman, the FASB technical director, the FAF president and CEO, and certain FAF staff met with Congressman Jim Himes to provide a briefing on key accounting projects and to answer questions on the status of convergence.
9. An FASB Board member and certain FAF staff met with the Chief Counsel-Pension Policy Director, Senate Committee on Health, Education, Labor & Pensions (HELP) to provide an update on the multi-employer disclosure project and to answer any questions about disclosure of withdrawal liabilities.
10. An FASB Board member and certain FAF staff met with the Deputy Assistant Secretary for International Monetary & Financial Policy, Department of Treasury to provide an update on FASB/IASB convergence projects including the schedule for completion.
11. An FASB Board member and certain FAF staff met with the Senate Banking Committee Majority Senior Counsel to provide an update on convergence projects and the multi-employer disclosure project.
12. The FASB staff developed and delivered in June an in-depth White Paper addressing the relevance of current accounting requirements for research and development costs for Congressman Brad Sherman of the House Financial Services Committee.
13. The FASB chairman, two FASB Board members, the FASB technical director, and an FAF staff member participated in quarterly meetings with staff members of the SEC's Office of the Chief Accountant and the Public Company Accounting Oversight Board.
14. The FASB chairman, an FASB Board member, the FASB technical director, and an FAF staff member attended the quarterly meeting with the bank regulators.

**ITEM 5: ADDITIONAL COMMUNICATIONS ACTIVITIES**

- a. The FASB issued the following press releases/media advisories:

1. 4-5-11: FASB Issues Accounting Standards Update to Improve Financial Reporting about Troubled Debt Restructurings
2. 4-21-11: IASB and FASB Report Substantial Progress toward Completion of Convergence Program
3. 4-22-11: FASB Issues Proposed Accounting Standards Update on Testing for Goodwill Impairment
4. 4-29-11: FASB Issues Accounting Standards Update to Improve Financial Reporting of Repurchase Agreements
5. 5-12-11: Financial Accounting Foundation to Discuss Next Steps in Post-Implementation Review Process in May 20 Webcast
6. 5-12-11: FASB and IASB Issue Common Fair Value Measurement and Disclosure Requirements
7. 6-1-11: Financial Accounting Standards Board Launches *IN FOCUS: WEBCAST* Educational Webcast Series with CPE Credit
8. 6-2-11: Media Advisory—Registration Is Now Open for June 17 Webcast, *IN FOCUS: FASB Update for Nonpublic Entities*
9. 2-14-11: Media Advisory—Registration Is Now Open for June 22 Webcast, *IN FOCUS: How to Use the XBRL 2011 US GAAP Financial Reporting Taxonomy*
10. 6-14-11: Financial Accounting Standards Board Launches New Taxonomy Online Review and Comment System
11. 6-15-11: IASB and FASB to Re-Expose Revenue Recognition Proposals
12. 6-16-11: FASB Issues Accounting Standards Update to Improve Presentation of Comprehensive Income.

b. The FASB issued “FASB in Focus” documents for the following:

- April 2011—Exposure Draft on Offsetting of Financial Assets and Liabilities and the Supplementary Document on Impairment of Financial Assets
- April 2011—Receivables: A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring
- April 2011—Transfers and Servicing: Reconsideration of Effective Control for Repurchase Agreements
- May 2011—Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs
- June 2011—Presentation of Comprehensive Income.

c. Interviews:

- March 2011—Matt Lamoreaux of Journal of Accountancy interviewed the FASB chairman.
- June 2011—The FASB chairman was interviewed by Adam Jones of the Financial Times.
- June 2011—The FASB chairman discussed convergence with Michael Rapoport of the Wall Street Journal.
- June 2011—Project manager Danielle Zeyher was interviewed by Barron’s on the leases project.

- d. New FASB members participated in media training in April.

**ITEM 6: GASB LIAISON ACTIVITIES**

- a. GASB meeting minutes were sent to the FASB directors.
- b. The GASB RTA director and the FASB P&S director held monthly meetings and met quarterly with the FASB and GASB chairmen.
- c. The GASB staff distributed the following drafts to the FASB for review:
- Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*
  - Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions*
  - Exposure Draft, *Accounting and Financial Reporting for Pension Benefits by Employers and by Nonemployer Contributing Entities*
  - Exposure Draft, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*
  - Preliminary Views, *Recognition of Elements of Financial Statements and Measurement Approaches*.
- d. The FASB staff distributed the following drafts for GASB's review:
- Accounting Standards Update, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*
  - Accounting Standards Update, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*
  - Proposed Accounting Standards Update, *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment*.
  - Proposed Accounting Standards Update, *Consolidation (Topic 810): Agent/Principal Analysis*
  - White Paper on Private Company Financial Reporting: Differential User Needs and Cost-Benefit Considerations.



REPORT OF THE FASB CHAIRMAN  
TO THE FINANCIAL ACCOUNTING FOUNDATION  
July 1, 2011 through September 30, 2011

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**ITEM 1: TECHNICAL ACTIVITIES**

**BOARD AND STAFF ACTIVITIES**

- a. Final Documents Issued:
1. Accounting Standards Update No. 2011-06, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers* (a consensus of the FASB Emerging Issues Task Force) (issued July 21, 2011)
  2. Accounting Standards Update No. 2011-07, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities* (a consensus of the FASB Emerging Issues Task Force) (issued July 25, 2011)
  3. Accounting Standards Update No. 2011-08, *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment* (issued September 15, 2011)
  4. Accounting Standards Update No. 2011-09, *Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80): Disclosures about an Employer’s Participation in a Multiemployer Plan* (issued September 21, 2011).
- b. Exposure Document Issued:
1. Proposed Accounting Standards Update, *Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification* (a consensus of the Emerging Issues Task Force) (issued July 20, 2011). Comment deadline: October 3, 2011.
- c. From time-to-time, the FASB issues Accounting Standards Updates to amend the nonauthoritative portions of the *FASB Accounting Standards Codification*® (such as the nonauthoritative SEC content). No such Updates were issued this quarter.
- d. New projects added to the agenda:
1. EITF Issue No. 11-A, “Parent’s Accounting for the Cumulative Translation Adjustment upon the Sale or Transfer of a Group of Assets within a Foreign Subsidiary That Meets the Definition of a Business” (August 2011)
  2. A project on impairment of indefinite-lived intangible assets, to consider whether to include a qualitative screen, similar to the recent Accounting Standards Update on goodwill impairment.
  3. A research project to develop a framework for identifying and assessing the need for differential standards for private entities (July 2011).

- e. New projects considered but not added to the agenda:
  - 1. A proposal that the Board defer the effective date of Accounting Standards Update 2010-26 on accounting for costs associated with acquiring or renewing insurance contracts.
  - 2. A proposal that the Board provide guidance on the accounting for subsequent out-licensing of assets used in in-process research and develop projects acquired in a business combination.
  - 3. A proposal to reconsider the various different definitions of nonpublic entity as used in the FASB Accounting Standards Codification. The proposal will be considered in the FASB's research project to develop a framework for identifying and assessing the need for differential reporting standards for private entities.
  - 4. A proposal to provide guidance on the accounting for joint and several obligations within the standalone financial statements of a subsidiary under common control. The FASB chairman decided to conduct further research through the formation of a working group before deciding whether to add the potential issue to the EITF agenda.
  - 5. A proposal to provide guidance on the capitalization of interest related to bonds guaranteed by the federal government.
- f. No projects were removed from the technical agenda.
- g. The FASB and the IASB decided to reexpose their revised proposals for a common leases standard after their redeliberations of the original.
- h. Outreach Activities—Meetings of FASB Standing Advisory Groups:
  - 1. Investors Technical Advisory Committee (ITAC)
    - i. July 2011 meeting: Six Board members and several FASB staff members met and discussed with ITAC members the Board's projects on the accounting for financial instruments, leases, and multiemployer pension plans. Participants also discussed the SEC workplan on IFRS and provided feedback about the IASB's recent revisions to its pension accounting standard.
    - ii. September 2011 meeting: In two separate closed sessions, several Board members (less than a voting majority) and several FASB staff members discussed with ITAC members the projects on accounting for financial instruments, insurance, revenue recognition, leases, and disclosure framework. Committee members also discussed their views about the potential incorporation of IFRS in the U.S. and the SEC workplan on IFRS.
  - 2. Not-for-Profit Advisory Committee (NAC) meeting. Board members and several FASB staff members met with NAC members in a September public meeting to discuss ways to improve the financial reporting model for not-for-profit organizations. The NAC recommended several potential reporting improvements for agenda consideration by the FASB chairman, and educational efforts that could be carried out by the FASB staff, the NAC, or other organizations. The agenda requests will be considered by the chairman in the fourth quarter. NAC

participants also discussed recent developments in the not-for-profit sector that could have accounting implications; updates on the FASB's projects on leases, revenue recognition, and disclosure framework; and the applicability of the differential factors between public and private companies.

3. Private Company Financial Reporting Committee (PCFRC)
  - i. July 2011 meeting: A Board member and several FASB staff members participated in the public meeting held in Minneapolis. The PCFRC discussed the Board's projects on consolidation: policies and procedures, consolidation: investment companies, investment properties, disclosures about an employer's participation in a multiemployer plan, accounting for financial instruments, revenue recognition, leases, disclosure framework, differential standard-setting framework for private companies, and goodwill impairment testing. Committee members also discussed the SEC staff Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers, recent activities of the IFRS for SMEs Implementation Group, and the FAF's post-implementation review process on the accounting for uncertainty in income taxes. Committee members also suggested improvements to the format and content of an Accounting Standards Update.
  - ii. September 2011 meeting: A Board member and several FASB staff participated in the public meeting held in Las Vegas. The meeting agenda included discussion of the SEC's so-called condorsement approach to incorporated IFRS into the U.S. financial reporting system and updates on various FASB projects (revenue recognition, accounting for financial instruments, insurance contracts, investment companies, investment properties, leases, and disclosure framework). Committee members also discussed the FAF's private entity initiative and issues related to certain existing U.S. GAAP standards including accounting for variable interest entities, interest rate swaps, and level-three fair value measurements.
4. Private Company Resource Group (PCRG). In connection with staff research on a decision-making framework for private company standard setting, several FASB staff members discussed issues related to transition methods with the PCRG. That August teleconference meeting also included discussions about effective date considerations for the revenue recognition project.
- i. Outreach Activities—Other Meetings with Industry or Other Representative Groups:
  1. National Investor Relations Institute (NIRI). Two Board members and several FASB staff members met privately with NIRI in August.
  2. Institute of Management Accountants (IMA): Six Board members met with the IMA's Financial Reporting Committee in a September public meeting. IMA representatives shared their general perspectives on the potential incorporation of IFRS in the U.S., the interpretive process for converged standards, and standard-

setting for nonpublic entities. They also discussed the Board's projects on accounting for financial instruments, revenue recognition, and leases.

3. AICPA Private Companies Practice Section Technical Issues Committee (TIC): Board members and several FASB staff members participated in a public meeting with TIC in September and discussed private company financial reporting issues, transition methods for private entities, and various ongoing FASB projects (investment properties, leases, revenue recognition, disclosure framework, and disclosures about risks and uncertainties and the liquidation basis of accounting.)
- j. Other significant project-specific outreach activities:
1. Accounting for financial instruments project: FASB staff conducted targeted outreach relating to the financial instruments project with a number of preparers and users of nonpublic entity financial statements.
  2. Impairment of indefinite-lived intangible assets: As part of its pre-agenda research activities, the FASB staff held a private workshop in August 2011 to discuss current standards with staff representatives of the SEC and PCAOB and preparer representatives of both public companies and private entities.
  3. Insurance contracts: The project was discussed in about a dozen conference calls with financial statements users and in various meetings with industry representative groups.
  4. Leases: The FASB staff discussed proposed accounting, presentation, and disclosure requirements with users of retail entity financial statements, participated in meetings and conferences with various industry representative groups, and conducted targeted outreach meetings with auditing firms. An FASB Board member and FAF staff met with the Executive Committee of the FEI Committee on Government Business to provide a briefing on the status of the leases project. Representatives of the FASB staff and the FAF staff met on two occasions with the U.S. Chamber of Commerce Leases Coalition.
  5. Revenue recognition: FASB staff discussed the project with various user groups, gave project update speeches at several conferences, and conducted targeted outreach activities with private company representatives.

#### COLLABORATION WITH THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

- a. The FASB and the IASB held several multi-day joint video-conference Board meetings and three face-to-face joint Board meetings (London).
- b. An FASB Board member attended a meeting on impairment in London.

- c. The FASB and the IASB held small-group video-conference meetings on insurance, leases, and impairment.
- d. Representatives of the FASB and the IASB met privately with several stakeholder groups to obtain feedback on accounting for impairment.
- e. The FASB and the IASB directors met periodically to discuss technical and administrative matters.

#### OTHER INTERNATIONAL ACTIVITIES

- a. The FASB chairman and a Board member met with representatives of the Accounting Regulatory Department of the Ministry of Finance in Beijing.
- b. The FASB chairman and a Board member met with the Accounting Standards Board of Japan and representatives of Japan's Financial Services Agency in Tokyo.
- c. The FASB chairman, a Board member, and the technical director participated in the National Standard Setters meeting in Vienna, Austria.
- d. The FASB chairman, a Board member, and the technical director participated in the World Standard Setters meeting in London.
- e. Two FASB staff members participated in the September 2011 European Financial Reporting Advisory Group (EFRAG) Disclosure Framework Advisory Panel meeting in Paris.
- f. The FASB research director met with the chairman and senior staff members of the ANE (French Standard Setter) in Paris to discuss research efforts and other matters.
- g. The FASB chairman participated as an observer in the July 2011 SEC Roundtable on International Financial Reporting Standards.

#### XBRL ACTIVITIES

The FAF is responsible for the ongoing development and maintenance of the U.S. GAAP Financial Reporting Taxonomy applicable to public issuers registered with the SEC. The FAF has delegated these responsibilities to the FASB.

- a. On September 1, 2011, the FASB released the proposed 2012 Taxonomy for public review and comment. This proposed release includes changes from the 2011 Taxonomy for ASUs finalized since the last release, accommodation of common practices identified in SEC registrant XBRL Exhibits, and other adjustments to enhance usability. The deadline to submit written comments is October 31, 2011. This release is on time and in accordance with SEC expectation. The next milestone date is December 15, 2011, for delivery of the "candidate" release 2012 Taxonomy for final SEC review and acceptance.

**ITEM 2: COMMUNICATIONS****SPEECHES DELIVERED**

FASB Board members or staff delivered speeches at the following conferences and events:

- ACPEN Accounting and Auditing Update Broadcast
- AICPA National Conference on Banks & Savings Institutions
- AICPA/NAATS
- American Accounting Association Government & NFP Conference
- American Accounting Association Annual Meeting Panel on the Blue Ribbon Panel
- American Accounting Association Conference
- American Gas Association Accounting Principles Committee
- American Petroleum Institute Accounting Subcommittee
- California Society of CPAs CPE session and nonpublics discussion
- Center for Corporate Reporting & Governance at California State University Tenth Annual SEC Financial Reporting Conference
- Deloitte/Dewey & LeBoeuf/Standard & Poor's 3<sup>rd</sup> Annual Reactions North America Conference Risk and Capital Management Issues in 2011
- ELFA Lease and Finance Accountants Conference
- EY and University of Texas at Arlington
- Hudson Global Resources XBRL Filings Panel Discussion
- Illinois CPA Society 17<sup>th</sup> Annual Midwest Financial Reporting Symposium
- Kentucky Society of CPAs Annual Not-for-Profit Conference
- NAREIT Senior Financial Officer/Investment Relations Officer
- National Association of Independent Sureties
- National Association of Regulatory Utility Commissioners Conference
- National Association of Surety Bond Producers Update Call
- National Rural Electric Cooperative Association Annual Accounting, Finance & Tax Conference
- SEC Institute's Annual SEC Reporting and FASB Forum for Small Public Companies
- Surety Association of American FASB update call
- University of Texas McCombs School of Business Distinguished Speaker Lyceum

**ITEM 3: ADMINISTRATIVE, PROCEDURAL, AND STRATEGIC ACTIVITIES**

## a. Administrative Matters:

1. All Board members attended the August FAF Trustees meeting.

## b. Professional Development—FASB Board and Staff

1. The following professional development sessions were presented to the Board and staff:

- a. Successful Leaders in Today's Business Environment (The second of the FAF Leadership Series), James H. Quigley, former chief executive officer for Deloitte Touche Tohmatsu and former member of the FAF Board of Trustees shared his insights on what makes a good leader; how good leaders inspire, motivate, and coach others to work together for a common objective; and what he believes are the challenges and obstacles to good leadership.
  - b. Dr. Sam L. Savage, Author of *The Flaw of Averages: Why We Underestimate Risk in the Face of Uncertainty* (Wiley 2009), Chairman and Chief Scientist of Vector Economics, and Consulting Professor in Management Science and Engineering at Stanford University, shared his views on the flaw of the practice of forecasting business conditions with single "average" outcomes.
  - c. Lunch and Learn: Marking Financial Decisions in Challenging Times, Anne Wilkins, CRPC<sup>®</sup>, CFP<sup>®</sup>, Chapter Coordinator of the Fairfield County Chapter of the Foundation for Personal Financial Education, presented a thorough review of the retirement planning process and the obstacles that can keep us from reaching our goals.
  - d. Video Presentation of *Inside Job*, produced, written, and directed by Charles Ferguson, and Discussion about the Financial Crisis of 2008, Christopher Roberge, FASB Project Manager. This session included a viewing of the documentary *Inside Job*, which is the first film to expose the shocking truth behind the economic crisis of 2008, followed by a discussion about the film, the lessons learned from the crisis, and related accounting issues.
- c. Professional staff attended the following external conferences:
1. AICPA NAAATs Annual Conference
  2. AICPA Not for Profit Conference Industry Conference.

#### **ITEM 4: GOVERNMENT AND REGULATORY LIAISON ACTIVITIES**

- a. Members of Congress, their staffs, and the Administration were informed about the activities of the FASB through various meetings and other forums, including:
  1. A briefing of Senate Committee Banking Staff by an FASB Board member, FASB technical director, and FAF staff about FASB activities.

2. A briefing of Senate Permanent Subcommittee members on the accounting for income taxes on foreign earnings by an FASB Board member, FASB technical director, and FAF staff.
3. A briefing on convergence and emerging issues was provided to the Senior Minority Counsel for the House Financial Services Committee by an FASB Board member, FASB technical director, and FAF staff.
4. Quarterly briefing of bank regulators provided by the FASB chairman, FASB Board members, FASB technical director, and FAF staff.

**ITEM 5: OTHER COMMUNICATIONS ACTIVITIES**

- a. The FASB announced the following significant events through press releases, media advisories, or tweets:
  1. The FASB and the IASB decision to re-expose their leasing proposals
  2. The issuance of final standards covering:
    - Enhanced disclosures by employers about their participation in multiemployer pension plans
    - Simplified requirements for testing goodwill for impairment.
  3. The announcement of public roundtable meetings with users, preparers, and auditors of financial statements about their concerns about private entity reporting standards.
  4. The availability of the U.S. GAAP Financial Reporting Taxonomy for Public Review and Comment.
  5. The decision to hold an educational webcast entitled *IN FOCUS: Summary of Changes for the Proposed 2012 Taxonomy and Using XBRL Tables*.
- b. The FASB issued “FASB in Focus” documents for the following:
  1. Private Companies: The Path to a Differential Standard-Setting Framework (July 11, 2011)
  2. FASB Completes Redeliberations on Multiemployer Pension Plan Disclosure Project (Subtopic 715-80) (July 28, 2011)
  3. FASB Simplifies Guidance for Testing Goodwill for Impairment (August 12, 2011)
  4. FASB Completes Project on Multiemployer Pension Plan Disclosures (Subtopic 715-80) (September 21, 2011)
- c. Podcasts:
  - In July we posted a podcast in which the FASB chairman discussed the FASB’s work on a differential framework for private company standard setting.
- d. Media Outreach:
  - During the quarter ended September 30, 2011, members of the FASB or its staff participated in numerous interviews with media.



- The FASB chairman and staff met with representatives from Accounting Today & Compliance week to discuss private-company and international issues.

**ITEM 6: GASB LIAISON ACTIVITIES**

- a. GASB meeting minutes were sent to the FASB directors.
- b. The GASB RTA director and the FASB P&S director held monthly meetings and met quarterly with the FASB and GASB chairmen.
- c. The GASB staff distributed the following draft to the FASB for review:
  - Exposure Draft, *Reporting Balances Previously Recognized as Assets and Liabilities*.
- d. The FASB staff distributed the following drafts for GASB's review:
  - Accounting Standards Update, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers—a consensus of the FASB Emerging Issues Task Force*
  - Accounting Standards Update, *Health Care Entities (Topic 954): Presentation and Disclosure of Certain Net Patient Service Revenue, Provisions for Bad Debts, and the Allowance for Doubtful Accounts—a consensus of the FASB Emerging Issues Task Force*
  - Accounting Standards Update, *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment*
  - Accounting Standards Update, *Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80): Disclosure about an Employer's Participation in a Multiemployer Plan*
  - Proposed Accounting Standards Update, *Property, Plant, and Equipment (Topic 360): Accounting for Derecognition of in Substance Real Estate—a Scope Clarification—a consensus of the FASB Emerging Issues Task Force*
  - Proposed Accounting Standards Update, *Technical Corrections*
  - Proposed Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*
  - Proposed Accounting Standards Update, *Real Estate—Investment Property Entities (Topic 973): Accounting and Reporting by Investment Property Entities*
  - Proposed Accounting Standards Update, *Financial Services (Topic 946): Investment Companies*
  - Proposed Accounting Standards Update, *Consolidations (Topic 810): Agent versus Principal Analysis*.

REPORT OF THE FASB CHAIRMAN  
TO THE FINANCIAL ACCOUNTING FOUNDATION  
October 1, 2011 through December 31, 2011

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**ITEM 1: TECHNICAL ACTIVITIES**

**BOARD AND STAFF ACTIVITIES**

a. Final Documents Issued:

1. Accounting Standards Update No. 2011-10, *Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification* (a consensus of the FASB Emerging Issues Task Force) (issued December 14, 2011)
2. Accounting Standards Update No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities* (issued December 16, 2011)
3. Accounting Standards Update No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05* (issued December 23, 2011).

b. Exposure Documents Issued:

1. Proposed Accounting Standards Update, *Technical Corrections* (issued October 14, 2011). Comment deadline: December 13, 2011.
2. Proposed Accounting Standards Update, *Real Estate—Investment Property Entities (Topic 973)* (issued October 21, 2011). Revised comment deadline: February 15, 2012.
3. Proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements* (issued October 21, 2011). Revised comment deadline: February 15, 2012.
4. Proposed Accounting Standards Update, *Consolidation (Topic 810): Principal versus Agent Analysis* (issued November 3, 2011). Revised comment deadline: February 15, 2012.
5. Proposed Accounting Standards Update, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05* (issued November 8, 2011). Comment deadline: November 23, 2011.

6. Proposed Accounting Standards Update (Revised)—*Revenue Recognition (Topic 605): Revenue from Contracts with Customers* (issued November 14, 2011). Comment deadline: March 13, 2012.
  7. Proposed Accounting Standards Update, *Consolidation (Topic 810): Parent's Accounting for the Cumulative Translation Adjustment upon the Sale or Transfer of a Group of Assets That Is a Nonprofit Activity or a Business within a Consolidated Foreign Entity* (a consensus of the FASB Emerging Issues Task Force) (issued December 8, 2011). Comment deadline February 6, 2012.
- c. From time-to-time, the FASB issues Accounting Standards Updates to amend the nonauthoritative portions of the *FASB Accounting Standards Codification*® (such as the nonauthoritative SEC content). No such Updates were issued this quarter.
- d. New projects added to the agenda:
1. Presentation of Other Comprehensive Income (October 2011). The objective of this standards-setting project is to reconsider how entities are required to present items reclassified out of accumulated comprehensive income, in response to stakeholder concerns about the operability of new requirements published in Accounting Standards Update 2011-12.
  2. Not-for-Profit Financial Reporting: Financial Statements (November 2011). The objective of this standards-setting project is to reexamine existing standards for financial statement presentation by not-for-profit organizations, focusing on improving net asset classification requirements and information organizations provide about liquidity, financial performance, and cash flows. The FASB's Not-for-Profit Advisory Committee had identified those areas as in need of examination.
  3. Not-for-Profit Financial Reporting: Other Financial Communication—a research project (November 2011). The objective of this research project is to study how not-for-profit organizations use written communications, other than financial statements, to communicate their financial story. At the conclusion of this research effort, the Board expects to consider whether educational or standards-setting efforts can contribute to promoting such communications.
  4. Nonpublic Entity Fair Value Measurement Disclosures (November 2011). The objective of this project is to evaluate whether nonpublic entities should be exempt from some or all required disclosures about Level 3 fair value measurements, in light of stakeholder concerns about the costs of preparing and providing those disclosures.
  5. Application of Asset- or Entity-Based Guidance to Nonfinancial Assets Held in an Entity—a research project (November 2011).
- e. New projects considered but not added to the agenda:
1. A proposal that the Board address a lender's accounting for in substance real estate when a borrower ceases to have a controlling financial interest in an in substance real estate subsidiary as a result of default by the subsidiary on its nonrecourse debt. The FASB chairman decided not to add this narrow project,

- but rather, to research whether a more fundamental change would solve a wider set of issues and provide a more durable solution. (See #d (5) above).
2. The Board considered several proposals relating to private companies and directed the staff to address these issues as follows:
    - a. To explore ways to clarify and provide examples about how private companies should apply consolidation guidance for variable interest entities.
    - b. To explore a request to exempt nonpublic entities from recognition and measurement of intangible assets acquired in a business combination.
    - c. To explore a request to permit private companies to disclose the terms of “plain vanilla” interest rate swap agreements and the fair value of the asset or liability positions of the swaps in the notes as a proxy for swap agreement’s current termination value.
  3. A proposal to address the scope of the exception allowed for measuring the fair value of a portfolio of financial instruments in paragraph 820-10-35-18D of Topic 820, as amended by Accounting Standards Update 2011-04. We will address this as part of our 2012 annual technical corrections project.
- f. No projects were removed from the technical agenda.
  - g. At the November 30, 2011 Board meeting, the Board ratified the consensus-for-exposure reached by the Task Force on Issue No. 11-A. The comment period for the Proposed Accounting Standards Update posted to the FASB website will end on February 6, 2012 (see Exposure Documents Issued above).
  - h. At the November 30, 2011 Board meeting, the Board ratified the final consensus reached by the Task Force on Issue No. 10-E (see Final Documents Issued above).
  - i. All seven Board members participated in the November 3, 2011 EITF meeting.
  - j. Outreach Activities—Meetings of FASB Standing Advisory Groups:
    1. Financial Accounting Standards Advisory Council (FASAC):
      - a. October 2011 meeting: All Board members and several staff members participated in the October meeting of the FASAC. Council members discussed a variety of topics, including the FAF Trustees’ plan for private company standard-setting, areas of difference between U.S. GAAP and IFRS (accounting for inventories; contingencies; impairment of nonfinancial assets; and property, plant, and equipment), disclosure framework, and risks and uncertainties.
      - b. December 2011 meeting: Six Board members and several staff members participated in the December meeting of the FASAC. Council members participated in an FASB webcast on the Revised Exposure Draft for Revenue Recognition and discussed various aspects of the proposed model, including identifying and satisfying performance obligations,

transaction price and allocation, onerous performance obligations, interim disclosures, and transfers of nonfinancial assets. Council members discussed a variety of other topics, including other comprehensive income.

2. Investors Technical Advisory Committee (ITAC): Three Board members and several staff members met with the ITAC in November 2011 in a closed meeting to discuss a variety of topics, including the use of IFRSs in the U.S. (including two SEC papers: *An Analysis of IFRS in Practice* and *A Comparison of US GAAP and IFRS*), financial instruments: impairment and risk and liquidity disclosures, hedge accounting research, European debt disclosures, the revenue recognition proposal, and two Proposed Accounting Standards Updates: Investment Property Entities and Investment Companies.
  3. Small Business Advisory Committee (SBAC): Six Board members and several staff members participated in the November 2011 meeting of the SBAC. The FAF president and CEO provided an overview of the FAF Board of Trustees' *Plan to Establish the Private Company Standards Improvement Council*. Committee members discussed the proposed plan and a variety of FASB projects, including the project to develop a decision-making framework for private companies, leases, disclosures about risks and uncertainties and the liquidation basis of accounting, and financial instruments: liquidity risk and interest rate risk disclosures.
  4. Private Company Financial Reporting Committee (PCFRC): The PCFRC met in Norwalk for 1 ½ days in November. A Board member and several staff members participated in the closed session held on the first day. Six Board members and several staff members participated in the public session on the second day. During the meeting, the FAF president and CEO discussed the FAF's *Plan to Establish the Private Company Standards Improvement Council*. Committee members discussed the proposed plan and a variety of FASB projects, including the project to develop a decision-making framework for private companies, leases (including related-party leases), investment property entities, disclosures about risks and uncertainties, revenue recognition, long-lived intangibles, and consolidations.
- k. General Outreach Activities—Meetings with Industry or Other Representative Groups:
1. October 2011 activities:
    - a. Edison Electric Institute (EEI) and American Gas Association (AGA). Two Board members and several staff members met with EEI and AGA in a closed meeting.

- b. Corporate Reporting Users Forum (CRUF). A Board member met with representatives of CRUF (closed meeting).
  - c. National Association of Corporate Directors (NACD). A Board member met with representatives of NACD in a (closed meeting).
  - d. Group of North American Insurance Enterprises (GNAIE). Two Board members and several staff members met with GNAIE representatives and several insurance company CEOs (closed meeting).
  - e. Committee on Bank Accounting and Reporting. A Board member and the FASB technical director participated via teleconference in a closed meeting with the association of large banks.
  - f. American Coalition of Stock Plan Administrators. A Board member and the FASB technical director met privately with members of the American Coalition of Stock Plan Administrators (closed meeting).
  - g. Small Business Financial & Regulatory Affairs Committee of the Institute of Management Accountants. A Board member discussed via teleconference various projects that may affect small businesses (closed meeting).
  - h. AICPA Auditing Standards Board (Audit Issues Task Force Members). A Board member and some staff met with members of the Audit Issues Task Force (closed meeting).
  - i. Representatives of large public accounting firms. Two Board members and the FASB technical director met with representatives from the national offices of several large public accounting firms (closed meeting).
2. November/December 2011 activities:
- a. Committee on Corporate Reporting of Financial Executives Institute. A Board member discussed via teleconference various projects of interest to the committee (closed meeting).
  - b. Independent Community Bankers of America (ICBA). Three Board members and several staff met with the ICBA (closed meeting).
  - c. Business Accounting Council (BAC) within the Financial Services Agency of Japan. Two Board members, the FAF chairman, and the FAF president and CEO met with the BAC (closed meeting).
  - d. Academic outreach: A Board member participated in a roundtable of research academics and a meeting of the American Accounting Association.
1. Project-Specific Outreach Activities. Summaries of outreach activities on priority projects follow.
- 1. Accounting for financial instruments: Board and staff members obtained user perspectives on the FASB's and IASB's hedge accounting proposals

through more than a dozen calls with financial analysts from more than 10 organizations. Staff and/or Board members also discussed with various investors the usefulness of proposed disclosures for impaired financial assets. The staff met with representatives of eight different corporations, primarily financial institutions, and the major accounting firms to learn about the operability of the FASB's tentative classification and measurement approach. Staff members discussed the so-called three-bucket approach to impairment with representatives of the American Bankers Association, the International Bankers Federation, and the major accounting firms. Staff also discussed the Board's proposals related to the accounting for impairment of debt securities with companies and representatives of industry groups that would be significantly affected by those proposals.

