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THE ROLE OF THE ACCOUNTING PROFESSION IN PREVENTING ANOTHER FINANCIAL CRISIS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING THE ROLE OF THE ACCOUNTING PROFESSION IN PREVENTING ANOTHER FINANCIAL CRISIS

APRIL 6, 2011

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C O N T E N T S

WEDNESDAY, APRIL 6, 2011

WITNESSES

THE ROLE OF THE ACCOUNTING PROFESSION IN PREVENTING ANOTHER FINANCIAL CRISIS

WEDNESDAY, APRIL 6, 2011

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 9:34 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Let me call the hearing to order.

First, my colleague and Ranking Member, Senator Crapo, very much wanted to be here. He is not 100 percent today physically, so just some minor sort of setback. But, unfortunately, he is not likely to join us. Other colleagues will arrive, but given the time of our witnesses and the importance of the topic, I think it is appropriate to begin.

Let me make an opening statement and then recognize my colleagues when they arrive, if we have not recognized witnesses for their statements. And I want to thank, obviously, the witnesses, both panels, for attending.

In the wake of the financial crisis of 2008, many have decried too big to fail, but there may be a more immediate problem: too big or too complicated or too powerful to be audited. And without effective auditing, directors, creditors, and shareholders are all flying blind, and failure could be just ahead and unavoidable.

Prior to the collapse or rescue of nine major financial institutions in 2007 and 2008, they each received unqualified audit reports within months of their demise from various major accounting firms. So this hearing is not about one company or one auditor. This is about systemic weaknesses in the audit process that may continue to impair investor confidence and provide inadequate information to the investing public and to directors of public companies and to the markets in general.

The costs of these problems are staggering. The Financial Crisis Inquiry Commission estimated that nearly $11 trillion in household wealth was lost through retirement accounts and life savings being diminished in the crisis. Auditors who have the responsibility for examining and reporting on the companies' books and records in the cases I have cited sounded no distinctive and helpful alarms prior to the demise of these companies.

As such, serious questions have been raised about the quality of financial reporting practices and about the quality of audits that should have revealed key financial irregularities or the poor status of these companies. Auditors have a special responsibility—not a unique or sole responsibility but a special responsibility—a public trust, as defined by the Supreme Court, to protect participants by certifying that information companies prepare and publish is accurate and transparent.

Without question, there seems to be a systemic lack of this transparency in the last several years. Investors never knew the risks and uncertainties embedded in certain of the securities they purchased. Huge financial firms used accounting gimmickry and financial engineering to obscure their financial health. And this leads us to important considerations.

Did the accounting profession contribute to the lack of transparency either in promulgating rules that allowed for financial engineering and a lack of transparency? Or were appropriate rules ignored by the companies? Why were there no alarms sounded in a meaningful and timely way to perhaps avoid or mitigate some of the consequences of these failures?

Regulators from around the world have undertaken inquiries regarding the sufficiency of audit firms and accounting methodologies. The European Commission has undertaken a number of inquiries. The British Parliament recently released a report on their examination recommending a number of detailed actions in addition to a call for further review. That report included findings that questioned both the audit profession and whether international financial reporting standards were sufficiently robust.

The purpose of this hearing is to examine the role of accounting professionals in preventing another financial crisis. The financial crisis that we endured may have been avoidable, and there were key missteps by many participants, including regulators and supervisors. And while I am interested in learning about the failings during the financial crisis, I want to emphasize again this is more about what we have to do now to protect ourselves in the future, to return our financial reporting in the United States to the world standard it once was and must be.

The accounting profession is one of the bedrocks of our financial marketplace. A robust and transparent financial reporting system is the key to establishing credibility and confidence in our markets, which in the end protects investors and lowers the cost of capital. And I look forward, again, to the testimony of the witnesses that are here today.

Let me now recognize and introduce the first panel.

James Doty is Chairman of the Public Company Accounting Oversight Board. Mr. Doty was appointed by the Securities and Exchange Commission as the Chairman of the Public Company Accounting Oversight Board in January 2011. Prior to his appointment, he served as a partner at the law firm of Baker Botts. Welcome, sir.

Leslie Seidman is Chairman of the Financial Accounting Standards Board, FASB. She was appointed to this position by the Financial Accounting Foundation effective December 23, 2010. She was originally appointed to the FASB in July 2003 and reappointed to a second term in July of 2006.

James Kroeker is the Chief Accountant of the Securities and Exchange Commission. He first joined the Commission as Deputy Chief Accountant in February 2007. Prior to joining the SEC, Mr. Kroeker was a partner at Deloitte & Touche LLP, and he has already assured me that he is an essential person at the SEC.

Mr. Doty.

STATEMENT OF JAMES R. DOTY, CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Mr. DOTY. Thank you, Chairman Reed. I appreciate, and on behalf of the Public Company Accounting Oversight Board we appreciate, the opportunity that you and Ranking Member Crapo and Members of your Subcommittee have extended to us to appear here.

I joined the Board, as you mentioned, on February 1, 2011. Many of the achievements and the initiatives I describe in our written testimony or refer to here today were the work of, or begun by, my predecessors on the Board as well as the PCAOB staff, and that work sometimes extended over several years.

The PCAOB is committed to applying lessons from the financial crisis through inspections, standard setting, and enforcement. We garnered those lessons from our inspections of audits conducted during the financial crisis and from dialog with investors and other users and preparers of audit reports.

Last fall, the PCAOB issued a report describing the kinds of audit deficiencies our inspectors identified in audits affected by the financial crisis. As described in that public report, the inspectors identified multiple instances where auditors failed to perform the work mandated by PCAOB standards.

In short, accounting firms must do a better job in adjusting to emerging audit risks as economic conditions change. They must adjust so that investors will have reliable information about the performance and financial position of public companies during periods of economic volatility.

Many investors were left wondering whether auditors could have done more during the recent crisis to highlight risks in our financial system, which raises questions about the reporting model. The Board has undertaken a comprehensive project to look at the very nature of the auditors' reporting model, which has not significantly changed in more than 60 years.

In addition, in 2011, the PCAOB will continue to focus on high-risk audit areas posed by the ongoing effects of the crisis. These areas may include, for example, the financial statement effect of an obligation to repurchase mortgages previously sold or mandated modifications to certain mortgages at financial institutions.

PCAOB inspectors will also look closely at corrective actions taken by accounting firms in areas where inspectors identify problems. A firm's failure to obtain sufficient evidence to support its opinion does not mean that the financial statements themselves are necessarily misstated. But it does mean that corrective actions are required, both to shore up the deficient audit as well as to better plan and perform future audits. Inspections can only protect investors from audit failures if firms act on inspection results.

Neither the financial statements, audits, nor the PCAOB oversight are intended to assess a company's liquidity structure, capital adequacy, or risk management. Nor does the PCAOB set accounting and disclosure requirements.

Rather, the PCAOB evaluates whether auditors have done their job, which is to make sure an institution's financial statements and related disclosures fairly present the results—good or bad—in conformity with applicable accounting and disclosure standards.

When we find that auditors did not do their jobs, we seek remediation through inspections. We examine existing standards. We issue staff alerts on key issues, in addition to considering whether new standards may improve the quality of audits and audit reports. And, the details of that are reflected in our written testimony. When appropriate, we discipline firms through our enforcement program.

The PCAOB is engaged in several investigations relating to audits of financial institutions and other public companies affected by the crisis. These investigations, and any contested disciplinary proceedings that may result, are confidential under the Sarbanes-Oxley Act.

This secrecy has a variety of unfortunate consequences. Interested parties, including investors, audit committees, issuers, and other auditors, are kept in the dark about alleged misconduct, even after a hearing and after adverse findings by us. Investors are not aware that the companies in which they have invested are being audited by accountants who have been charged by the PCAOB.

As my colleagues on the Board have previously suggested, only Congress has the power to lift this veil. The PCAOB stands ready to work with Members of this Subcommittee and the full Banking Committee to further the protection of investors that has been the hallmark of the Committee's work from its earliest days.

Thank you, and I look forward to your questions.

Chairman REED. Well, thank you very much, sir, and obviously the full text of your statement will be made part of the record, and not only you, sir, but the other witnesses may summarize, and your full text will be part of the record.

Mr. DOTY. Thank you.

Chairman REED. Ms. Seidman.

STATEMENT OF LESLIE F. SEIDMAN, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Ms. SEIDMAN. Chairman Reed, my name is Leslie Seidman, and I am the Chairman of the Financial Accounting Standards Board. I would like to thank you for the opportunity to participate in this important hearing today.

As the Subcommittee examines the role of auditors and accountants in helping to prevent another financial crisis, 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. I also want to be sure that this Subcommittee understands both the FASB's robust due process and how we remain accountable to our stakeholders. Finally, I want to update you on some convergence projects with the International Accounting Standards Board, many of which address issues related to the financial crisis. My written testimony provides more expansive information about our technical activities.

The FASB is an independent private sector organization that operates under the oversight of the Financial Accounting Foundation and the Securities and Exchange Commission. For nearly 40 years, the FASB has established standards of financial accounting and reporting for nongovernmental entities, including both private and public 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 the U.S. economy. Investors, creditors, donors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information. 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 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. Our process is similar to the Administrative Procedures Act process used by Federal agencies for rulemakings but provides far more opportunities for interaction with all interested parties.

Our process involves public meetings, roundtables, workshops, surveys, field visits, and the exposure of our proposed standards for formal public comment. We meet regularly with the staff of the SEC and the PCAOB and with banking regulators.

In recent years we have significantly improved our ability to engage with interested parties in a variety of ways so that we can obtain the feedback we need to make informed decisions about how to improve financial reporting standards. We videocast our Board meetings and have created podcasts and webcasts to provide short summaries of our proposals and new standards so that people can quickly assess whether they have an interest and want to weigh in. We have also been reaching out proactively to a wide range of investors and reporting entities. I particularly like these interactive meetings because we can ask questions to better understand why a person holds a particular view, which can accelerate the identification of issues and possible solutions. In short, the FASB actively seeks input from all of its stakeholders on proposals and processes, and we are listening to them.

Finally, we continue our work on convergence of U.S. and international accounting standards in several key areas. We developed improved accounting and disclosure standards relating to securitizations and consolidation of special purpose entities, and we plan to issue this month a converged standard on how to measure fair value when it is required by another standard.

We recently exposed a revised joint proposal on the accounting for loan losses and plan to discuss the feedback on it with the IASB starting next week. These are the key topics identified by the FASB's Financial Crisis Advisory Group and the Financial Stability Board, and we have made significant progress on them.

Mr. Chairman, that concludes my remarks, and I would be pleased to answer any questions.

Chairman REED. Thank you very much.

Mr. Kroeker, please.

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

Mr. KROEKER. Chairman Reed, thank you, thanks to Ranking Member Crapo and to the Members of the Subcommittee.

Let me apologize in advance for my voice. It is 90 percent better than yesterday, but as you might notice, I am having some throat issues.

I am Jim Kroeker, Chief Accountant of the Securities and Exchange Commission, and I serve as the principal adviser to the Commission on accounting and auditing matters. I appreciate the opportunity to testify today on behalf of the Commission regarding the role of the accounting profession in preventing another crisis.

Financial reporting plays a critical role in establishing and maintaining the confidence of the investing public. Information provided to participants in our capital markets must be neutral, reliable, and portray economic results in an accurate and faithful manner. An audit by an independent public accountant has long been recognized as important to reliable financial reporting.

The recent crisis resulted in the deepest economic recession since perhaps the Great Depression. As the crisis unfolded, regulators responded in various ways to financial reporting issues and auditing developments. Now, as our Nation emerges from this crisis, we have both the opportunity and the responsibility to consider the lessons and what can be learned to improve auditing and accounting going forward.

First, we must consider the current role of auditors and the audit work performed during the crisis. A financial statement audit is designed to provide reasonable assurance that a company's financial statements are presented fairly in all material respects in conformity with U.S. generally accepted accounting principles. In exercising this vital function, auditors seek to address the risk of material misstatement in financial statements reported to investors or "financial reporting risk." An audit is not designed to address other risks, such as business or operational risk, which may affect the company's results and impact investor decisions.

Focusing on financial reporting risk, there is reason to consider the extent to which improper, fraudulent, or inadequate financial reporting played a role in the crisis. When poorly performed audits contributed to or failed to detect financial reporting abuses, there are existing mechanisms for dealing with such misconduct, including SEC and PCAOB enforcement actions. We have and will continue to prosecute those who fail to comply with their obligations.

Second, in addition to considering whether audits performed during the crisis complied with the current standards, we and the

PCAOB are actively working to determine how standards and even the role of the auditor itself can be improved, and I would like to highlight just three of those projects.

First, each PCAOB inspection results in a report that details audit deficiencies noted during the inspection. We continue to support the PCAOB's efforts to identify and consider root causes of recurring audit deficiencies.

Second, the PCAOB actively has been seeking input from investors, preparers, and auditors on a variety of topics, including its standard-setting activities. That outreach was considered by the Board in adopting its recently issued standards that deal with the auditor's assessment of and response to risks of material misstatement.

Third, some investors have questioned the sufficiency of the information they receive from auditors, including whether investors could benefit from additional early warnings. In response, the PCAOB is actively working on an important project related to what should appear in the auditor's report.

The crisis also made clear how interconnected global financial markets are. We have been working with the PCAOB in their ongoing efforts to reach agreement with regulatory bodies in other jurisdictions to conduct inspections.

Turning now to accounting, the recent crisis also provided us with the opportunity to examine whether accounting standards could be improved. The crisis highlighted the types of information that investors, regulators, and other users of financial reports need to see in a company's financial statements. Consistent with input from my office, this Subcommittee, and the President's Working Group on Financial Markets, the FASB completed a major standard-setting initiative to improve financial reporting for many financings, securitizations, and other transactions that had previously not been consolidated on a company's balance sheet.

These new standards are effective for financial reporting results in 2010 and should enhance financial reporting transparency. We will continue to monitor their effectiveness.

In addition to these crisis-specific initiatives, the FASB continues to work with the IASB on joint projects to improve financial reporting and eliminate unnecessary differences between U.S. GAAP and IFRS.

Thank you for the opportunity to discuss these important auditing and accounting developments, and I will be happy to answer any questions you may have.

Chairman REED. Thank you very much. I want to thank the panel for excellent testimony.

Let me ask what for many people is a threshold question, and we are very fortunate today. We have the organization that essentially supervises the auditing process, we have the organization that prepares the rules for accountants, and then we have the Federal agency charged decisively with regulating the accounting profession and the reporting of public companies.

And the threshold question is: Why were there no timely warnings about companies that within months of an unqualified report collapsed or were rescued at taxpayers' expense? Your perceptions, Mr. Doty?

Mr. DOTY. Well, Mr. Chairman, I think as our report in September of this past year indicates, there are a number of areas where auditors should have delved deeper, more deeply into issues, valuation issues, the sources of information based on which financial instruments were being valued, the issues of when going-concern issues arise in a financial institution that may be heavily leveraged, being alert to end-of-reporting-period transactions, significant transactions entered into at the end of a financial reporting period that may have had principally financial reporting purpose without business substance.

These are, Mr. Chairman, enduring and recurring problems in financial reporting and in auditing, and our inspections show, if one goes back and beginning in 2006 starts looking at our inspection reports, they begin to show and they show with increasing frequency, defects and failures in pursuing these issues. Our 2011 audit review will do the same. We expect to have more deficiencies found in these audits. And, frankly, as I indicated, the key here in our mind is whether auditors are taking this to heart, going back and seeking to correct those audits, taking those defects up the line, and in some cases, frankly, whether they are presenting them as deficiencies to audit committees or whether they are minimizing them. That is a subject we are looking into. We have issued audit practice alerts. We will continue to do it. As Chief Accountant Kroeker says, we are going to be continuing to work very closely with the SEC on these standard-setting proposals in order to be sure that we have done what we can do to be sure there is transparency in what auditors do and that they have accurately talked about what they do and that the public understands it and that that's meaningful to them.

Chairman REED. You have pointed out some of the issues which have been identified by many other people, but there is another question, I think, which it raises. You know, why did this go on? I mean, if it was being reported to auditing companies in 2005 and 2006 that there is a lack of attention to these particular things, what were the incentives or disincentives that prevented them from dealing adequately with all the issues you cited?

Mr. DOTY. Mr. Chairman, that is a penetrating and excellent question, and I would defer to the views also of my colleagues on the panel. But I think you can see in the building of the financial crisis and the approach to it, you can see something we have seen before in capital markets called momentum investing. There was a certain sense that practices were going on that were gaining momentum. Everyone was doing it. It is disturbing to us as the regulator of auditors, obviously, that auditors were not more self-reliant and did not feel that they could go to audit committees and management and start sounding an alarm early. We think that comes to rest in very fundamental problems of the audit profession, that, in fact, the auditors themselves are recognizing has to change, that the audit profession knows that it is standing on the edge of a period of real change.

Chairman REED. Ms. Seidman, your comments.

Ms. SEIDMAN. Thank you, Mr. Chairman. Focusing on the role of the FASB in the financial system and our role being to establish financial reporting standards that provide investors with complete and neutral information with which to make informed investing decisions, we have procedures in place that we use to monitor whether standards are producing complete and neutral information or are perhaps resulting in unintended consequences, as well as cases where perhaps there is a lack of a standard and, therefore, a standard-setting implication for a financial reporting issue.

We have a number of standing advisory committees, and a regular agenda item is to ask them: Are there issues out there that the FASB or another party should be working on so that we can quickly respond and provide guidance to help improve financial reporting?

We also have regular meetings with the staff of the Securities and Exchange Commission, the PCAOB. We have an emerging issues task force. All of these outreach activities are designed to have timely identification of financial reporting issues from the people who are out in practice and closest to the businesses and the transaction so that we know if problems are emerging.

On a going-forward basis, we have some improvements in place to try and do an even better job of identifying those issues on a timely basis. With my colleagues, Mr. Doty and also Mr. Kroeker, we are planning to initiate a new financial reporting series that we plan to start in July the purpose of which is to convene regular meetings with interested parties to discuss what issues are emerging in the financial markets and among financial reporting professionals so that we can have a mechanism for surfacing those issues from informed constituents and then determining what is the nature of the issue. Is it a financial reporting matter, is it an auditing matter or possibly an enforcement matter? And then assigning accountability to the right party.

Getting back to the situation that unfolded in recent years with the crisis, the processes that we had in place we felt, given the global nature of the issues, warranted extra measures. And so together with our counterpart internationally, the International Accounting Standards Board, we convened a special advisory group to help us identify which accounting standards might be in need of improvement during the times of crisis as well as other parties were certainly weighing in at the time and providing feedback to us as well.

Those issues really came down to concerns about adequacy of guidance with respect to fair value measurement, the standards relating to securitizations and consolidations, as well as particularly the accounting for loan losses or impairments. And that is where we have been focusing our efforts in recent years. We have issued revised standards on fair value measurement as well as consolidations and securitizations, and we are working very diligently on that last item, the accounting for financial instruments, specifically with respect to impairment, and we are hoping to make progress on that standard this year.

So with all of these changes and enhancements that we have made and are continuing to make, we are hoping that those efforts will provide the accurate and neutral information that investors need to evaluate the risks inherent in companies on a going-forward basis.

Chairman REED. Thank you for that. Before I recognize Mr. Kroeker, I want to follow up with a specific issue and that is, in 2002, in the wake of Enron, we passed Sarbanes-Oxley, and one of the provisions, Section 401, was, we thought, specifically designed to address what we found to be one of the fundamental accounting issues with Enron, which was off-balance sheet transactions which were not appropriately recognized by the profession.

The scope was very broad about what we assumed that the rules would cover. That is 2002. In fact, our presumption was we had taken the effective legislative action to sort of finally sort of clarify, fix, if you will, the abuse of off-accounting transactions. It turns out that as we all now recognize, one of the major problems with some of these entities was off-balance sheet transactions, special investment vehicles, all sorts of other exotics.

In February of 2008, I wrote your predecessor, Mr. Herz, and said, essentially, Where are the rules and the guidance on these off-balance sheet transactions? Why has not Section 401 been fully implemented so that accountants know precisely what they have to recognize?

And as I read your testimony today, which was excellent testimony, it appears that by May of 2011, there will be a final kind of determination. I guess the point is, is that one could argue, or at least hypothesize, that had this regulation, this statute been effectively implemented by regulations, that some of the problems we saw in 2008 with some of these companies—in fact, I think we were all sort of taken aback when very eminent directors of some of these companies said they had never heard of a liquidity put, they had no idea that they had the responsibility to buy back, in an illiquid market, these things because they were totally off the books.

So in that regard, can you explain why it took so long to do something that we thought was central and obvious and necessary?

Ms. SEIDMAN. Thank you, Mr. Chairman. We have, in the last several years, been approaching a number of issues with respect to off-balance sheet financing, and that term is a very broad term that can include things like the accounting for derivatives. It can include things like repurchase agreements as well as securitizations and off-balance sheet special purpose entities.

And so, in a number of those areas over recent years the FASB has issued standards to improve the accounting and the disclosure relating to off-balance sheet transactions. Immediately following the Enron scandal, the FASB did issue a revised standard on off-balance sheet financing with respect to variable interest entities or special purpose entities. And that standard went into effect.