2. Leases: Board and staff members discussed the leases project at six conferences and at three FASB standing advisory group meetings (FASAC, SBAC, and PCFRC). Staff and/or Board members also discussed the project with six different investor/user groups, several industry representative groups (National Association of Investment Real Estate Trusts and Aviation Working group), a major accounting firm, and an accounting firm focused primarily on the nonpublic entity sector.
3. Revenue recognition: The Board and staff raised awareness through participation in revenue recognition webcasts sponsored by two major accounting firms and discussions of the project with two FASB advisory groups (FASAC and ITAC). To gather information about the operability of the approach, staff and/or Board members have begun extensive outreach with stakeholders, including targeting specific industries that will be particularly affected by the proposals. The staff and Board members have discussed the Board's proposals with well over a dozen various preparer groups and two of the four major accounting firms. To obtain the perspectives of nonpublic entities, the project was discussed at meetings of the FASB's SBAC and PCFRC. In addition, staff or Board members presented information at approximately a dozen different conferences focused on the nonpublic sector including private companies and not-for-profit entities. Targeted outreach also was performed with private companies primarily in the construction industry, which included industry groups and associations.
4. Insurance contracts: Staff or Board members discussed the project with 8 different user groups and 18 different insurance companies or insurance industry representative groups.

5. Consolidation of investment companies and investment property entities: The project was discussed at a meeting of the FASB's ITAC and four other groups of investors and other users (these groups consisted of approximately 15 user organizations). Board or staff members gathered input and reactions on the proposal through meetings with five different preparer/auditor groups (these groups consisted of more than 25 organizations) and the FASB's PCFRC. Significant user outreach and additional preparer/auditor outreach for these proposals is planned to be completed in the first quarter of 2012 (to align with the comment period deadline).
6. Risks and uncertainties (formerly going concern): The project was discussed at meetings of the FASB's advisory groups (FASAC, SBAC, and PCFRC). To gather information about the needs of users, the staff discussed the project with members of ITAC and another group that represents users. The staff gathered information about a possible going concern assessment by management and held discussions and other correspondence with various preparers and accounting firms.
7. Reporting comprehensive income: The staff discussed various application issues with several stakeholders.
8. Private company issues roundtables. Three Board members and some staff participated in a roundtable in Chicago, and three other Board members and some staff participated in a roundtable in San Francisco.

COLLABORATION WITH THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

- a. The FASB and the IASB held several multi-day joint video-conference Board meetings and two face-to-face joint Board meetings (Norwalk and London).
- b. The FASB and the IASB held an insurance working group meeting in London.
- c. An FASB Board member attended an IFRS Advisory Committee meeting in London.
- d. The FASB technical director attended the IASB Valuation Advisory Committee meeting.
- e. Two Board members attended the Deloitte/IFRS Summit in New York.
- f. The FASB and the IASB held small-group video-conference meetings on insurance, leases, and financial instruments classification and measurement.



- g. The FASB and the IASB directors met periodically to discuss technical and administrative matters.

#### OTHER INTERNATIONAL ACTIVITIES

- a. The FASB chairman attended the IFRS conference in Boston.
- b. One Board member, the FASB technical director, and the FAF president and CEO met privately with the Australian Financial Reporting Council (closed meeting).
- c. The FASB chairman, a Board member, and the FASB technical director participated in a conference call with EFRAG (closed meeting).
- d. An FASB Board member participated in the Financial Stability Board roundtable on risk disclosures in Basel, Switzerland (open meeting).
- e. An FASB Board member participated in a discussion about the joint insurance contracts project at the IFRS Advisory Council meeting (open meeting).
- f. Two Board members and the FASB technical director met with members of the China Ministry of Finance (closed meeting).
- g. The FASB research director attended a meeting of the EFRAG project team on disclosure framework and participated by phone in two meetings.

#### XBRL ACTIVITIES

The FAF is responsible for the ongoing development and maintenance of the U.S. GAAP Financial Reporting Taxonomy applicable to public issuers registered with the SEC. The FAF has delegated these responsibilities to the FASB.

- a. The FASB delivered the final US GAAP Financial Reporting Taxonomy (UGT) and all supporting collateral to the SEC as per the SEC MOU requirements dated February 4, 2010, to enable its final review of the UGT).
- b. The staff hosted a face-to-face meeting of the FASB Taxonomy Advisory Group (TAG). The TAG includes participants from preparers, CPA firms, service providers, data aggregators, and analysts. This advisory group provides valuable input on the changes and directions taken with each taxonomy release.
- c. An FASB Board member and staff visited with management of SNL Financial to solicit their feedback and provide guidance on using the UGT. SNL Financial collects, standardizes, and disseminates corporate, financial, market, and M&A data. This was an initial outreach for the purpose of understanding XBRL consumption issues and how those consumption issues affect UGT developments, and providing guidance on using the current XBRL formatted data.
- d. XBRL staff participated in several presentations at the XBRL International 23<sup>rd</sup> Conference held in Montreal.

- e. An FASB Board member represented the FASB at an SEC roundtable, hosted by Columbia University, which brought together representatives from the filer and analyst community to address XBRL document creation and consumption issues.
- f. XBRL staff participated in the IASB XAC and XQRT face-to-face meeting in London. These two groups provide input and guidance for the IFRS taxonomy effort.
- g. FASB hosted an IN FOCUS webinar, "Summary of Changes for the Proposed 2012 Taxonomy and Using XBRL Tables." In addition to providing an overview of the proposed 2012 Taxonomy, this was a technical session designed to help users with the more challenging aspects of using the Taxonomy. This was the 3rd XBRL webinar in 2011. These webinars continue to be very popular with over 1,000 live viewers participating in the latest session.

## **ITEM 2: EDUCATION AND COMMUNICATIONS**

### **EDUCATIONAL WEBCASTS AND PODCASTS DELIVERED**

- a. Webcasts (which averaged 850 participants for the live webcasts):
  - 1. IN FOCUS: Summary of Changes for the Proposed 2012 Taxonomy and Using XBRL
  - 2. The FAF's Plan to Improve Private Company Financial Reporting
  - 3. IN FOCUS: Understanding the FASB's Proposals for Investment Companies, Investment Property Entities, and Consolidations
  - 4. IN FOCUS: Understanding the FASB's Exposure Draft Revenue from Contracts with Customers
  - 5. IN FOCUS: FASB Update for Nonpublic Entities.
- b. Podcasts:
  - 1. November: Proposed Accounting Standard Update: Revenue Recognition from Contracts with Customers.

### **SPEECHES DELIVERED**

FASB Board members or staff delivered speeches at the following conferences and events:

- AICPA Annual Health Care Industry Conference
- AICPA Governmental & NFP Training Program
- AICPA/IFRS Conference on International Financial Standards (IFRS):  
The North American Perspective

- AICPA National Conference on Credit Unions
- AICPA National Conference on Current SEC and PCAOB Developments
- AICPA/SIFMA Financial Management Society National Conference on the Securities Industry
- Alabama Society of CPAs Educators Conference
- American Accounting Association Northeast Region Conference
- American Accounting Association 2011 Midwest Region AAA Meeting
- Assoc. General Contractors of America Financial Management Conference
- CalCPA Education Foundation 2011 Accounting and Auditing Conference
- COBAR Fall Meeting
- Connecticut Society of CPAs Not-for-Profit Organization Committee Session
- Deloitte & Touche IFRS Summit 2011
- Ernst & Young Financial Services Accounting Change Symposium
- FDIC Division of Finance and Corporate University 2011 Accounting & Auditing Conference
- FEI CFRI Conference
- FEI Central PA Chapter Meeting
- FEI Northeastern Wisconsin Chapter Monthly Meeting
- Financial Executives Networking Group
- Financial Stability Board Roundtable
- Financial Times and Credit Suisse Lex Forum Series
- Florida Institute of CPAs (FICPA) and the University of Florida Fisher School of Accounting Conference
- Geneva Association Insurance and Finance Seminar
- Georgia Society of CPAs A&A Conference
- Greater Washington Society of CPAs 23<sup>rd</sup> Annual GWSCPA Not-for-Profit Organizations Symposium
- Illinois CPA Society Accounting & Auditing Conference
- Investment Company Institute Conference
- Kennesaw State University Financial Reporting Roundtable
- KPMG Financial Reporting & Valuation Conference
- Michigan State University Postgraduate Technical Assistant Program Presentation
- Mortgage Bankers Association Accounting, Tax & Financial Management Conference
- NASBA Annual Meeting
- National Association of Real Estate Companies Annual Conference
- National Council for Public Private Partnerships Real Estate Forum
- NYSSCPA Rockland Chapter CPE Program
- NYSSCPA/FAE IFRS Conference
- NYSSCPA Banking Committee Breakfast
- NYSSCPA Annual SEC/FASB Conference
- Ohio Society of CPAs SEC Conference
- Oklahoma State University Financial Reporting Conference
- Padgett Stratemann 2011 Construction Conference
- Pennsylvania Institute of Certified Public Accountants Construction Industry Conference
- Pepsico Annual Conference

- PhRMA and Pharma/Biotech Companies Accounting and Reporting Annual Meeting
- PKF North American Summit
- PricewaterhouseCoopers 13<sup>th</sup> Annual Meet the Experts
- Professional Development Institute University of North Texas Accounting & Financial Reporting Update Conference
- RR Donnelly SEC Hot Topics Institute
- Society of Insurance Financial Management SIFM December Meeting
- South Carolina Association of CPAs 2011 Accounting & Auditing Conference
- Standard & Poor's Accounting Hot Topics Conference
- The Clearing House First Annual Business Meeting & Conference
- Washington Society of CPAs Annual NFP Conference
- Washington Society of CPAs Accounting & Auditing Update Conference
- William & Mary College Veris CPA Trek Program

### **ITEM 3: ADMINISTRATIVE, PROCEDURAL, AND STRATEGIC ACTIVITIES**

#### a. Administrative Matters:

1. All Board members attended the November FAF Trustees meeting.

#### b. Professional Development—FASB Board and Staff

1. The following professional development sessions were presented to the Board and staff:
  - a. Long-Term Health Care Planning, Owen Svalestad, Financial Representative with New England Financial Group—the facts and myths of long-term health care and the importance of proper planning. The presentation covered the cost of care and who pays the bills (what Medicare and Medicaid cover).
  - b. The Fiscal Policy Space and Condition of Cities, Christopher Hoene, Center Director, Research & Innovation, National League of Cities (NLC). The presentation provided an overview of the “fiscal policy space” of cities—the structures and attributes that determine the fiscal policy tools available to cities, including state rules and constraints, underlying economic drivers, variation in local service demands, and local political and institutional factors. The presentation also provided the latest assessment of the fiscal health of the nation’s cities, drawing on NLC’s release of “City Fiscal Conditions in 2011,” a report based on an annual survey of city finance officers and city budgets. Contemporary concerns about pension and health care costs, municipal default, and municipal bankruptcy also were addressed in the presentation.
  - c. Lunch and Learn: Real Estate Today, Patricia Rattray. Selling your home and finding qualified buyers can be extremely challenging in today’s real estate market, but it is absolutely possible. This workshop helped employees

avoid losing thousands of dollars in price reductions and provided a step-by-step process for adding 10 percent or more to the price of a sale.

- d. The Conceptual Framework Project: An Overview, Part 2—Current Issues, Ron Lott, FASB Research Director, and Jim Leisenring, FASB Senior Advisor. Messrs. Lott and Leisenring continued their discussion on the history of the Conceptual Framework, including the issues that were in process when work on the framework was suspended. At the conclusion of this presentation, participants were able to understand the difficulties that the Board will face when deliberations are resumed.
  - e. Reflections on My Time at the Securities and Exchange Commission, Wayne Carnall, Partner—PriceWaterhouseCoopers, Former Chief Accountant in the Division of Corporation Finance. Mr. Carnall discussed his experiences at the Securities and Exchange Commission and focused on discussing accounting and reporting issues in which the staff noted entities that had challenges complying with the accounting guidance and/or the staff had challenges enforcing compliance with the accounting guidance. He also shared his perspective on changes that can be made to improve financial reporting.
  - f. Successful Leaders in Today's Business Environment (the third of the FAF Leadership Series), Ursula Burns, Chief Executive Officer, Xerox Corporation. This session provided the staff with Ms. Burns' insights on what makes a good leader; how good leaders inspire, motivate, and coach others to work together for a common objective; and what she believes are the challenges and obstacles to good leadership. The objective of this session was to provide the staff with a better understanding of what makes a great leader and how those traits can be used to find success outside the workplace.
- c. Professional staff attended the following external conferences:
- 1. FEI 30<sup>th</sup> Annual Current Financial Reporting Issues Conference
  - 2. AICPA National Conference on Current SEC and PCAOB Developments
  - 3. 2011 FASB-IASB Financial Reporting Issues Conference.

#### **ITEM 4: GOVERNMENT AND REGULATORY LIAISON ACTIVITIES**

- a. Members of SEC, PCAOB, Congress, their staffs, and the Administration were informed about the activities of the FASB through various meetings and other forums, including:
  - 1. An FASB Board member participated in a meeting of the Financial Reporting Series, with the Chairman of the PCOAB, the SEC Chief Accountant, and

- numerous external participants. The topic was measurement uncertainty. Several planning and follow-up calls were held.
2. An FASB Board member, the FAF president and CEO, and FAF staff conducted a conference call with U.S. Treasury Deputy Assistant Secretary for International Markets & Development to discuss the drafting of the G20 communiqué for accounting issues.
  3. FASB Board members, FASB senior staff, and the FAF president and CEO participated in a monthly update conference call conducted by FAF staff on pending and emerging congressional activities and issues as well as Administration regulatory initiatives.
  4. FASB Board members and FAF staff provided a quarterly briefing of emerging technical, and policy issues to the SEC and PCAOB leadership and senior staff, in addition to numerous telephone conversations about various matters.
  5. The FASB chairman, an FASB Board member, and the FASB technical director met with a representative of FINRA to discuss matters of mutual interest.

#### **ITEM 5: OTHER COMMUNICATIONS ACTIVITIES**

- a. The FASB issued the following press releases/media advisories/Tweets:
  1. 10.3.11: FASB Not-for-Profit Advisory Committee Recommends Improvements to Financial Reporting
  2. 10.12.11: MEDIA ADVISORY: FASB Adds Agenda Project to Consider Deferring Certain Aspects of Accounting Standards Update No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*
  3. 10.14.11: FASB Seeks Comments on Proposed Technical Corrections to Codification
  4. 10.21.11: FASB Seeks Comments on Proposal to Clarify Criteria for Investment Company Accounting
  5. 10.21.11: FASB Seeks Comments on Proposal on Accounting for Investment Property Entities
  6. 11.4.11: FASB Seeks Comments on Proposal for Improving Financial Reporting of Consolidations
  7. 11.9.11: FASB Chairman Adds Two Agenda Projects to Improve Financial Reporting by Not-for-Profit Organizations
  8. 11.14.11: IASB and FASB Publish Revised Proposal for Revenue Recognition
  9. 11.17.11: MEDIA ADVISORY: Registration Is Now Open for November 28 Webcast, *IN FOCUS: Understanding the FASB's Proposals for Investment Companies, Investment Property Entities, and Consolidations*
  10. 11.29.11: FASB Chairman Adds an Agenda Project on Fair Value Measurement Disclosures for Private Companies and Not-for-Profit Organizations
  11. 11.30.11: MEDIA ADVISORY: Registration Opens for December 20 Webcast, *IN FOCUS: FASB Update for Nonpublic Entities*
  12. 12.1.11: MEDIA ADVISORY: Registration Opens for December 8 Webcast, *IN FOCUS: Understanding the Exposure Draft, Revenue from Contracts with Customers*
  13. 12.16.11: IASB and FASB Issue Common Offsetting Disclosure Requirements

14. 12.21.11: The FASB Announces Public Roundtable Meetings to Solicit Input on Proposal to Improve Accounting for Investment Companies and Proposal on Investment Property Entities
  15. 12.23.11: FASB Defers Certain Aspects of Comprehensive Income Accounting Standards Update
- b. The FASB issued “FASB in Focus” documents for the following:
1. 11.18.11: Proposed Improvements to Criteria for Investment Company Accounting and Proposed Accounting Guidance for Investment Property Entities
  2. 11.23.11: FASB Issues Proposed Improvements to Consolidation Accounting
  3. 11.14.11: FASB and IASB Publish Revised Exposure Draft on Revenue from Contracts with Customers
  4. 12.19.11: FASB Issues Accounting Standards Update No. 2011-11: *Balance Sheet (Topic 21): Disclosures about Offsetting Assets and Liabilities*
  5. 12.23.11: FASB Defers Certain Aspects of Comprehensive Income Accounting Standards Update
- c. Media Outreach:
1. During the quarter ended December 31, 2011, members of the FASB or its staff participated in numerous interviews with media.

**ITEM 6: GASB LIAISON ACTIVITIES**

- a. GASB meeting minutes were sent to the FASB directors.
- b. The GASB and FASB directors met monthly to discuss their technical agenda projects and other matters of mutual interest. The FASB and GASB chairmen and their respective directors held their quarterly meeting to discuss technical issues and other matters of mutual interest.
- c. The GASB staff distributed the following draft to the FASB for review:
  - Exposure Draft, *Government Combinations*.
- d. The FASB staff distributed the following drafts for GASB’s review:
  - Accounting Standards Update, *Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification* (a consensus of the FASB Emerging Issues Task Force)
  - Accounting Standards Update, *Balance Sheet (Topic 210): Offsetting Disclosures*
  - Accounting Standards Update, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items of Other Comprehensive Income in Accounting Standards Update No. 2011-05*

- Proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*
- Proposed Accounting Standards Update, *Consolidation (Topic 810): Principal versus Agent Analysis*
- Proposed Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*
- Proposed Accounting Standards Update, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items of Other Comprehensive Income in Accounting Standards Update No. 2011-05*
- Proposed Accounting Standards Update, *Consolidation (Topic 810): Parent's Accounting for the Cumulative Translation Adjustment upon the Sale or Transfer of a Group of Assets That Is a Nonprofit Activity or a Business within a Consolidated Foreign Entity* (a consensus of the FASB Emerging Issues Task Force)
- Proposed Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers—Proposed Amendments to the FASB Accounting Standards Codification®*.





### FASB Accounting Standards Updates

Effective July 1, 2009, changes to the source of authoritative U.S. GAAP, the *FASB Accounting Standards Codification*® (FASB Codification), are communicated through an Accounting Standards Update (Update). Updates will be published for all authoritative U.S. GAAP promulgated by the FASB, regardless of the form in which such guidance may have been issued prior to release of the FASB Codification (e.g., FASB Statements, EITF Abstracts, FASB Staff Positions, etc.). Updates also will be issued for amendments to the SEC content in the FASB Codification as well as for editorial changes.

An Update is a transient document that (1) summarizes the key provisions of the project that led to the Update, (2) details the specific amendments to the FASB Codification, and (3) explains the basis for the Board's decisions. Although ASUs will update the FASB Codification, the FASB does not consider Updates as authoritative in their own right.

Prior to the release of the FASB Codification as the single source of authoritative U.S. GAAP, the FASB amended pre-Codification standards and issued them in an "as amended" form. The FASB will not amend Updates. It will only amend the FASB Codification.

### FASB Accounting Standards Updates

- **Update No. 2011-12**—Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05
- **Update No. 2011-11**—Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities
- **Update No. 2011-10**—Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification (a consensus of the FASB Emerging Issues Task Force)
- **Update No. 2011-09**—Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80): Disclosures about an Employer's Participation in a Multiemployer Plan
- **Update No. 2011-08**—Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment
- **Update No. 2011-07**—Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities (a consensus of the FASB Emerging Issues Task Force)
- **Update No. 2011-06**—Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers (a consensus of the FASB Emerging Issues Task Force)
- **Update No. 2011-05**—Comprehensive Income (Topic 220): Presentation of Comprehensive Income
- **Update No. 2011-04**—Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs
- **Update No. 2011-03**—Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements
- **Update No. 2011-02**—Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring
- **Update No. 2011-01**—Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20



**Current Technical Plan and Project Updates**

The FASB prepares a project plan to communicate information about its standards-setting activities to stakeholders. The project plan lists all agenda projects and includes:

- Estimated publication dates through 2012 (Discussion Papers (D), Exposure Drafts (Es), and Final Accounting Standards Updates or Final Conceptual Framework chapters (Fs).)
- Comment periods expected to close in the next 4 quarters (indicated by a C)
- Roundtable meetings or other public forums planned (indicated by an R)

The FASB sets standards following established due process procedures that include extensive consultation. This project plan is subject to change as a result of those consultations or for other reasons.

The project plan includes links to staff prepared project summaries that describe Board decisions and provide other information. The decisions are tentative and do not change current accounting. Official positions of the FASB are determined only after extensive due process and deliberations.

Current Technical Plan		2012
ACTIVE JOINT FASB/IASB PROJECTS:		1Q 2Q 2H
<b>Standards Projects:</b>		
<input checked="" type="checkbox"/> <u>Accounting for Financial Instruments</u> (Updated December 1, 2011)		
Liquidity and Interest Rate Risk Disclosures		E
<input checked="" type="checkbox"/> <u>Impairment</u> (Updated November 10, 2011)		E <sup>1</sup>
<input checked="" type="checkbox"/> <u>Classification and Measurement</u> (Updated November 10, 2011)		E <sup>1</sup>
<input checked="" type="checkbox"/> <u>Hedging</u> (Updated December 1, 2011)		
<input checked="" type="checkbox"/> <u>Consolidation: Policy and Procedures</u> (Updated December 13, 2011)		F
<input checked="" type="checkbox"/> <u>Investment Companies</u> (Updated March 21, 2012)	R	
<input checked="" type="checkbox"/> <u>Revenue Recognition</u> (Updated March 15, 2012)		R
<input checked="" type="checkbox"/> <u>Leases</u> (Updated March 9, 2012)		E
<input checked="" type="checkbox"/> <u>Insurance Contracts</u> (Updated March 7, 2012)		E
<b>INACTIVE JOINT FASB/IASB PROJECTS:</b>		
The following joint projects were reassessed as lower priority projects. Further action is not expected in the near term.		
<input checked="" type="checkbox"/> <u>Emissions Trading Schemes</u> (Updated December 6, 2010)		
<input checked="" type="checkbox"/> <u>Financial Instruments with Characteristics of Equity</u> (Updated October 26, 2010)		

<input checked="" type="checkbox"/> <b>Financial Statement Presentation</b> <i>(Updated May 3, 2011)</i>	
<input checked="" type="checkbox"/> <b>Reporting Discontinued Operations</b> <i>(Updated July 29, 2010)</i>	
<b>Earnings per Share</b> <i>(Updated May 7, 2009)</i>	
<b>Income Taxes</b> <i>(Updated November 6, 2009)</i>	
<b>Postretirement Benefit Obligations including Pensions (Phase 2)</b> <i>(Updated January 21, 2009)</i>	
<input checked="" type="checkbox"/> <b>Conceptual Framework Project:</b> <i>(Updated as of November 23, 2010)</i>	
Reporting Entity	
Measurement	
Elements and Recognition	
	<b>2012</b>
<b>FASB PROJECTS:</b>	<b>1Q 2Q 2H</b>
<input checked="" type="checkbox"/> <b>Disclosures about Risks and Uncertainties and the Liquidation Basis of Accounting (formerly Going Concern)</b> <i>(Updated February 24, 2012)</i>	E
<input checked="" type="checkbox"/> <b>Investment Property Entities</b> <i>(Updated March 20, 2012)</i>	R
<input checked="" type="checkbox"/> <b>Codification Technical Corrections (including Certain Amendments to Various Codification Topics to Conform Terminology to Topic 820)</b> <i>(Updated October 19, 2011)</i>	F
<input checked="" type="checkbox"/> <b>Nonpublic Entity Fair Value Measurement Disclosures</b> <i>(Updated November 29, 2011)</i>	E
<input checked="" type="checkbox"/> <b>Disclosure Framework</b> <i>(Updated February 15, 2012)</i>	D
<input checked="" type="checkbox"/> <b>Impairment of Indefinite-Lived Intangible Assets</b> <i>(Exposure Draft issued 01/25/12. Updated February 21, 2012)</i>	C
<input checked="" type="checkbox"/> <b>Disclosure of Certain Loss Contingencies</b> <i>(Updated October 24, 2011)</i>	
<input checked="" type="checkbox"/> <b>Not-for-Profit Financial Reporting: Financial Statements</b> <i>(Updated November 11, 2011)</i>	
<input checked="" type="checkbox"/> <b>Presentation of Comprehensive Income: Reclassifications Out of Accumulated Other Comprehensive Income</b> <i>(Updated January 5, 2012)</i>	
<input checked="" type="checkbox"/> <b>Definition of a Nonpublic Entity</b> <i>(Added to agenda March 2012. Updated March 7, 2012)</i>	
<b>Repurchase Agreements and Similar Transactions</b> <i>(Added to agenda March 2012)</i>	
	<b>2012</b>
<b>FASB RESEARCH PROJECTS:</b>	<b>1Q 2Q 2H</b>
<b>Application of Asset- or Entity-Based Guidance to Nonfinancial Assets Held in an Entity</b>	E
<input checked="" type="checkbox"/> <b>Decision-Making Framework for Private Companies<sup>2</sup></b> <i>(Updated October 18, 2011)</i>	
<input checked="" type="checkbox"/>	

Not-for-Profit Financial Reporting: Other Financial Communications (Updated November 11, 2011)			
		2012	
FASB EMERGING ISSUES TASK FORCE PROJECTS:		1Q	2Q 2H
Parent's Accounting for the Cumulative Translation Adjustment upon the Sale or Transfer of a Group of Assets That is a Nonprofit Activity or a Business within a Consolidated Foreign Entity (11-A)			F
Not-for-Profit Entities: Classification of Gifts of Securities Immediately Sold in the Statement of Cash Flows (12-A)			E
Not-for-Profit Entities: Contributed Services from an Affiliate (12-B)			
Subsequent Accounting for an Indemnification Asset Recognized as a Result of a Government-Assisted Acquisition of a Lending Institution (12-C)			E
Accounting for Joint and Several Liability for Which the Total Amount of the Obligation is Fixed (12-D)			
Accounting for Fair Value Information That Arises Subsequent to the Measurement Date and Its Inclusion in the Impairment Analysis of Unamortized Film Costs (12-E)			E
Accounting for Multiple Foreign Currency Exchange Rates (10-B) (inactive issue)			

<sup>1</sup>The FASB is continuing to redeliberate the issues in this project and once those redeliberations are completed, the Board likely will decide whether to reexpose those decisions for public comment. However, official positions are reached by the FASB only after extensive due process and deliberations. At a minimum, before issuing the final document, the FASB intends to expose for public comment the proposed amendments to the FASB Accounting Standards Codification® (as required by the FASB's Rules of Procedure).

<sup>2</sup>The timing of the Discussion Paper will be coordinated with the outcome of the FAF's Plan to Establish the Private Company Standards Improvement Council (PCSIC).

**Codes:**

C – Comment Deadline  
D – Discussion Paper  
E – Exposure Draft  
F – Final Document  
R – Roundtable Discussion

# **The Financial Accounting Foundation Board of Trustees**

**Request for Comment**

***Plan to Establish the Private Company Standards  
Improvement Council***

**October 4, 2011**

**Norwalk, Connecticut**



**Financial Accounting Foundation**  
401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116  
[www.accountingfoundation.org](http://www.accountingfoundation.org)

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**EXECUTIVE SUMMARY OF THE FAF BOARD OF TRUSTEES PLAN TO ESTABLISH THE PRIVATE COMPANY STANDARDS IMPROVEMENT COUNCIL**

As a result of outreach to external stakeholders, study, and deliberation, the Financial Accounting Foundation (FAF) Board of Trustees plans to establish a “Private Company Standards Improvement Council” (PCSIC) to improve the standard-setting process for private companies. The Trustees seek public comment on the plan, as outlined in this document, until January 14, 2012. The Trustees will make a final decision on the plan following the end of the comment period.

***Authority and Critical Responsibilities***

The PCSIC would determine whether exceptions or modifications to nongovernmental US Generally Accepted Accounting Principles (US GAAP) are required to address the needs of users of private company financial statements. Jointly with the Financial Accounting Standards Board (FASB), which sets accounting standards for public and private companies and not-for-profit organizations in the United States, the PCSIC would develop criteria for determining whether and when exceptions or modifications to US GAAP are warranted for private companies. Based on those criteria, the PCSIC would conduct a review of existing US GAAP and identify standards that require reconsideration and vote on possible exceptions or modifications for private companies. Any proposed changes to existing US GAAP would be subject to ratification by the FASB and undergo thorough due process, including public comment. The PCSIC would be overseen by the FAF Board of Trustees.

***Formation and Membership***

The PCSIC would comprise a chairman and 11 to 15 members. The PCSIC chairman, who would be selected and appointed by the Trustees, would be a FASB member with substantial experience with and exposure to private companies during his or her career. PCSIC members also would be selected and appointed by the Trustees. Members would include users, preparers, and practitioners who have significant experience using, preparing, and auditing (and/or compiling and reviewing) private company financial statements.

Nominations for membership on the PCSIC would be sought from a broad array of interested stakeholders and stakeholder groups. Members would be appointed for a three-year term and could be reappointed, based on input from the PCSIC chairman and FASB chairman, for up to two additional one-year terms (for a total of five years). Membership tenure would be staggered to assure appropriate continuity on the PCSIC. FASB staff would be assigned to support and work closely with the PCSIC on outreach and research projects to leverage the FASB’s resources and to avoid duplication of efforts.

***Meetings***

The PCSIC would meet four to six times per year. The meetings would be held at the FASB’s offices in Norwalk, Connecticut, with the intention that all FASB members would participate. PCSIC meetings would be webcast and open to the public, except for discussions of an administrative nature, which could be closed.

***Oversight***

During the first three years of operations, the PCSIC would provide periodic in-person reports to a newly created, special-purpose Private Company Review Committee of the FAF Board of Trustees. The PCSIC also would provide quarterly written reports to the full FAF Board of Trustees. Following the three-year period, the oversight responsibilities of the Private Company Review Committee would be transferred to the existing Standard-Setting Process Oversight Committee of the Trustees. Quarterly written reports by the PCSIC to the Trustees also would continue following that transition. In addition to this oversight, the Trustees would conduct an overall assessment of the PCSIC at the end of the three-year period to determine whether its mission is being met and whether further changes to the standard-setting process for private companies would be warranted.

***The planned PCSIC best addresses constituent concerns***

The FASB has made recent, substantive changes to the manner in which it engages with private company stakeholders, and has demonstrated a greater operational and structural commitment to further address these issues. However, constituents continue to express concerns about private company needs.

In addressing these concerns, the Trustees considered a range of options, including:

1. Creating a new, autonomous, and authoritative standard-setting board for private company issues, under the oversight of the FAF, as recommended by the Blue-Ribbon Panel on Standard Setting for Private Companies
2. Establishing a new body, under the oversight of the FAF, to identify standards that require modification and to vote on specific proposed exceptions or modifications that would then be subject to ratification by the FASB and submitted to the public for comment
3. Establishing a new committee on private company issues that would serve solely in an advisory role to the FASB
4. Continuing to monitor the FASB's existing and ongoing initiatives to better serve the needs and interests of private companies.

In deciding on the second option, the Trustees concluded that creating a separate standard-setting board for private companies would likely lead to the establishment of two separate sets of US accounting standards—a so-called “little GAAP” for private companies and a “big GAAP” for public companies, which is not a desired outcome.

Concerns communicated to the Trustees about the complexity and relevance of US GAAP to private companies appear to involve a small but key group of standards. The Trustees concluded that improvements should focus on those standards first.