Chairman REED. When did it go into effect?

Ms. SEIDMAN. That standard, I believe, went—I am going to have to check specifically.

Chairman REED. Page seven of your testimony?

Ms. SEIDMAN. Sorry. I was looking at a list. Chairman, I apologize. That section refers to later standards that were issued, so I was referring to an earlier effort so I will get that information to you.

Chairman REED. Thank you.

Ms. SEIDMAN. That approach was based on a quantitative evaluation of the risks and rewards that an entity held, and we later became aware of practice issues related to that standard, which we immediately undertook to remedy, which is more in the timeframe of 2008 and 2009. At the same time, we were working with our international counterpart to determine what the appropriate standard would be on a global basis for the consolidation of these special purpose entities.

At that time, we decided to pursue a more principle-based approach, which was based on who had control of the entity and who would have the majority of the benefits and exposures to risk, and that is the standard that we issued in 2009 and it became effective in 2010. So we, I do believe, have a more principle-based standard, which is going to require all practitioners to use judgment in determining whether to consolidate these entities that they have involvement with or have significant investments in.

Prior to issuing that standard, we had also developed some significantly improved disclosures. So regardless of whether the accounting was to consolidate or not consolidate, we provided the information to investors for any situations where there was involvement with the entity so that it was less dependent on the particular evaluation of whether it was on or off-balance sheet, but it provided both views.

This is one of those matters where there are questions about whose assets and liabilities they are. Everybody wants to report all of the assets and liabilities of an entity, but in some of these very complex transactions, it requires a very detailed analysis of the specific forms of involvement and provisions, so that we wanted to provide disclosures so that regardless of those very close calls and whether it ended up on the balance sheet or not on the balance sheet, the investor had all of the information in order to make that determination.

There are a couple of other standards that we have issued in recent years relating to off-balance sheet financing that I thought would be important to emphasize as well. One of the key players in the financial crisis were the monoline insurers, in other words, the ones who would guarantee the bond offerings, *et cetera,* and we issued a standard in, I believe it was in, 2009, to require significantly improved disclosures for the monoline insurers as well as a more robust approach to the measurement of their liabilities.

So we have undertaken a number of efforts to try and present more complete and neutral information about the financing activities of an entity. We do have one active project with respect to lease accounting, which is another form of off-balance sheet financing, and we are working diligently to conclude on those matters this year with the IASB.

Chairman REED. Thank you. I am going to recognize Mr. Kroeker and then I am going to recognize Senator Hagan for any comments or questions she might have, and then I have additional questions. Mr. Kroeker, please. The basic question is, why no alarms adequately and timely enough to warn the investing public about the demise of these companies?

Mr. KROEKER. First, I think in those examples where management, auditors, or accountants were aware of risk—aware of a significant buildup and it went undisclosed—the important step to take is vigorous enforcement action. We have been doing that and that will continue. So I think a very important first step is where people failed to comply with their obligations, holding them accountable.

Second, the issue of why not broader early warning signals from either the auditors or the accounting profession, I think as Chairman Doty outlined, there are some serious questions about performance of audits. They see that in PCAOB inspection reports. But the issue of an auditor's responsibility with respect to going concern—and they do have a responsibility to highlight whether there is substantial doubt about going concern—and that is an active project at the FASB as well.

Interestingly enough, it is an area where going back four or five, maybe even 6 years, an observation that management does not have, at least in the base financials themselves, a similar obligation or responsibility as clearly outlined as that which there is for the auditor with respect to going concern. And FASB has an active project on that.

Of course, the way it is designed today, that is, in some people's view, a very binary determination. There either is or there is not substantial doubt about a going concern and whether or not a reduction in the binary nature of that—more early warning signaling than just we have got to the point where there is now substantial doubt about going concern—but earlier warning even than the point where you say, "The doubt is so high, is that really enough for investors?" So I think that is an extremely important project that the PCAOB has on its agenda as well.

Chairman REED. Thank you very much. Again, I have additional questions. Let me recognize Senator Hagan for any comments or questions she might have, then Senator Merkley, and then I will reclaim. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman, and thank you for holding this hearing.

Ms. Seidman, in your testimony, you mentioned that FASB acts to consider promptly any significant areas of deficiency in financial reporting, and one of the things that became apparent following the collapse of Lehman Brothers was that the firms would forum shop to arbitrage regulatory standards in various jurisdictions.

First off, I would like to understand to what extent the accounting standards were and continue to be gamed by the international financial institutions. It seems to me that Lehman's ability to obscure its balance sheet, helped by booking transactions through affiliates under British law and then accounting for them in the U.S. using GAAP, would be considered a significant area of deficiency.

Ms. SEIDMAN. Thank you, Senator. The accounting issues relating to the Repo 105 transactions that you are referring to relate to an accounting standard that was issued in 1996 that provides guidance for how to distinguish between a sale and a financing on a repurchase agreement.

There are two key considerations in that evaluation. One is the legal analysis that you referred to. The entity has to satisfy itself that it has been transferred beyond the reach of the entity. And then the second is an evaluation of whether the entity, notwithstanding the surrender of legal control, has retained effective control through the repurchase agreement and through other means. So both of those aspects come into play in evaluating the Repo 105 transactions.

The FASB was not aware of any practice issues with respect to those particular provisions of the standard. As I say, it had been in effect for quite some time, and we first became aware of this issue with the release of the Bankruptcy Examiner's report with respect to Lehman Brothers.

And so, at that time, the SEC issued some Dear CFO letters to evaluate the pervasiveness of the issue. When those letters came in and through discussions with the staff of the SEC and others, we did determine that it would be appropriate for us to review whether those particular provisions continued to be relevant in evaluating whether repurchase agreements should be accounted for as sales or borrowings.

We did two things to respond to that. First, with respect to the legal analysis, when we issued Statement 166, which was a revision of the standard that does provide a requirement to evaluate legal isolation, we clarified that that analysis should take place at the consolidated level.

So in other words, if you are a U.S.-based entity, you ultimately need to consider whether the transaction is beyond the reach of the entity in the U.S.; whereas, previously, perhaps there was some ambiguity about at what level. In other words, could it be done at the subsidiary level or must you satisfy that threshold at the consolidated level? So that standard was put in place without repos particularly in mind, but, in fact, it does address a particular aspect of this issue.

The second had to do with whether the specific collateral provisions, in other words, the requirement to maintain collateral, really remained relevant in today's environment. When those provisions were included, they were intended to describe market practices at the time. In other words, if you were doing a repurchase agreement with treasury securities, then entities were typically maintaining a high level of collateral. But elsewhere in the world, perhaps that was not true, and there was thought at the time that that should matter.

Our board undertook an effort to review those provisions and has concluded that we do not believe that those technical provisions should be determinative in evaluating whether a repurchase agreement should be accounted for as a purchase or a sale. We are actually finalizing our balloting process on that improvement right now as we speak, and we hope to issue that clarification by the end of the month or early in May.

Senator HAGAN. What about actual forum shopping concerning arbitrage regulatory standards in various jurisdictions? Is that something that you are actually looking into?

Ms. SEIDMAN. That is not something I am in a position to evaluate, but I do believe that the clarification of the requirement, in other words, that this analysis must be passed at the consolidated level, would seem to limit the ability to do that.

Senator HAGAN. Mr.—is it Kroeker?

Mr. KROEKER. Yes.

Senator HAGAN. Thank you. I know that the efforts being undertaken by FASB are extremely important to the SEC. Can you describe what the SEC's involvement has been in the effort to streamline standards across jurisdictions and what you see as challenges to success in this effort?

Mr. KROEKER. Yes. We are highly involved in the standard-setting process, both in the U.S. and abroad, and we have active day-to-day work in our oversight capacity over the FASB having, on a day-to-day basis, project managers of the FASB work closely with accountants on our staff as we identify issues in practice, making the FASB aware of those, following their deliberations, importantly pointing out, for example, in 2008 the strong need for further improvement to off-balance sheet accounting. So we play a very active role in working with the FASB.

As it relates to, I think, the second part of your question, both challenges and opportunities with the FASB and standards around the world, we have, for the better part of three decades, recognized the desire or the need for a high quality set of accounting standards that is implemented not just in the U.S., but around the world, and have been very supportive of the IASB, the International Accounting Standards Board, in developing a high quality set of standards.

It has become increasingly a set of standards that is used around the world and has increased significantly in its quality. The opportunities and the challenges that exist, both on the FASB's and the IASB's agenda, many of which were highlighted by the financial crisis, let me highlight just a couple.

Their standard on accounting for financial instruments, whether or not we can do a better job of providing forward-looking information as it relates to credit impairment of loans. Right now, we have a model that is very much based on identification once a loan has an incurred loss. Investors and those charged with oversight of the financial reporting process have observed that may be too late in terms of the credit cycle.

The FASB and the IASB have a joint project and it is imperative that they continue to work together and deliberate those issues jointly. Improvements to hedge accounting: The IASB has an exposure draft on improvements to hedge accounting and derivative accounting. The U.S. model is, some have described and depending on what book you look at, somewhere around 800 pages of guidance dealing with derivatives and hedge accounting.

It is a very complex, rules-driven model and there is room for significant improvement. The IASB model is largely based upon that U.S. model. The IASB has an exposure draft, the intent of which is to simplify that depth of rules to have derivatives and hedge accounting match up with an entity's risk management strategy, and in concept that sounds great.

Their proposal has a number of areas where there, I believe, will need to be significant greater clarity as to the objective and how to achieve the objective. But my point being that it is imperative that the FASB work together with the IASB, that they do not leapfrog each other, that they deliberate those issues jointly. I think it is one of the biggest challenges we face going forward.

Senator HAGAN. Thank you, Mr. Chairman.

Chairman REED. Thank you. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chairman. Thank you to the panel for your testimony and I just want to thank Chairman Reed for calling this conversation together, about understanding the better the role of the accounting world in the crisis that we have all gone through and what issues we should be focusing on and what we should be considering doing differently down the road.

In the second panel today, Mr. Valukas has testimony that I thought I would quote a passage of and ask for a response. He notes, Lehman's executives, not regulators or auditors, made the decision to load up on illiquid assets. Lehman's executives, not regulators or auditors, were responsible in the first instance for preparing fair and accurate financial reports.

He continues, I found that Lehman's decision not to disclose to the public a fair and accurate picture of its financial condition gave rise to colorable claims against senior officers who oversaw and certified misleading financial statements. And he later says in his testimony, I found that colorable claims exist against Lehman's external auditor in connection with Lehman's issuance of materially misleading financial reports.

Now, there is a lot of conversation, attention being paid these days to Barry Bonds and his accountability for truth under oath. In town halls that I am holding, I am often asked the question, perhaps one of the most common questions I am asked is, why have not high members of the financial community been held accountable for accuracy or truth in financial statements, or to put it differently, why have so few executives at major institutions been prosecuted by the SEC or by the Department of Justice? Now I have a chance to get experts' insights on that, so please share with me.

Mr. KROEKER. Let me start. One, and as I also address in my testimony, we have taken action against a number of actors in the financial crisis. Of course, investigations and enforcement activity continues, and I think it is important to hold those accountable where they have not lived up their obligations.

Without commenting specifically on individual cases, because I do not want to get into the nonpublic aspects of where and what we are investigating, I can tell you that we have taken the Bankruptcy Examiner's report extremely seriously. It is a detailed and chilling report. Our staff, our chairman and others, have spent time with Mr. Valukas to understand the nature of that report.

We took immediate action to determine the pervasiveness or the lack thereof of transactions, so-called Repo 105s, and immediately issued interpretative guidance to MD&A that would clarify for anyone that, of course, you need to disclose your liquidity position, those things that have a tremendous impact on capital. We are also, again, continuing investigative and enforcement activity promptly.

Senator MERKLEY. Well, thank you. I thought maybe you were going to say to me something along the lines of, "Well, actually, there are three dozen executives in jail and we have this many prosecutions underway," and something that I can relay back to folks back home.

Mr. KROEKER. With respect to people in jail, the SEC has civil authority. We do not have criminal authority, but I can certainly work with our enforcement division to get a more detailed list of what we can provide with respect to cases to date, and then see what we can provide with respect to what is ongoing, of course, in the nature of, many of those are nonpublic proceedings.

Senator MERKLEY. Well, thank you. Because I think the public wants to understand this better; that is, was it essentially deregulation that made activities permissible, that by taking away the traffic signals, if you will, we caused a major crash or traffic paralysis in the financial markets. Or did things seriously go awry in terms of integrity and have those issues been adequately dealt with as they should be in all areas where integrity—violations of law are involved, whether civil or criminal. So thank you.

I want to go on to a second area here. Is it Mr. Doty?

Mr. DOTY. Yes.

Senator MERKLEY. Doty. You have identified in your testimony that PCAOB inspectors identified many audit deficiencies relating to auditing fair value estimates, especially related to insufficient evidence gathered by the auditor when using third-party pricing sources, pricing services, or broker quotes when valuing financial instruments such as investment securities.

Is this really part of the case to be made for trading derivatives on exchanges so that there is a market that establishes proper valuation, if you will?

Mr. DOTY. Senator, that is an interesting question. I think our focus at the present on the auditing side of this is on the difficulty of obtaining valuations when an auditor goes in and the issuer being audited has obtained a third-party valuation. That comes often in the form of proprietary information from a firm that has an actual adverse interest.

You are pointing to a clouded area of the market function, and we would have to acknowledge to you that we think—we are working with our colleagues at the SEC on rule proposals, standard-setting proposals that go to the issues of how you value. We have a task force at the PCAOB. This, I think, is a knotty, difficult issue of knowing what value is.

I can't tell you as an audit regulator what the collateral effects would be on market activity if you did this. I can agree with you, though—and there is always a collateral problem with whatever you do in this area, the market as being a mechanism, but I can certainly agree with you that one of the most difficult problems we face, as an audit regulator in framing standards and will face going forward, is the fact that valuation is hard to come by. Auditors are having to do more work themselves, which one would hope the issuer would have done, and that that work is not always sufficient to establish value.

Senator MERKLEY. Thank you. Thank you, that was very helpful, Mr. Chair.

Chairman REED. Thank you very much, Senator Merkley. Let me pose a few more questions, and again, I think this is in the order of one of these threshold questions, which I will address to the whole panel. Is auditing today a loss leader for these accounting agencies, *i.e.,* the pricing of the services, given all of the complexity and everything else, provides maybe implicitly, not explicitly, a disincentive to do extra, to do more, because the compensation is not adequate?

Or, alternatively, is there, because of the limited nature of major auditing firms—it is a small group, the British describe it as an oligopoly, the fear that telling the truth to power will find yourself out on the street. So these are issues that are not measurable by charts, but I think they profoundly or may profoundly influence the behavior of companies and auditors. So your thoughts would be appreciated, Mr. Doty and Ms. Seidman and all.

Mr. DOTY. Mr. Chairman, I think it is a significant problem, the most significant problem today and that is how do we restore and buttress the counterweight, which the auditor is, to management expediency. And there are rule proposals, thoughts of doing that. If you take the collection of proposals we have now with the SEC as joint projects, you will see some of them.

But it is clear that the audit firms get most of their money from auditing. The global firms are large enough to audit the multinational corporations. Therefore, it is a serious question in my mind as to whether size is the problem. I think size is not the problem. Coordination among the networks and the establishment and enforcement of quality control within the network, I think, is the achievement that we have to seek.

So in order to have what we want, we have to have auditors who will say what has to be said and will challenge management without regard to the fact that the audit committee may seek lower audit fees or the management may have questions about retaining them. It is the audit committee that retains the auditors. We have a project on communication with the audit committee. We are going to be looking at this hard to be sure that audit committees do not fall into the trap of judging the cheapest audit to be the best audit.

Chairman REED. Ms. Seidman, your comments?

Ms. SEIDMAN. Mr. Chairman, with respect, this is not an area that I am knowledgeable about, so I am going to defer to Mr. Kroeker.

Chairman REED. OK. Mr. Kroeker.

Mr. KROEKER. Yes, with respect to the first piece of your question, are audits today loss leaders, I certainly hope that is not the case. I think we saw that in an earlier crisis, the Enron crisis, where there was much concern about whether an audit was being used as a loss leader to higher value—not higher value, certainly not higher importance—but the ability to earn higher fees on consultancy or other services.

And I think with respect to the company under audit, that has been addressed by independence rules that prohibit many of those types of services, and so I am hopeful that audits are not being priced as loss leaders because that other revenue stream does not—should not exist, in any case. Whether or not there is enough focus on auditors being selected because of quality as opposed to other means—and Chairman Doty outlined in some remarks earlier this week troubling examples that they had seen either in engagement letters or proposals, things like, "If you choose us, we will have a reduced audit footprint." Asking the question of what is, in fact, a reduced audit footprint, that could sound like "we will not be as rigorous." And to the extent that that exists, strengthening—audit committees having a stronger role in selecting auditors because of quality as opposed to fee pressures or other things that are very real but may get in the way of quality. And I think that is a very real concern, something that we are actively in discussions with the PCAOB about.

As it relates to the number of firms that might audit a large percentage of the capital market, whether that is the largest of four or the largest of six or the largest of eight, the GAO has studied that on a couple of occasions recently, once in 2003 and again in 2008, and has not necessarily found the same types of issues that might exist in other markets, for example, in Europe, where auditor selection may be even more constrained in an individual country or within an individual sector; that is, there may be only one or two auditors of choice. So there are some differences in the marketplace as well.

Chairman REED. Thank you very much.

Let me turn to another question. There have been some studies, recently a October 2009 study, "Did Fair Value Accounting Contribute to the Financial Crisis?" And the conclusion of this study was that there is little support for claims that fair value accounting leads to excessive writedowns of banks' assets. In 2008, the SEC studied this. More recent academic studies noted, perhaps suggested—or the debate is still large—that the overvaluation of bank assets—Mr. Kroeker, what is your sort of sense now? And then I will ask your other colleagues about fair value accounting. Did it overvalue assets? Is it accurate? Is it something that you have adjusted so that it is more finely tuned?

Mr. KROEKER. I participated intimately in that 2008 study. I think part of the reason for a statement that says fair value was not a significant contributor was taking a look at the financial institutions that we looked at in that study. A significant percentage of assets are not, in fact, carried at fair value. Derivatives are; assets in a trading portfolio are. But large percentages of financial institutions' assets—loans and other investments that it holds for long-term cash collection—are, in fact, not marked down on a daily basis or even a quarterly basis based on fair value. They are supposed to be marked down when there are credit impairments or longer-term impairment. But we do have—continuing through this day—that loans are marked down for credit impairments, not daily or quarterly fluctuations in value. And it is an area where I think it is important to determine whether those assets, because we wait until we can identify an incurred credit loss, whether those assets are, in fact, written down effectively too late. And the FASB has a project jointly with the IASB and has made significant progress. I think they are encouraged that they will be near final in the short term.

Chairman REED. Ms. Seidman.

Ms. SEIDMAN. Thank you. I completely agree with all the comments that Mr. Kroeker just made. Let me just elaborate that in the course of the crisis, the FASB was asked to provide additional guidance to help practitioners determine fair value, especially in the cases where the market was very illiquid and disrupted, which we did provide, and I do believe that it reinforced the basic principle of fair value measurement, but it provided some guidance to help people exercise judgment and come to a conclusion of how to estimate fair value during those difficult times.

Those interim pieces of guidance that we developed have now been incorporated into a standard that we are finalizing with the International Accounting Standards Board and plan to release in the short term.

Part of that was also to provide much more extensive disclosure about the extent to which fair value is actually used in the financial statements, and this builds on a point that Mr. Kroeker just made. For many financial institutions, it is fairly limited as to what is actually carried at fair value. But to make that very clear to the investor, these are the items that are carried at fair value and also require that information to be provided at a much more disaggregated level so that investors have a good sense of exactly what is being carried at fair value as well as what methods are being used to estimate fair value. So there would be a clear distinction between cases where fair value is based on actively traded items versus cases where there is a very judgmental estimate being made, and then in those cases even more information to show the reason for the changes in the estimates and the key inputs to the measurement. So we are trying to make it much clearer to investors what is being carried at fair value and how subjective those estimates are.

Chairman REED. Thank you.

Mr. Doty, if you have a comment, please, but I have an additional question I would like to address to you and to Mr. Kroeker, and this has become a topic of recent reporting. There appears to have been an increase in foreign operating companies using reverse mergers to access the U.S. capital markets. Does this pose a threat to the markets? And are you, both the SEC and your organization, beginning to think hard about it? There have been a lot of reports about the Chinese companies who are acquiring public companies in the United States and essentially becoming public companies without a lot of the rigorous hurdles that other companies go through? Your comments, Mr. Doty.

Mr. DOTY. It is a priority, Mr. Chairman, for us to get access to inspect audits in China and with respect to U.S. firms performing audits of Chinese companies in China. We are working closely with the SEC. We have initiatives underway. Clearly, if Chinese auditors are auditing companies who are then by reverse merger and without full SEC disclosure becoming the firms whose securities are held by U.S. shareholders, that is of concern to us. Without regard to its percentage of the capitalization of our securities market, it is of concern to us. And we will continue to pursue that vigorously, working with the SEC, and I think you can expect some initiatives coming out in the course of the summer and the fall.