In addition, the Trustees concluded that the FASB should address—and is committed to addressing—complexity, relevance, and cost-benefit issues more broadly, as other constituents, in addition to private companies, have expressed similar concerns.



## **Plan to Establish the Private Company Standards Improvement Council**

### **BACKGROUND**

Since it was created in 1972, the Financial Accounting Foundation (FAF) has committed itself to the challenging mission of balancing two critical, but sometimes conflicting, objectives:

- Ensuring that its standard-setting bodies (the Financial Accounting Standards Board and the Governmental Accounting Standards Board) develop high-quality accounting standards that provide investors, lenders, and other users of financial statements with clear, comparable, and decision-useful financial information about a wide variety of companies, not-for-profit organizations, governmental bodies, and other entities
- Ensuring that those standards also take into account the individual needs and circumstances of the constituents of the disparate entities that issue financial statements under US Generally Accepted Accounting Principles (US GAAP), specifically related to relevance, complexity, and costs versus benefits.

The ongoing effort to reconcile those two goals has continued for nearly 40 years. One of the greatest challenges has involved the needs of nonpublic entities, including privately held companies and not-for-profit organizations. Over the years, no fewer than 12 separate reports, studies, or formal recommendations on issues related to private companies were produced, with varying degrees of impact and success.

In the past ten years, as businesses and business transactions have become increasingly global and complex, some have argued that the needs of public company and private company users of financial statements have moved further apart, even as the demands of capital markets have made it more important to maintain the comparability of financial reporting among disparate companies and organizations.

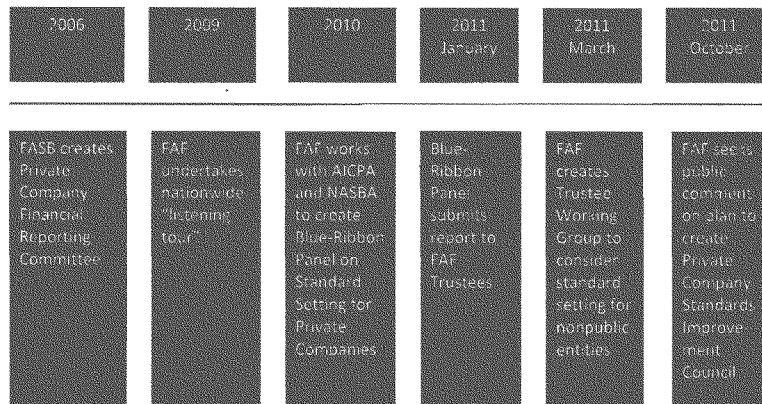
### ***Focus on Private Company Issues***

In 2006, the Financial Accounting Standards Board (FASB) created the Private Company Financial Reporting Committee (PCFRC) in an effort to further improve its ability to incorporate the views of private company constituents in its standard-setting process. Comprised of a chairman and 12 members representing nonpublic business entities, regardless of size, the mission of the PCFRC was to provide recommendations to the FASB on issues related to standard setting for private companies and to focus on how standard setting affects day-to-day technical activities at private companies.

Three years later, the FAF Board of Trustees undertook a nationwide “listening tour,” during which groups of Trustees and senior FAF leadership met with diverse constituents to hear and

understand their views on the independent standard-setting process and key issues affecting financial reporting.

During the tour, the Trustees learned that many constituents continued to be concerned about the cost and complexity of standards for nonpublic entities and, frankly, were not satisfied with the results of the collaboration between the FASB and the PCFRC. Some constituents believed that in the PCFRC’s early years, the FASB did not participate fully in its processes or pay sufficient attention to its recommendations. In addition, they said the PCFRC was not initially effective in engaging with the FASB and advocating on behalf of its constituents. A major issue cited by constituents was that the FASB and the PCFRC did not develop and agree upon a framework for considering exceptions or modifications to US GAAP for private companies.



***Blue-Ribbon Panel on Standard Setting for Private Companies***

As a result of these concerns, the Trustees collaborated with the American Institute of Certified Public Accountants (AICPA) and the National Association of State Boards of Accountancy (NASBA) to create the Blue-Ribbon Panel on Standard Setting for Private Companies. The panel was charged with studying the needs of users of private company financial statements and making recommendations to the Trustees about how the standard-setting process can best meet those needs.

Separately, the FASB took additional steps to improve the standard-setting process for private companies. The FASB, for example, assembled a team of professionals focused on formally representing and soliciting input from private companies; established a series of roundtables on private company issues; undertook efforts to develop a framework for identifying whether and

when differences in standards are warranted for private entities; increased education efforts to help private company constituents become informed about changes in US GAAP; created a dedicated electronic portal to make it easier for private company stakeholders to access information; developed an electronic feedback forum to enable private company stakeholders to more easily comment on the FASB proposals; and specifically addressed private company concerns in a series of standard-setting decisions related to goodwill impairment, revenue recognition, and financial instruments.

In January 2011, the Blue-Ribbon Panel submitted a report to the Trustees with its recommendations, including, among others, the creation of a new, separate, and authoritative standard-setting board (under the oversight of the Trustees) that would establish exceptions or modifications to US GAAP for private companies.

#### *The Working Group*

In March 2011, the FAF appointed several Trustees and senior FAF staff members to a “Working Group” to further consider standard setting for nonpublic entities.

The Working Group received significant input from users, practitioners, and preparers of private company and not-for-profit financial statements. The Working Group also reviewed the current process by which the FASB considers the concerns of private companies and not-for-profit organizations. Specifically, the Working Group conducted a series of meetings with stakeholders, including meetings with representatives of large, mid-market, and small CPA firms, all with significant practices serving private companies and not-for-profit organizations.

The Working Group also met with leading members of the academic community who have reviewed and, in some cases, undertaken significant research on issues relating to private company and not-for-profit financial reporting. Representatives of the Working Group also participated in discussions with the FASB’s advisory groups, including the Financial Accounting Standards Advisory Council (FASAC), the PCFRC, the Not-for-Profit Advisory Committee (NAC), and the Small Business Advisory Committee (SBAC).

Representatives of the Working Group had meetings with lenders, investors, regulators, donors, and others. Also, the Working Group considered the content of more than 2,800 unsolicited letters, most of which made similar points in support of the Blue-Ribbon Panel’s recommendation for a separate standard-setting board for private companies.

#### **KEY CONCLUSIONS**

As a result of this outreach and their analysis of the Blue-Ribbon Panel’s report, the Trustees reached these key conclusions:

- Despite significant progress made in recent years by the FASB and the PCFRC in addressing the needs of the constituents of private company financial reporting in the standard-setting process,<sup>1</sup> their efforts stopped short of achieving all of their intended objectives. In other words, private company needs were not addressed as thoroughly or directly as had been intended.
- A new body with increased authority and scope—the Private Company Standards Improvement Council (PCSIC)—should replace the PCFRC (which would be disbanded) as part of a new structure to ensure that the needs of private companies are appropriately addressed in the standard-setting process.
- As an essential element in creating the new structure, the PCSIC, jointly with the FASB, should be responsible for developing specific criteria for determining whether and when exceptions or modifications to US GAAP for private companies are warranted. Those criteria would be subject to public comment.
- Using the new criteria, the PCSIC should develop, deliberate, and formally vote on specific exceptions or modifications to US GAAP. PCSIC meetings should be attended by all FASB members and the conclusions of PCSIC deliberations should be subject to FASB ratification. Those ratified exceptions or modifications should then be exposed for public comment. At the conclusion of the public comment process, the PCSIC should publicly redeliberate in meetings attended by the FASB the proposed exceptions or modifications, vote on final changes, and submit them to the FASB for final ratification.
- The FAF should create a special-purpose committee of Trustees, the Private Company Review Committee, to oversee the activities of the PCSIC and its interactions with the FASB during a three-year transition period. (Following the transition, that responsibility should be assumed by the FAF Standard-Setting Process Oversight Committee.)
- The Private Company Review Committee should hold both the PCSIC and the FASB accountable for achieving the objective of ensuring adequate consideration of private company issues and input in the standard-setting process. The Review Committee should be chaired by a Trustee, appointed by the Board of Trustees, who has had substantial experience with and exposure to private companies during his or her career. The Committee should include among its members Trustees who also have significant experience with private company accounting issues.
- The needs of the users of not-for-profit financial statements differ substantially from those of private company financial statements. In fact, not-for-profits have many characteristics that are more in common with publicly traded companies than with privately held companies, particularly related to the variety and diversity of their user constituents. Further, the FASB recently established an advisory group, the Not-for-Profit Advisory Committee (NAC) to consider issues specifically related to not-for-profit organizations. Accordingly, the Trustees have limited the current plan to addressing the concerns of private companies.

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<sup>1</sup>As described in detail in the appendix.

**THE “PRIVATE COMPANY STANDARDS IMPROVEMENT COUNCIL”**

Because of the outreach and analysis outlined above, the Trustees plan to establish a Private Company Standards Improvement Council (PCSIC), under the oversight of the Trustees, to improve the standard-setting process for private companies. The plan, following a period of public comment, will be subject to further discussion and deliberation by the Trustees, including consideration of comments received, before it becomes final.

***Authority and Critical Responsibilities***

The PCSIC would determine whether exceptions or modifications to US GAAP are required to address the needs of the users of private company financial statements.

In that regard, the PCSIC will have the following critical responsibilities:

- The PCSIC, jointly with the FASB, would develop a set of specific criteria to determine whether and when exceptions or modifications to US GAAP are warranted for private companies.
- Based on those criteria, the PCSIC would identify aspects of existing US GAAP that its members believe require exceptions or modifications for private companies, based on the criteria it developed.
- For those areas of US GAAP identified through this process that are not already under active reconsideration on the FASB’s technical agenda, the PCSIC would obtain input from a broad array of constituents and then deliberate and vote, in meetings attended by FASB members, on specific modifications to those standards to ensure that they meet the needs of users of private company financial statements.
- Any proposed changes to existing US GAAP would be subject to ratification by the FASB and thorough due process, including public comment.
- Following the public comment period, the PCSIC would publicly redeliberate the proposed exceptions or modifications at meetings attended by the FASB members and then vote on final changes. Changes would have to be approved by a supermajority (two-thirds) of PCSIC members. Following an affirmative vote, the final changes would be forwarded to the FASB for final ratification.
- For items under active consideration on the FASB’s technical agenda, the PCSIC would serve as the primary source of advice on appropriate treatment for private companies by working actively and closely with FASB members and staff, and providing advice for consideration by the FASB members in their deliberations. In addition, the PCSIC would have the ability to vote to take a position on the appropriate treatment for private companies related to issues under active consideration by the FASB.

***Formation and Membership***

The chairman of the PCSIC, who would be selected and appointed by the Trustees, would be a FASB member with substantial experience with and exposure to private companies during his or her career. The Trustees believe that appointing a FASB member as chairman and having FASB members attend meetings of the PCSIC would establish a strong and direct link between the two bodies and ensure that private company issues raised by the PCSIC would receive a thorough, detailed, and considered hearing by the FASB. The PCSIC chairman would be a voting member of the Council; other FASB members would not vote but would be expected to add perspective to the issues being deliberated.

The PCSIC would comprise 11 to 15 members (in addition to the chairman), including users, preparers, and practitioners who have significant experience using, preparing, and auditing (and/or compiling and reviewing) private company financial statements.

Members of the PCSIC would be selected and appointed by the Trustees. Nominations for membership on the PCSIC would be sought from a broad array of interested constituents and stakeholder groups. Members would be appointed for a three-year term and may be reappointed, based on input from the PCSIC chairman and FASB chairman, for up to two additional one-year terms (for a total of five years). Membership tenure would be staggered to assure appropriate continuity on the PCSIC.

FASB staff will be assigned to support and work closely with the PCSIC on outreach and research projects in order to leverage the FASB's resources and to avoid duplication of efforts.

***Meetings***

PCSIC would schedule meetings four to six times per year. The meetings would be held at the FASB's offices in Norwalk, Connecticut, with the intention that all FASB members would attend and participate. Participation of FASB members would facilitate their understanding of PCSIC member views and enable a more efficient ratification process.

PCSIC meetings would be webcast and open to the public, except for discussions of an administrative nature, which could be closed.

***Oversight***

The PCSIC will provide periodic in-person reports to the FAF Private Company Review Committee during its first three years of operation, as well as quarterly written reports to the full Board of Trustees. Following the three-year transition, the PCSIC will provide in-person reports to the FAF Standard-Setting Process Oversight Committee and continue to provide quarterly written reports to the full Board of Trustees.

The FAF's post-implementation review (PIR) process, as currently designed, includes engagement with and input from private companies. The PIR process will be further enhanced to include the input of the PCSIC and the post-implementation evaluation of changes made to US GAAP as a result of the PCSIC's work. The objective of this evaluation is to consider whether the resulting standards are achieving the intended objectives. In addition to this oversight, the FAF Trustees will conduct an overall assessment of the PCSIC in three years to determine whether its mission is being met and whether further changes to the standard-setting process for private companies are warranted.

### CONSIDERATIONS

In developing this proposal, the Trustees considered a range of options, including:

1. Creating an autonomous, new, and authoritative standard-setting board for private company issues, under the oversight of the FAF, as recommended by the Blue-Ribbon Panel
2. Establishing a new body, under the oversight of the FAF, to identify standards that require modification and to vote on specific proposed modifications that would then be subject to ratification by the FASB and submitted to the public for comment
3. Establishing a new committee on private company issues that would serve solely in an advisory role to the FASB
4. Continuing to monitor the FASB's existing and ongoing initiatives to better serve the needs and interests of private companies.

In deciding on the second option, the Trustees observed the following:

- Establishing two sets of US GAAP (informally described as “big GAAP” and “little GAAP”) is not a desired outcome. Creation of a separate standard-setting board would likely lead to that outcome over time.
- Concerns communicated to the Trustees about the complexity and relevance of US GAAP to private companies appear to involve a small but key group of standards. Therefore, improvements should focus on those standards first.
- The FASB should address—and is committed to addressing—complexity, relevance, and cost-benefit issues more broadly, as other constituents, in addition to private companies, have expressed similar concerns.
- The FASB has made recent, substantive changes to how it engages with private company constituents, and has demonstrated a greater operational and structural commitment to further address these issues.<sup>2</sup> The Trustees believe it is appropriate to allow a period of time for those efforts to mature and are monitoring those efforts closely.

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<sup>2</sup>As described in detail in the appendix.

- The PCFRC has not been wholly successful in achieving its mission, in part because in its early years, the FASB did not participate fully in its processes or pay sufficient attention to its recommendations. In addition, the PCFRC was not initially effective in engaging with the FASB and advocating on behalf of its constituents. Other factors contributing to the shortcomings of the partnership were: (1) the FASB and the PCFRC did not develop and agree upon a framework for considering exceptions or modifications and exceptions to US GAAP for private companies and (2) the two organizations did not integrate their administrative processes in support of their common objective. Based on their outreach and analysis, the Trustees believe that meaningful change in the standard-setting process for private companies can occur only if a common understanding of mutual objectives for the FASB and private company constituents is embedded in both the structure and processes of the FASB.

#### COMMON CONSTITUENT CONCERNS

As noted above, the Working Group in the course of its outreach efforts received significant input from users, practitioners, and preparers of private company financial statements. That input was instrumental in helping the Working Group frame and consider many of the issues discussed in this paper.

Summarized below are the issues and concerns most commonly raised by constituents in meetings with Trustees and representatives of the Working Group during the outreach process:

- While some practitioners and preparers expressed support for the formation of a separate board as recommended by the Blue-Ribbon Panel, the view was not widely held. In fact, many of those who initially spoke in support of the creation of a new authoritative board, moved away from that view after hearing concerns of others. Such concerns included the likelihood of confusion, the lack of acceptance of new standards by banks and sureties who expect to see US GAAP financial statements, the establishment of a bifurcated profession, a recognition that the formation of a new board and the promulgation of new rules would take years, and a fear that financial statements prepared in accordance to “little GAAP” would be viewed as inferior to “big GAAP” financial statements.
- Many constituents noted that “complexity” in financial reporting is, in many ways, the real problem that concerns the private company community. Complexity, however, affects all entities whether public or private, large or small. There is a general belief that the FASB does not do a sufficient job undertaking a cost-benefit analysis before issuing standards. Nor has the FASB performed systematic post-implementation reviews to determine whether the standards have achieved their goals. There is a concern that GAAP financial statements sometimes do not properly capture the economics of transactions and the standards are not “faithful to the transaction” and do not reflect the “real economic situation.” Nonetheless, there was an acknowledgement that complex financial transactions often require complex accounting.
- A number of constituents believe that the FASB historically has not been attentive to concerns of private companies. Yet, there also was a recognition that private company



constituents do not actively participate in the standard-setting process. Several participants suggested that the FASB should develop methods to more easily facilitate private company input (recognizing that preparing comment letters can be difficult and time consuming for resource-constrained enterprises).

- Despite these criticisms, most participants believe that recent changes at the FASB demonstrate a significant move in the right direction. There are concerns, however, about whether this improvement is sustainable and permanent or dependent on the current board and its interests. To address these concerns, the Trustees will continue to monitor the FASB's efforts and will hold both the FASB and the PCSIC accountable for ensuring that the concerns of private company stakeholders are addressed.
- There also is consensus that between six and ten current standards cause most, if not all, of the problems for private companies.
- When speaking with users of private company financial statements, representatives of the Working Group heard that US GAAP financial statements provide a useful and sound starting point for underwriting and investment decision making. In fact, some said that they are "critical." But, since lenders and investors have significant access to management and outside accountants, financial statements are neither the only nor the best source of information.

The Trustees also acknowledge receipt of more than 2,800 unsolicited letters, most of which made similar points in support of the Blue-Ribbon Panel's recommendation for a separate standard-setting board for private companies.

#### **REQUEST FOR COMMENTS**

The FAF Board of Trustees invites individuals and organizations to send written comments on the "Plan to Establish the Private Company Standards Improvement Council."

The Trustees request that responses from those wishing to comment on the plan be received in writing by January 14, 2012. Interested parties should submit their comments by email to [PrivateCompanyPlan@f-a-f.org](mailto:PrivateCompanyPlan@f-a-f.org). Those without email should send their comments to "Private Company Plan," FAF, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. Please do not send responses by fax.

All comments received constitute part of the FAF's public file. The FAF will make all comments publicly available by posting them to the FAF website.

An electronic copy of this plan is available on the FAF's website.

**PUBLIC ROUNDTABLE MEETINGS**

The FAF Board of Trustees plans to hold public roundtable meetings after the end of the comment period to hear the views of, and obtain information from, interested parties regarding the “Plan to Establish the Private Company Standards Improvement Council.” The Trustees plan to seek participants for the meetings that represent a wide variety of constituents (including users, preparers, auditors, and others) to ensure that it receives broad input. The schedule, location, and other details of the process for participating in these roundtables will be announced in the coming weeks by the Trustees on the FAF website ([www.accountingfoundation.org](http://www.accountingfoundation.org)).

**APPENDIX: FASB INITIATIVES TO IMPROVE THE STANDARD-SETTING PROCESS FOR PRIVATE COMPANIES**

As noted earlier, the Trustees concluded that the FASB has made considerable progress in addressing private company concerns in the standard-setting process, a view that was confirmed by many of the constituents with whom members of the Working Group spoke. Some constituents, however, were concerned that this improvement may not prove to be sustainable and permanent, depending on the composition of future boards and their members' interests. To address these concerns, the Trustees will continue to monitor the FASB's efforts and will hold both the FASB and the PCSIC accountable for ensuring that the concerns of private company stakeholders are addressed.

The following appendix outlines the manner in which the FASB is addressing private company issues:

***The FASB has increased its effort to understand and address the needs of the users and preparers of private company financial statements.***

- The FASB released an initial staff analysis (*FASB in Focus*—July 11, 2011) identifying six specific ways in which use of financial statements for private companies differs from that of public companies.
- FASB staff is working closely with its Private Company Resource Group (PCRG), a working group, to make recommendations on developing a set of criteria that will assist the FASB in deciding whether and when to adopt exceptions or modifications to US GAAP for private companies.
- While efforts to develop these criteria are proceeding, FASB staff is working to evaluate potential exceptions or modifications for private companies for the FASB's consideration, in current standard-setting projects.

***The FASB has put in place the infrastructure and processes required to develop, field test, and implement accounting standards for private companies.***

- The FASB has built a team of professionals dedicated to soliciting the input of private company stakeholders in all standard-setting projects.
- The FASB's due process incorporates feedback and opinions from these constituents.

***The FASB has been increasingly responsive to criticism of the manner in which the FASB handled private company issues in the past.***

- The FASB has established a series of roundtables during which private company stakeholders share their views directly with FASB members.
- For major standard-setting projects, the FASB has created issue-specific roundtables for private company stakeholders.
- FASB members now regularly attend meetings of the PCFRC.

- The FASB created a dedicated electronic portal to make it easier for private company stakeholders to access information that pertains to their needs.
- The FASB developed the Electronic Constituent Feedback Forum to make it easier for private company stakeholders to offer comments on the FASB proposals.
- FASB staff has developed a resource list of private company contacts that can be consulted on an ad hoc basis.
- The FASB has increased the transparency of its decision-making process on US GAAP related to private companies, including increased use of video webcasting of its meetings.

***The FASB is increasingly willing to take action on private company concerns as part of the standard-setting process. For example:***

- In response to recommendations from private company financial statement preparers, the Board completed a project (Testing Goodwill for Impairment) to reduce the cost and complexity of testing goodwill for impairment.
- In its revenue recognition project, the FASB has tentatively decided to exempt private companies from certain new disclosure requirements.
- In its financial instruments projects, the FASB has proposed a measurement exemption for nonmarketable equity securities.
- For many recent projects, the FASB instituted one-year deferrals for nonpublic entities to enable them to implement new standards more effectively and efficiently.

***The FASB has undertaken a series of new educational efforts intended to provide more information to stakeholders about their private company initiatives and issues.***

- In June 2011, the FASB held its first FASB Update webcast geared specifically to nonpublic entities—including private companies—for CPE credit and has scheduled the next semiannual webcast for December 2011.
- The FASB provides plain-English executive summaries (*FASB in Focus* documents) and brief podcasts for all new proposed and final ASUs, as well as educational webcasts for major projects.
- FASB Board and staff members participate, as presenters and panelists, in many educational conferences and meetings geared primarily toward the private company sector, at both national and local levels.

**Questions for the Hearing Record**  
**House Financial Services Capital Markets & Government**  
**Sponsored Enterprises Subcommittee**  
**“Accounting & Auditing Oversight: Pending Proposals & Emerging Issues**  
**Confronting Regulators, Standard Setters and the Economy”**  
**March 28, 2012**

**Questions for Ms. Leslie F. Seidman, Chairman, Financial Accounting Standards Board, from Congresswoman Biggert:**

1. *U.S. GAAP is a well-established, well understood, functioning set of accounting standards. However, we have been moving steadily toward adopting a set of uniform international accounting standards. Some U.S. stakeholders are concerned that converging U.S.GAAP with IFRS could have a potential accounting tax impact of \$50 billion due to changes in inventory methods and potential debt compliance issues for retailers and restaurants due to changes to lease accounting standards. What is the FASB doing to address those concerns as they continue to negotiate convergence with IFRS? Is the FASB, in light of tough economic conditions, considering the costs and benefits of changing our accounting model? If so, do these benefits outweigh the potential risks?*

The FASB’s mission is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports. That mission is accomplished through a comprehensive and independent process that encourages broad participation, objectively considers all stakeholder views, and is subject to oversight by the FAF’s Board of Trustees. We recognize the critical role that reliable financial reporting plays in supporting the efficient functioning of the capital markets. Robust financial reporting increases investor confidence, which in turn leads to better capital allocation decisions and economic growth. Accounting standards are not intended to drive behavior in a particular way; rather, they seek to present financial information so that financial statement users can make informed decisions about how to best deploy their capital.

Many stakeholders, including leaders of the G-20 nations and the SEC, have called for the FASB and the IASB to continue efforts for achieving convergence of accounting standards in key areas. On May 26, 2011, the SEC staff issued a paper titled, *Exploring a Possible Method of Incorporation under the SEC’s Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting*

*System for U.S. Issuers.* The SEC Staff Paper described an approach to incorporation colloquially referred to as “Condorsement.” The FAF Board of Trustees and the FASB Board members carefully considered the proposed approach and the comments made by U.S. stakeholders to the SEC about the approach. In November 2011, the Chairman of the FAF, on behalf of the Board of Trustees, submitted a letter to the SEC supporting an incorporation approach with some recommended modifications and clarifications intended to address the concerns that were raised by many who offered comments to the SEC staff.<sup>1</sup> The SEC is considering the decision to incorporate IFRSs into U.S. financial reporting based on the feedback it received on this specific approach as well as other information it has analyzed relating to the remaining differences between U.S. GAAP and IFRS and the use of IFRS in practice<sup>2</sup>.

The FASB continues to support the goal of developing high-quality, comparable global accounting standards, and we have been working together with the IASB to develop converged standards in several key areas that are widely acknowledged as needing improvement.<sup>3</sup> However, it is ultimately the SEC’s decision as to whether, or how, to incorporate IFRS more broadly into U.S. financial reporting.

In the area of accounting for inventory, the application of IFRS prohibits using the last-in-first-out (LIFO) inventory accounting method that is used by some entities that report under U.S. GAAP. This difference could have consequences on those U.S. entities’ income taxes if they were to adopt IFRS and change their inventory accounting method. At this time, the FASB is not considering making changes in the accounting for inventory, nor eliminating the use of the LIFO inventory method. The SEC staff has highlighted this issue in its reports to date.

The FASB is actively deliberating improvements to lease accounting standards to address the concerns expressed among many stakeholders that the current guidance does not provide transparency to lease transactions that are today recognized off-balance-sheet.

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<sup>1</sup>John J. Brennan , Letter to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, November 15, 2011. <http://www.sec.gov/comments/4-600/4600-158.pdf>.

<sup>2</sup> *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: A Comparison of U.S. GAAP and IFRS*, A Securities and Exchange Commission Staff Paper dated November 16, 2011. <http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-paper-111611-gaap.pdf>. *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: An Analysis of IFRS in Practice*, A Securities and Exchange Commission Staff Paper November 16, 2011. <http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-paper-111611-practice.pdf>.

<sup>3</sup> Based on the 2002 Norwalk Agreement and the 2006 Memorandum of Understanding (MOU) (as updated in 2008). The MOU reflects the decision by the FASB and the IASB, with concurrence of the SEC, that their resources should focus on developing converged and improved standards in those areas in U.S. GAAP and IFRS that were most in need of improvement.

Investors have told us that they routinely adjust the financial statements of companies to add the liabilities relating to operating leases. The proposal that the FASB is discussing jointly with the IASB aims to provide that important information in a consistent and unbiased way to investors—not to influence business activities in any particular way. The FASB has already decided to make numerous changes to the 2010 Exposure Draft on leasing and continues to seek input from financial statement users, preparers, auditors, and regulators as we deliberate additional issues relating to our lease accounting proposal, including cost-benefit concerns. We are aware of the concern that there could be debt covenant compliance issues caused by the proposed changes to lease accounting, specifically from the proposed requirement to recognize lease liabilities on the balance sheets of lessees. We will consider that issue as well as other implications of the proposals in our ongoing discussions.

Following those redeliberations, the FASB and the IASB will issue a revised Exposure Draft on lease accounting so that stakeholders will have another opportunity to evaluate the proposals and provide feedback. The Exposure Draft will include a specific request for additional feedback on the expected costs and benefits of the proposals.

2. ***The proposed guidance for impairments of financial instruments increases the complexity and subjectivity of the impairment calculation. How does this fit into the objective of creating well-understood and comparable financial statements? How is it an improvement to U.S. GAAP?***

We acknowledge that the estimation of credit losses is inherently subjective and requires practitioners to exercise professional judgment. As with each of our standard-setting projects, our aim is to improve U.S. GAAP through a focus on clear objectives and principles, supported by a sufficient level of implementation guidance. By focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency, we are committed to ensuring that the guidance that we are developing jointly with the IASB results in useful financial information for investors.

The impairment guidance for financial assets currently in U.S. GAAP includes several different approaches depending on the types of financial assets (for example, loans versus debt securities) and the characteristics associated with those types of financial assets (for example, financial instruments resulting from securitizations and debt securities purchased at an amount that includes a discount related to credit quality). Our stakeholders have expressed concerns to us about both the complexity of having several different impairment approaches for similar financial instruments and the timing of when credit impairment losses are recognized under these approaches. For example, the existing incurred loss impairment guidance for loans has been criticized because it delays the recognition of a loss until the loss becomes *probable* of occurring.

The goal of the impairment guidance that is being developed jointly with the IASB is to reduce some of the complexity associated with the various impairment approaches and to provide for earlier recognition of impairment losses. This approach is based on expected losses and is more forward looking than the current incurred loss guidance. Under this approach, companies would recognize losses as financial assets deteriorate on the basis of supportable information (for example, past events, current conditions, and reasonable and supportable forecasts) that is consistent with externally available information and is considered relevant in measuring the associated credit impairment allowance. We also aim to leverage existing best practices for estimating credit losses.

The FASB continues to perform extensive outreach to determine whether the proposed approach is operational; our deliberations are not complete. The FASB and the IASB are planning to issue converged Exposure Drafts in the second half of 2012 so that our stakeholders will have an opportunity to provide us with feedback on the proposal.

3. *If IFRS is fully implemented, the current proposal from the IASB states that there is only one accounting model for insurance and no distinction between life and non-life contracts. However, these insurance products are financially and economically different businesses. Are you concerned that requiring the use of the same model would result in less useful information for the users of non-life financial statements?*

We believe that there are important economic differences between some life insurance and non-life insurance products and that, accordingly, many non-life insurance contracts warrant a separate and distinct model. The FASB believes that the use of two different models best facilitates the delivery of the most relevant information to investors and other financial statement users that represents the underlying economics of different insurance products. The FASB and the IASB are discussing jointly improvements to insurance accounting. The Boards have tentatively decided on criteria that, if met, will require insurers to account for those insurance contracts under a separate accounting model. Under the tentative decisions reached to-date, we believe that most non-life insurance contracts would meet these criteria. The FASB is planning to issue an Exposure Draft later this year which will allow our stakeholders to provide feedback to us on the improvements we have made to insurance accounting. The changes to existing U.S. GAAP will be highlighted within this Exposure Draft.

4. *Much of the world is already using the U.S. GAAP reporting standards, or something very similar, for insurance accounting. For example, international companies use a combination of "local GAAP's" (e.g. UK GAAP) that is very similar to U.S. GAAP, even if not derived specifically from U.S. GAAP. These standards have been refined and developed over many years. Why not work toward improving the current GAAP accounting standards, instead of starting over and trying to develop a controversial, unproven and entirely new insurance accounting standard?*



In August 2007, the Board issued an Invitation to Comment, *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper*, Preliminary Views on Insurance Contracts, which included the IASB's Discussion Paper. Many of the comment letters in response to the Invitation to Comment expressed a strong desire for a global standard on insurance and urged the FASB to participate in the project jointly with the IASB (in their previously initiated insurance contracts project) as a means to ensure that U.S. stakeholder perspectives were adequately represented. In deciding to participate jointly with the IASB in this project, the FASB identified a number of targeted improvements that we believe would improve the transparency and informational usefulness of insurance company financial statements.

The insurance contracts proposal that we are currently developing heavily leverages many of the proven concepts already contained within U.S. GAAP. While we are discussing the proposal jointly, our starting point has been different from the IASB, since we look at how we can improve the guidance that exists currently under U.S. GAAP, and the IASB does not currently have any insurance accounting standards within IFRS. In several circumstances, the FASB and IASB have come to different conclusions on certain fundamental aspects of the proposal. As a result, it is unlikely that we will have proposals that are completely converged. The FASB is planning to issue an Exposure Draft later this year which will allow our stakeholders to provide feedback to us on the improvements we have proposed to insurance accounting. The changes to existing U.S. GAAP will be highlighted within this Exposure Draft.