Chairman REED. Mr. Kroeker, please.

Mr. KROEKER. It is extremely important, and I think in part people are reading about it because we are taking action. We have an internal task force, cross-office, cross-divisional, involving enforcement, the Division of Corporation Finance, our office, and others. We have been asking through filing reviews questions about preparers' understanding—particularly if there are language barriers anywhere around the world—their understanding of U.S. GAAP and U.S. GAAS. Does that lead to questions about the integrity of internal controls if you do not have an understanding of U.S. GAAP? Asking serious questions to auditors, and anecdotally, I have heard from a number of auditors that they are asking more serious questions because we are asking, and I think that is resulting in increased press accounts. We have seen a number of auditor resignations, which are publicly filed with us. The PCAOB is highlighting the issue, so it is something we take very seriously. It is a very important issue to continue asking about.

Chairman REED. Thank you.

Just a final question, Mr. Kroeker. My colleague Senator Merkley referred to Mr. Valukas' testimony about the management deficiencies or apparent deficiencies there. But there was also something I found quite interesting and in a way disturbing, and let me read it. "The SEC and the Fed each knew that significant amounts counted as liquidity were in fact posted as comfort deposits in order for Lehman to do business; the Fed knew that significant amounts counted as liquidity were, in fact, actually pledges to lenders. The agencies internally disagreed with Lehman's inclusion of these amounts as liquidity, yet took no action to require Lehman to adjust its public reporting of the numbers."

Essentially at the end, the last day, it was a liquidity crisis. They had no liquidity. The repo market overnight dried up, and that was the death knell of this company. And it appears that both the SEC and the Federal Reserve knew about it, thought it was bad, and kept their silence.

Are you aware of that? Is that accurate? And are we doing that today?

Mr. KROEKER. We are not doing that today, and I am aware of the bankruptcy examiner's report and that specific section as well. And my understanding, it was individuals in our CSE, our consolidated supervisory program, that, in fact, were aware of concerns about liquidity pools, and those were not being communicated broadly across offices and across divisions. And I can tell you our Chairman has taken extraordinary measures to break down those communication barriers and those silos. We have interagency working groups specifically focused on large financial institutions, a college of internal regulators that address cross-cutting issues. If we are seeing something in one area of the building, are the important players in other areas of the building deeply involved and aware? So I can tell you it is a very serious observation in that report, but it has been addressed.

Chairman REED. Well, thank you very much. Thank you for your testimony. There are numerous other questions. I would ask you if you would bear with us. Some of my colleagues might have additional written questions which we will provide to you and ask for a prompt response, and thank you very much for your testimony, and we will call forward the second panel. Thank you.

[Pause.]

Chairman REED. Well, thank you all for joining us. We look forward to the second panel. I want to thank the first panel for their excellent testimony. Let me introduce the members of the second panel.

Anton Valukas is the Chairman of the national law firm Jenner & Block. In early 2009, Mr. Valukas was appointed as the examiner in Lehman Brothers Holding bankruptcy, reputed to be the largest such case in U.S. history, and as you know, we have already made reference to your testimony, and the previous panel has duly noted your testimony and your report. Thank you, Mr. Valukas.

Cindy Fornelli is the executive director of the Center for Audit Quality. Prior to become the center's executive director, Ms. Fornelli was the regulatory and conflicts management executive at Bank of America. Thank you for joining us.

Thomas Quaadman is the vice president of the U.S. Chamber of Commerce for Capital Markets Competitiveness. Prior to joining the chamber, Mr. Quaadman was chief of staff to Congressman Vito John Fossella, Jr., from New York, from 1997 to 2008. Thank you for joining us, Mr. Quaadman.

And, finally, Lynn Turner served as the Chief Accountant of the Securities and Exchange Commission from July 1998 to August 2001. Mr. Turner has served in a variety of capacities as a member of boards and audit committees of public companies, a trustee of a mutual fund and a public pension fund, a professor of anything, a partner in a major international auditing firm, the managing director of a financial research firm, and as a chief financial officer. Thank you again, Mr. Turner, for joining us.

Mr. Valukas, please. Your testimony will be made part of the record. Feel free to summarize. Thank you very much. You have to push the button, I think, sir.

Mr. VALUKAS. The one that says "Talk"?

Chairman REED. The one that says "Talk."

[Laughter.]

Chairman REED. We do not need any encouragement.

STATEMENT OF ANTON R. VALUKAS, CHAIRMAN, JENNER & BLOCK LLP

Mr. VALUKAS. I am a quick learner. Thank you, Mr. Chairman. Let me summarize just a few points that are made in my testimony, but that I think are germane to today's activities.

Lehman's failure was in large part the result of poor investment decisions, inadequate liquidity, and ultimately a failure of confidence by Lehman's lenders. Lehman's auditors did not make the business decisions that caused Lehman to fail, but the auditors did play a critical role in the disclosure or nondisclosure of information which would have been critical for the public to know about and which masked the nature of Lehman's crisis.

The investing public is entitled to believe that a clean report from an independent auditor stands for something, and whereas in Lehman, the auditors became aware of questions practices that were being followed by Lehman, the public has a right to expect that the auditors are going to say something about that. I have found that there were colorable claims against the auditors in connection with their activities. Those claims are in litigation, and I really do not want to address those today. That would not be appropriate. But I want to point to two items which were discussed previously.

Two metrics were of critical importance to Lehman Brothers in the last year of its existence: leverage and liquidity. In both instances Lehman reported these metrics in misleading ways. The significance of them cannot be underestimated. The global treasurer recognized in 2007, the global treasurer of Lehman Brothers said that ratings agencies were "most interested and focused on leverage." It was a critical point. They looked at leverage as being an issue that if leverage was not considered to be appropriate, they might get a downgrade in their rating, which, of course, would foretell a real problem.

Lehman opted to create the perception of reducing its net leverage through Repo 105, which has been discussed here and elsewhere extensively. But let me just point out what Repo 105 accomplished.

It removed temporarily—and I mean temporarily—$50 billion off the balance sheet right at quarter end, and that was what was published in the public documents. Their executives in their internal e-mails referred to this as "a gimmick," "window dressing," and this comes from the president of Lehman Brothers, "a drug we are on."

Lehman's former global financial controller stated unequivocally in our interview with him that there was "no substance to the transactions." Fifty billion dollars worth of transactions with no business purpose.

Lehman's auditors were aware of the use of Repo 105, and whether due to gaps in professional audit standards or a failure to follow the standards, the results are the same. The auditors did not object when Lehman omitted any reference to these transactions in their financial statements.

Liquidity. After Bear Stearns' near collapse in March of 2008, regulators, lenders, and the investing public looked to liquidity as being a critical issue for Lehman Brothers. Lehman Brothers was intimately aware of that focus and began to cut corners, and clearing banks and overnight lenders sought increasing amounts of collateral. By the summer of 2008, Lehman began to count in its liquidity pool significant assets which, in fact, were pledged or encumbered in those pools.

On September 12th, 3 days before the bankruptcy, Lehman announced that it had over $40 billion in its liquidity pool. In point of fact, $40 billion of that liquidity pool was not liquid.

Lehman was able to do this in part because there was no definition of what should be included in a liquidity pool. The SEC had one definition, looked at the liquidity pool that Lehman had, and determined that things should not be in there and did nothing about that. The Fed observed billions of dollars worth of assets which they did not believe should be in the liquidity pool, said nothing to either the SEC or the public about that, taking the position that they were not the regulator. So the public was not told anything about the fact that the pool was significantly impaired. Literally hundreds of millions of shares of stock traded without that information being public.

The auditors looked at the pool, but they only looked to see what the numbers were, not what was in the pool itself. They said that role was the role that the regulators had. So among the three of them, no one took any responsibility for that pool.

So what are the lessons to be learned with regard to the auditors? Lehman's collapse and misleading disclosures offer a tragic example of silo mentality with no one facing responsibility. The only consistent story I heard from among the regulators and the auditors is it was not their job. Lehman's senior executives asserted they were not responsible because they relied on the auditors and the auditors' opinion and other executives. The auditors said they were not responsible because they relied on executives and the lawyers. And the lawyers said that they relied on the executives. Who did the public get to rely on?

I have identified several areas—my time is gone here, but several areas where we think improvement can be made, but that is what we found.

Chairman REED. Thank you very much, Mr. Valukas.

Ms. Fornelli.

STATEMENT OF CYNTHIA M. FORNELLI, EXECUTIVE DIRECTOR, CENTER FOR AUDIT QUALITY

Ms. FORNELLI. Thank you, Mr. Chairman. My name is Cindy Fornelli, and I am the Executive Director of the Center for Audit Quality. I appreciate very much the opportunity to testify today on the role of the accounting profession in preventing a future financial crisis. This is a very important topic for all of us who are committed to protecting investors and maintaining confidence in our capital markets.

The financial crisis fundamentally was an economic and liquidity crisis driven by a systemic breakdown in risk management practices at many levels. As we heard from the first panel in their oral and written testimony, everybody agreed that this was not a crisis caused by auditing or anything. Nevertheless, auditors, like all participants in the capital markets, do have a responsibility to examine the lessons learned to see what more they can do to protect investors.

The financial statement audit is a robust process which looks at a point-in-time snapshot of a company's financial position and results as of the end of a fiscal year. The audit provides reasonable assurance that the financial statements taken as a whole are fairly presented in accordance with GAAP.

Auditors can and do provide warning signs. In October 2007, when liquidity began to evaporate, the profession's response was to focus even more closely on appropriate fair value measures. The CAQ published three white papers on the auditor's assessment of fair value measurements in illiquid markets as well as other audit issues relating to the fluctuating market conditions. It is widely recognized that the papers enhanced consistency, skepticism, and professional judgment by auditors and clarified the accounting for these instruments. In fact, the magnitude of writedowns of asset values at the end of 2007 generated enormous pressure to suspend fair value accounting. And you may well remember that the profession stood shoulder to shoulder with investors to defend fair value accounting.

Investors understand that the true value of the audit likes in the extensive amount of work that is performed in order for the auditor to issue an opinion. While investors greatly value the audit report itself, they increasingly want it to be supplemented with information about the quality of financial reporting at the company and the scope and quality of the audit.

We support the PCAOB's consideration of changes to the auditors' reporting framework. The CAQ has suggested a number of areas where the auditor's report could be enhanced. These range from providing additional information relating to a particular audit's scope and procedures to providing assurance in connection with management's discussion and analysis.

There is still more, though, at issue, and that is the broader question of whether and how the role of the auditor can evolve. The CAQ convenes and collaborates on key policy issues with all stakeholders that have an interest in financial reporting. We have done this successfully on a number of instances, most recently advancing the deterrence and detection of financial reporting fraud.

Our governing board has been thinking for some time about the same questions posed by you and the Subcommittee. So in January, it agreed to convene the full range of stakeholders again, this time to discuss how the role of the auditor could evolve to better serve the needs of investors.

Some of the issues we plan to raise include identifying the information most needed by investors and who can best provide that information. We also plan to explore the potential for providing early warning signals about business risks, assurance around non-financial disclosures in annual reports, and disclosures made by management outside of the annual report.

Our hope is that these discussions will expose stakeholders to these potentially paradigm-changing issues, encourage hard thinking around the cost/benefits of various proposals, whether they might require modification to current standards and regulatory frameworks, and hopefully to find consensus. Certainly today's hearing will help inform our discussions.

Any changes to the role of the auditor should reinforce, not undermine, the responsibilities of auditors, CEOs, CFOs, and audit committees to assure the integrity of information that is provided to our investors.

In summary, the public company auditing profession already is engaged in a dialog to determine whether more could be done with policy makers and regulators here and abroad. I feel confident that these efforts will benefit investors and other users of financial information and maintain confidence in our capital markets.

Thank you for your time, and I would be happy to answer any questions you may have.

Chairman REED. Thank you very much.

Mr. Quaadman, please.

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

Mr. QUAADMAN. Thank you, Chairman Reed, and thank you for the opportunity to testify before you today.

Businesses need and want to have strong financial reporting policies. In our view, financial reporting has been in crisis before, during, and after the financial crisis. What is best indicative of this problem is the explosion of restatements over the last 10 years. While that number has been going down from historic highs, the number of restatements today are still far above what has been normal in the past. In fact, at the height of the restatement bubble, 10 percent of financial statements in the United States had to be restated. In fact, if the American industry was to have a 10-percent failure rate, the current financial crisis would be merely a walk in the park.

The fair value crisis was actually a microcosm of the problems in financial reporting. There was a flaw within the fair value standard that did not allow for the appropriate valuation of assets in an inactive market. Because of that there was a lack of confidence by all parties within financial reporting, and it is important to understand as well that financial reporting is actually a three-legged stool made up of accounting, auditing, as well as regulators.

There was an inability for FASB to have dialog and broad outreach during the fair value crisis with all these stakeholders. This allowed for the flawed standard to continue for a period of time, and it also provided for an exacerbation of the problems that were streaming throughout the economy.

As a result, we went to FASB to try and seek to have the problem corrected. We also went to the PCAOB because the flawed financial information on accounting, of course, at some point has to be audited. At that point we were told by the PCAOB it was effectively not our problem.

We also went to the regulators because of this because obviously that financial information was also being used to establish capital standards and requirements, and we received a similar reply.

Simply put, the era of “not my problem” has to end.

As Leslie Seidman talked about, we are engaged in the convergence projects of accounting standards. This is the most radical and bold rewriting of accounting standards and will set our financial reporting policies for the next 25 years or so. We have been strong supporters of that, and, in fact, with eight other trade associations, we created a coalition called FIRCA to ensure that there was appropriate input in those projects to avoid the problems that had occurred with fair value. That dialog—and I have to say that Leslie and Seidman and Jack Brennan, the head of FAF, and Jim Kroeker have gone an awful long way to ensuring that there is appropriate dialog from all stakeholders in that, and that dialog has actually led to very constructive changes that have solved some very serious problems. However, we have to ensure that those projects get done right and not just done by an arbitrary time deadline.

Additionally, we have to ensure that those accounting standards are auditable before they are implemented. Additionally, regulators have to understand what the interplay between those accounting standards are with regulatory standards. And as we sit here today, as you very well know, our financial regulators are engaged in the most drastic rewriting of our financial regulations because of Dodd-Frank. We have to understand—and I think hedge accounting is the best example of that, of how an accounting standard could actually potentially undo what those regulators are doing.

So, with that, we have proposed—which is in our testimony—a ten-point plan to shore up financial reporting and to put those policies on a strong footing for the next generation. We believe that FASB and the PCAOB should abide by the Administrative Procedures Act and that their advisory committees follow FACA, which is Federal law. We believe that the standard setters of transparency should be transparent in their processes and also follow an orderly process to establish standards. We believe that there should be a formal pre- and post-implementation review process, that there should be a financial reporting forum made up of regulators, standard setters, investors, and businesses to identify and try and solve midterm and long-term accounting problems. This was actually in the House-passed financial regulatory reform bill. It did not make it through Dodd-Frank.

We believe that materiality for investors, which is a recommendation from the CIFiR report, should be a trigger for financial restatements. We believe that the PCAOB should have business roundtables as well as a business advisory group to understand how businesses or investors actually use investment products in everyday business activities, such as derivatives; that the PCAOB should have an audit advisory group. Judge Sporkin at the end of the last Investor Advisory Group meeting said that there should be an auditor at the table, and we do not think that one-sided conversations are good.

We believe that there should be—that liability issues should be addressed, that there needs to be a mix of auditors, both large to small, because—just as we need to have large to small financial institutions. We believe that there should be global standards for both accounting and auditing.

And, finally, in closing, we also believe that there should be less reliance on prescriptive rulemaking. If we want to have the auditors calling balls and strikes, which they should be doing, they should be given the judgment to do so.

With that, I would like to close and welcome any questions that you may have.

Chairman REED. Thank you very much.

Mr. Turner, please.

STATEMENT OF LYNN E. TURNER, FORMER CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION

Mr. TURNER. Thank you, Chairman Reed, and I would like to thank Ranking Member Crapo as well for holding this hearing. It is an important hearing.

I have been listening to the dialog, the testimony this morning, including your questions, Chairman Reed, and it strikes me because the questions you aptly asked about why weren't there any warnings or why was this allowed to go on, I have been hearing in similar hearings in this building and across the way for 26 years now, since 1985, hearings on ZZZZ Best, on savings and loans, on derivatives, on the corporate scandals, and now this crisis. And the questions have not changed. I think Congress has aptly over those two to three decades kept asking the questions. And what has also remained the same is the problem. We never seem to get the problem fixed.

I have heard the FASB this morning come back and say here is how we operate and here are our processes, and the SEC say the same. If you had been in the hearings 25 years ago, you would have heard almost the same testimony.

What we are missing, it seems to me, after listening to everyone today, is there has been a failure of the groups to really go back and do some retrospective look at what in that process the FASB or the SEC or the PCAOB has that did not work, and that is the piece that we did not hear this morning.

I would probably disagree with most of the comments the chamber made this morning, but they do raise some questions, and I think we probably both agree we would like to get to a good answer, we would like to get to transparency for investors. And I doubt that—I am probably the only investor on either panel today serving as a trustee on a $40 billion fund that manages assets for about a half billion dollars. I will give my remarks of my own today, but it seems that if the system had worked as intended, as everyone described it this morning, it is even more scarier that we have not heard, you know, what was wrong with that system.

So, with that, I think shortcomings have been exposed at the FASB. They consistently over those two to three decades have failed to issue timely standards that work. I personally do not think the fair value standard was flawed, and I thought that the efforts of the Center for Audit Quality and investors on that was right on. I do not think it was a problem of valuation as much—or the standard as much as it was people failing to report to us as investors the losses that they had incurred.

I note the Federal home loan bank, for example, testified that the standard was terrible; they were only going to have $14 million worth of loses, then later sued people for $3 billion worth of losses. It seems like it was not the standard. It was the internal accounting that was the problem. But clearly—and as you have noted in letters in the past, the off-balance-sheet thing did not work. Congress, as you aptly noted, said it was a problem. FASB did a new standard after Enron. Shortly after that, at a research firm that I was running, we issued a report that said the new standard absolutely would not work, and as we now know, it did not work. Yet the FASB did not change.

I think the SEC has probably not done the oversight it needed to do. You mentioned some of the lack of disclosure that was identified in the Valukas report. That is certainly troubling. And there is a role here for audit committees as well, as we have seen from some of the FCIC reports coming out of the financial institutions. It looks like the audit committees were not engaged as they should have been.

So what do we do about it? I think as Ranking Member Shelby has said, and said back in 2009, I think each of these institutions, perhaps the GAO, need to be called upon to do an in-depth, retrospective review, not unlike what the IMF has recently done, and issue a report to the public saying, OK, how did we end up where we were and what went wrong. Because the one thing we know is something went wrong here, and seriously wrong, and cost, as you noted, trillions of dollars to hundreds of Americans.

We also need to turn around and implement recommendations that a very distinguished committee put together by Treasury Secretary Paulson at the time called the ACAP Committee. They issued a number of recommendations to the auditing profession, to the PCAOB and the SEC. We have now been sitting on those for 2–1/2 years without any results whatsoever. They address some of the issues in terms of communication that go back to that first hearing back in 1985 I was at and have never been addressed.

It seems like after 2–1/2 decades it is reasonable for us—I know it may be a rush, but it is probably reasonable for us to be able to say we would like to see some results here. And so I think those ACAP recommendations need to be looked at.

I think the SEC does need to get serious about enforcement. I know the Chamber of Commerce has always been a supporter of strong enforcement. And I think when you have strong enforcement, you can have a reduction in regulation almost. And I do not necessarily think that is a bad thing, but when we look at the executives at Lehman, we look at an excellent report I have read from Mr. Valukas on the Lehman thing, we see no prosecution there. We see no prosecution at Merrill. We see no prosecution of the top people at Bear Stearns. And you can go on and on.

I think as the other Senator noted, people in America are asking, Where are our watchdogs here? What is the SEC? And is the SEC a watchdog or a lapdog?

To that end, there is the issue out there of funding, and I think we have shortchanged the SEC for the last two decades on funding. I know that is being debated now. It is not an issue of balancing the budget because we as investors pay those fees, and we as investors have never said that we were not willing to pay those fees. And so I think it is time once and for all to finally provide the SEC and Chairman Schapiro with the resources she sorely needs to do the job. If we do not do that, then the one thing about the watchdog, the law enforcement agency, is we know that they will be in handcuffs.

Thank you.

Chairman REED. Thank you very much, Mr. Turner. Thank you all for very insightful testimony.

I am going to begin with Mr. Valukas and pose the same question that I posed initially, the threshold question of, you know, why was there not an adequate warning. Let me sort of preface that by my understanding—this goes back to a very brief legal career. An accountant, an auditor that walked into a board or management and said, “We have problems about giving you an unqualified opinion,” had huge leverage in terms of producing change, real change. And it appears—and not just since—I want to emphasize you have done an excellent report on Lehman, but we could go and look at many other financial institutions that failed with clean reports, you know, the ink still not dry. So what dynamic was there? And, in fact, I must say it is rather discouraging to hear you sort of say the only consistent response was, “That is not my job, that is not my job, that is not my job.” Maybe it is, you know, beginning my life in the army where everybody assumed it was their job regardless of who officially was responsible. But your comment, and then I will ask everyone, because I think this is a critical threshold question, because if we do not kind of understand—not every detail but what were the incentives, the disincentives, what can we do to fix it. So I will start with you, Mr. Valukas, please.