5. ***Many investors have expressed concerns about replacing the U.S. GAAP accounting system; they believe the life insurance industry could become "uninvestable" if the current proposal is adopted. Has the Board considered these concerns and the possibility that the current proposal may not constitute an improvement over current accounting systems.***

The FASB proactively reaches out to investors and other user stakeholders and places significant weight on feedback that we receive from them. This ensures that financial accounting and reporting standards provide investors with the information they need to confidently invest in the U.S. markets. The FASB continues to perform extensive outreach with investors to solicit their views and understand their concerns and recommendations. In our decision-making process, we consider current key performance indicators used by investors and the effect that our decisions will have on those key performance indicators. Inevitably, different investors have different perspectives, but we continue to be responsive to feedback we receive from investors by the impact it has on our exploration of alternative solutions.

For example, we heard specific concerns from investors in the life insurance industry that were addressed through the proposals highlighted in the FASB's Discussion Paper, including limiting the number of accounting models for different insurance products; using updated assumptions in the measurement of the liability; and reflecting the entire contract, such as guarantees and options, in the financial statements. We also received feedback on the Discussion Paper from investors in the life insurance industry about the need for transparent volume information regarding insurer growth and the related obligation, the volatility created through the use of discount rates that reflect the characteristics of the liability, and accounting mismatches between the insurance liability and the financial instruments backing those liabilities. We continue to explore solutions for these concerns as we continue to discuss the proposal, including considering additional disclosures that will provide investors with the information they seek.

The FASB is planning to issue an Exposure Draft later this year which will allow our stakeholders to provide feedback to us on the improvements we have proposed to insurance accounting. The changes to existing U.S. GAAP will be highlighted within this Exposure Draft.

**Question for Ms. Leslie F. Seidman, Chairman Financial Accounting Standards Board, from Congressman Capuano:**

- 1. I would like to know how the FASB is communicating with each of the other organizations [SEC and PCAOB] on accounting standards guidance so that you have one, clear, unequivocal rule that every practitioner will be able to utilize in the same fashion.*

Members of the FASB and its staff meet with the staffs of both the SEC and the PCAOB on a quarterly basis as a way to exchange information, provide updates on current accounting standards projects and identify emerging financial reporting issues. In addition, we regularly communicate specifically about the progress we have made on our technical projects and invite the staffs of the SEC and PCAOB to participate as observers in our roundtables and working group meetings. With this coordination among the FASB, SEC and PCAOB, we have an effective and coordinated means to address any major financial reporting issue that may arise. In addition, last year, the SEC launched a Financial Reporting Series, which is a series of roundtables designed to assist in the proactive identification of risks related to, and areas for potential improvements in, the reliability and usefulness of financial information provided to investors. The FASB Chairman and the PCAOB Chairman are participants in these roundtables.

Since the banking regulators have a keen interest in U.S. GAAP financial statements as a starting point in assessing the safety and soundness of financial institutions, we also meet with them on a quarterly basis and otherwise, as appropriate.



**Statement of the Investment Company Institute and the Independent Directors Council**  
**Hearing on “Accounting and Auditing Oversight: Pending Proposals and Emerging Issues Confronting Regulators, Standard Setters and the Economy”**

**Subcommittee on Capital Markets and Government Sponsored Enterprises**  
**Committee on Financial Services**  
**United States House of Representatives**  
**March 28, 2012**

The Investment Company Institute<sup>1</sup> and the Independent Directors Council<sup>2</sup> are pleased to provide this written statement in connection with the hearing on accounting and auditing oversight to consider amending the Sarbanes-Oxley Act of 2002 to prohibit the Public Company Accounting Oversight Board (“PCAOB”) from requiring public companies to use specific auditors or require the use of different auditors on a rotating basis—commonly known as mandatory audit firm rotation.<sup>3</sup>

ICI and IDC strongly support the draft legislation.<sup>4</sup> While ICI and IDC support the PCAOB’s focus on strengthening the quality and integrity of the audit process and would

<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.98 trillion and serve over 90 million shareholders.

<sup>2</sup> IDC serves the fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC’s activities are led by a Governing Council of independent directors of ICI-member funds. There are almost 1,900 independent directors of ICI-member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

<sup>3</sup> Last August, the PCAOB published a concept release asking for views on mandatory rotation or other measures to enhance auditor independence, objectivity, and professional skepticism. Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011-06 (August 16, 2011) (“Release”). The PCAOB received over 600 comment letters on this proposal, with over 90 percent opposed to it.

<sup>4</sup> ICI and IDC submitted comment letters to the PCAOB strongly opposing a mandatory audit firm rotation. See Letter from Gregory M. Smith, Director – Fund Accounting, ICI to Mr. J. Gordon Seymour, Secretary, PCAOB, regarding Concept Release on Auditor Independence and Audit Firm Rotation; PCAOB Rulemaking Docket Matter No. 37 (Dec. 14, 2011); Letter from Dorothy A. Berry, Chair, IDC Governing

be open to considering alternative proposals, we strongly oppose mandatory audit firm rotation for investment companies (“funds”). With no empirical basis for the mandate, and in light of the negative consequences, an audit firm rotation requirement would be a costly and disruptive solution in search of a problem. Indeed, the PCAOB has not cited any concerns with respect to fund audits, nor are we aware of any, and there is no clear correlation between any audit deficiencies and a lack of auditor independence, yet such a requirement would impose unnecessary burdens on funds, diminish the quality of audits, enhance the risk that problems may be associated with the audit, and increase audit costs, all to the detriment of fund shareholders. Also, an audit firm rotation mandate would be impracticable for funds given the limited number of qualified audit firms. Finally, a mandatory audit firm rotation requirement would inappropriately marginalize the role of fund boards and their audit committees.

#### **Existing Safeguards in the Fund Industry Promote the Integrity of Fund Audits**

We firmly believe, and history has shown, that existing safeguards are more than adequate to assure the independence of auditors. In addition, the premise behind mandatory audit firm rotation—that audit deficiencies are attributable to a lack of auditor independence—is not applicable to funds. The PCAOB has not cited to any deficiencies in fund audits, nor are we aware of any such deficiencies.

The Investment Company Act of 1940 (“1940 Act”) and SEC rules have long required funds to have strong systems of controls and procedures in place to protect investors and to ensure the integrity of financial statements. The Sarbanes-Oxley Act of 2002 bolstered these protections.<sup>5</sup> In 2003, the SEC, in implementing various sections of Sarbanes-Oxley, adopted a variety of rules designed to strengthen auditor independence.<sup>6</sup> For instance, the rules expand the types of non-audit services that, if provided to an audit client, would impair an audit firm’s independence. The rules also establish a “cooling off” period before a member of the audit engagement team could work at the audit client. Most notably, though, the rules impose rotation requirements for lead audit partners and concurring review partners.

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Council, to Mr. J. Gordon Seymour, Secretary, PCAOB, regarding Concept Release on Auditor Independence and Audit Firm Rotation; PCAOB Rulemaking Docket Matter No. 37 (Dec. 14, 2011).

<sup>5</sup> We note that the SEC’s Chief Accountant recently expressed his belief that “auditor performance and the reliability of financial reporting have improved significantly in the past decade.” Speech by James L. Kroeker, SEC Chief Accountant, Remarks Before the 2011 AICPA National Conference on Current SEC and PCAOB Developments (December 5, 2011).

<sup>6</sup> See Strengthening the Commission’s Requirements Regarding Auditor Independence, SEC Release No. 33-8183 (January 28, 2003).

In adopting these reforms, the SEC worked to “strike a balance between the need to achieve a fresh look on the engagement and a need for the audit engagement team to be composed of competent accountants.”<sup>7</sup> We agree with the SEC’s balanced approach and believe that requiring the audit partner, rather than the audit firm, to rotate best promotes the twin goals of an independent audit performed by qualified and experienced auditors. For this reason, we also agree with the GAO’s conclusion that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional costs it would entail and the other reforms being implemented at the time.<sup>8</sup> More recently, in its comments on the Release, the GAO indicated that the PCAOB has not provided compelling evidence that the root cause of audit quality issues is related to a break down in auditor independence. The GAO goes on to state that even if such a link could be established, it is unclear that the problem would be prevented or mitigated by mandatory audit firm rotation.<sup>9</sup>

Moreover, fund independent directors provide a critical safeguard with regard to the fund’s auditor under the 1940 Act and the rules thereunder. Specifically, the statute requires independent directors to select the fund’s auditor.<sup>10</sup> Funds are exempt from seeking shareholder ratification for the selection of the auditor if, among other things, the fund’s board has an audit committee composed solely of independent directors. The importance of this responsibility is underscored by the fact that the selection of a fund’s auditor is one of only four responsibilities specifically assigned by the 1940 Act to independent directors.

In addition, fund independent directors are guided by their own responsibilities and duties—namely, their fiduciary duty to protect the interests of fund shareholders—to promote the integrity of fund audits. Virtually every fund’s audit committee is composed entirely of independent directors. This has been adopted as a best practice even though funds are not required to do so unless relying on certain SEC rules.<sup>11</sup> The vast majority of fund boards (97%) also have an audit committee financial expert.<sup>12</sup> This strong oversight

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<sup>7</sup> *Id.*

<sup>8</sup> See U.S. General Accounting Office, *Required Study on the Potential Effects of Mandatory Audit Firm Rotation* (November 2003) (“GAO Report”).

<sup>9</sup> See Letter from James R. Dalkin, Director – Financial Management and Assurance, GAO to the Office of the Secretary, PCAOB, regarding PCAOB Rulemaking Docket Matter 037 (December 14, 2011).

<sup>10</sup> Section 32 of the 1940 Act.

<sup>11</sup> See ICI Report of the Advisory Group on Best Practices for Fund Directors: *Enhancing a Culture of Independence and Effectiveness* (June 24, 1999).

<sup>12</sup> ICI/IDC *Overview of Fund Governance Practices, 1994-2010*.

mechanism provides ample protection and further renders an audit firm rotation requirement unnecessary.

Finally, there are a number of other incentives, such as the PCAOB's own inspection and enforcement programs, as well as the ever-present threat of litigation, that help to ensure the independence, objectivity, and professional skepticism of audit firms.

#### **Mandatory Rotation Would Likely Have Adverse Effects on Fund Audits**

An audit firm rotation requirement would likely have adverse effects on fund audits. Specifically, mandatory rotation would impose unnecessary burdens on fund boards and fund managers, diminish the quality of audits, enhance the risk that problems may be associated with the audit, and increase audit costs. We do not believe that the PCAOB fully considered the important differences between funds and operating companies with respect to a mandatory audit firm rotation and the impact that such a requirement would have on funds.<sup>13</sup>

Funds can and do change audit firms under circumstances appropriate for the particular fund, but replacing one of a fund's principal service providers is a significant undertaking and one that funds do not typically undergo without serious consideration.<sup>14</sup> First, the process of selecting a new audit firm can be burdensome to both the fund's board and the fund's manager. This process includes interviewing auditors and evaluating a significant amount of information regarding the resources, capabilities, reputation, and independence of each audit firm under consideration. Once selected, the new auditor would need to spend additional time working with the fund's manager to understand and document the fund's structure, trading strategy, operations, and internal controls to enable it to develop its initial audit plan. This process could be complicated by the extent to which fund operations are outsourced. A new audit firm's lack of familiarity with the fund also could increase the risk of problems with the audit.

The new audit firm's initial review, as well as the transition process, would be disruptive and time-consuming, and likely distract the fund manager and board from other important responsibilities. The disruption of changing audit firms would be particularly acute for fund complexes that stagger the fiscal year ends of their funds and,

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<sup>13</sup> The United States Court of Appeals for the District of Columbia recently vacated the SEC's proxy access rule, finding that with regard to the application of the rule to investment companies, the SEC had failed to address adequately whether the regulatory requirements of the 1940 Act reduce the need for, and hence the benefit from, proxy access for fund shareholders and whether the rule would impose greater costs upon investment companies by disrupting the structure of their governance. *Business Roundtable et. al v. SEC*, No. 10-1305 (D.C. Cir. Decided July 22, 2011).

<sup>14</sup> See *IDC Task Force Paper on Board Oversight of Certain Service Providers* (June 2007).

thus, are in a “continuous audit cycle.”<sup>15</sup> Moreover, the additional time and effort involved in “getting up to speed” could translate into an unnecessary increase in audit costs, which ultimately would be borne by fund shareholders.<sup>16</sup>

Another negative impact on audit quality and cost may occur by virtue of the fact that audit firms will know their client relationships will end at a set time. If an audit firm knows its relationship with a client will sunset at a predetermined time, the auditor may be more focused on looking over the horizon for its next client and less focused on the existing client’s audit. Likewise, if an audit firm knows its engagement is for only a limited period, the auditor may have less incentive to negotiate its fees. Higher audit fees would likely have a disproportionate impact on smaller fund complexes, and in particular new complexes, that struggle to compete with more established and larger fund complexes.

#### **Our Concerns are Heightened by the Limited Number of Qualified Audit Firms**

Our concerns about a mandatory audit firm rotation are heightened in the fund context due to the limited number of audit firms that are qualified—in terms of expertise and independence—to audit funds. If funds are forced to rotate audit firms and engage a firm that does not have sufficient experience and expertise in auditing fund financial statements, the impact on audit quality, risk, and cost would be that much more severe, to the detriment of fund shareholders.

Auditing fund financial statements requires specialized industry and regulatory expertise. Only a limited number of audit firms currently possess this expertise. Firms that perform fund audits typically have personnel dedicated to the asset management industry who are knowledgeable about the industry-specific accounting model required by FASB Topic 946, the special tax status afforded funds under Subchapter M of the Internal Revenue Code, and the overlay of SEC regulation imposed by the 1940 Act. In addition, because fund audits require the audit firm to test the valuation of 100 percent of a fund’s assets, the audit firm would likely need a dedicated team of valuation experts, who can value complex or thinly traded securities where market quotes are not readily available. A “deep bench” of audit partners with this expertise is oftentimes necessary for complexes with continuous audit cycles for funds with staggered fiscal years.

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<sup>15</sup> The use of staggered fiscal years is a mechanism to help manage the workflow associated with the end of each fund’s fiscal year, which includes the update to the fund’s registration statement as well as the preparation and audit of its financial statements.

<sup>16</sup> Indeed, in a study by the GAO, large audit firms estimated that, under mandatory audit firm rotation, initial year audit costs would increase by more than 20 percent over subsequent year costs because of the need to acquire the knowledge necessary to perform the audit. See GAO Report, *supra* note 8.



Moreover, the prevalence of mutual funds as investment options in 401(k) plans, including those plans offered to audit firm employees, may limit choice in hiring a new auditor. For example, if a particular fund family's funds are offered through an audit firm's 401(k) retirement plan to the audit firm's employees, then that audit firm likely would not be willing to audit those funds because of the independence issues it would raise.<sup>17</sup> While the audit firm could cause its employees (and their immediate family members) to sell their investments in the funds in order to cure the independence problem, we believe that the audit firm would be unlikely to do so because of the disruption it would cause its employees and their retirement planning. Indeed, we understand that certain audit firms have identified certain fund families which they will not audit, so as to ensure funds from these families are available to their employees for investment through the audit firm's 401(k) plan. In addition, audit firm personnel may hold investments outside of tax-deferred accounts in those funds and any forced divestment could impose significant tax consequences on the audit firm personnel.

The limited number of qualified audit firms in the fund industry is evidenced by informal ICI data, which reveal that only four accounting firms serve as auditors to 94% of funds and that these funds represent about 99% of industry assets. In addition, the remainder of the funds in the industry, which are among the smallest funds in the smallest complexes, are audited by only a handful of other accounting firms. Some believe that mandatory audit firm rotation could present an opportunity for accounting firms other than the few large audit firms to compete more effectively.<sup>18</sup> But these firms currently do not have the expertise and experience typically necessary to audit fund financial statements. Assuming that they would be able to develop this expertise is speculative and fails to take into account the significant time and resources necessary to do so.

#### **The Authority and Discretion of Fund Boards and Audit Committees Would Be Undermined by Mandatory Audit Firm Rotation**

A mandatory audit firm rotation would ignore both the important role of fund boards and their audit committees in overseeing fund audits and the unique statutory and regulatory framework for funds established by Congress in the 1940 Act and by SEC rules. We firmly believe that the PCAOB should not infringe upon this long-standing and successful framework by imposing a mandatory audit firm rotation requirement.

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<sup>17</sup> We recognize the concept of "covered person" within rule 2-01 of Regulation S-X affords employees not associated with the engagement, in the engagement office, or in the chain of command to invest in the funds. We understand, however, that audit firms may adopt more restrictive policies that prohibit *all* employees from investing in the funds.

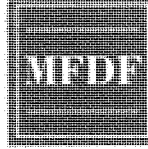
<sup>18</sup> See Release, *supra* note 3.

A primary duty of a fund board audit committee is to recommend to the board's independent directors the selection of the fund's auditor. A mandatory rotation of audit firms would undermine the authority and discretion of the committee, which works diligently to oversee the auditor and make determinations that are in the best interest of the fund and its shareholders. Determining whether to retain the fund's current auditor and, if not, the most appropriate time to replace the auditor is a decision best left to the judgment of a fund's independent directors, taking into account the particular facts and circumstances of the fund.

### **Conclusion**

ICI and IDC strongly support the proposed legislation to prohibit the PCAOB from requiring mandatory audit firm rotation. We fail to see a basis for the mandate for funds inasmuch as the PCAOB has not cited any concerns with respect to fund audits, nor are we aware of any, and there is no clear correlation between any audit deficiencies and a lack of auditor independence. We firmly believe that mandatory audit firm rotation would impose unnecessary burdens on fund boards and fund managers, diminish the quality of audits, enhance the risk that problems may be associated with the audit, and increase audit costs, all to the detriment of fund shareholders. Also, an audit firm rotation mandate would be impracticable for funds given the limited number of qualified audit firms. Finally, a mandatory audit firm rotation requirement would inappropriately marginalize the role of fund boards and their audit committees.

We appreciate your consideration of our views.



**Written Statement of the  
Mutual Fund Directors Forum**

**House Financial Services Subcommittee on  
Capital Markets and Government Sponsored Enterprises**

**March 28, 2012**

**“Accounting and Auditing Oversight:  
Pending Proposals and Emerging Issues Confronting Regulators, Standard  
Setters and the Economy”**



**MUTUAL FUND DIRECTORS FORUM**  
*The FORUM for FUND INDEPENDENT DIRECTORS*

December 13, 2011

Office of the Secretary  
 PCAOB  
 1666 K Street, NW  
 Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 37

Dear Board:

The Mutual Fund Directors Forum<sup>1</sup> (“the Forum”) welcomes the opportunity to respond to the request for comments by the PCAOB (the “Board”) on its recent concept release discussing mandatory audit firm rotation (“Concept Release”).<sup>2</sup>

The Forum, an independent, non-profit organization for investment company independent directors, is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through continuing education and other services, the Forum provides its members with opportunities to share ideas, experiences and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern. Mutual fund independent directors, particularly those independent directors who sit on audit committees, share the Board’s interest in a robust financial reporting process and good audit quality and therefore are keenly interested in how the issues discussed in the concept release will impact investment company shareholders.

\*\*\*\*

**I. Summary**

The Concept Release seeks comment on whether mandatory audit firm rotation would enhance auditor independence, objectivity and professional skepticism. Yet the release cites no empirical evidence – and the Forum is aware of none – showing that

<sup>1</sup> The Forum’s current membership includes over 650 independent directors, representing 98 independent director groups. Each member group selects a representative to serve on the Forum’s Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum’s Board of Directors, although it does not necessarily represent the views of all members in every respect.

<sup>2</sup> *Concept Release on Audit Independence and Audit Firm Rotation; Notice of Roundtable*, PCAOB Release No. 2011-006, PCAOB Rulemaking Docket Matter No. 37 (August 16, 2011).

mandatory audit firm rotation has any positive impact upon auditor independence, objectivity, and skepticism. The proposal would, however, raise costs to shareholders. The Forum sees no justification for imposing additional shareholder costs in return for speculative potential benefits.

The Forum believes that mandatory firm rotation would impair the ability of an audit committee to do its important work, a result contrary to the express purpose of recent regulatory initiatives designed to strengthen the responsibilities and independence of audit committees. Further, mandatory auditor rotation could critically damage the ability of mutual funds to obtain the high quality and specialized audit services required. In sum, the concept of mandatory audit firm rotation represents a potentially costly initiative that would reduce the choices available to fund boards for audit services without empirical evidence that it would have a positive impact on auditor independence, objectivity, and skepticism. Consequently, mandatory audit firm rotation is not in the best interests of fund shareholders and the Forum respectfully opposes the concept.

## **II. Fund Independent Directors**

Under the federal securities laws, mutual funds are overseen at two levels. At the federal level, the Securities and Exchange Commission (“SEC”) oversees and regulates the activities of funds pursuant to the Investment Company Act of 1940 (“1940 Act”). In addition, funds also have a second layer of oversight – an independent board of directors (or trustees) that oversees the management of each fund on behalf of its shareholders. Under the 1940 Act, a fund’s independent auditor must be selected each year at an in-person meeting by a majority of the fund’s independent directors. As a practical matter, the involvement of fund independent directors with the audit team is significant. For example, the Sarbanes-Oxley Act of 2002 mandates rotation of the lead and concurring audit partner every five years.<sup>3</sup> When audit partners are required to rotate off the audit engagement, the fund independent directors approve the proposed replacement audit partners.

Independent directors represent a coming together of a fund’s investors to collectively supervise their investment. Because fund independent directors have detailed knowledge of the funds they oversee, they are able to respond flexibly and quickly to the specific issues faced by their funds. The ability of fund audit committees to act in a manner best suited to the shareholders’ needs is a critical component of the statutory scheme governing funds.

## **III. Audit Committee Oversight**

Since the federal securities laws were originally enacted, regulators have focused on ensuring that a strong and engaged board, particularly the audit committee of the board, oversees the accounting and financial reporting processes of the issuer as well as the

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<sup>3</sup> Release No. 33-8183 (January 28, 2003).

independent audits of the issuer's financial statements.<sup>4</sup> In the investment company context, Section 32(a) of the 1940 Act provides that the independent auditors must be selected each fiscal year by a majority vote of the independent directors at an in-person meeting. Because virtually all fund audit committees are independent of fund management, no shareholder ratification of the board's decision is required.<sup>5</sup>

Regulators, as well as the auditing and business communities, have long sought to promote effective and independent audit committees. The consistent regulatory objective has been for the audit committee to play "a critical role in providing oversight over and serving as a check and balance on a company's financial reporting system."<sup>6</sup> For example, the Sarbanes-Oxley Act of 2002 resulted in new requirements for all listed companies related to matters such as the independence of audit committee members, the audit committee's responsibility to select and oversee the issuer's independent auditor, and funding for the independent auditor and any outside advisors engaged by the audit committee. While these Sarbanes-Oxley provisions only apply to listed companies, they have commonly been adopted by investment company audit committees.<sup>7</sup>

The purpose of these changes was to further strengthen the ability of the audit committee to provide "independent review and oversight of a company's financial reporting processes, internal controls and independent auditors."<sup>8</sup> As the SEC has noted,

By effectively carrying out its functions and responsibilities, the audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practices.<sup>9</sup>

The Sarbanes-Oxley Act also required all registered investment companies to either identify and disclose the name of at least one audit committee member who is an "audit committee financial expert," or explain why the audit committee lacks such an expert. The purpose of such a person, the SEC explained, is to serve as a resource for the audit committee in carrying out its functions.<sup>10</sup> The practical result of this disclosure obligation has been for virtually all fund audit committees to have at least one designated audit committee financial expert.

<sup>4</sup> Section 3(a)(58) of the Exchange Act (15 U.S.C. 78c(a)(58)).

<sup>5</sup> Rule 32a-4 under the 1940 Act exempts investment companies from obtaining shareholder approval of the selection of independent accountants if the fund has an audit committee composed entirely of independent directors and the audit committee has adopted a written charter.

<sup>6</sup> Release 33-8220, Standards Relating to Listed Company Audit Committees, effective date April 25, 2003.

<sup>7</sup> Robertson, *Fund Governance Legal Duties of Investment Company Directors*, section 4.04; A.B.A. Section of Bus. L., *Fund Director's Guidebook* 15-17 (2006).

<sup>8</sup> Release 33-8220.

<sup>9</sup> Release 33-8220.

<sup>10</sup> Investment Company Act Rel. No. 25775 (Oct. 22, 2002).

Several times in the past, the existence of well-functioning audit committees has been judged sufficient to encompass any perceived benefits of mandatory audit firm rotation, without the increased costs that the release notes will inevitably accompany such a regulatory move. For example, in 1978 the AICPA's "Cohen Commission" recommended against mandatory audit firm rotation, noting that the audit committee would be in the best position to determine, under the facts and circumstances of each individual company, whether a change in auditor would be appropriate.<sup>11</sup> Similarly, Congress considered, but rejected, including the requirement in the Sarbanes Oxley Act of 2002, instead determining to enhance and strengthen audit committee independence as well as require mandatory rotation of the lead and concurring audit partner ever five years.

The Sarbanes-Oxley Act also required the GAO to study the potential effects of mandatory audit firm rotation. In 2003, the GAO concluded that "mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality."<sup>12</sup> Instead, the GAO highlighted the important role that audit committees play in enhancing auditor independence and audit quality. As the GAO noted, if audit committees regularly evaluate whether audit firm rotation would be beneficial and are actively involved in helping to ensure auditor independence and audit quality, many of the intended benefits of audit firm rotation could be realized at the initiative of the audit committee.<sup>13</sup>

#### **IV. The Critical Importance of Well-Functioning Fund Audit Committees**

The relationship between a fund's audit committee and its independent auditors is critically important. The two work together to build a shared understanding of the control environment and the personnel at the firm. The relationship allows the audit committee to gain additional, independent insight into the fund's risk control environment, the internal accounting processes, and other important matters. To get the full benefit of the information flow, the independent auditor and the audit committee must have a shared trust and confidence which is developed over time.

The relationship is particularly important in the investment company context. Each year the audit committee evaluates whether to continue the engagement or to hire new independent auditors. Under the statutory scheme, the independent directors of the board are responsible for, under the unique facts and circumstances of each fund, determining whether shareholders would be served best by retaining the current outside auditors or replacing them. Requiring mandatory audit rotation would disrupt this appropriately crafted regulatory approach, which recognizes that the various and changing circumstances at each fund complex require the audit committee members to make an independent evaluation of how the audit relationship can best serve shareholders going forward.

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<sup>11</sup> The Commission on Auditors' Responsibilities, Report, Conclusions and Recommendations xi (1978) ("Cohen Commission Report") at 109.

<sup>12</sup> November 2003 report, Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation (GAO-04-216) at 8.

<sup>13</sup> Id. at 9.

Importantly, it takes time for an audit firm to become sufficiently familiar with the fund to be of optimal help to the audit committee. Mandatory audit firm rotation might well require an audit firm transition just as the audit committee has achieved an effective working relationship with the outside auditors. Such a result is not in the best interests of fund shareholders. The Concept Release provides little justification for superseding the judgment of an audit committee and independent directors of how best to manage the relationship with the independent auditor.

The Concept Release appears to be aimed at issues not relevant to investment companies. For example, the Release asks whether mandatory rotation might “dramatically reduce” what it sees as an inherent distortion of the system – the entity paying for the audit is the one creating the financial statements being audited. Yet in the investment company context, the independent directors who select the auditor are directors of the fund, and the audit fees are paid from the fund. It is the adviser or a third party whose personnel prepare the financial statements, yet those entities do not select the auditor.

**V. Mandatory Audit Firm Rotation is Not in the Best Interests of Fund Shareholders**

Question 6 of the Concept Release asks whether there are reasons for applying an audit firm rotation requirement only to companies in certain industries. Sound reasons to exempt the mutual fund industry from any audit firm rotation requirement.

**A. Few Audit Firms and a Specialized Area Mean Fewer Available Eligible Firms**

The structure and nature of investment company operations are quite different from other reporting issuers. Investment company audits require specialized knowledge, especially in the area of valuation of portfolio securities. There is a separate audit guide for investment companies, as well as unique regulatory requirements. As a result of the unique nature of the industry, fewer firms have developed expertise in auditing investment companies than those available to audit operating companies.

The problem of relatively few audit firms with the appropriate level of expertise in this area is exacerbated by the fact that some of the otherwise qualified audit firms may have a financial business relationship with the fund complex, such as lines of credit with a bank or management of the audit firm’s retirement plan, which may render the firm not independent with respect to the audit of the fund. Financial business relationships can also suddenly create independence issues when the fund complex, as part of normal business operations, develops new affiliations, merges, or in some other manner changes a portion of its business relationships. The limited universe of appropriately qualified audit firms can be particularly significant when the fund is part of a broadly diversified financial services enterprise. In such cases, consulting services provided to other portions of the enterprise can be financially much more significant than audit fees, which in turn will cause individual accounting firms to view the fund as an undesirable audit client. These factors,



combined with the relatively small size of the available pool of qualified, high quality audit firms that possess the requisite expertise to audit mutual funds, mean that mandatory firm rotation would present a significant issue for many investment companies.

#### **B. In Practice, Many Fund Complexes Use Several Audit Firms**

The Concept Release appears to suggest that one benefit of mandatory audit firm rotation would be to bring a different auditor's viewpoint to the engagement. Yet many fund complexes already engage several audit firms and thus already have the benefit of multiple viewpoints when the independent directors believe it important to do so. For example, it is not uncommon a mutual fund complex to use two audit firms to audit the funds. The independent fund directors of these complexes have determined that, for the complex they oversee, this is the best arrangement for fund shareholders. In addition, although not required under the 1940 Act, some fund audit committees have adopted the practice of using a different audit firm to audit the funds than that which audits the funds' advisor.

These practices, which are not formally required under the securities laws and regulations, have been judged by the independent directors of some fund audit committees to be in the best interests of their fund shareholders, given the unique facts and circumstances of each individual fund. However, particularly in view of the relatively limited available pool of qualified high quality audit firms with expertise in the investment company area, a requirement of mandatory audit firm rotation might well make it impossible for audit committees voluntarily to engage the services of multiple audit firms, because at the time of the mandatory firm rotation, there may well not be multiple alternative firms available that are independent. The Concept Release offers no justification for diminishing the ability of independent fund directors to make the auditor selections they deem to be in the best interests of fund shareholders.

#### **C. Individual Funds Have Various Fiscal Year Ends**

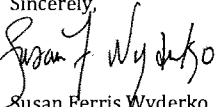
By their very nature, investment company complexes do not file a single set of quarter or year-end statements, as do other reporting entities. Instead, each fund or series of funds in an investment company complex has its own filing requirements. Different funds within a single complex often have different year-ends. Therefore, it would be difficult to identify a natural cut-off date at which it would be appropriate to change the audit firm. Rather, in a complex with many different fiscal year ends, there would need to be a period of auditor overlap. For a period of time, both audit firms would need to be in place, reviewing and testing internal controls of the fund complex. This duplication would not occur as a result of a decision by the audit committee that doing so would benefit shareholders; rather it would stem solely from an arbitrary rule. The result would be costly to shareholders and disruptive to fund management as well as to audit committee oversight of the fund's accounting and financial reporting processes.

**D. Fund Shareholders Should Not Be Financially Penalized for a Speculative Result**

The Concept Release appears to implicitly concede that the early years of an auditor-client relationship pose higher audit risks than other years.<sup>14</sup> It also admits that there is no evidence that mandatory audit firm rotation will significantly enhance auditors' objectivity and independence.<sup>15</sup> While the benefits of mandatory firm rotation are speculative, rotation would clearly increase mutual fund investors' costs as new audit personnel are brought on, and the audit committee and fund management work to establish new relationships with entirely new personnel. For mutual fund shareholders, the costs of such a requirement would appear to far outweigh the speculative goal advanced by the proposal, that theoretically, such a move would enhance auditors' objectivity. Therefore, we do not believe this result would be in the best interests of fund shareholders.

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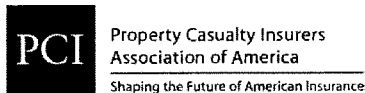
We look forward to continuing to participate in this ongoing discussion, as independent directors have an important role to play in fostering healthy audit environments. If you would like to discuss our comments further, please feel free to contact us at 202-507-4488.

Sincerely,  
  
Susan Ferris Wyderko  
Executive Director

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<sup>14</sup> Release at p. 24.

<sup>15</sup> Id. at 17.



March 27, 2012

Committee on Financial Services  
 Capital Markets and Government Sponsored Enterprises Subcommittee  
 2129 Rayburn House Office Building,  
 Washington, DC 20515

**Re: Subcommittee Hearing on "Accounting and Auditing Oversight: Pending Proposals and Emerging Issues Confronting Regulators Standard Setters and the Economy"**

Dear Chairman Garrett and Ranking Member Waters:

The Property Casualty Insurers Association of America (PCI) appreciates your oversight of the Securities Exchange Commission (SEC), International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) as they negotiate convergence of U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS). PCI represents the broadest cross-section of insurers of any national property/casualty trade association, with over 1000 members writing over \$180 billion in direct written premium annually, over 38 percent of the nation's property/casualty insurance. While PCI supports movement toward more uniform high quality global accounting standards, comprehensive adoption of IFRS for property-casualty (P/C) insurance in its current form would create needless confusion for investors and impose excessive costs and unwarranted burdens on the marketplace.

U.S. GAAP is a well-established, well understood, functioning set of accounting standards, which recognizes the fundamental differences between life and P/C insurance contracts by providing separate standards for each type of contract. However, there is pressure from the international community to move toward a set of uniform international accounting standards that provides only one standard for all types of insurance.

We have heard from U.S. stakeholders that such a "one-size-fits all" approach could have many negative impacts, including:

- Less meaningful financial results stemming from discounting requirements in IFRS that are not a part of GAAP
- Greater volatility in the financial reports resulting from the internationally-proposed discounting requirements, which would lead analysts to seek to "unwind" the discounting to get a clearer picture from a U.S. accounting perspective
- Costly system changes for insurers, which would not help consumers or investors.

While greater international convergence is a worthy goal, the US must be vigilant to resist international requirements that are ill-suited to the US marketplace and that will therefore be unhelpful to US consumers and investors and costly to US insurers.

We note that a study conducted last year by the SEC indicated that, among those countries currently using IFRS, local differences are allowed. The current convergence discussions must similarly accommodate local differences in order to avoid the negative results noted above.

2600 South River Road, Des Plaines, IL 60018 Telephone 847-297-7800 Facsimile 847-297-5064 [www.pciaa.net](http://www.pciaa.net)  
 444 North Capitol Street NW, Suite 801, Washington, D.C. 20001 Telephone 202-639-0490 Facsimile 202-639-0494 [www.pciaa.net](http://www.pciaa.net)

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PCI appreciates the openness of FASB in continuing to recognize the need for distinct treatment of life and P/C insurance and encourage it to maintain existing U.S. GAAP accounting treatment for P/C insurers. We encourage the Subcommittee to support FASB's strong work in this area.

Please feel free to contact James Olsen with any questions at 847-553-3664 or via email at [james.olsen@pciaa.net](mailto:james.olsen@pciaa.net)

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**Blue-Ribbon Panel on Standard Setting  
for Private Companies**

**Report to the Board of Trustees of the  
Financial Accounting Foundation**

**January 2011**

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**BLUE-RIBBON PANEL (BRP) ON STANDARD SETTING FOR PRIVATE COMPANIES****I. EXECUTIVE SUMMARY**

In December 2009, the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF), the parent organization of the Financial Accounting Standards Board (FASB), and the National Association of State Boards of Accountancy (NASBA) established a “blue-ribbon” panel (the Panel or BRP) to address how accounting standards can best meet the needs of users of U.S. private company financial statements.<sup>1</sup> The Panel was charged with providing recommendations on the future of standard setting for private companies to the FAF Board of Trustees (the Trustees). (See Appendices A and B for additional information about the Panel and the conduct of its work.) This report represents the culmination of the Panel’s work and includes its members’ recommendations to the Trustees.<sup>2</sup>

The Panel has concluded that there are urgent and growing systemic issues that need to be addressed in the current system of U.S. accounting standard setting. The Panel members believe that the system has not done a sufficient job of (a) understanding the information that users of private company financial statements consider decision-useful and how those information needs differ from those of users of public company financial statements and of (b) weighing the costs and benefits of GAAP for use in private company financial reporting. These issues have caused a lack of relevance of a number of accounting standards for many users of private company financial statements and an overall level of complexity in U.S. GAAP that continues to concern preparers of private company financial statements and their CPA practitioners. Some members believe that GAAP is overly complex for public companies, too. Many Panel members believe that within the U.S. marketplace, significant, unnecessary cost is being incurred for GAAP financial statement preparation and audit, review, or compilation services. Thus, change is urgently needed.

This report proposes major and other enhancements aimed at fostering an accounting standard-setting system that would seek to maintain a high degree of financial reporting comparability for business entities, regardless of capital structure, but also significantly increase the chances of effecting potential differences, where warranted, in measurement, recognition, and presentation, and not just disclosure. The Panel believes that, at least in the near term, the system should focus on making exceptions and modifications to U.S. GAAP for private companies that better respond to the needs of the private company sector rather than move toward a separate, self-contained GAAP for private companies or a wholesale reorganization of GAAP.

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<sup>1</sup>While some stakeholders had suggested that the Panel’s work include private-sector not-for-profit entities (NPEs) as well, the Panel has limited its work to private for-profit companies. The Panel acknowledges that many NPEs have a much broader and somewhat different set of users of their GAAP financial statements, either directly or indirectly (through the IRS’s Form 990), than do many private companies.

<sup>2</sup>As noted in Appendix A, the Panel or BRP comprises 18 members (including 1 nonvoting member) but also benefited from input from several nonvoting participating observers. References in this report to Panel conclusions and recommendations should be interpreted as those of its voting members rather than its participating observers. The BRP acknowledges that on January 14, 2011, the FAF announced the appointment of Daryl Buck to the FASB for a term beginning February 28, 2011. In light of this announcement, Mr. Buck resigned as a member of the BRP on January 17, 2011, and did not participate in the final vote.

One major enhancement, supported by a supermajority of Panel members, is to establish, under the FAF's oversight, a separate private company standards board to help ensure that appropriate and sufficient exceptions and modifications are made, for both new and existing standards. That new board would work closely with the FASB to achieve a coordinated and efficient standard-setting process but would have final authority over such exceptions and modifications. A comprehensive review of the new board would be conducted in three-to-five years to evaluate its effectiveness and determine whether to maintain it as is, make additional process improvements, or sunset it.

Another major enhancement, supported by all Panel members, is to create a differential framework (set of decision criteria) to facilitate a standard setter's ability to make appropriate, justifiable exceptions and modifications.

The Panel is also recommending certain short-term and transitional actions by the FAF and the FASB to provide near-term relief for private companies and help ensure a smooth transition to a new board.

These recommendations were developed after examining a full range of options that included everything from maintaining the status quo to developing an entire new set of standards for private companies. In making the recommendation for a new board, the Panel has considered the actions currently under way by the FASB to help improve the standard-setting process for private companies (including those described in Appendix F), along with the recommended short-term and transitional actions. A supermajority of the Panel believes that these actions do not remove the need or the urgency for a new standards board for private companies.

Section II of this report contains the Panel's principal recommendations of a U.S. GAAP model with exceptions and modifications for private companies and a separate private company accounting standards board to set those exceptions and modifications. Section III describes the problems that the Panel has identified in the current standard-setting system. Section IV describes why the Panel believes its recommendations will best address the problems identified. Section V contains the recommendations that the Panel believes are important in helping transition to and otherwise achieving the recommended model and structure. Section VI captures alternative views held by a small minority of the Panel members.

We urge the Trustees of the FAF to consider carefully and act upon each of the recommendations of the BRP, and we thank the FAF, the AICPA, and the NASBA for requesting us to consider this important issue.



## II. BRP RECOMMENDATIONS ON STANDARD-SETTING MODEL AND STRUCTURE

- **GAAP with exceptions and modifications for private companies (with process enhancements)**
- **Separate private company accounting standards board**

The BRP recommends a U.S. GAAP model with exceptions and modifications for private companies, with process enhancements. A supermajority of BRP members further recommend that a separate private company standard-setting board under the FAF be established to ensure that those enhancements are made and result in appropriate and sufficient exceptions and modifications for private companies.

### A. RECOMMENDED MODEL

#### **U.S. GAAP with Exceptions and Modifications for Private Companies (with Process Enhancements)**

The BRP recommends that accounting standards for private companies be based on existing U.S. GAAP (The *FASB Accounting Standards Codification*<sup>TM</sup>) but with exceptions and modifications that would result in financial statements that provide relevant, decision-useful information that meets the needs of users of private company financial statements in a cost-effective manner. Private company accounting standards under this model would be based on existing U.S. GAAP modified as necessary in the standard-setting process. This model contemplates the continued use of U.S. GAAP for public and private companies, with exceptions and modifications made for private companies. The BRP believes that appropriate modifications and exceptions to existing GAAP should be made to better meet the needs of users of private company financial information. This could result in different measurement, disclosure, presentation, and recognition standards for private companies, but the modifications and exceptions would have to be justified using a differential framework (set of decision criteria) and not created just for the sake of having differences.

A cost-benefit analysis would be performed to take into account the costs to prepare, report on, and use the financial statements. The benefit side of the equation would consider whether or not users would be able to make appropriate decisions with the information provided and whether those users have access to management to obtain additional information. In other words, is the information in the financial statements relevant and necessary, and can additional information be made available to such users, if needed? The BRP understands that the cost-benefit analysis can sometimes be subjective in nature because of the difficulty in estimating the monetary consequences of omitting information in the financial statements or having one measurement attribute versus another.

Another important aspect of the BRP recommendations is the creation of a differential framework to enable the private company accounting standard-setting board to evaluate whether exceptions or modifications are needed for private companies. The BRP envisions the framework

functioning as a guide to evaluate whether differences would be appropriate, rather than as an entirely new foundation from which to develop a separate body of GAAP for private companies. The BRP considers this framework, and the willingness to interpret the framework to create differences, to be essential to the successful implementation of this model. Historically, standards have been established with differential reporting for private companies without defining what should constitute a difference. This lack of a differential framework has contributed to the current private company concerns about relevance, complexity, and costs.

## **B. RECOMMENDED STRUCTURE**

### **Separate Private Company Accounting Standards Board**

To complement the model, a supermajority of BRP members recommend that the FAF create a separate accounting standards board (hereinafter referred to as “new board”) with the ultimate standard-setting authority to determine and set exceptions and modifications in GAAP for private companies. The paragraphs below highlight some of the key features that the Panel recommends for the new board. Additional detail is provided in the chart in Appendix C.

#### New Board Mission and Process

As stated earlier, the new board’s mission would be to establish appropriate exceptions and modifications to GAAP for private companies, while helping to ensure that users of private company financial reports receive decision-useful information. The new board would monitor the activities and deliberations of the FASB and work alongside the FASB as necessary to ensure that differences in GAAP for private companies, where warranted, are promulgated efficiently and effectively. The BRP believes the FASB, working with the new board, should try to develop the best possible standards for all entities. The differential framework, as discussed above, will help in determining whether differences in GAAP for private companies are warranted.

Either the new board or the FASB could promulgate differences depending on the circumstances of the topic. However, the Panel members believe it is critical that all differences reside in the one GAAP codification. For example, the FASB likely would not attempt to promulgate a difference on an existing GAAP standard that is not on its project agenda, and thus the task would be handled by the new board, which would initiate its own project. If a topic is on the FASB’s agenda, the FASB might promulgate a difference (with the support of the new board) or the new board might promulgate a difference if the FASB believes such a difference is unwarranted.

Regardless of how the boards choose to operationalize the promulgation of differences on a facts-and-circumstances basis, the Panel believes that the ultimate authority to approve the exceptions and modifications should reside with the new board. The new board could also initiate its own projects as deemed necessary.

#### Other Specifics on Board Recommendation

The new board would consist of members that are representative of the private company sector and would work closely with the FASB. The new board would have the responsibility to

conduct outreach to private company stakeholders and provide input and feedback to the FASB. Nothing would preclude the FASB from receiving input from private companies, but the specific responsibility for seeking such input would reside with the new board. The FASB and new board would each have official observers at their respective meetings to maintain effective two-way communication. (The FAF could further solidify this coordination by having the primary advisory board to the new board also advise the FASB on private company matters.) Much of the cost for the new board and staff would likely require funding by a viable, new source, such as mandatory annual or one-time (endowment) contributions from stakeholders.

#### **Comprehensive Review of the New Board**

The BRP believes that the FAF's oversight and governance should include a comprehensive review of the new board after three-to-five years. This comprehensive review should evaluate the effectiveness of the board and determine whether to maintain the board as is, make additional process improvements, or sunset the board. The FAF's review should include but not be limited to the following qualitative and quantitative measures:

- A survey to collect qualitative information from private-company-sector stakeholders, such as, but not limited to, financial statement users' concerns about relevance and complexity and preparers' and practitioners' concerns about complexity and cost-benefit. A baseline survey could be taken in the near future, and subsequent surveys would be compared with the results of the baseline survey.
- To the extent the information can be obtained, obtain quantitative information on the prevalence of (1) audit/review/compilation reports with GAAP exceptions and (2) Other Comprehensive Basis of Accounting (OCBOA) financial statements. Information obtained in subsequent years would then be compared to such baseline information.

Additionally, the BRP believes that the FAF's recently initiated post-implementation assessment of FASB and GASB standards also should apply to significant differences in GAAP that the new board may approve for private companies. Such reviews would be crucial in assessing how well the two-board system is functioning and also help assist the FAF in determining the next stage of evolution in standard setting for private companies as described below.

The BRP believes that the recommendations on the model and structure described above are the best solution to the problems in the current standard-setting system for private companies that are discussed in the following section. Section IV of the report provides the BRP's primary reasons for this belief.

### III. WHAT THE RECOMMENDATIONS ARE ADDRESSING—THE PROBLEM STATEMENT

There are approximately 28 million private companies in the United States.<sup>3</sup> Many are very small businesses that have no reporting requirements other than filing income tax returns. However, a significant number of private companies are required to prepare GAAP financial statements by lenders, bonding companies, regulators, and others, in addition to the approximately 14,000 public companies, which have SEC reporting requirements. Most of the private companies preparing GAAP financial statements do not have the accounting resources that public companies have, especially larger public companies.

The BRP has concluded that the current U.S. accounting standard-setting process has systemic issues, involving (a) an insufficient understanding of the needs of users of private company financial statements and (b) an insufficient weighing of the costs and benefits of GAAP for use in private company financial reporting. These issues have caused a lack of relevance of a number of accounting standards—for example, those on variable interest entities, uncertain tax positions, fair value measurements, and goodwill impairment—for many users of private company financial statements. Since it also appears that the least relevant standards for private company users are often the most complex, the BRP believes that private companies are incurring significant unnecessary cost for GAAP financial statement preparation and audit, review, or compilation services. Indeed, the increase in costs to provide potentially irrelevant information has led to more users who are willing to accept qualified opinions—a development that calls into question whether those aspects of GAAP are truly “generally accepted.” These increasing instances of nonacceptance, coupled with a concern about the overall complexity of GAAP expressed by many private company preparers and their CPA practitioners—a concern that some BRP members have noted extends to public companies as well—have led the BRP to conclude that, at a minimum, the current accounting standard-setting system needs to be improved to better address the needs of users of private company financial statements in a cost-effective manner.

Based on both the FASB’s history and the competing standard-setting pressures on the FASB that are emanating from the public company sector, including those related to the FASB’s joint projects with the International Accounting Standards Board (IASB), a supermajority of BRP members believe that the FASB will not be able to fully assess and respond sufficiently and appropriately to the needs of the private company sector.

In arriving at these conclusions, the BRP has considered:

- Previous studies

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<sup>3</sup>This number is based on the U.S. Census Bureau’s *Nonemployer Statistics: 2008* report (21.4 million nonemployer establishments) and *2008 County Business Patterns* report (7.0 million employer establishments, excluding not-for-profit and government establishments, and the approximately 14,000 public companies). Only businesses that are subject to federal income tax are included in the *Nonemployer Statistics: 2008* report. Accordingly, most not-for-profit entities are excluded from that figure, except those that are not exempt from federal income tax.

- The experience of the Private Company Financial Reporting Committee (PCFRC), as described primarily by the current PCFRC chair and a former PCFRC member, who serve as a participating observer and a BRP member,<sup>4</sup> respectively
- The FASB's activities historically
- The growing use of reports with GAAP exceptions and the availability of IFRS for Small and Medium-sized Entities (SMEs)
- Individual BRP members' perspectives (generally representing their constituent organizations) about the current system
- Feedback received through written public submissions
- The experience of international standard setters who have addressed similar issues.

### **PREVIOUS STUDIES**

BRP members were given an overview of the numerous studies, reports, and recommendations on private company accounting that have been prepared over the last 40 years. (A full list of those studies and reports is contained in Appendix D.) Most of the older studies were practitioner-driven. The last time that the FASB formally researched the needs of private companies was in 1983. Since that time, the number of standards that have been issued by the FASB (now included in the Accounting Standards Codification) has increased greatly. Some private company constituencies have said that some of the more recently issued standards have shown little to no relevance to their users coupled with an overall increase in complexity of those standards. Two of the more noteworthy reports were the Wheat and Castellano Reports.

### **The Wheat and Castellano Reports, Conclusions, and Associated Activities**

In 1971, the AICPA conducted a study (Study) that had a significant effect on the standard-setting process in the United States and produced what was called the Wheat Report. The Study was charged with examining the process and means by which accounting principles were established in the United States and providing recommendations for improvement. At that time, accounting standards were being established by the Accounting Principles Board (APB), a senior committee within the AICPA. The Study recommended the creation of the FAF and the FASB. The FAF would oversee the FASB, hence replacing the APB. The FASB would be an independent body with a full-time board and research staff. The Study reached this conclusion after reviewing and addressing the independence of the current APB board and the benefits and costs of having a part-time board. (Appendix E provides current information about how the FASB is constituted, operates, and is overseen by the FAF.)

After the creation of the FASB, there were a number of other studies (as listed in Appendix D) conducted that were generally focused in part on what the accounting profession calls "standards overload." The most recent study on private company accounting was done in 2005 by an AICPA task force, which produced what is referred to as the Castellano Report.

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<sup>4</sup>Daryl Buck was a PCFRC member from 2007 to 2009. The BRP acknowledges that on January 14, 2011, the FAF announced the appointment of Mr. Buck to the FASB for a term beginning February 28, 2011. In light of this announcement, Mr. Buck resigned as a member of the BRP on January 17, 2011, and did not participate in the final vote.

The AICPA formed the Private Company Financial Reporting Task Force (the Task Force) to conduct research to determine whether private company GAAP financial statements were meeting the needs of their users and whether the cost of providing GAAP financial statements was justified compared to the benefits of doing so. On the basis of the research performed, the Task Force concluded that the users of private company financial statements have different needs than users of public company financial statements, that GAAP exceptions and OCBOA should not be the resolution to the private company financial reporting problems, and that fundamental changes should be made to the current standard-setting process.

The Castellano Report was presented to the FAF Trustees in 2006. The FASB responded by issuing an Invitation to Comment, *Enhancing the Financial Accounting and Reporting Standard Setting for Private Companies*, and subsequently forming the PCFRC in 2007 and adding a staff member with extensive experience in the private company sector. That individual's role was to work with the PCFRC, otherwise liaise with the sector, educate the FASB Board and staff about private company issues, and offer alternatives for private companies during the standard-setting process.<sup>5</sup>

Because of the extensiveness of the research conducted in connection with the Castellano Report, and because the BRP's ensuing discussions and the responses contained in the written public submissions were generally consistent with the Castellano Report's findings, most BRP members do not believe that additional formal research is needed at this time.

#### **THE PCFRC AND FASB ACTIVITIES SINCE 2007**

The PCFRC began its work in 2007. By its charter, the PCFRC consists of a chair who is a part-time employee of the FASB, four users of private company financial statements (currently two commercial bank lenders, a surety, and a venture capitalist), four preparers of private company financial statements (current members represent companies with annual revenues ranging from \$25 million to \$1 billion), and four CPA practitioners (who have been from small to mid-size firms). Since very small private companies generally rely on their CPA firms to assist with the preparation of financial statements in accordance with GAAP, the CPA practitioners are seen as representing the smaller companies.

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<sup>5</sup>These changes built upon the FASB's creation of a Small Business Advisory Committee (SBAC) in 2004. Stakeholders viewed the SBAC as an important step forward in the standard-setting process, helping to put the Board more in touch with the concerns of smaller businesses, both public and private. However, some stakeholders also felt that the SBAC did not provide sufficient input for the Board to comprehensively address private company concerns.

Over the years, the SBAC has played a valuable role in providing strategic and other advice to the FASB about its standard-setting process and proposed and existing standards, as they pertain to small businesses, both public and private. In discussing standard setting for private companies, its members have noted that the informational needs of private company users are often different from those of public company investors and that those differences should be considered by the FASB throughout its projects. Its members have also called upon the FASB to continue to improve the Board's outreach to the private company sector throughout the standard-setting process.

The PCFRC's mission is to provide recommendations that will help the Board determine whether there should be differences in prospective and existing accounting standards for private companies. The PCFRC meets four to five times per year to evaluate existing and proposed standards from a private company perspective to develop positions for their recommendation letters. Consistent with the FASB's open due process, the PCFRC's meetings are open to the public. Beginning in April 2010, Board members began attending the PCFRC meetings on a rotating basis, allowing for better two-way communication.

The FASB addresses the PCFRC's recommendations and is supposed to articulate within the basis for conclusions section of standard-setting documents (both Exposure Drafts and final Accounting Standards Updates) the basis for its decisions on whether differences should exist for private companies.<sup>6</sup> Although the Board considers the recommendations received from the PCFRC, it has not always documented in the basis for conclusions why it did not agree with the PCFRC's recommendations.

Over time, internal changes have been made at the FASB to better focus on private company issues. In June 2009, an assistant staff director was named to oversee all nonpublic entity (private company and not-for-profit organization) issues. The BRP also notes that all recent Exposure Drafts have directly posed questions about how a proposed standard would affect nonpublic entities.<sup>7</sup>

The PCFRC has submitted approximately 40 recommendation letters since its formation in 2007. The Board, considering PCFRC input along with input from other sources, has made various modifications to standards, generally involving different effective dates for private companies and in some cases different disclosures. These changes notwithstanding, the PCFRC chair has indicated that many stakeholders in the private company sector have seen the PCFRC's work with the FASB as not being wholly successful because the FASB has not also shown a willingness to consider carefully and approve, where appropriate, the possibility of measurement, recognition, or presentation differences. (This message was echoed in the written public submissions.)

#### **GROWING USE OF REPORTS WITH GAAP EXCEPTIONS AND AVAILABILITY OF IFRS FOR SMEs**

Unlike other countries around the world, the United States has no statutory requirement for private companies, other than certain regulated companies such as financial institutions,<sup>8</sup> to prepare GAAP financial statements. Under current practice in the United States, private companies may report under U.S. GAAP or OCBOA (usually cash or income tax basis). Because the AICPA now recognizes the IASB as an authoritative standard setter, in many instances private companies (other than financial institutions) may also report under IFRS or IFRS for

<sup>6</sup>This requirement was articulated in the Invitation to Comment that preceded the PCFRC's formation (see p. 8).

<sup>7</sup>In recent months, the FASB has continued to make various changes to its processes concerning nonpublic entities, including transferring additional staff to specifically work in that area. These changes are described in Appendix F.

<sup>8</sup>Federal law requires accounting principles applicable to reports or statements required to be filed with the federal financial institution regulators by insured depository institutions and credit unions to be uniform and consistent with GAAP.

SMEs,<sup>9</sup> although thus far there do not appear to be many private companies that have chosen this option.

Because of the lack of relevance, and the complexity, surrounding some GAAP standards, notably accounting for variable interest entities (formerly FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, as recently amended by FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*), many private companies have opted to receive qualified or except-for opinions. Lender and CPA-practitioner members of the BRP have reported that they have seen an increase in the acceptance of such reports from private companies, mainly because application of some standards does not produce relevant information for lenders and is costly to prepare and audit, review, or compile. Some would respond that this is not necessarily a problem, as users of private company financial statements accept them. However, it does raise concerns about potentially reaching a point at which the frequency of exceptions undermines the very idea of “generally accepted.” In addition, many loan covenants for larger private companies require GAAP financial statements and these companies typically do not have the option of taking exceptions or using OCBOA.

#### **INDIVIDUAL BRP MEMBER PERSPECTIVES**

At its first meeting, the BRP heard from its members who are users of private company financial statements. Users of private company financial statements primarily include lenders, other creditors, bonding and credit-rating agencies, regulators, and business owners. While the specific informational needs varied among users, they told the BRP that they liked the “gold standard” of GAAP, for consistency, comparability, and related assurance. According to these members, most users focus heavily on cash flow measures, adjust the financial statements to meet their end needs, and do not make decisions on the basis of the financial statements alone. Users almost always require additional information when making decisions to lend, invest, or bond, and many users have access to management to obtain that information. (This contrasts to the lack of direct access to management for certain users of public company financial statements under the SEC’s Regulation FD.) These members stated that certain GAAP standards are complex, and that most companies, especially smaller ones, need outside CPA assistance to comply. They also noted that more recently, companies seem to be taking more exceptions to GAAP because certain information is not relevant. These users stated that while comparability is certainly important to them, they would not oppose differences in GAAP for private companies, perhaps even a separate standalone set of U.S. GAAP along the lines of IFRS for SMEs or Canadian GAAP for Private Enterprises, if that would spur more companies to move from OCBOA to GAAP financial statements. However, some BRP members observed that the call for change did not seem to be coming, in any widespread way, from the user community and that the users of private company financial statements are accustomed to adjusting financial statements to make the financial statements more useful for their end needs.

At the second meeting, preparers and practitioners agreed that there are broad-based concerns about the current standard-setting system. They stated that private company issues have not been

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<sup>9</sup>IFRS for SMEs specifically preclude all financial institutions, including those that are privately held, from using these standards.



heard or fully considered by the FASB, and that the FASB has not made sufficient exceptions or modifications for private companies in measurement and recognition, as well as disclosure. As a result, those preparers and practitioners indicated that standard setting seems to be driven to a large degree by public company financial statement user needs and often tends to be more relevant to some of the users in that sector (especially equity investors) than it does to many users in the private company sector.

At later meetings of the BRP, the word *relevance* was frequently used when speaking about accounting standards. Most BRP members agreed that too many GAAP requirements were not relevant to some users of private company financial statements and that the benefits of complying with certain standards did not justify the costs. The BRP noted that change would not be driven by private company financial statement users. Rather, the users would likely accept differences in GAAP for private companies, since some GAAP pronouncements are not useful or relevant to providing appropriate understanding or analysis of the entity's relative financial position.

#### **FEEDBACK FROM PUBLIC SUBMISSIONS**

The BRP published a set of questions on August 5, 2010, requesting written input from the public. Appendix G to this report contains the questions asked, a list of respondents, and a full summary of the responses received. Many CPA practitioners and preparers responded but few users submitted responses.

The common issues and concerns cited by respondents were:

- Private company financial statements often lack relevance to users.
- Standards have become increasingly complex.
- The pace of the standard-setting process has increased.
- Costs often exceed benefits.
- There has been an increase in qualified opinions and use of OCBOA where possible.

The general thrust of the written responses did not differ from the general thrust of comments made by most BRP members, with many respondents indicating that there were systemic issues with the standard-setting process. The largest firms, however, generally recommended attacking the issue of complexity through simplification efforts for all entities, both public and private, especially until the SEC makes a decision about whether to incorporate IFRS into the financial reporting system for public companies. While supporting one set of high-quality standards for all public and private companies in the United States, the Federal financial institution regulators<sup>10</sup> recognized that accounting standards need to address the circumstances and needs of all financial statements users, for both public and private companies. In their written response to the Panel, the regulators recommended that the standard setters include more small-firm and private company representation on a single board and incorporate practical expedients, wherever

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<sup>10</sup>The U.S. federal financial institution regulatory agencies as a group is a participating observer on the Panel, but is not a member of the Panel.

possible, that would allow the standards to be implemented by all companies in a cost-effective manner.

#### **THE INTERNATIONAL EXPERIENCE**

The Panel consulted standard setters outside the United States to learn what is being done for private companies as their public companies adopt IFRS. Most standard setters have come to believe that one size does not fit all when it comes to accounting standards and that there needs to be significant differences for private company reporting:

- A number of countries around the world have adopted IFRS for SMEs. Most of these countries have universal or widespread statutory reporting requirements for all companies, public and private, which in part drove the initiative for the SME project.
- The U.K. is planning to adopt IFRS for SMEs for use by its private companies and, for now, to continue to allow very small private companies to use its Financial Reporting Standard for Smaller Entities (FRSSE) standards.
- Canada has taken a “made in Canada” approach by simplifying existing Canadian GAAP and creating a standalone set of accounting standards for private enterprises. It has an advisory board to the Canadian Accounting Standards Board, which will propose updates and changes, but the ultimate authority to change accounting standards for private enterprises remains with the Canadian Accounting Standards Board. Going forward, changes to IFRSs will be examined to determine whether similar changes should also be made to the accounting standards for private enterprises. This does not mean that the private enterprise standards are on a path to converge with IFRSs for SMEs. The private enterprise standards are a long-term solution focused on the needs of the private enterprise marketplace and will exist as long as the marketplace finds them useful.

#### **BRP CONCLUSIONS**

After considering prior studies, the PCFRC’s experience, trends in the marketplace, the perspectives of BRP members, the public written submissions, and the experience of international standard setters, the BRP believes that significant change is needed in the system of setting accounting standards for private companies to address the issues underlying the lack of relevance of a number of GAAP standards for many users of private company GAAP financial statements and the complexity of GAAP for private companies. Some of the BRP members acknowledge that some of the complexity concerns extend to public companies and that some of the relevance concerns extend to some users of public company GAAP financial statements; however, the BRP’s focus is on providing recommendations that are within its purview—the accounting standard-setting system as it pertains to private companies. The BRP believes that the recommendations in Sections II and V are in the best interest of users of private company financial statements and will sufficiently address the systemic issues in a cost-effective manner.

#### IV. WHY THE BRP'S RECOMMENDATIONS BEST ADDRESS THE PROBLEMS

To develop its best recommendations for addressing the systemic issues described in Section III, the BRP considered various models and structures as alternatives to the current standard-setting process. The individual models and structures contemplated what would be in the best interests of the private company sector in the United States, that is, the process and product that would best facilitate financial reporting to meet the needs of users of private company financial statements in a manner that is cost-effective for private company preparers, practitioners, users, and others in the financial system. The models and structures, which are further detailed in Appendix H, describe an end-state process, taking into account that there might be certain short-term and long-term actions that would need to occur to achieve a particular model or structure.

This section provides a brief overview of the models and the structures considered and explains why a U.S. GAAP model with exceptions and modifications for private companies and a separate private company standard-setting board are the best recommendations to address the problems noted in Section III of the report.