Mr. VALUKAS. Your comment was spot on. If the auditors had walked into the board of Lehman Brothers and said, "Lehman is engaging in $50 billion worth of off-balance-sheet transactions, the sole purpose of which is to improve their leverage numbers because they are concerned about public perception," those transactions are reversed 5 days after the close of the published opinion, I have no doubt that that—and we cannot abide that. I have no doubt that those transactions would have ended as of that moment and/or, alternatively, they would have written a disclosure statement which would have included it, which would have obviated the reason for the transactions in the first place. The whole idea was to conceal that that is the way they were reducing the leverage.

So an auditor threatening a public company with something other than a clean report has enormous leverage. I represent a large number of corporations in the board room. Everybody looks to see what the auditor is going to say. So the auditor in one sense controls the entire process.

In this situation, the auditor and their able representative took the position that the only thing they were required to review was the theory behind the practice, not the practice itself, that they had no responsibility for determining the volume of Repo 105s or the timing of Repo 105s or the purpose of Repo 105.

Simple questions we—this was no great mystery. There were at least a dozen executives within Lehman who we interviewed who said the purpose of Repo 105 is the following, and this is what we are doing, and the e-mail traffic reflected it. So there was no shortage of information. The auditors, in fact, only interviewed one person who claimed they did not have information about it. The auditors at the time they did that interview knew that there had been $50 billion worth of transactions. But they pointed to various aspects within the accounting rules which relieved them of the responsibility of having to do anything further than to check the theory behind the practice and not how the practice was being used.

It seems to me a simple question that someone ought to put on their auditors is on their checklist: Are there any transactions the purpose of which is to dress up the balance sheet? If so, what are they? What is the volume? And we need to disclose that to the audit committee. That would go a long way toward ending the practice, because the executives knew what they were doing and they did not really conceal it.

Chairman REED. Let me just ask a follow-up question. Senator Hagan made reference to regulatory arbitrage. I seem to recall—and please correct me if I am in error—that part of what they did was get opinions from British attorneys because there was a British subsidiary, and that under British accounting rules this theoretical approach was appropriate. Am I misconstruing that?

Mr. VALUKAS. No. You are absolutely accurate. They could not get an opinion from U.S. counsel that a Repo 105 which qualify as a sale under U.S. law. They were able to get an opinion from reputable counsel in England that it would qualify under British law, so what they would do is transfer the assets, in essence a wash sale, to the British subsidiary and transact the repo transactions in that subsidiary. It was a consolidated balance sheet, so it was all done under GAAP, but that was the manner in which they were able to do it.

Chairman REED. I guess the final question on this topic, Mr. Valukas, is: Are you confident from what you have heard today that those simple sort of changes, like the checklist or the rules that basically require—and not just auditors but also lawyers. Apparently at least the United States lawyers were nervous enough about this that they were not going to sign anything—are going to be adopted by the FASB and enforced by the PCAOB?

Mr. VALUKAS. I am not sufficiently qualified to answer that. I have not been following that. But I——

Chairman REED. That is a wise response.

Mr. VALUKAS. But I would suggest one thing, and that is that the default should not be immateriality. It should be transparency. And that to me is a mind-set, that, you know, we seek to find something to be immaterial rather than going behind it and suggest that transparency is critical. That is an issue, it seems to me, that those boards need to wrestle with and come up with some clear answers.

Chairman REED. Thank you very much.

Ms. Fornelli, please, your comments.

Ms. FORNELLI. Well, as we heard Ms. Seidman and Mr. Kroeker talk about, the FASB and the SEC have addressed these accounting and disclosure issues. They have got rules that are in the process of being implemented, and I think with the design toward making sure that—or helping to enhance the transparency to investors. And so transparency to investors is the primary goal, and I think that is well underway.

Chairman REED. Thank you.

Mr. Quaadman, your comment, please.

Mr. QUAADMAN. Sure, just a few thoughts on those very good questions that you raised. A couple things.

One is, you know, there is, number one, the tryer of fact in the Lehman's case has not actually made a decision, so I think there is still some information that needs to come out there. And I think there is also a lag time between the last audited financial reports in that case and the final crack-up in Lehman. I just raise that because I think the situation between April 2008 and September 2008 was obviously different. From September 10th to September 15th could have been radically different as well.

I do believe that regulatory arbitrage is a problem. I do believe that having international standards for both accounting and auditing does start to get at that. But I think it is also important to understand as well—and I was happy to hear that, you know, the PCAOB is doing some work on what the role of the auditor is, which I know that CAQ is doing as well. But there is also a difference between auditing financial information and actually strategic decisions. Because I think if you look at some people in the financial services community, they were looking at economic situations and making radically different strategic decisions. Some of them failed. Some of them survived.

So I think it is important to understand that the auditor does not necessarily pass judgment on strategy and risk but is focused on the financial statements.

Chairman REED. Mr. Turner, your comments. You have, I think, alluded to some of these comments, but please go ahead.

Mr. TURNER. Thank you, Chairman Reed.

When I step back, this is one where I think you have to get back out of the trees, and it is a very simple. If the auditor is right that the accounting is correct, then we have got a seriously flawed accounting standard. To turn around and say you can take stuff off your balance sheet at the very end of that period, dress up your balance sheet, make it look better than what you really are, and then 5 days after reverse it and say that is OK, I do not think it takes an accounting degree to figure out, and you do not need to be a business strategician. This is a business strategy. This was a scheme and device. I have been an executive in a couple businesses. This is not strategy. This is nothing to do with business strategy. This is how to mislead your investors, your owners of your company. It is that simple. And if the accounting was correct, then we have got an accounting standard setter that we got big problems with.

I personally think Mr. Valukas is right with the use of the words "colorful claims." Some may say that color is black and white, and, in fact, if someone knew that someone had gone hunting for an opinion in the U.S., could not get it, and then had to go and find one from the Brits, that in and of itself tells you from a commonsense perspective this was not a good thing that was going on. And to think that the very people that we have to rely on for confidence in the numbers was turning around and, without giving us any warnings, saying that was OK, regardless of how the tryer of fact turns out, that is very troubling to me as an individual, as an investor. So I think it is very problematic.

Do we have it fixed? The FASB is working on some stuff. We will see if that standard works. But I think Mr. Valukas hit on what needs to be done and has not been done, and that is, you cannot hide behind materiality if something is not transparent. And the FASB has for years been urged to adopt a rule that says if additional disclosure is necessary to keep the financials from being misleading, you need to make it. And the FASB has constantly refused to put that standard in place, and until we put that standard in place, as Mr. Valukas just urged, we are going to have a problem.

Chairman REED. Thank you very much.

Let me ask a question about some of the recommendations or suggestions or comments made by the previous panel. Mr. Doty testified, "It is troubling to me that we do not see firms . . . going back and performing more work to address the significant audit deficiencies identified by inspectors." And, again, please feel free to correct me, but my recollection is that in every audit there are recommendations even if the audit is given unqualified, but there are specific concerns addressed typically. I think that is accurate. And what Mr. Doty seemed to be saying is a lot of these, you know, helpful hints, if you will, are not being followed through.

Is that something you would agree with? And is your group trying to encourage more sort of proactive remediation?

Ms. FORNELLI. Well, Mr. Chairman, the Center for Audit Quality and the audit profession is very focused on audit quality and trying to continuously improve audit quality. And so the system of oversight that was put into place by Sarbanes-Oxley is a very robust one and one that we very much respect and support. And part of that system, of course, is the inspection process, and the audit process, and I would say the inspection process as well, is one of continuous improvement.

So we take very seriously the findings that the PCAOB has. The firms work very closely with the PCAOB to understand where the deficiencies may lie and then work to improve on those and to implement them. And so I know this is something that the firms take very seriously, and we will continue to work with the PCAOB and our member firms.

Chairman REED. Just let me follow up. With respect to the comment that Mr. Turner made that there should be a specific guidance to disclose information if, in fact, it is necessary or that it would give a more accurate picture of the status of the company, what is your view on that type of proposal?

Ms. FORNELLI. Well, as Ms. Seidman stated, they work very closely, and I think they have been doing a much better job lately of working with a whole constituency of stakeholders as they go about setting their accounting standards. And so I think that is very important to get that wide range of input, and we will continue to be part of that process.

But, again, the process that was put into place by Sarbanes-Oxley where you have these counterbalances—I think that is how Chairman Doty referred to them—that you have got a strong audit committee, you have got a strong, independent auditor, you have management who is responsible for preparing those statements, and then also a rigorous inspection and, if needed, enforcement program is the counterbalance to some of these issues that we are talking about.

Chairman REED. Let me also bring up another suggestion Mr. Doty made, which is that under Sarbanes-Oxley the PCAOB is restricted from public disclosure of its deliberations, of its disciplinary proceedings, and this, as he points out, actually raises the question that there could be a company that has already been if not sanctioned, at least a finding has been made, but still operating in the public without the public having any knowledge of that. Is that something we should move for, a more open process? Mr. Quaadman, do you have——

Mr. QUAADMAN. Sure. Thank you for asking that question. You know, Lynn and I do agree; the Chamber of Commerce does believe in strong enforcement.

You know, just a couple thoughts in that regard. The current procedures put in place by Congress in Sarbanes-Oxley—and actually it is very analogous to similar procedures with the Securities and Exchange Commission, other agencies, including the Federal Election Commission. So I think if there is going to be more openness, I think there should be a debate about that, because I think some of what we have to look at here is are we going from a system that allows for innocent before guilty to shifting to a system of guilty before being proven. And if we are going to go to a system like that, what are the impacts going to be on investors? Because if you are going to have ten proceedings and one of them leads to a finding that is going to lead to more enforcement, what do you do with the other nine? It is the old saying of, you know, where do I go to get my reputation back.

So I think we have to have a debate about that and really understand what the potential downsides are for that with investors, and also, I think we also need to ask the question as well, is there a reason we want to single out the auditing community from other financial institutions and even elected officials with the disciplinary proceedings they would have to go through in similar circumstances.

Chairman REED. Mr. Turner or anyone else have a comment on the proposal that would be a much more open and transparent process in which a company was being evaluated by the PCAOB?

Mr. TURNER. There are two aspects to that. Currently, and since 1989, the SEC has made its enforcement actions against professionals open. The SEC adopted that rule about the time I went to it the first time, in 1989. That has served, I think, the public very well, and there is no reason, I think, to have a difference between what has worked well for the SEC and what is currently not working very well for the PCAOB.