#### OVERVIEW OF MODELS AND STRUCTURES

The BRP initially debated the following models:

##### U.S. GAAP Models

- **U.S. GAAP with Exceptions and Modifications for Private Companies—current system**
- **U.S. GAAP with Exceptions and Modifications for Private Companies—with process enhancements**
- **Baseline U.S. GAAP with Add-ons for Public Companies**
- **Separate, Standalone U.S. GAAP for Private Companies Derived from Current U.S. GAAP (the “Canadian” Approach)**
- **Separate, Standalone U.S. GAAP for Private Companies Developed from the Ground up Based on Robust Private Company Framework**

##### IFRS Models

- **IFRS for SMEs as Issued by the IASB**
- **IFRS for SMEs Customized (“Americanized”) for U.S. Private Companies**

These models were viewed as two continua, one based on U.S. GAAP and another based on IFRS. Within each continuum, the change necessary to achieve such models gradually increased with respect to current standards and the standard-setting system. In all the U.S. GAAP-based models except the current system model, the creation of some sort of underlying, standard-setting framework for private companies was viewed as a near-term necessity. The private company framework in the respective models ranged from a differential framework to a separate, ground-up framework. The IFRS-based models already have an underlying set of decision criteria (“Concepts and Pervasive Principles”) created by the IASB.

The Panel rejected four of the models during its initial deliberations:

- U.S. GAAP with Exceptions and Modifications for Private Companies—current system
- Separate, Standalone GAAP for Private Companies Developed from the Ground up Based on Robust Private Company Framework
- IFRS for SMEs as Issued by the IASB
- IFRS for SMEs Customized (“Americanized”) for U.S. Private Companies.

In general, these models were rejected because that BRP felt that:

- The status quo is unacceptable.
- Separate, standalone GAAP created from the ground up could take a significant amount of time to create and could be significantly different from current U.S. GAAP.
- U.S. private companies should not be leading the charge, *en masse*, to an IFRS-based set of standards before the SEC makes a decision on U.S. public companies, especially given the extent of change management efforts that private company stakeholders might have to undertake.

The remaining three models were refined for further deliberations. Two of the models contemplated two structural variations, one featuring a restructured FASB and the other featuring a separate private company board. Because of the nature of the baseline model, only a version with a single standard-setting board for both public and private companies (a restructured FASB) is feasible and was considered.<sup>11</sup>

The baseline U.S. GAAP with add-ons for public companies and the separate, standalone GAAP for private companies derived from current U.S. GAAP were not supported by the majority of the BRP members. However, most members believed a baseline or a separate private company GAAP (based on current U.S. GAAP) could be in the best, long-term interest of users of U.S. private companies’ financial statements within the broader context of the overall U.S. financial reporting system. Under a baseline GAAP model, the “burden of proof” would shift more to justifying why users of public company financial statements need certain information, rather than why users of private company financial statements do not. And a separate private company GAAP could permit a more exclusive focus on the needs of users of private company financial statements, more than would other models.

There was an overriding concern among BRP members that a baseline GAAP model or a separate private company GAAP model would likely take much longer and be more costly to implement than a GAAP model with exceptions and modifications, with enhancements to the current system. As such, the BRP rejected these models because of expediency. Many users on the BRP also support a GAAP model with exceptions and modifications, with enhancements to the current system, for reasons of consistency and comparability.

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<sup>11</sup>Baseline GAAP with add-ons for public companies contemplates reviewing and reorganizing current (existing) U.S. GAAP into a baseline GAAP for all entities, based on user needs, and with additional GAAP requirements (“add-ons”) for public companies. Having two boards sharing responsibility for determining that baseline was not considered practicable.

**PRIMARY REASONS FOR THE BRP RECOMMENDATIONS**

As noted above, many of the models had attributes that were attractive to BRP members, but the overriding factors that led the BRP to choose the recommended model from others are a sense of urgency and the support by many users for financial statement comparability. A U.S. GAAP model with exceptions and modifications for private companies affords the best opportunity to implement change quickly and, with proper coordination between the boards, affords relatively less opportunity for unintended divergence to a separate, standalone GAAP, which could result in less comparability and confusion in the marketplace.

Change Needs to Be Made Quickly

As noted above, some models were appealing as long-term solutions, but the BRP believes that those models could not be achieved quickly enough to provide relief to private companies in the near term. For example, some BRP members noted that a model with a baseline GAAP for all companies and additional requirements (“add-ons”) for public companies would be their ideal solution but that the time to develop such a model would be significant and would not provide near-term relief. That model would require an analysis of all GAAP requirements, possibly with significant involvement by the SEC. Such a task would be difficult at best and might have been more appropriate years ago.

Another model that had some appeal to BRP members but that was rejected to achieve a near-term solution was the creation of a separate set of U.S. GAAP for private companies. That solution was viewed by some BRP members as a long-term goal, but it would require much more time to develop because it would involve a similar analysis of all GAAP requirements as would be required to create the baseline GAAP portion of the baseline-with-add-ons model described in the preceding paragraph (though it would probably not necessitate significant SEC involvement).

Those BRP members who perceived other models as potential long-term solutions believe that U.S. GAAP with exceptions and modifications could be a stepping stone or bridge to those ends. They note that the recommended model does not close off the possibility of a strategic shift by the FAF and the standard setter(s) to one of these other models if it is determined, sometime in the future, to be in the best interest of users of private company financial statements and other stakeholders in the U.S. financial reporting system.

Comparability

BRP members that are primarily financial statement users indicated that comparability is an important attribute for them. A GAAP model with exceptions and modifications for private companies would be based on a single foundation or set of core principles. If GAAP for private companies were a separate document created independently from GAAP for public companies, it could result in two GAAPs that might diverge more dramatically than would be desirable, resulting in less comparability and potentially more confusion in the marketplace.

New Board

The supermajority view of BRP members is that the current FASB and even a restructured FASB cannot produce the needed exceptions and modifications to GAAP for private company financial reporting. Those BRP members believe that throughout its history, the FASB has been geared, in its composition and its processes, very heavily toward public companies, with exceptions and modifications in GAAP for private companies too rare and extremely difficult to achieve, especially in areas other than disclosure—that is recognition, measurement, and presentation. Members of a board with authority to set accounting standards for private companies must possess the perspective of those stakeholders, and the FASB cannot be sufficiently restructured or possess enough of the essential private company representation needed to set GAAP for private companies. A new board is the most realistic path forward in overcoming the systemic issue related to the relevance of GAAP for private companies.

**PROS AND CONS CONSIDERED FOR THE BRP RECOMMENDATIONS**

The BRP considered the following pros and cons in its deliberations to arrive at the recommended model and structure:

Pros:

A GAAP-with-exceptions-and-modifications model:

- Can be achieved more quickly than some of the other models considered
- Maintains a significant degree of consistency and comparability between public and private companies compared with other models considered
- Minimizes the costs to private companies that choose to “go public” compared with other models considered
- Avoids confusion and system complexity from two highly divergent sets of U.S. GAAP
- Has lower education and training costs than other models considered.

A separate private company board:

- Could provide appropriate structural separation from the pressures that the FASB faces in addressing the needs of public company stakeholders, including the SEC
- Could better address the different needs of private company financial statement users given a targeted focus on one constituency.

Cons:

- A GAAP-with-exceptions-and-modifications model might not be perceived as being sufficiently responsive to complexity and cost issues for private companies (compared with, for example, a separate, self-contained set of private company standards).
- Since the pace of standard setting is often driven (or perceived to be driven) by SEC/ public company sector needs or concerns, a GAAP-with-exceptions-and-modifications model probably affords less opportunity for the standard setter to keep the pace of standard-setting activities to a level that facilitates participation by the private company

sector (which generally has fewer resources) in the standard setter's due process compared with other models considered.

- Depending on the extent of exceptions and modifications made by the new board, the result could be substantially different accounting standards for private companies resulting in a lack of comparability, and additional costs and strain to some in the U.S. financial reporting chain. Once a separate board is given authority over private company standard setting, there may be limited ability to stop any such divergence.
- Two boards having authoritative responsibility for an overall, single-GAAP model is unproven and has not been used in other countries.
- It could make engagement in due process inefficient and even confusing for stakeholders that are interested in both public and private companies, and it could possibly undermine the authority of one or both boards.
- Additional funding sources will be required.

The BRP considered the various pros and cons and placed more weight on some factors than on others. The general consensus was that although some models had appeal in the long term, the recommended model has the advantage of achieving needed relief in the near term without adding significant complexity or comparability complications. The BRP also believed that, with a clear mission for the new board, proper coordination of the board with the FASB, and appropriate oversight of the board by the FAF, at least some of the cons would be mitigated.

#### **CONCLUSION ON BRP RECOMMENDED MODEL AND STRUCTURE**

In light of the frustrations expressed about the lack of relevance of some GAAP standards and the complexity and rapid pace of change in GAAP by many private company preparers and CPA practitioners in the written public submissions and elsewhere, and because of the length of time needed to achieve the various end-state models, the BRP recommends the U.S. GAAP model with exceptions and modifications for private companies, set by a separate private company board. The BRP believes that this model and structure would be the most effective approach to improve relevance of standards and to get relief for private company stakeholders in the near term. The BRP acknowledges that a two-board structure has risks (as noted above) but firmly believes that through proper coordination and effective two-way communication, the two boards will be able to set appropriate standards that best meet the needs of users of private company GAAP financial statements in a cost-effective manner.

The BRP also recognizes that the FAF or the new board could consider a succession (evolution) of models, such as described on page 15, as a longer-term solution.

#### **V. ADDITIONAL BRP RECOMMENDATIONS: SHORT-TERM, TRANSITIONAL, AND OTHER**

##### Short-term and Transitional Actions by the FASB and the FAF

While the BRP firmly believes that significant change is urgently needed and encourages the FAF to take prompt action to implement the Panel's recommendations on model and structure, the Panel recognizes that the Trustees will need time to vet the recommendations, especially concerning the creation of a new board, both internally and publicly, and, if the Trustees concur,

to then put a new board into place. In light of this, the BRP recommends that the FAF and the FASB take, or in some cases continue to take, certain actions that can be implemented in the short term or can be transitional actions to achieve needed near-term relief for private companies and help ensure a successful transition to the model and structure that the Panel recommends. The BRP believes that these actions, in whole or in part, do not change its recommendations for fundamental changes or the urgency needed to enact them.

Those recommendations are:

1. The FAF should fill at least one of the currently open board positions with individuals who have primarily private company background and experience.<sup>12</sup>
2. The FASB should continue to work closely with the PCFRC or another similar dedicated work stream. It should continue to have one or more board members present at each PCFRC meeting. PCFRC recommendations on Exposure Drafts and other matters should be discussed specifically at open FASB Board meetings.
3. In the short term and continuing as transitional actions until a new board is in place, the FASB should perform the following:
  - Continue to hold separate private company roundtables for major projects at locations around the country.
  - Incorporate private company concerns expressed at roundtables and in comment letters in the ongoing projects to evaluate whether there should be differences in recognition, measurement, presentation, disclosures, and/or effective dates. In view of publicly expressed concerns, if the board decides that there should be no differences, a clear explanation of their reasoning should be included in the basis for conclusions section of the final standards.
  - Consider a delay for private companies in the effective date of major new standards, especially those issued in connection with the FASB-IASB Memorandum of Understanding (MOU) projects, that is longer than the now-routine one-year delay.<sup>13</sup>

These processes described above will most likely continue once the new board is in place but will be led by and/or significantly involve the new board.

4. The BRP recommended that differences in GAAP for private companies be based on a framework (set of decision criteria). Using what it has learned from the two recent roundtables on private company issues with existing GAAP standards as key input, the FASB should begin to articulate “what differentiates private companies from public companies.” This articulation would be used to create the differential framework for private company accounting. The framework would be used to determine whether differences for private companies should be approved.

<sup>12</sup>The BRP acknowledges that on January 14, 2011, the FAF announced the appointments of two new FASB members, one of which has substantial experience as a private company CFO and the other of which has substantial experience as a user of financial statements, including financial statements of private companies.

<sup>13</sup>The delay would be with respect to the public company effective date. Thus, if, for example, the effective date for a particular MOU project is 2014 for public companies, this recommendation would contemplate an effective date of 2016 or later, rather than 2015, for private companies.



The FASB Board and staff could do much of this work, perhaps with the assistance of an appropriate, broad resource group, even before a decision by the Trustees on a desired model and board structure is finalized. The broad resource group should include significant user representation.

If and when a new board is established, it could then complete this work or, if already completed, could review it and either ratify it or revise it.

5. The FASB should look at the public comment process in its standard setting and consider taking steps to make it simpler to encourage responses by a broad base of stakeholders.

#### FAF and FASAC Structure

The BRP also believes that it is important that the FAF reassess the composition of its Board of Trustees to see that it has an appropriate number of members from the private company sector, including small and mid-sized private companies, to ensure its ability to reach out to and consider the needs of private companies in its oversight of the FASB and, if approved, a new private company standard-setting board.

In order for the FASB to consider private company needs in the standard-setting process, the FAF should reassess the composition of the FASB's primary advisory body, the Financial Accounting Standards Advisory Council (FASAC), to ensure that it has an appropriate number of members from the private company sector, including small and mid-sized private companies, to ensure its ability to consider the needs of the private company sector when providing strategic and other input to the FASB.

#### Marketplace Solution

In addition to its primary recommendations on private company accounting standards, BRP members generally believed that allowing the marketplace to effectively and efficiently function and allowing choices for private companies would prove to be a successful course for standard setting to follow. If GAAP with exceptions and modifications for private companies were developed, the choice of which version of GAAP a private company would apply—the set of standards under the new board's authority ("private company GAAP") or the set of standards under the FASB's authority ("FASB GAAP")—should be market driven, rather than set by the standard setters themselves.<sup>14</sup> If the users of a private company's financial statements demanded adherence to FASB GAAP, that would be a cost-benefit decision that the company would have to make in consultation with the users of its financial information. Some regulated private companies (such as privately-held financial institutions) could be required, by statute or otherwise, to adhere to FASB GAAP in order to comply with specific industry requirements. Regardless of these situations, the standard setter would not be the decision maker; rather, the decision of which GAAP a private company (if not subject to regulatory requirements) should

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<sup>14</sup>For example, both IFRS for SMEs and Canadian GAAP for Private Enterprises specifically preclude all financial institutions, including those that are privately held, from using those standards.

use would be in the hands of the company and its financial statement users. The BRP believes there should be a market-driven choice as to whether a private company would follow GAAP as set by the FASB or private company GAAP.

## **VI. ALTERNATIVE VIEWS**

### **Dissenting View**

One BRP member dissents from the BRP's recommendations for differential standards for private companies and a separate private company standard-setting board. This member's dissent may be found following Section VII.

### **Minority View**

A small minority of BRP members, while generally agreeing with the other recommendations contained in this report, believe that the FAF should not create a new board but instead:

- Allow sufficient time to determine whether the recent changes in the FASB staffing and processes (see Appendix F) have improved the systemic issues of relevance, complexity, and the cost of certain standards
- Restructure the Board, and its processes, as necessary to help ensure that it produces accounting standards that meet the needs of users of private company financial statements in a manner that is cost-effective for both users and preparers
- Implement the actions described in Section V to achieve the best possible outcome for private companies.

These members believe that a decision to create a separate board is premature at this time because of the number of changes the FASB is currently implementing and the uncertainties about the future role of the FASB concerning public companies. These members feel that the FAF in its oversight role, including its post-implementation reviews, should hold the FASB fully accountable for standard-setting activities that achieve an appropriate cost-benefit balance for private companies, minimizing irrelevant information for users of private company GAAP financial statements and reducing the complexity of GAAP where appropriate for private companies, and likely for public companies as well. (Indeed, these members believe that the BRP's recommendation concerning a separate board may well have been different if the concerns of both public company stakeholders and private company stakeholders had been considered by the BRP as being under its purview.)

These BRP members also recommend that the FAF examine the FASB's composition and adjust as necessary to ensure that the Board includes members with sufficient private company experience and perspective to appropriately consider private companies in the standard-setting process. These BRP members recommend that the FAF explore the following restructured FASB Board scenarios as alternatives to a new board:

- As the FAF has already announced, increase the FASB board size to seven members from the current five and ensure that at least one member has primarily a private company background.<sup>15</sup> Or, the FAF could further expand the FASB and increase the proportion of members with primarily private company backgrounds.
- Regardless of changes to the FASB Board, create an advisory task force structure (work stream) with the ability to effectively consider and determine exceptions and modifications in GAAP for private companies. In this scenario, the structure's decisions are subject to FASB Board ratification. This approach is akin to the way the FASB Board ratifies decisions of its Emerging Issues Task Force.

These BRP members believe that a single board, coupled with the enhancements noted in Section V of this report, provides the best opportunity for improving the standard-setting process for all companies. A single group of individuals that collectively has broader experience and perspective regarding private as well as public companies, along with the help of an advisory task force structure that can supplement the board composition and bring the needed focus and perspective for the private company constituency, will overcome the systemic issues in standard setting. These BRP members also feel that a single board lessens the risk of unintentionally diverging to a separate set of private company GAAP standards.

## VII. BRP CONCLUDING COMMENTS

The BRP has spent a considerable amount of time developing recommendations that we believe will help address how accounting standards can best meet the needs of users of U.S. private company financial statements. We are pleased to be able to present our report to the FAF and hope that our conclusions and recommendations will be helpful to the FAF Trustees as they strategically address the standard-setting system for private companies.

We believe that significant improvements to the system are urgently needed, and we stand ready to assist in any way that we can to help ensure expeditious, beneficial change.

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<sup>15</sup>The BRP acknowledges that on January 14, 2011, the FAF announced the appointments of two new FASB members, one of which has substantial experience as a private company CFO and the other of which has substantial experience as a user of financial statements, including financial statements of private companies.

**DISSENTING VIEW**

Teri Lombardi Yohn dissents from the recommendations of the Blue Ribbon Panel on Private Company Financial Reporting suggesting the establishment of differential standards for private companies and a separate private company standard-setting board. According to the FASB's Conceptual Framework, the objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. In addition, financial reporting should provide information to help users assess the amount, timing, and uncertainty of future cash flows as a result of providing resources to the entity.

In the view of Ms. Yohn, there has been no compelling evidence presented to the Panel to suggest that the objectives of financial reporting are not being met for private companies. An argument presented to the Panel in support of differential standards is that users of private company financial statements are more likely to be lenders than equity holders and that U.S. GAAP focuses on information needs of equity investors. However, financial statements presented under U.S. GAAP are intended to provide decision-useful information for external users in general, and the Panel has not been presented with arguments or evidence that private company financial statements do not meet the needs of users. In fact, the push for differential standards has not been driven by users of private company financial statements, suggesting that the financial statements are providing decision-useful information.

There has also been no compelling evidence or framework presented to the Panel to suggest that the objectives of financial reporting differ between private companies and public companies. The Panel has merely been presented with a list of standards that accountants associated with private companies do not find desirable. The specific standards that have been highlighted are those related to fair value, uncertain tax positions, variable interest entities, and financial instruments. Public companies have similar concerns about the same standards. This suggests that perhaps these standards need to be reviewed to determine if they meet the objective of financial reporting. If the concerns over these standards are valid, then the standards should be improved for both private companies and public companies.

Proponents of differential standards for private companies suggest that some of the standards under U.S. GAAP are not relevant and/or are not cost beneficial for private companies and, therefore, that all private companies should be exempt from these standards. There is potentially a basis for differentiation of financial reporting for different classes of entities; however, the Panel has not been presented with evidence suggesting that there are sufficient similarities among private companies to warrant general exemptions. In addition, the Panel has not been presented with evidence to suggest that there are sufficient differences between private companies and public companies to warrant different standards for private companies. For example, there has been no analysis presented to the Panel suggesting that the differences for private versus public companies are any more significant than differences across other classes of companies, such as industry membership. The relevance of a standard should be judged on the basis of whether it meets the objectives of financial reporting. Without evidence that the financial reporting objectives differ between private companies and public companies, there is no basis to conclude that the relevance of standards differs across private and public companies.

There have been concerns presented to the Panel about the complexity of the standards under U.S. GAAP. However, the complexities in U.S. GAAP arise from an attempt to best capture the economics of the business and its transactions. By applying more simplified standards, the economics of the transaction are not likely to be captured in the same meaningful manner. If the economics could be captured more simply, then the standards for public and private companies should be modified to do so.

Proponents of differential standards for private companies focus on the costs and benefits of applying standards from the company's perspective. The proponents have considered only the cost of providing financial information and having the information audited. This is a narrow view of the costs and benefits associated with financial reporting. It is important to note that not providing relevant information to financial statement users can also be costly. In addition, establishing separate standards for private companies will add significant complexity and cost to other dimensions of financial reporting. For example, differential accounting standards will make it more costly for users to understand, standards setters to develop and maintain, educators to teach, and assurance providers to obtain proficiency in financial reporting.

Establishing differential standards for private companies will also reduce the comparability of financial statements. It is widely accepted that comparability of financial statements between entities, and over time for a given entity, enhances the decision usefulness of the information. The FASB's Conceptual Framework suggests that comparability is the principal reason for the development of accounting standards. Allowing for differential standards for private companies will reduce comparability across public and private companies. In addition, given that private companies would be allowed to follow either U.S. GAAP or private company standards, the comparability of financial reporting will be diminished even across private companies supplying audited financial statements.

Proponents of differential standards for private companies raise a concern over the number of qualified opinions that have been issued for private companies. However, given that there is no regulatory requirement to file audited financial statements for most private companies, these companies can choose to not prepare financial statements under U.S. GAAP if it is not beneficial. If a company chooses to apply U.S. GAAP, then the company should recognize that U.S. GAAP was established to best capture the economic position and profitability of a company. This is the "gold standard." There is no reason to modify the standards so that companies can get unqualified opinions. This is like writing an exam so that every student gets 100 percent. Just as formulating exams so that everyone would obtain a perfect score would make a mockery of exams, writing standards so that all companies get unqualified opinions would make a mockery of the standards. It is much better for a company to be held to the gold standard and have audit qualifications that explicitly state the standards that the company chose not to apply. This is more informative and transparent than having a differential set of standards with general exemptions. If private companies do significantly differ from public companies in terms of cost-benefit analyses of specific standards, then perhaps these concerns should be addressed through modifying the auditing standards and/or types of qualifications issued rather than through establishing a separate set of standards.

In summary, the Panel has not been presented with compelling evidence that the financial reporting objectives for private companies are significantly different from the objectives for

public companies. The Panel has also not been provided with guiding principles or compelling evidence to elicit how the financial reporting needs of users of private company financial statements differ from those of public company financial statements. The Panel has merely been presented with opinions as to what standards are preferred by accounting practitioners associated with private companies. Differential accounting standards for private companies will add significant complexity and cost to financial reporting. Given these costs, it is the responsibility of proponents of differential standards to articulate underlying principles and to provide compelling evidence to suggest that such a change is warranted.

For these reasons, Teri Yohn has concluded that, absent supporting evidence, there should be one set of U.S. GAAP standards and one standard-setting board. She thinks that changes could be made to the structure of the FASB and the supporting staff to better incorporate the views of private companies into the standard-setting process. Given the arguments and evidence presented to the Panel, Teri Yohn sees no basis to support the establishment of differential standards or a separate standard-setting board for private companies.

## APPENDIX A

### About the Blue-Ribbon Panel (BRP)—Mission, List of Members, Participating Observers, and Staff

#### I. Blue-Ribbon Panel Overview

As mentioned in the report's Executive Summary, the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF, the parent organization of the Financial Accounting Standards Board (FASB)), and the National Association of State Boards of Accountancy (NASBA) established a "blue-ribbon" panel (the Panel or BRP) to address how accounting standards can best meet the needs of users of U.S. private company financial statements.

#### II. History

Three key factors led to the formation of the BRP:

- Summer 2009 FAF Listening Tour
- Fall 2009 AICPA Council meeting
- Fall 2009 Private Company Financial Reporting Committee (PCFRC) Letter to the FAF

##### Summer 2009 FAF Listening Tour

After John J. Brennan became Chairman of the FAF, he, other FAF Trustees, and FAF staff embarked upon a "listening tour" in various cities around the country in the summer of 2009 as part of the FAF's strategic planning process. The team heard from all key stakeholder groups of the FASB. One of the primary lessons learned from this tour was the need for the FASB to improve its consideration of private companies' views during the standard-setting process.

##### Fall 2009 AICPA Council Meeting

At its 2009 Fall Council meeting, the AICPA's governing council discussed the current state of standard setting for private companies. More than 95% of Council members at that meeting supported differences in the GAAP applied by U.S. private companies, where appropriate, from GAAP applied by U.S. public companies (most of them strongly supporting such differences). Additionally, more than 90% said the idea of having a self-contained, standalone GAAP for U.S. private companies is worthy of major exploration.

##### November 2009 PCFRC Letter to the FAF

In November 2009, the PCFRC wrote a letter to the FAF recommending that it strategically consider the issue of U.S. private company accounting in the context of both the mission of the FASB and global developments, such as the creation of International Financial Reporting Standards (IFRS) for Small and Medium-sized Entities (SMEs) and Canadian GAAP for Private Enterprises. In its letter, the PCFRC indicated that its preferred approach was a separate, self-

contained set of standards for U.S. private companies tailored to the needs of statement users, though the FAF should explore other alternatives as well.

### **III. Composition and Outreach**

The Panel is chaired by Rick Anderson, Chairman and CEO of Moss Adams, LLP, and FAF Trustee,<sup>16</sup> and comprises 18 members. Panel Members are senior leaders who represent a cross-section of financial reporting constituencies, including lenders, investors, and owners, as well as preparers and auditors. All members have both extensive experience in their field and a keen and broad interest in financial reporting for private companies. In addition to the Panel members, the Panel has invited certain regulators and other key stakeholders to serve as participating observers for all of the Panel's work (see below for list of members, participating observers, and staff). The Panel also invited other guests to specific meetings for their expertise and perspective, and it solicited written submissions from the public on a series of questions on private company financial reporting.

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<sup>16</sup>Mr. Anderson's term as an FAF Trustee ended as of December 31, 2010, due to term limits.



**PANEL MEMBERS:**

**CHAIR:**

**Rick Anderson**, Chairman and CEO, Moss Adams, LLP

**MEMBERS:**

**Billy Atkinson**, Board Chair, NASBA

**Daryl Buck**,<sup>17</sup> Senior Vice President and CFO, Reasor's Holding Company, Inc.

**Steve Feilmeier**, Chief Financial Officer, Koch Industries

**Hubert Glover**, President and Co-founder, REDE, Inc.

**David Hirschmann**, President and CEO, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce

**William Knese**, Vice President, Finance and Administration, Angus Industries

**Kewsong Lee**, Managing Director, Warburg Pincus

**Paul Limbert**, President and CEO, WesBanco, Inc.

**Krista McMasters**, CEO, Clifton Gunderson

**Barry Melancon**, President and CEO, AICPA

**Jason Mendelson**, Managing Director and Co-Founder, Foundry Group

**Michael Menzies**, President and CEO, Easton Bank and Trust Company

**David Morgan**, Co-Managing Partner, Lattimore, Black, Morgan, and Cain, PC.

**Terri Polley**,<sup>18</sup> President and CEO, FAF

**Dev Strischek**, Senior Vice President and Senior Credit Policy Officer, Corporate Risk Management, SunTrust Banks, Inc.

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<sup>17</sup>The BRP acknowledges that on January 14, 2011, the FAF announced the appointment of Daryl Buck to the FASB for a term beginning February 28, 2011. In light of this announcement, Mr. Buck resigned as a member of the Blue-Ribbon Panel on January 17, 2011, and did not participate in the final vote.

<sup>18</sup>Non-voting member.

**PANEL MEMBERS: (continued)**

**Mark Vonnahme**, Professor, University of Illinois; former Executive Vice President, Surety, Arch Insurance Group

**Teri Yohn**, Associate Professor, Indiana University

**PARTICIPATING OBSERVERS:**

**Karen Kelbly**, U.S. Federal Financial Institution Regulatory Agencies Group

**Dan Daveline**, National Association of Insurance Commissioners

**Dillon Taylor**, U.S. Small Business Administration

**Judith O'Dell**, Chair, FASB Private Company Financial Reporting Committee

**Mark Ellis**, Member and Agenda Subcommittee chair, FASB Small Business Advisory Committee

**Russ Golden**, Board member, FASB; former Technical Director, FASB

**STAFF:**

**Jeffrey Mechanick**, FAF/ FASB

**Meredith Vogel**, Grant Thornton LLP

**Robert Durak**, AICPA

**Paul Glotzer**, FAF/ FASB

**Daniel Noll**, AICPA

**APPENDIX B****BRP Process—Agendas, Outreach, and Invited Guests**

To accomplish its mission, the Panel held five in-person meetings, during which it considered:

- Previous studies and other reports on standard setting for U.S. private companies (see Appendix D)
- The current standard-setting system from the perspective of the various members, participating observers, invited guests, and the public (through a summary of the written submissions; see Appendix G)
- Efforts of global and other national standard setters concerning private companies
- Various alternatives to the current system, in terms of processes (models) and structures, including short- and longer-term actions that may be necessary for putting into place any desired alternatives (see Appendix H).

As part of its process, the Panel invited other guests to its meetings for their expertise and perspective on topics relevant to the Panel’s work and conducted an outreach effort to private company stakeholders.

**I. Meetings Agendas and Minutes**Meeting 1 – April 12, 2010 (New York, NY)

The agenda for the Panel’s first meeting included a general overview session, including a history of the debate on private company standards within the U.S. financial reporting system and a brief overview of actions taking place in other countries on private company financial reporting. Panel members reviewed and discussed the current U.S. standard-setting process (see Appendix E) and previous studies and reports, especially the 2005 Private Company Financial Reporting Task Force Report (“Castellano Report”) (see Appendix D).

To better understand the views of and issues facing private company financial statement users, Panel members and participating observers representing a user perspective delivered prepared remarks to the Panel. The Panel discussed the following questions:

- Who are the actual users of private company financial statements?
- What is the key, decision-useful information that the various users need from GAAP financial statements? Is there information users don’t need or can’t get?
- Are current U.S. GAAP financial statements meeting those needs? Why or why not?
- Do users routinely “adjust” the GAAP financial statements to meet their needs?
- Are users concerned about the cost-benefit issues of preparing GAAP financial statements?

Meeting 2 – May 14, 2010 (Norwalk, CT)

The Panel continued its discussion about private company financial statement user needs and continued to hear testimony from those users, including a corporate director and a credit analyst. Panel members then heard the viewpoints of private company financial statement preparers and practitioners. Panel member preparers and practitioners delivered prepared remarks, and Panel members heard testimony from a “Big Four” practitioner. The Panel considered whether US GAAP is meeting private company user needs in a cost-effective manner for both users and preparers.

The Panel then looked at alternative private company financial reporting standard-setting processes in other countries in some detail. After receiving an overview of standard setting in other countries and regions, the Panel listened to a presentation about Canadian GAAP for Private Enterprises, a proposed standard-setting system for private companies in the United Kingdom, and a presentation about IFRS for Small and Medium-sized Entities. Afterwards, Panel members considered the following questions:

- How does standard setting for private companies in the U.S. compare to standard setting in other countries, both those that have adopted IFRS for Small and Medium-sized Entities and those that have not?
- To the extent that current U.S. GAAP is not meeting user needs in a cost-effective manner, what can the Panel learn from the alternatives seen in other countries?

Meeting 3 – July 19, 2010 (Chicago, IL)

After some additional discussion about the nature of the problems in the standard-setting system with respect to private companies, the Panel considered alternative models and structures for private company standard setting (see Appendix H). Panel members expressed their views on which alternative(s) was preferable and why, on whether there were any new or different alternatives not identified by staff, and on what structural changes, if any, would be needed to achieve the preferred model(s) and why.

The Panel also held a discussion about overarching issues surrounding the models and considered whether there should be scope limitations regarding the Panel’s recommendations, specifically:

- Should private companies with some form of public accountability or over a certain size be excluded?
- Alternatively, should this be left up to the U.S. marketplace, that is, to users and possibly regulators?

Meeting 4 – October 8, 2010 (New York, NY)

The fourth meeting began with Panel members learning about recent changes at the FASB (see Appendix F). After that, the Panel reviewed and discussed a summary of written submissions received from the public in response to the Panel’s outreach (see Appendix G).

The Panel then continued its discussion of alternative models and structures, while considering the following questions:

- Generally, which model is preferable in the long run and why?
- Given the amount of time required to achieve that model, are there other models (or aspects of other models) that should be considered as intermediate steps and why?
- What short-term and/or long-term structural changes are necessary to achieve the preferred model (or combination or sequence of models) and why?

After considering those questions, the Panel worked on reaching a consensus about which model and structure to recommend to the FAF.

Meeting 5 – December 10, 2010 (Norwalk, CT)

At its last meeting, the Panel worked on finalizing the details of its recommendations to the FAF, including a discussion about the new private company standards board's mission, role, structure, composition, protocols, budget, and funding.

The Panel also discussed:

- What other short-term and/or long-term actions may need to be taken by the FAF, FASB, or both?
- Are there any other recommendations that should be discussed by the Panel?

For further information, refer to the [Panel Meeting Minutes](#) webpage on the FAF's website.

## **II. Guests Invited to Panel Meetings**

### Meeting 1

- Paul Beswick (Deputy Chief Accountant for Professional Practice in U.S. Securities and Exchange Commission Office of the Chief Accountant)
- Jim Castellano (RubinBrown)

### Meeting 2

- Keith Alm (National Association of Corporate Directors)
- Greg Edwards (Accounting Standards Board, Canada)
- Tom Jones (former Vice Chairman, International Accounting Standards Board)
- Joyce Joseph (Standard and Poor's)
- Ian Mackintosh (Chairman, UK Accounting Standards Board)
- Tricia O'Malley (Chairman, Accounting Standards Board, Canada)
- Joel Osness (Deloitte & Touche LLP)
- William Schramm (PricewaterhouseCoopers LLP)

Meeting 3

- Paul Beswick (Deputy Chief Accountant for Professional Practice in U.S. Securities and Exchange Commission Office of the Chief Accountant)
- John Perrell (Trustee, FAF)

Meeting 4

- Douglas Donahue (Trustee, FAF)
- John Perrell (Trustee, FAF)
- Leslie Seidman (Chairman, FASB)

Meeting 5

- Jeff Diermeier (Trustee, FAF)
- John Perrell (Trustee, FAF)
- Leslie Seidman (Chairman, FASB)

## APPENDIX C

## Recommended New Board Structure and Operating Protocol Chart

Function	Recommendation	Alternatives Considered	BRP Commentary
New board mission	The mission of the new board is to establish exceptions and modifications to GAAP for private companies, while ensuring that such exceptions and modifications provide decision-useful information to lenders and other users of private company financial reports. That mission is accomplished through a comprehensive and independent process that encourages broad participation, objectively considers all private company stakeholder views, and is subject to oversight by the Financial Accounting Foundation's Board of Trustees.		Wording is consistent with FASB's mission, but tailored to the specifics of this board.
New board model and how it works with the FASB	<p>New board has authority to modify existing and future GAAP for private companies, where appropriate.</p> <p>FASB board considers input from all companies (including private companies) during the standard-setting process.</p> <ol style="list-style-type: none"> <li>1. The goal is the FASB should try to produce the best possible standard for all entities (public companies, private companies, not-for-profit entities).</li> <li>2. The new board has the responsibility for outreach to private company stakeholders, and it provides input to the FASB Board along the way so that the FASB can produce the best possible standards for all companies (both public and private companies).</li> </ol>		To some degree the new board and FASB will be best positioned to decide how to operationalize the promulgation of modifications and exceptions, depending on the facts and circumstances of a standard-setting topic.

Function	Recommendation	Alternatives Considered	BRP Commentary
	<p>3. Nothing precludes the FASB on a current agenda project from receiving input directly from private company stakeholders, but the specific responsibility for seeking such input resides with the new board, which then shares the results of such outreach with the FASB.</p> <p>4. The new board reviews the product of the FASB and effectively endorses it or proposes modifications/ exceptions through its own due process.</p> <p>5. The new board takes formal due process actions when it believes modifications/ exceptions are warranted beyond what the FASB has promulgated; otherwise, FASB output is accepted through non-action.</p> <p>6. The new board, not the FASB, ultimately authorizes modifications/exceptions in GAAP for private companies, but such differences may be promulgated within a FASB standard (with the support of the new board).</p> <p>7. The new board adheres to a differential framework to help ensure that there is no undue divergence in GAAP for public and private companies.</p>		



Function	Recommendation	Alternatives Considered	BRP Commentary
New board overall process	The new board works with the FASB throughout the standard-setting process; the new board conducts robust outreach to private company stakeholders when the need arises; it issues Exposure Drafts (EDs) when proposing modifications/exceptions. The boards can issue joint EDs on fast moving topics, thus allowing the FASB and the new board to propose modifications/exceptions within a joint ED; the FASB or the new board (which one depends on facts and circumstances) issues final standards for such differences that are then embedded in the Codification.	The new board issues a separate ED and final standard on everything the FASB (including EITF) does.	The BRP believes the two boards and staff should work together to ensure that GAAP remains a single “language” wherever possible, and that the FASB still should attempt to consider input from private company stakeholders with a goal of developing the best possible standard for all companies.
New board composition/ structure	Full-time chair, full- or part-time other members, Possibly 5 to 7 total members, 1–2 users 1–2 practitioners 1–2 preparers Possibly 1 academic		The FAF should consider the pros and cons of a full-time versus a part-time board. A full-time board would allow for greater independence while a part-time board would require less funding and could help the board members stay better connected with private company constituencies and private company financial reporting issues.
Staff composition	Staff should have primarily private company sector background. Some shared staffing with FASB desirable.		Staffing composition depends on the board’s structure and workload.

<b>Function</b>	<b>Recommendation</b>	<b>Alternatives Considered</b>	<b>BRP Commentary</b>
Board observers	Full-time new board chair or other member of new board attends all FASB board meetings as an official observer; the FASB designates one board member as an official observer to all new board meetings. Official observers have the right of the floor but do not vote.	Official observers have the right to vote (meaning they serve in effect as a board member).	Cross voting is impractical—for example, an observer might vote for something as part of the FASB Board and then would be hard-pressed to change his/her vote as a new board observer.
Advisory groups	The new board forms a primary advisory group—the PCFRC could possibly become such a body.		
New board governance	The FAF oversees the new board as it does the FASB/GASB; there is a 3–5 year sunset provision. The FAF increases the number of Trustees with private company stakeholder backgrounds; the FAF’s post-implementation assessment on FASB/GASB standards is also applicable to new board.		
Approximate budget	\$4–6 million; that could vary upward or downward subject to operating and structural specifics.		
Funding sources	A portion of FAF publications sales and mandatory contributory model from stakeholders (subject to further analysis, including legal).	State board licensing fee allocation.	An endowment approach might be an appropriate mandatory contributory model.

**APPENDIX D****List of Previous Studies and Reports Considered by the BRP**

The following is a list of previous studies conducted and reports issued by the FASB, various AICPA committees, and others concerning private company standard setting in the U.S. The Panel reviewed these as background information and discussed some of them during the course of its meetings.

1. *Report of the Study on Establishment of Accounting Principles*, AICPA, March 1972 (“Wheat Report”)
2. *Report of the Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses*, Accounting Standards Division of AICPA, Discussion Paper, August 1976
3. *Report of the Special Committee on Small and Medium-Sized Firms*, AICPA, 1980 (“Derieux Committee”)
4. *Tentative Conclusion and Recommendations of the Special Committee on Accounting Standards Overload*, AICPA, December 23, 1981
5. *Report of the Special Committee on Accounting Standards Overload*, AICPA, February 1983
6. a. Invitation to Comment, *Financial Reporting by Private and Small Public Companies*, FASB, November 1981  
 b. Special Report, *Financial Reporting by Privately Owned Companies: Summary of Responses to FASB Invitation to Comment*, FASB, 1983
7. Research Report, *Financial Reporting by Private Companies: Analysis and Diagnosis*, FASB, August 1983
8. *Standards Overload: Problems and Solutions*, AICPA, June 1995
9. *Report of the Private Companies Practice Section Special Task Force on Standards Overload*, August 1, 1996
10. *What Do Users of Private Company Financial Statements Want?*, Financial Executives Research Foundation, 1996
11. *Private Company Financial Reporting Task Force Report*, AICPA, February 28, 2005, and supplementary survey results:
  - a. Random Research Survey Results
  - b. Broad Outreach Survey Results
  - c. Comparison of Certain Random and Broad Outreach Survey Results
12. Invitation to Comment, *Enhancing the Financial Accounting and Reporting Standard-Setting Process for Private Companies*, FASB, June 8, 2006

**APPENDIX E****Overview of the FAF and the FASB**

The Blue-Ribbon Panel on Standard Setting for Private Companies (the Panel) was formed to develop a recommendation to the Financial Accounting Foundation (FAF) addressing accounting standards for private companies and the standard-setting process used to develop those standards.

Organized in 1972, the FAF is the independent, private-sector organization with responsibility for:

- Establishing and improving financial accounting and reporting standards
- Educating stakeholders about those standards
- The oversight, administration, and finances of its standard-setting Boards, the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB), and their advisory councils
- Selecting the members of the standard-setting Boards and advisory councils
- Protecting the independence and integrity of the standard-setting process.

Although the FAF has responsibility for establishing and improving financial accounting and reporting standards, it does not set those standards. That responsibility falls on the two Boards it oversees, the FASB and GASB. The FAF's role is to ensure that the Boards are independent and act with objectivity and integrity through an open due process which encourages active and collaborative involvement from all interested parties. It accomplishes that role through the oversight, administration, and financing of the Boards and their advisory councils, the Financial Accounting Standards Advisory Council (FASAC) and the Governmental Accounting Standards Advisory Council (GASAC). The FAF recently augmented its oversight procedures by establishing a formal post-implementation review process for the standards issued by the two Boards.

The Financial Accounting Standards Board (FASB), established in 1973, has been the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. The FASB's mission is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports.

Accounting standards issued by the FASB have been recognized by the U.S. Securities and Exchange Commission (SEC) as generally accepted for federal securities law purposes. State Boards of Accountancy and the AICPA have also recognized those standards as GAAP for financial statements of nonpublic entities.

For more information, the FAF website provides an overview of the FAF, with additional links to information about its officers and Trustees and contact information. For additional information about the FASB, the FASB website provides an overview of the FASB, with links to information about the Members of the FASB and its Rules of Procedure.

**APPENDIX F****Recent Changes at the FASB**

Since mid-2009, the FASB has made, and has continued to make, changes to bring greater focus on and otherwise improve its standard-setting activities with regard to the private company sector. FASB Board Chairman Leslie Seidman reported on these activities during the October 8, 2010, and December 10, 2010 BRP meetings.

Some of the key changes have involved augmenting the staff dedicated to private companies. In June 2009, the FASB appointed an assistant director who is responsible for strategic and technical oversight of private entity issues, including those of both private business entities and not-for-profit organizations, in addition to the project manager who was already dedicated to private company issues. In the last half of 2010, the FASB reassigned three other staff members to the private entities team to help address private entity issues throughout the FASB's projects, especially its Memorandum of Understanding projects with the IASB.

In August, 2010, the FAF announced that the FASB Board would increase in size from five members to seven members, with a private company background being one of the focal areas in recruiting for the new members. Among other benefits, the additional members will enable the Board to do more outreach through meetings and conferences attended by representatives of the private entity constituencies.

Beginning in 2010, a Board member started attending all meetings of the Private Company Financial Reporting Committee (PCFRC) to hear firsthand about private company issues arising from proposed standards. The interaction between the PCFRC and the Board benefits both groups, and thus the standard-setting process. The Board gets a better understanding of the issues and hears potential solutions. The PCFRC hears from a Board member why the Board has made the decisions it has made.

Outreach activities have been expanded in other ways to obtain more information specifically from the private company perspective. For the major projects, the Board and staff meet with private companies in field visits. To illustrate, the Financial Statement Presentation project team with help from the Technical Issues Committee (TIC) of the AICPA Private Companies Practice Section obtained financial statements from approximately 20 private companies, representing various industries, that recast the statements from the current presentation model to the proposed model. The recast statements were used in a study to see whether those statements resulted in better information for making lending decisions. A panel of 20 users of private company financials was assembled to provide feedback on those recast financials. The Board and staff are also now conducting public roundtables for various projects to hear specifically from the private entity constituencies about their issues and concerns on proposed standards.

The FASB held roundtables in October and November 2010 to hear about private company concerns with existing GAAP. Two items on the agenda were FIN 48, *Accounting for Uncertainty in Income Taxes*, and FIN 46R, *Consolidation of Variable Interest Entities*. The format of the roundtables allowed for users, practitioners, and preparers to discuss issues with the Board and help give insight as to what information is useful, and how it can be provided cost-

effectively. Another issue raised was the use of fair value by private companies, especially with regard to impairment testing. At the December 10<sup>th</sup> Panel meeting, Ms. Seidman stated that the FASB had added a near-term project to its agenda to look at this issue.

Other activities designed to better serve private entities include the use of plain English in webcasts, podcasts, and Twitter feeds to help educate them about the FASB's projects and to solicit more participation by them in the standard-setting process.

Ms. Seidman stressed that these actions show that the Board is committed to understanding private company issues and incorporating a careful consideration of them in the standard-setting process.

**APPENDIX G****List of Respondents to Questions Posed by the BRP and Summary of Written Submissions****WRITTEN SUBMISSIONS FROM THE PUBLIC**

List of Interested Parties Who Responded to Questions Posed by the Blue-Ribbon Panel (in order received)

<b>Letter</b>	<b>Affiliation or Individual<sup>19</sup></b>
1	Thomas Malkoch
2	Jodi Gill
3	Russell Abernathy
4	Carl Bagge
5	Jeremy Veilleux
6	Lance Mann
7	Laura Lewis
8	Lauren Barnet
9	Frankel And Topche, PC
10	Joan Waggoner
11	Anonymous
12	Bruce Benator
13	O'Sullivan Creel, LLP
14	Jay Tolsma
15	David Wagner
16	Todd Lisle
17	Morris, Kalish + Walgren, P.C.
18	Howard Bornstein
19	Mike Sedam
20	Gross, Mendelsohn & Associates, P.A.
21	Michael Nesland
22	Ken Posner
23	Peter Kwong
24	Philip Stoler
25	Ernest Lapp
26	Frank Minter
27	Flexco
28	Nancy Mcclary

<sup>19</sup>Some of the respondent letters were grouped together by affiliation.

<b>Letter</b>	<b>Affiliation or Individual</b>
29	Shaun Bawden
30	Scott Robinson
31	Peter Philbrick
32	Eric Smith
33	Scott Womble
34	Brenda Smith
35	Carl Chatto
36	Michael Atkins
37	Medina Company, PSC
38	Theodore Medrek
39	Parentebeard, LLC
40	David Johnson
41	Carol Uhl
42	Quick & Mcfarlin, P.C.
43	Garry Hutchison
44	Larry Sample
45	Art Thielen
46	Robert Foley
47	Steve Freimuth
48	Doug Knights
49	Leatham & Associates, CPAs
50	Curtis Root
51	Doug Hawkes
52	Withumsmith+Brown P.C.
53	Alan King
54	Doug Chaffins
55	Hoots, Baker & Wiley, PC
56	Tommy Thomson
57	David Frizzell
58	Charles Postal
59	James Lagana
60	Stu Harden
61	Steve Rabin
62	Caler, Donten, Levine, Porter & Veil, PA
63	Bart Tiffany
64	Vickie Martin
65	Gish Seiden, LLP
66	Candido Fernandez



<b>Letter</b>	<b>Affiliation or Individual</b>
67	Michael Moore
68	Sherman Rosenfield
69	Hogan - Hansen, PC
70	David Hurley
71	Doug Donaghue
72	Mahesh Chithkala
73	Cherry, Bekaert & Holland, LLP
74	David Strottmann
75	Susan Ryan
76	Culver Lamb
77	National Rural Electric Cooperative Association
78	Steve Morris
79	National Cooperative Business Association
80	Kennedy And Coe, LLC
81	Arthur Hendricks
82	Institute Of Chartered Accountants In England And Wales
83	Yeo & Yeo CPAS and Business Consultants
84	Dee Brown, Inc.
85	Stan Sterk
86	Packer Thomas
87	Mike Beach
88	Don Lueger
89	O'Brien Energy Company
90	Descret Power
91	Kreston International
92	Vickie Beer
93	Ernst & Young LLP
94	The Madray Group
95	John Litchfield
96	Beach Fleischman
97	Jerry Mcmillon
98	Steakley & Gilbert, P.C.
99	Prather Kalman, P.C.
100	Geoff Flynn
101	Jerry Woods
102	Tom Hoey
103	Heidi Lee
104	Patrick Murry

<b>Letter</b>	<b>Affiliation or Individual</b>
105	David Baugh
106	David Kasuba
107	Bart Adams
108	James Branch
109	Karen Keller
110	Pricewaterhousecoopers
111	Pennsylvania Institute of Certified Public Accountants
112	Financial Executives International, Committee on Private Company Standards
113	Barfield Murphy Shank & Smith, P.C.
114	Munninghoff, Lange and Company
115	Clifton Gunderson, LLP
116	Deloitte & Touche, LLP
117	Anders Minkler & Diehl, LLP
119	Ohio Society of Certified Public Accountants
120	John McDaniel
121	Texas Society of Certified Public Accountants
122	Susie Repko
123	Pershing Yoakley & Associates, P.C.
124	Rea & Associates, Inc.
125	Ima/Sbc
126	Marc Porter
127	Plante & Moran PLLC
128	Emilio Colapietro
129	Maryland Association of Certified Public Accountants
130	Mark Blackburn
131	James Pistillo
132	Ted Lodden
133	Illinois CPA Society
134	Battelle & Battelle, LLP
135	California Society of Certified Public Accountants
136	Hines Interests L.P., Southwest Region
137	Weisermazars, LLP
138	Harry Drew
139	Sensiba San Filippo, LLP
140	Fort Pitt Group, LP
141	Barnes Wendling CPAs
142	Crowe Horwath, LLP
143	Clark Nuber P.S.

Letter	Affiliation or Individual
144	Grant Thornton, LLP
145	Piercy Bowler Taylor & Kern, CPAs
146	McGladrey & Pullen, LLP
147	Managed Health Care Associates, Inc.
148	KPMG, LLP
149	Great American Insurance Company, Contract Surety Division
150	CPAmerica
151	Federal Financial Institution Regulatory Agencies

#### RESPONDENT PROFILE

- As of October 1, 2010, the Panel received written submissions from 148<sup>20</sup> respondents. Three additional response letters (#149–151) were received after October 1, 2010, and were not included in the summary below but were discussed at the October 8, 2010 BRP meeting. Certain key aspects of letter #151 have been included in the body of the report. The entire respondent population has been identified below:

Respondent Type	Number of Respondents	Percentage
CPA firm with fewer than 5 partners (including sole practitioners)	36	24%
CPA firm with 6 to 20 partners	26	17%
CPA firm with 21 to 100 partners	13	9%
CPA firm with 101 to 500 partners	5	3%
CPA firm with over 500 partners	6	4%
CPA firm, size not specified	11	7%
Lender	2	1%
Owner	2	1%
Preparer	15	10%
State CPA society	6	4%
Trade organization	4	3%
Regulator	1	1%
Other (anonymous or not specified)	24	16%
<b>TOTAL</b>	<b>151</b>	<b>100%</b>

<sup>20</sup>Some of the respondent letters were grouped together by affiliation.

**SUMMARY OF RESPONSES**

2. The opinions of respondents varied considerably. Given the quantity of the comment letters, the following sections are meant to highlight common themes they presented.

**QUESTIONS FOR SUBMISSIONS****All respondents:**

**Question 1: Please complete the attached form to help compile information on the respondents and send as a separate attachment.**

3. See above respondent profile.

**Question 2: Users (e.g., lender, surety, investor, owner) only:**

**a) Briefly describe how you use U.S. GAAP financial statements in your decision making concerning private companies.**

4. One trade organization indicated that users use GAAP financial statements as one of their tools to monitor a company's performance and to ensure that they have a complete picture of the company. A member of a different trade organization said they use financial statements to look for "red flags" but not much else. This member felt that financial statements provide some comfort but also mentioned that users didn't feel that GAAP financial statements are very useful.
5. Another trade organization felt that GAAP financial statements are not a desired tool for operating an enterprise.
6. Lenders stated that they use financial statements to analyze a customer's financial position to make appropriate lending decisions. One lender stated that the majority of its customers prepare financial statements on a cash or tax basis.
7. One owner stated that they only use GAAP financial statements once a year to share the results with their employee owners and with their bankers. This owner further discussed certain GAAP accounting requirements that would terribly misstate information if the owners used the statements to manage the business.

**b) Tell us about any issues or concerns that you may have with respect to the relevance of the information contained in those statements. Please be as specific as possible in your answer.**

8. Many of the trade organizations commented that there is an overload of financial information in GAAP financial statements that is not relevant. One trade organization felt that if GAAP financial statements were simplified, it would be more useful to small and private companies from an operational perspective.
9. One lender felt that if all financial statements were prepared in the same fashion, it would help make decision making more uniform. However, in reality, a "one size fits all" approach in relation to GAAP financial statements does not work. This

lender stated that fair value accounting is not relevant to an investor and owner and that it frequently increases accounting costs and confusion.

**Question 3a: Tell us about any issues or concerns you have with current U.S. GAAP accounting standards as those standards apply to private company financial statements.**

**Lack of relevance to users**

10. CPA practitioners with fewer than 5 partners shared several concerns about the relevance of U.S. GAAP to private companies. These respondents generally shared a view that there is a disconnect between private companies and the standard-setting process that has led to reporting requirements that do not seem to be useful or relevant to the users of private company financial statements.
11. These small CPA practitioners also stated that the users, generally banks and bonding companies, are interested in financial information that can help them determine the amount, timing, and uncertainty of cash flows. Many of the most costly standards for private companies to implement contain complex disclosures that focus on information that their users do not understand and which does not provide value to the users. One respondent suggested that their bankers will often ignore fair value disclosures because of this reason. This point is further demonstrated by the fact that many users have been accepting of financial statements that are prepared on an other comprehensive basis of accounting (“OCBOA”), usually the tax basis.
12. CPA practitioners with 6 to 20 partners shared some of the views above. Some of these respondents noted that accounting standards are primarily designed to meet the needs of equity analysts. There are certain disclosure requirements that do not provide any incremental benefit to the users of private company financial statements. For example, these users will not be concerned about how a stock price increases in value based on how a company performs. These respondents maintained that different users have distinct needs, and that the current accounting standards are not fulfilling the needs of users of private company financial statements.
13. Most CPA practitioners with 21–500 partners also agreed that the public company focus of standard-setting activities leads to complex accounting and that ultimately provides little benefit to many users of the financial statements.
14. Certain CPA practitioners with over 500 partners shared the general concern that some standards are not relevant to certain users. However, these respondents arrived at some different conclusions. One such respondent noted that, broadly speaking, accounting should faithfully represent the economics of an underlying transaction. As a result, recognition and measurement should be based on the transaction itself and applied consistently regardless of the nature of the reporting entity. Moreover, there is a benefit to using consistent standards as a private company grows and becomes more similar to its public counterparts. This respondent noted that both private and public companies have questioned the relevance of certain standards, at times the same standards, to the decision making of their users and further concluded that the improvements and changes should relate to all companies.
15. CPA practitioners with over 500 partners also felt that the issue of relevance is not confined to private company financial reporting. Echoing the sentiments of the other

CPA practitioners' responses, they noted that public and private company financial statement user needs vary by user. However, users are already currently equipped to deal with this, and they have the ability to adjust financial statements prepared under GAAP to tailor them and eliminate the effects of certain standards that they do not find relevant.

16. Responses from lenders expressed a similar view that information they look for depends on the specific entity, and a "one size fits all" approach would not be able to fulfill their needs.
17. A preparer respondent stated that "we do not use GAAP financial statements for any business decision making in our capacity as asset manager or investor" and that GAAP financial statements provided little value to their particular user group. Another stated that:

"In theory, if all financial statements were prepared the same, it would simplify the analysis of the information and make decision-making more uniform. However, in application, this is not practical. One size does not fit all. There is a cost/benefit perspective that needs to be applied. And relevance becomes the overriding issue."

18. Trade organizations shared similar sentiments to the CPA practitioners above. One respondent specifically pointed out that as fair value becomes more embedded into the balance sheet, the assets and liabilities that are presented do not translate into future cash flows. As a result, users find it difficult to make sense of that information.
19. Owners expressed a lack of interest in the GAAP financial statements. One respondent stated that the GAAP financial statements were used only once a year to share results with their owners. Owners and lenders have a historical cost perspective, and the information they are interested in is not being captured by the financial statements.

#### **Complexity and pace of standard setting**

20. CPA practitioners with fewer than 5 partners generally agreed that there were challenges related to not only the complexity of standards but to the recent pace of standard setting. Many respondents found that complexity not only led to difficulty for their clients in preparing the financial statements but also to a lack of understandability by internal and external users. Some respondents felt that the disclosures required by GAAP are incomprehensible to both the average reader and even some sophisticated users. At the same time, the increased pace of standard setting recently has only served to intensify this issue. Respondents explained the difficulty of keeping abreast of new Exposure Drafts issued by the FASB. These respondents have found it challenging to find the means to comment on Exposure Drafts and to participate in the stages of due process.
21. CPA practitioners with fewer than 5 partners also believed that the complexity of the standards are exposing firms to additional liability and risk because they do not have the in-house capabilities and time to stay abreast of the changing standards.

22. CPA practitioners with 6 to 20 partners echoed the sentiments about the complexity of standards. One practitioner felt that the new and complex accounting standards have placed an unnecessary burden on small businesses and CPAs.
23. A CPA practitioner with 21 to 100 partners also noted that the increased complexity of accounting standards has been causing clients to rely more heavily on CPA firms, potentially causing independence issues.
24. CPA practitioners with over 500 partners shared many of the same concerns about complexity. One practitioner felt that the increase in complexity was partly due to the increasing complexity of business transactions and partly due to certain disclosure requirements that have become too burdensome.
25. Several CPA practitioners, varying in firm size, and trade organizations were concerned about the increasing frequency with which proposed standards are being issued. One practitioner stated that it appeared the window of time during which FASB accepts comment letters had decreased. In addition, the pace of change makes it more difficult to keep up with and evaluate the applicability of new proposals. Other practitioners and preparers also claim that the timing of certain standards was rushed. As such, there has been an increase in revised standards and numerous staff positions (now ASUs) to help deal with complexities that they felt were not addressed prior to the initial release of the standards.
26. Chief financial officers and a respondent from a state CPA society felt similarly that accounting standards had become too complex for the average accounting department at a private company and frequently were beyond the expertise of their auditors. One CFO stated that:
 

“Those of us out in the economy doing day in and day out financial reporting find it almost impossible to even keep up with the changes in GAAP and what current GAAP applies to our companies’ (sic) situations and financial transactions. Most people, no matter how well educated, cannot read much less understand a GAAP financial report ... they are for use by the “financial elite” who probably do not understand them either.”
27. A preparer responded that the biggest challenge was not the complexity of the standards themselves but rather having to provide the necessary education for private sector accountants.

**Costs exceed benefits**

28. CPA practitioners with fewer than 5 partners generally agreed that the cost of preparing GAAP financial statements has increased compared to the perceived benefits that certain new standards have brought to financial reporting. One practitioner felt that “there seems to be no consideration of the cost to implement a standard, whether in terms of internal resources, external costs or even the ability of the CPA to get paid for the additional work necessary to conform a client to new standards.” Practitioners in the same group felt that the FASB is so concerned with public companies that they do not consider the cost to implement certain standards with respect to private companies. They believed the cost to pay for external valuation analysis such as goodwill impairment, acquisition accounting, and stock

- compensation is a greater financial strain for private companies than for public companies.
29. CPA practitioners with 6 to 20 partners generally agreed that the benefits do not exceed the costs because private company users have the ability to confer directly with management. This group also believed that if private companies were subject to a limited or simplified set of standards, companies would benefit because they would be more apt to have a financial statement audit. These practitioners felt that many of their clients rely on the CPA firm to draft their financial statements, so the compliance costs and CPA firm's liability goes up. Generally, this group felt that the new standards are placing an undue financial burden on many private companies while there is no perceived benefit for private company users.
  30. CPA practitioners with 100 to 500 partners also generally felt that the cost of GAAP financial statements often exceeds the benefits. One practitioner felt that the costs that private companies incur to obtain technical knowledge to comply with GAAP and to be able to prepare GAAP financial statements outweigh the benefits.
  31. CPA practitioners with 500 or more partners felt that the FASB should develop concepts to help the standard setting with cost-benefit analysis. One practitioner in this group stated that "private companies face different cost/benefit considerations that make it difficult to justify application of certain aspects of U.S. GAAP." Another practitioner suggested that the cost-benefit considerations could differ between public and private companies, which could justify disclosure differences for private companies.
  32. Another CPA practitioner with 500 or more partners stated that "because the needs of private company users may be different from those of public company users, we encourage the FASB to increase its outreach to private company preparers, users, and auditors to better ascertain the costs and benefits of applying new accounting standards. The feedback received will help the FASB better evaluate the situations in which divergence in the guidance for public and private companies is appropriate. Disclosure, transition, and effective dates are examples of areas in which such divergences may be warranted."
  33. Some trade organizations felt a cost-benefit analysis based on some clearly defined parameters to help guide deliberations on new standards may help with cost-benefit considerations. Another trade organization felt that companies without audited financial statements pay a premium to obtain capital.
  34. A lender response also pointed out a concern relating to unintended consequences of new GAAP as it relates to regulatory requirements. The lender noted that, often, changes in GAAP will lead to changes in the regulatory requirements to which a private company must adhere. However, in many of these cases, the regulatory requirements will not consider materiality thresholds, and private companies will become subject to extensive and sometimes onerous regulatory reporting.
  35. One chief financial officer felt that accounting standards such as fair value are not useful to the users and compliance costs are going up to comply with such standards.



**Increasing Qualified Opinions and use of OCBOA**

36. Some CPA practitioners expressed concerns about the increasing number of qualified opinions that they see issued for private companies.
37. One respondent from a firm with 6 to 20 partners observed that small businesses are increasingly receiving deficiencies in internal controls because of the inability to prepare financials with appropriate footnotes.
38. A respondent from a firm with 101 to 500 partners felt that GAAP departures dilute the usefulness of financials because such departures allow private companies to pick and choose which standards to comply with.
39. Many of the smaller practitioners stated that their clients prepare financial statements under an OCBOA method. One practitioner from a firm with fewer than 5 partners that provide statements on the income tax basis noted that “our firm quit providing our clients and their lenders and owners GAAP statement over ten years ago. We could not justify the cost of compliance to these standards for the benefits received.”

**Standard-setting process**

40. Many CPA practitioners felt that the standard-setting process has historically been driven by the needs of public companies. Many of the CPA practitioners with fewer than 5 partners felt that some recent standards are perceived as being reactionary measures borne from emergencies, political pressures, and fraud.
41. Some responses from CPA practitioners cited concerns about the responsiveness of the standard-setting process to the needs of private companies. One respondent from a CPA firm with fewer than 5 partners noted that there is a perception that the input that private companies provide is not taken seriously, and that the time and effort spent on that endeavor is wasted. Other respondents felt that the standard-setting process is overly focused on the perceived needs of users of large public company financial statements. One respondent from a firm with 6 to 20 partners suggested that the voluntary nature of the comment process does not capture the needs of small companies.
42. A CPA firm with over 500 partners felt that:  
“...[a] board composed of accounting experts whose experience and dedication is primarily to meet the objectives of preparers, auditors, and users of the financial statements of publicly accountable entities is likely not the best choice for setting standards for private companies that are less focused on capital allocation decisions and more concerned with meeting the needs of a broad range of users in a cost-effective manner.”
43. One trade organization stated that issues and concerns about the standard setters has been a growing issue and hit a “tipping point” when the FASB voted against the work of the PCFRC relative to the release of FIN 48 and FIN 46R.

**Question 3b: Are those issues or concerns confined to one or more specific standards, or are they more systemic?**

44. The overwhelming majority of the respondents felt the issues or concerns were systemic. Approximately 60% of the respondents cited certain accounting issues as being most problematic. Over half of those respondents had specific concerns regarding income taxes/uncertain tax positions, variable-interest entities, and fair value. Other accounting issues cited included derivatives and other financial instruments, stock compensation, straight-lining of leases, comprehensive income, business combinations, and the proposed lease and revenue recognition standards. In addition to the problematic standards, the majority of the respondents felt the issues were systemic due to the broad-based issues such as the increase in complexity, the pace of change of U.S. GAAP, the increase in qualified or exception-based GAAP opinions, the number of companies reporting under OCBOA, and compliance costs as mentioned above.

**Question 3c: Do you believe that those issues or concerns are largely confined to private companies, or are they broader? Please be as specific as possible in your answers.**

45. There were varying responses regarding whether the issues or concerns were largely confined to private companies. Many respondents did not respond directly to this question or indicated that they were not able to judge whether the issues were broader because they only deal with private companies. Many respondents suggested that the issues and concerns were broader and also applied to public companies. However, many of those respondents felt that public companies have more resources to deal with the problems. Some of the respondents indicated that the issues also apply to smaller public companies, in particular, because, similar to many private companies, they tend to have limited company resources. One trade organization stated that complexity is a problem for all, but “public companies enjoy access to public capital as a benefit. Private companies and their users do not receive the benefits but have the same costs.”

**Question 4: What short-term and/or long-term actions do you believe are necessary to address those issues or concerns? Please be as specific as possible in your answer, and explain your reasoning.**

**Short-term actions**

46. CPA practitioners with fewer than 5 partners generally felt there is some urgency in the need to take action. With regard to proposed new accounting standards, these respondents felt that there should be increased education and awareness about the proposals, specifically targeting private companies. Some suggested webcasts, educational publications, and field tests to fully gauge the real-world impact of new standards on private company stakeholders. One respondent from a CPA firm with 6 to 20 partners felt that the FASB should specifically seek commentary and feedback

from creditors and creditors' organizations. Respondents also expressed the need for delayed effective dates and longer implementation periods on the new standards.

47. CPA practitioners with over 500 partners generally echoed the sentiments that the FASB should seek more input from private companies during the standard-setting process. One respondent suggested developing a standardized method of collecting and considering views from private company constituents to capture their perspective during the deliberations of each new standard. Additionally, one respondent added that the FASB could strive to provide clearer explanations in the basis for conclusions section of new standards.
48. One CPA firm with over 500 partners also felt that, going forward, an effort should be made to ensure that new standards are more easily understood by all companies. Moreover, practical expedients for private companies should be considered, and disclosure requirements should be scaled to be appropriate for the primary users of private company financial statements.
49. A lender responded stating that one short-term solution would be to slow the current pace of standard-setting activities, allowing more private companies to stay current with and participate in the process.
50. With regard to existing standards, CPA practitioners with fewer than 5 partners felt that there should be more willingness by the FASB to provide private companies with exceptions to specific standards. Firms with 6 to 20 partners felt similarly, stating that there should be exemptions from standards that do not benefit the assessment of essential operations. One respondent from a firm with 6 to 20 partners suggested that standards that have been identified as having questionable relevance to the users of private company financial statements should be immediately suspended and a cost-benefit analysis performed. One respondent proposed forming a coalition of creditor users and those engaged in the standard-setting process to identify areas of the accounting literature in which the needs of creditor users and equity investors differ. This analysis would be performed first on the conceptual framework and second on a standard-by-standard basis.
51. A chief financial officer similarly requested that more exemptions be allowed for private companies. This respondent felt that the problems with some standards, for example fair value, warranted differences in recognition and measurement.
52. Other respondents also supported exemptions from certain standards, specifically those that did not focus on cash inflows and outflows. Another suggestion was a simplified checklist format for disclosures, with an emphasis on understandability and use of non-technical language.
53. CPA firms with over 500 partners generally indicated that, in some cases, relevance and cost-benefit concerns might warrant differences in effective date, transition, and disclosure requirements for private companies. One firm noted that reduced disclosures may be appropriate if it can be shown that users can obtain any incremental information they might need directly from management.
54. Others suggested that the FASB suspend all proposed standards for private companies until a definitive resolution is determined by the FAF.

**Long-term actions**

55. Respondents discussed a wide variety of possible long-term actions. Several CPA firms with fewer than 5 partners advocated a separate board devoted to developing standards for private companies. One respondent stated that such a board should be made up of CPAs from regional firms, who would better understand closely held companies. Another respondent advocated for differential reporting and regulatory standards based on size rather than filing status.
56. One response from a CPA practitioner with 21 to 100 partners supported an approach in which the standards issued up to a certain date would be retained for use by private companies. Going forward, each new standard promulgated for public companies would be evaluated for its relevance to private companies. All private companies would retain the option of reporting under full public company standards. Thus, the market would essentially determine which set of standards a private company would report under.
57. Another respondent from a CPA firm with 6 to 20 partners shared a similar idea. This respondent stated that banks were the primary users of private company financial statements. As such, they would ultimately determine the standard setter and level of reporting that is appropriate to meet their needs.
58. Several CPA firms with over 500 partners felt that any substantial recommendations by the Panel might be premature in light of the SEC's forthcoming decision regarding IFRS for public companies. Although the SEC's actions would only directly affect public companies, there would be ramifications for private companies as well. Actions by the Panel may result in unnecessary confusion and complication.
59. Another practitioner with over 500 partners stated that the Disclosure Framework and Conceptual Framework projects should consider the needs of private companies in their goal to create meaningful and effective financial statement disclosures. This respondent also recommended performing some research to help determine whether there were disclosures that could be easily eliminated for private companies.
60. Another respondent from a CPA firm with over 500 partners had a similar suggestion to perform research in order to determine how best to meet the different needs of users of private company financial statements. However, this respondent discussed changes beyond disclosures and into possible differences in recognition and measurement.
61. Another possibility presented was utilizing special-purpose reports to fulfill the diverse needs of users when the use of audited GAAP financial statements is limited.
62. One respondent from a CPA firm with over 500 partners presented several alternative solutions to consider. The first possibility was establishing two distinct standard-setting boards, one to focus on standards for publicly accountable entities and another to focus on the reporting objectives of private companies. The second possibility was creating two boards that had some level of overlapping membership in order to foster collaboration and maintain some consistency. The third possibility was retaining one standard-setting board but creating a subsidiary board to focus on issues relating to private company and not-for-profit entity issues. Respondents from this group also noted that with any of these potential solutions, there would be a need for increased funding and education.

63. Responses from preparers generally indicated that substantial changes were desired. They felt that the lack of relevance of certain standards justified differences not only in disclosure but in recognition and measurement as well. One respondent also had specific concerns about the current cash flow statement. This respondent recommended examining whether the statement was providing value to users in its current form.
64. A response from a state CPA society concurred that some distinction was needed between the reporting for public and private companies. Another state society felt that preparing financial statements on the tax basis was a practical solution to the relevance issue. However, this state society also noted that more guidance was necessary to support using the tax basis as OCBOA.
65. Other respondents had some differing views. Some felt that developing a new set of standards would introduce unnecessary complications since private companies already have the choice of reporting under other comprehensive bases of accounting. On top of that, the complexity of an additional set of GAAP would have implications for academia and practice.
66. Alternatively, a respondent felt that the existing accounting literature should undergo a full relevance review with the perspective of private company concerns.
67. There were other mixed reviews about whether a separate board should set private company standards. One CPA practitioner suggested a practitioner board composed of small to medium firms should set private company GAAP. Another practitioner felt that the separation of standards was long overdue and that a separate private company board made up of users, preparers, and issuers of private companies should set those standards.
68. Another practitioner felt that any attempt to revise U.S. GAAP for private companies would not be successful without a related revision to the framework. This practitioner shared similar views to other practitioners that private companies should have a greater representation in the standard-setting process.

**Question 5a: To what extent, if any, would an SEC requirement for public companies to adopt IFRS at a date certain affect your answers above? Why?**

**IFRS**

69. Some respondents felt that while a separate set of standards might be desirable, the SEC decision to require public companies to adopt IFRS should be made first. Some felt IFRS for SMEs would be a viable option. Some of these respondents felt that the Panel may have been too hasty in rejecting IFRS for SMEs.
70. CPA practitioners had widely differing views on IFRS and the role that it might play in financial reporting for private companies. Some respondents from CPA firms with fewer than 5 partners found that their clients did not have a great concern for or awareness of IFRS broadly and IFRS for SMEs. They indicated that many small firms simply do not care and feel that IFRS is irrelevant for companies that do not have significant international operations. One respondent from a CPA firm with 6 to 20 partners agreed that IFRS should not be mandatory for private companies that do not have international investors.

71. On the other hand, a CPA practitioner with 6 to 20 partners observed that its clients were increasingly engaging in international transactions.
72. Some CPA practitioners with fewer than 5 partners felt that the move toward IFRS in the realm of public companies would have a trickle-down effect on private companies in the U.S. Some of the perceived consequences of this trickle-down effect would be increased complexity and limited comparability, increased costs for conversion, and division of the talent pool.
73. Still other respondents felt that private company financial reporting could benefit from a shift toward IFRS. IFRS for SMEs was developed to address the differing reporting needs of private companies. One respondent felt that a move toward a single global standard and worldwide comparability is a positive step.
74. A respondent from a CPA firm with over 500 partners shared a similar sentiment, noting that IFRS for SMEs could be used as a starting point for developing any differential standards for private companies or not-for-profit entities. The respondent maintained that this could help to provide some timely relief for private companies while mitigating some of the risk of diverging too greatly if financial reporting for public companies in the U.S. moves towards IFRS.
75. A preparer expressed concerns about inconsistent application and the subjectivity involved in the more principles-based international standards. Another respondent, however, felt that the principles-based approach could help to address the overwhelming complexity of the current rules.
76. One respondent also noted that a move towards IFRS could increase companies' exposure to international interests, potentially opening up new commercial opportunities.
77. Some respondents feel that IFRS for SMEs was created for very small companies and for developing nations that lack much accounting structure.
78. Another respondent indicated that the future of accounting of private companies affects not only the U.S. It is an issue in Europe and the rest of the world as a growing number of countries are moving toward IFRS.

**Question 5b: To what extent, if any, would other outside factors affect your answers above? Which factors and why?**

79. Some commented that the needs of users could have an impact on their answers. Another respondent felt that users would be practical about the financial information they would be willing to accept. Other respondents stated that if users started to require IFRS statements, some of their answers would change.
80. Another respondent suggested that the biggest outside factor is the income tax system.

**Question 6: Is there any other input that you'd like to convey to the Panel?**

81. Some CPA practitioners had general concerns regarding comparability if the Panel were to recommend going to two separate standards. One CPA practitioner with 6 to 20 partners stated that "many new pronouncements appear to be geared toward the complex transactions of the public filers. That all being stated, I have some angst

with respect to the impact two sets of standards might have, given that two sets of standards would clearly mean differences in comparability of a public company versus a private company, both of which might also operate internationally. I'm unsure how analysts, investors, creditors and other would assess the differences, or what impact those differences might have on such things as the cost of financing, investor confidence and our financial markets."

82. One practitioner felt that two sets of standards would appropriately address the problems but most standards should remain the same for comparability issues. The practitioner believes that standard setters should try to fix the main issues for private companies but leave the majority of the standards the same.
83. One practitioner with 6 to 20 partners felt that there was a benefit to retaining consistency between the financials for private and public companies, but that some relief was necessary. The practitioner suggested retaining a single set of accounting literature but varying the degree of application for public and private companies; in this way, there would be consistency across accounting principles, with flexibility in application.
84. One trade organization felt that a more principles-based approach could also decrease comparability among companies.
85. Some respondents felt that the standard setters should keep the economics of implementation in mind.
86. Some respondents were concerned about the proposed leasing standard. One CPA practitioner was concerned that putting leases on the balance sheet would not improve the value of financial statements and would overcomplicate and confuse users. Another practitioner maintained that CFOs and banks need to know the true cash impact of leases as approximated by Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). If nearly all operating leases become capital leases, interest and depreciation associated with the capital leases will be added back to EBITDA calculations resulting in the illusion that these leases do not impact EBITDA.
87. One trade organization felt that the cost of capital is another part of the problem. Companies without audited financial statements or without clean opinions pay more for capital.

**Questions 7: Do these responses represent your individual views or are they submitted to represent the views of the organization with which you are associated?**

88. Many respondents indicated that their response represented their individual views and many indicated their response represented the view of their particular organization. It appeared that the larger the CPA practitioner the individual represented, the more likely he or she responded as an organization.

**APPENDIX H****Models and Structures Considered**

The staff prepared public meeting handouts to facilitate the audience's understanding of the issues being discussed by the Blue-Ribbon Panel during its July 19, 2010 and October 8, 2010 meetings on alternative standard-setting models and structures for U.S. private companies. This appendix contains portions of those handouts.

**“Blue-Ribbon Panel” on Standard Setting for Private Companies  
Third Meeting (July 19, 2010): Alternative Standards/Standard-Setting  
Models and Structures for U.S. Private Companies**

Based on what the “Blue-Ribbon Panel” (the Panel) has heard at its first two meetings, there appear to be broad-based concerns among private company stakeholders, especially preparers and practitioners, with the current standard-setting system (especially some of the resulting standards). In this meeting, we will focus primarily on various alternative models and structures for standard setting for private companies.

The discussion of models will focus on what type of standards and standard-setting process will best facilitate financial reporting that will meet the needs of users of private company financial statements in a manner that is cost-beneficial for private company preparers, practitioners, users, and others in the financial system. The models are as follows:

**U.S. GAAP-BASED/ “HOMEGROWN” MODELS:****Model 1 – U.S. GAAP with Exclusions for Private Companies – current system****Model 2 – U.S. GAAP with Exclusions for Private Companies – with enhancements****Model 3 – U.S. GAAP—Baseline GAAP with Public Company Add-Ons****Model 4 – Separate, Standalone GAAP Based on Current U.S. GAAP (the “Canadian” Approach)****Model 5 – Separate, Standalone GAAP from the Ground up Based on New Framework**



**IFRS-BASED MODELS:****Model 6 – Unmodified IFRS for SMEs****Model 7 – IFRS for SMEs Customized (“Americanized”) for U.S. Private Companies**

Many of these models, which are briefly described in the Appendix, build upon work performed by the Private Company Financial Reporting Committee (PCFRC) and other organizations. Most of the models contemplate the creation and/or use of some sort of private company conceptual framework. The models represent two continua, one based on U.S. GAAP and another based on IFRS. Along these continua, the model that the Panel ultimately homes in on may actually combine features of more than one of the models. Or, the Panel might home in on a succession of models, one shorter-term and potentially another longer-term—if, for example, the ultimate model would take a long time to achieve or if the choice of an ultimate model is viewed as somewhat dependent on outside factors, such as the SEC’s decision regarding whether and how to adopt/incorporate IFRS for public companies.

In its discussion of models, the Panel will weigh the pros and cons of the models, both in the specific context of the private company sector and the broader context of the financial reporting system as a whole.

The Panel will also discuss various possible structures for the standard-setting board (and related resources, such as advisory groups), perhaps the key driver in achieving the desired model(s). These structures are arrayed along the following two continua:

**STRUCTURES FOR U.S. GAAP-BASED/ HOMEGROWN MODELS:****Structure A – Current FASB Board****Structure B – Restructured FASB Board (with greater private company representation)****Structure C – New, Separate Private Company Standards Board****STRUCTURES FOR IFRS-BASED MODELS:****Structure D – IASB Board****Structure E – Board Structure for Customized IFRS for SMEs (in addition to IASB Board)****i) Current FASB Board****ii) Restructured FASB Board****iii) New, Separate Private Company Standards Board**

As with the models, the Panel could ultimately home in on only certain elements of the structure, on a combination of structures, or on an evolutionary series of structures.

#### **APPENDIX: MODELS**

##### **Model 1 – U.S. GAAP with Exclusions for Private Companies – current system**

- Current U.S. GAAP (the Codification) would be used by all companies and improved as necessary through the FASB's regular standard-setting activities.
- Those activities utilize the current FASB Nonpublic Entity staff (Assistant Director, Project Manager, Postgraduate Technical Assistant), who work with the FASB project staff and the FASB board in a close, consultative capacity (leading to explicit consideration of private company issues and feedback, documented in the Basis for Conclusions section of all proposed and final Accounting Standards Updates), and with the PCFRC and FASB's Small Business Advisory Committee in their current advisory roles.
- Differences (exclusions) for private companies would continue to be determined on a standard-by-standard basis.
- This model would not contemplate the creation of a separate conceptual framework for private companies.
- However, a project to simplify standards, especially in the area of disclosures, could be undertaken for all entities (private and public), perhaps in connection with the FASB's Disclosure Framework Project.

##### **Model 2 – U.S. GAAP with Exclusions for Private Companies – with enhancements**

- Current U.S. GAAP (the Codification) would be used by all companies and improved as necessary through the FASB's regular standard-setting activities.
- Differences (exclusions) for private companies would continue to be determined on a standard-by-standard basis.
- A conceptual framework for private companies would be created to serve as a basis for making exceptions. Such a framework would be based on user needs but would be modest (approximately on the level of the "Concepts and Pervasive Principles" chapter that the IASB put into the IFRS for SMEs document).
- Various other enhancements could be made, such as to board structure, staffing, and other elements of standard-setting. For example, the FASB could be expanded to include a member with small, private company experience. Together with the private company conceptual framework, these enhancements might further ensure that appropriate and adequate focus is placed on private company issues, with resulting differences for private companies.

##### **Model 3 – U.S. GAAP—Baseline GAAP with Public Company Add-Ons**

- Current (existing) U.S. GAAP (the Codification) would be reviewed and reorganized into a baseline GAAP for all entities, based on user needs, and with additional GAAP requirements ("add-ons") for public companies.

- The approach to standards currently under development could be changed to establish a baseline standard for all entities and additional requirements for public companies even before completion of the overall baseline separation project.
- This model contemplates the need to create a separate conceptual framework for private companies, or to reexamine/revise the existing conceptual framework, to serve as a basis for making decisions as to what to put in the baseline. If separate, such framework would be modest (approximately on the level of the “Concepts and Pervasive Principles” chapter that the IASB put into the IFRS for SMEs document).

**Model 4 – Separate, Standalone GAAP Based on Current U.S. GAAP (the “Canadian” Approach)**

- Current U.S. GAAP would be reviewed, modified, and developed into a comprehensive and self-contained set of accounting standards for private companies.
- This approach contemplates a major overhaul project to review and significantly streamline current U.S. GAAP, as well as ongoing activities to update but keep simplified (similar to what the IASB and the Canadian AcSB will be doing with their respective private company standards).
- This model contemplates the need to first create a conceptual framework for private companies that would serve as a yardstick for making streamlining and other simplification decisions. Such a framework would be modest (approximately on the level of the “Concepts and Pervasive Principles” chapter that the IASB put into the IFRS for SMEs document).

**Model 5 – Separate, Standalone GAAP from the Ground up Based on New Framework**

- This model is focused solely on the private company sector and begins with the creation of a new private company conceptual framework based on private company user needs. As opposed to the private company framework described in Models 2–4, which could be described as a “differential framework,” the framework would be from the ground up, entail a major project to create, and could be significantly different from the current GAAP conceptual framework (including revisions currently being contemplated by the FASB and IASB). The model framework suggested in the draft white paper released by FET’s Committee on Private Companies-Standards (the Committee) is an example of this type of framework.
- A comprehensive set of standards would be developed based on this new framework and would then constitute a separate, self contained set of standards for use by private companies.

**Model 6 – Unmodified IFRS for SMEs**

- This model would use IFRS for SMEs as it exists today
- IFRS for SMEs, as promulgated by the IASB, is not intended for entities that have public accountability (e.g., financial institutions).
  - Part of a possible recommendation of IFRS for SMEs could be a recommendation about whether IFRS for SMEs should be permitted to be used

by private companies with public accountability. (However, if used by such entities, they would not technically be able to refer to such standards as IFRS for SMEs.)

- IFRS for SMEs includes a group of Concepts and Pervasive Principles that serve as a framework for the simplifications made from full IFRS.

**Model 7 – IFRS for SMEs Customized (“Americanized”) for U.S. Private Companies**

- The IFRS for SMEs standards would be tailored to suit the needs of private company stakeholders in the U.S.
- This model contemplates an initial project to review and modify IFRS for SMEs as appropriate, possibly significantly. (However, depending on the nature and extent of the modifications, we might not actually be able to refer to the resulting standards as IFRS for SMEs.)
- Ongoing decisions would be required to elect to accept IASB revisions to the SME document verbatim or elect to modify them for U.S. private companies.

**“Blue-Ribbon” Panel on Standard Setting for Private Companies  
Fourth Meeting (October 8, 2010): Discussion of Standard-Setting Models  
and Structures (cont’d), Recommendations**

In this meeting, the “Blue-Ribbon” Panel (the Panel) will continue its discussion and debate on alternatives to the current standard-setting system. At its July 19, 2010 meeting, there was wide agreement among Panel members that:

- The status quo is unacceptable
- U.S. private companies should not be leading the charge, *en masse*, to an IFRS-based set of standards in advance of a potential move by U.S. public companies

Accordingly, the Panel asked staff to make refinements to the following set of U.S. GAAP-based standard-setting models discussed at the July 19 meeting:

**Model 2 – GAAP with exceptions for private companies**

**Model 3 – Baseline GAAP with add-ons for public companies**

**Model 4 – Separate, standalone GAAP for private companies**

For Models 2 and 4, the staff also outlined two structural variations, one featuring a **restructured FASB** (Models 2A and 4A) and the other featuring a **separate private company board** (Models 2B and 4B). Because of the nature of Model 3, only a version with a single standard-setting board for both public and private companies (a restructured FASB) is feasible, so only one refined version of that model has been outlined. The outline of the five models is contained in the pages that follow.

After discussing a summary of responses received in connection with the Panel’s call for written public submissions—with a focus on any new information—the Panel will proceed with the discussion and debate of the models. The Panel’s aim will be to reach a substantial consensus among Panel members as to which model to recommend to the FAF Board of Trustees as being in the best long-term interest of users of financial statements of U.S. private companies within the broader context of the overall U.S. financial reporting system.

Because the models represent points along a continuum of possible models, the Panel could recommend a hybrid model. And, because the models will take a period of time to fully achieve, with the length of time varying somewhat among the models, the Panel could recommend an evolutionary sequence of models, and/or some additional shorter-term actions by the FAF and/or the FASB.

**Blue-Ribbon Panel  
Model Outline**

Based on what we heard at the last meeting, the staff has narrowed the alternatives to three possible models, with structural variations for two of those models, to bring forward for discussion at the October 8<sup>th</sup> meeting. As with the first round of models and structures, the models and structural variations outlined here are meant simply as a starting point for discussion. The model that the Panel ultimately homes in on may actually combine features of more than one of the models, or the Panel might recommend something in-between models. Please also note that, in this round of models, the staff has avoided speculating within the models about what recognition, measurement, disclosure, or presentation differences could occur, since the standard setter will ultimately determine those differences.

In reviewing the models, the Panel should consider what short-term and long-term changes may need to be made to be able ultimately to achieve the respective models. The most effective approach to accomplish the desired end-state model could well be a succession (evolution) of models.

**Overview of Models and Structures**

In the pages that follow, we present the following models/structures:

**Model 2A – GAAP with exceptions for private companies (enhanced) with restructured FASB Board**

**Model 2B – GAAP with exceptions for private companies (enhanced) with separate private company standards board**

**Model 3A – Baseline GAAP with add-ons for public companies with restructured FASB Board**

**Model 4A – Separate, standalone GAAP for private companies with restructured FASB Board**

**Model 4B – Separate, standalone GAAP for private companies with separate private company standards board**

MODELS: U.S. GAAP-Based			
STRUC TURES	2 GAAP with exceptions for private companies, enhancements to current model	3 Baseline GAAP with add-ons for public companies	4 Separate, standalone GAAP for private companies
A) Restructured FASB Board	<p style="text-align: center;"><b>MODEL 2A</b></p> <p>Description:</p> <ul style="list-style-type: none"> <li>Current U.S. GAAP (the Codification) would be used by all companies and continue to be improved as necessary through an exception-based standard-setting process, with specific enhancements as discussed below. A restructured FASB would act as the standard setter.</li> </ul> <p>Framework:</p> <ul style="list-style-type: none"> <li>The current conceptual framework would be examined and augmented as necessary to include a differential framework, which would serve as a basis for making decisions about what is appropriate for private company exclusions.</li> </ul>	<p style="text-align: center;"><b>MODEL 3A</b></p> <p>Description:</p> <ul style="list-style-type: none"> <li>Current U.S. GAAP (the Codification) would be reviewed and reorganized into a baseline GAAP for all entities, based on user needs, and with additional GAAP requirements ("add-ons") for public companies, and continue to be improved as necessary through a standard-setting process based on that split. A restructured FASB would act as the standard setter.</li> </ul> <p>Framework:</p> <ul style="list-style-type: none"> <li>The current conceptual framework would be examined and augmented as necessary to include a differential framework, which would serve as a basis for making decisions about what is the appropriate baseline for all companies and what are appropriate as add-ons for public companies.</li> </ul>	<p style="text-align: center;"><b>MODEL 4A</b></p> <p>Description:</p> <ul style="list-style-type: none"> <li>Current U.S. GAAP (the Codification) would be reviewed, modified, and developed into a simplified, self-contained set of accounting standards for private companies, which would then be improved as necessary on a periodic basis. A restructured FASB would act as the standard setter.</li> </ul> <p>Framework:</p> <ul style="list-style-type: none"> <li>The current conceptual framework would be examined and augmented as necessary to include a differential framework, which would serve as a basis for making streamlining and other simplification decisions.</li> </ul>

<b>MODELS: U.S. GAAP-Based</b>			
<b>STRUC TURES</b>	<b>2 GAAP with exceptions for private companies, enhancements to current model</b>	<b>3 Baseline GAAP with add-ons for public companies</b>	<b>4 Separate, standalone GAAP for private companies</b>
	<b><u>MODEL 2A—continued</u></b>	<b><u>MODEL 3A—continued</u></b>	<b><u>MODEL 4A—continued</u></b>
	<p>Boards:</p> <ul style="list-style-type: none"> <li>• In the expansion of the FASB back to seven members and perhaps ultimately more, the FAF should assess the FASB’s composition and adjust as necessary to include sufficient private company experience and perspective. In connection with this, the FAF should consider appointing one or more members whose experience is primarily with the private company sector.</li> <li>• Assess and adjust the FAF’s composition as necessary to ensure its oversight function has the appropriate private company experience and perspective.</li> <li>• Assess and adjust Financial Accounting Standards Advisory Council (FASAC) composition as necessary to ensure its advisory function has the appropriate private company experience and perspective. (FASAC is FASB’s primary advisory group.)</li> </ul>	<p>Boards:</p> <ul style="list-style-type: none"> <li>• In the expansion of the FASB back to seven members and perhaps ultimately more, the FAF should assess the FASB’s composition and adjust as necessary to include sufficient private company experience and perspective. In connection with this, the FAF should consider appointing one or more members whose experience is primarily with the private company sector.</li> <li>• Assess and adjust the FAF’s composition as necessary to ensure its oversight function has the appropriate private company experience and perspective.</li> <li>• Assess and adjust Financial Accounting Standards Advisory Council (FASAC) composition as necessary to ensure its advisory function has the appropriate private company experience and perspective. (FASAC is FASB’s primary advisory group.)</li> </ul>	<p>Boards:</p> <ul style="list-style-type: none"> <li>• In the expansion of the FASB back to seven members and perhaps ultimately more, the FAF should assess the FASB’s composition and adjust as necessary to include sufficient private company experience and perspective. In connection with this, the FAF should consider appointing one or more members whose experience is primarily with the private company sector.</li> <li>• Assess and adjust the FAF’s composition as necessary to ensure its oversight function has the appropriate private company experience and perspective.</li> <li>• Assess and adjust Financial Accounting Standards Advisory Council (FASAC) composition as necessary to ensure its advisory function has the appropriate private company experience and perspective. (FASAC is FASB’s primary advisory group.)</li> </ul>



MODELS: U.S. GAAP-Based			
STRUCTURES	2 GAAP with exceptions for private companies, enhancements to current model	3 Baseline GAAP with add-ons for public companies	4 Separate, standalone GAAP for private companies
<b>B) New Separate Private Company Standards Board</b>	<p style="text-align: center;"><b><u>MODEL 2B</u></b></p> <p>Description:</p> <ul style="list-style-type: none"> <li>• Current U.S. GAAP (the Codification) would be used by all companies and continue to be improved as necessary through an exception-based standard-setting process, with specific enhancements as discussed below. This model would contemplate a new, separate private company standards board under the FAF—see board section.</li> </ul> <p>Framework:</p> <ul style="list-style-type: none"> <li>• The current conceptual framework would be examined and augmented as necessary to include a differential framework, which would serve as a basis for making decisions about what is appropriate for private company exclusions.</li> </ul>	<p>A separate, private company standard-setting board under a baseline GAAP model would not be feasible.</p>	<p style="text-align: center;"><b><u>MODEL 4B</u></b></p> <p>Description:</p> <ul style="list-style-type: none"> <li>• Current U.S. GAAP would be reviewed, modified and developed into a simplified and self-contained set of accounting standards for private companies, which would then be improved as necessary on a periodic basis. This model would contemplate a new, separate private company standards board under the FAF—see board section.</li> </ul> <p>Framework:</p> <ul style="list-style-type: none"> <li>• The current conceptual framework would be examined and augmented as necessary to include a differential framework, which would serve as a basis for making streamlining and other simplification decisions.</li> <li>• Alternatively, a separate, robust conceptual framework specifically geared to private companies could be created to help the board develop a “from the ground up” private company GAAP. (This was described as model 5 in the previous model write-up.)</li> </ul>

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	<p><b><u>MODEL 2B—continued</u></b> Boards:</p> <ul style="list-style-type: none"> <li>• Separate private company standard-setting board that follows the work of the FASB. The private company board would be empowered to review both proposed standards and existing standards that the FASB sets and determine whether to make exceptions or modifications for private companies.</li> <li>• Assess and adjust the FAF's composition as necessary to ensure its oversight function has the appropriate private company experience and perspective.</li> <li>• The new standard-setting board would need new primary advisory group in lieu of FASAC.</li> </ul>		<p><b><u>MODEL 4B—continued</u></b> Boards:</p> <ul style="list-style-type: none"> <li>• The board under this model would be the standard setter for the separate, standalone GAAP for private companies.</li> <li>• Assess and adjust the FAF's composition as necessary to ensure its oversight function has the appropriate private company experience and perspective.</li> <li>• The new standard-setting board would need new primary advisory group in lieu of FASAC.</li> </ul>