What I do know from talking to people not only within the PCAOB but outside amongst attorneys is the fact that these cases are kept under wraps and quiet is having a detrimental effect in that they are causing the auditing firms to drag out the proceedings as long as they possibly can. I think some of that would be mitigated—in fact, I think a lot of that would be mitigated with public hearings. And you do not make it public until you have gone through all your investigation and you have got a good reason for cause. So the rights of people need to be protected, as you would know, Chairman, and that process that the SEC has does protect those rights very carefully. So I think that has worked.

The other piece of it, though, is the PCAOB—and there was a good case just this last week. The PCAOB has also kept from investors which companies were being audited where the audits did not get done right. And, of course, we quite often vote on auditors each year, whether or not to reappoint them.

If the PCAOB knows that an audit has not been done right and there are problems and even cites it in a report but keeps it confidential from us, that is troubling as well, and that is occurring today. We recently have seen a situation where people were able to match it up, and the company acknowledged it, where the auditor, in fact, failed to get adequate audit evidence on a very significant item in the audit. I think we ought to be on top of that when we decide whether or not to reappoint a particular auditor. So I think that needs to be made public, and people need to quit withholding that information from us as well so we can make informed decisions rather than flying in the dark.

Chairman REED. Ms. Fornelli, do you want to comment?

Ms. FORNELLI. Certainly, I would be happy to. Mr. Chairman, there is a process now and a mechanism now for the disclosure of these proceedings, and that is through the SEC. So there is that valve there available.

Also, I would point out in the Sarbanes-Oxley Act it was set up so that the inspection reports, a portion of those are made public, so the public does have some insight into some of the issues that would be flagged in the inspections. So there is some transparency, and we do not see that with respect to the inspections of mutual funds or broker-dealers or even banking financial institutions.

Chairman REED. Thank you. Well, I want to thank you all for very thoughtful, obviously well-prepared testimony that has, I think, provided us a great deal of insight. I think it is also good to emphasize that once again this is an issue not specific to one auditing firm or to one company, but this unfortunately was a systemic crisis of multiple computers and multiple firms. And what we are trying to do is avoid such a crisis by thoughtful rules.

And the other aspect, too, I just have to say is that—you know, and again this is a reflection going back—you know, we felt a sense of accomplishment and I maybe dare say self-satisfaction that after the Enron problem we did enact a provision we thought was just this soup-to-nuts direction to go ahead and take care of these off-balance-sheet transactions, and then to sort of begin to probe in 2008 and then at the end of 2008 to discover that this was one of the major problems with a major finance institution who essentially had to pull back billions of dollars worth of transactions on their books and then discover that it took so long for the rules to be written, the guidance to be given, I think another important lesson of this process. And, you know, Mr. Quaadman has made a very good point about the need to do these Dodd-Frank regulations. Part of this is getting good regulations done with the notion that they can and will be improved over time, but searching for the perfect regulation for 6 years usually ends up with another bigger problem occurring. So that is just a thought.

Again, thank you very much. We will ask my colleagues to provide questions by Friday, and we would ask you for answers as quickly as possible.

Thank you very much, and the hearing is adjourned.

[Whereupon, at 11:32 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF JAMES R. DOTY

CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

APRIL 6, 2011

Chairman Reed, Ranking Member Crapo, 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 role of the accounting profession in preventing another financial crisis.

I look forward to discussing with the Subcommittee the role that the PCAOB plays in protecting investors and fostering confidence in our securities markets. I joined the Board on February 1, 2011. Many of the achievements and initiatives I will describe to you were the work of, or begun by, my predecessors on the Board as well as the PCAOB staff. The PCAOB remains actively engaged in these and many new initiatives to protect the investing public by enforcing high quality audits.

I. Introduction

You have asked me to address three questions: Did the accounting profession perform as expected leading up to and during the financial crisis? What, if any, improvements have been made or should be made by the U.S. Securities and Exchange Commission (SEC or Commission), the Financial Accounting Standards Board (FASB), or the PCAOB as a result of the financial crisis? And what, if any, policy changes should Congress consider?

In general terms, the PCAOB's inspections of audits conducted during the financial crisis indicated that accounting firms must do a better job of addressing in their audits the risks of misstatements in financial statements that emerge as economic conditions change. The PCAOB issued a report last fall describing the kinds of audit deficiencies the PCAOB identified on audits affected by the financial crisis. The PCAOB also issued several practice alerts on various auditing risks during the course of the crisis.

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 to improve the quality of audits during periods of economic stress.

I will discuss each of these points and explain how the PCAOB is using the lessons from the financial crisis to improve the quality of audits and auditor communications to investors. Finally, I will echo a suggestion made previously by the Board of a policy change for Congress to consider. It is a legislative change to enhance the PCAOB's effectiveness by permitting the Board to disclose its decisions to institute disciplinary proceedings to enforce applicable laws and standards against registered public accounting firms and their associated persons.

II. The Responsibilities of the PCAOB

More than half of American households invest their savings in securities to provide for retirement, education, and other goals. The financial statement auditor's job is to protect these investors' interests by independently auditing and reporting on management's historical financial statements. Reliable financial reporting is one of the linchpins on which our capital markets depend. If investors lose confidence in financial reporting, they may demand prohibitively high returns as a condition of investing or they may withdraw from the 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 layoffs. Even accurate, well-supported financial information does not mean the business strategy is good.

As the accounting scandals related to Enron, Adelphia and other public companies demonstrated, auditors can face strong pressures and incentives to acquiesce to questionable accounting. The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or the Act) was passed in the wake of the collapse of confidence that resulted from these and other financial reporting breakdowns. Title I of the Act created the PCAOB to serve as a counterweight to those pressures and incentives. Congress rightly determined in 2002 that rigorous, independent oversight was essential to the credibility of the auditor's watchdog function.

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

- *Registration of accounting firms*—No accounting firm may prepare, or substantially contribute to, an audit report for a public company that files financial statements with the SEC, or for a broker-dealer, without first registering with the PCAOB. There are currently 2,431 accounting firms registered with the Board. This includes 906 non-U.S. firms and 522 firms that are registered only because they have broker-dealer audit clients. Registered firms must file annual and other reports that provide the Board and the public with updated information about the firm and its audit practice. Contrary to what some believe, mere registration with the PCAOB does not reflect an examination of the firm's audit quality, which does not happen until we inspect.
- *Inspection of firms and their public company audits*—Since 2003, the PCAOB has conducted more than 1,600 inspections of firms' quality controls and reviewed aspects of more than 7,000 public company audits. The audit engagements the PCAOB reviews are not selected at random. To make the most effective use of its resources, the PCAOB uses a variety of analytical techniques to select high-risk engagements and audit areas that are likely to raise challenging or difficult issues.[1] Throughout this rigorous process, PCAOB inspections have identified numerous audit deficiencies, including failures by the largest U.S. and non-U.S. firms. These findings have led to changes in firm auditing processes, and, in some cases, more audit work performed after the fact or to corrections of client financial statements.
- *Investigation and disciplinary proceedings*—The Board has broad authority to impose sanctions on registered firms and associated persons that have violated applicable laws and standards. The PCAOB has publicly announced the resolution of 37 enforcement proceedings. These proceedings include 29 sanctions on firms, including 19 revocations of firms' registrations, preventing them from auditing public companies in the future, and 40 sanctions on individuals. Sanctions have also included significant monetary penalties. The announced decisions do not, however, reflect the full extent of PCAOB enforcement activity. Under the Sarbanes-Oxley Act, all PCAOB investigations and all contested proceedings (*i.e.,* cases in which the Board files charges and the respondent elects to litigate, rather than settle) are nonpublic. There are a significant number of matters under active investigation and an additional number in litigation, which may take years to be resolved.

  The Board closely coordinates its enforcement efforts with the SEC. In certain instances, the PCAOB investigates the auditor's conduct and the SEC focuses its investigation on the public company, its management, and other parties. In other cases, the SEC's Division of Enforcement takes responsibility for an auditor investigation and requests that PCAOB defer to that investigation.
- *Establishing auditing, quality control, ethics, independence, and other standards*—The Board is responsible for establishing the auditing and related professional practice standards under which public company audits are performed. Prior to the Sarbanes-Oxley Act, public company audits were performed according to standards set by the profession itself. The PCAOB has an active standard-setting agenda, as I will describe later in my testimony.

All of the Board's responsibilities are discharged under the oversight of the SEC. Chairman Schapiro, the Commissioners, and Chief Accountant Kroeker have taken a deep interest in the PCAOB's work, and I am grateful to them for their support and for the strong working relationship they have fostered between our organizations.

III. Auditor Performance Before and During the Financial Crisis

Through its inspection and enforcement programs, the PCAOB actively assesses whether auditors are doing their job appropriately and takes action when they are not.

Neither financial statement audits nor PCAOB oversight are intended to assess any company's liquidity structure, capital adequacy or risk management, including

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

financial institutions. Nor does the PCAOB set accounting and disclosure requirements. That is the purview of the FASB, the International Accounting Standards Board, in the case of institutions permitted to use International Financial Reporting Standards, and the SEC.

Rather, the PCAOB evaluates whether auditors have done their job, which is to make sure an institution's financial statements and related disclosures fairly present its results—good or bad—to investors in conformity with applicable accounting and disclosure standards. The Board is deeply focused on the lack of transparency in financial reporting during the crisis and the corresponding effect this had on the fairness of our securities markets. The Board is also focused on implementing lessons from the financial crisis in audits and our programs.

A. Inspections

The PCAOB's inspection program is the core of its oversight of registered firms' public company audit work. The PCAOB's inspection staff represents more than half of its staff. In addition, the PCAOB's Office of Research and Analysis devotes the majority of its resources to support the inspection program. As required by the Act, the PCAOB conducts annual inspections of firms that regularly audit the financial statements of more than 100 public companies. In 2010, the PCAOB inspected nine such firms. Firms that regularly audit the financial statements of 100 or fewer public companies must be inspected at least once every three years. The PCAOB inspected 245 such firms in 2010, including 64 non-U.S. firms located in 20 jurisdictions. Many of these non-U.S. firms are affiliated with a global network of firms. They can be quite large, measured by number of professionals as well as by market capitalization of audit clients.

Each firm in a global network of firms, including the Big Four, is independently owned by the partners in their country. Since each of those firms must register separately with the PCAOB, they are subject to the same frequency of inspections as any other firm. Substantial portions of the audits of many of the largest U.S. companies are performed by affiliated network firms, including firms we have not inspected.

In the course of the PCAOB's 2010 inspections, PCAOB inspectors reviewed portions of more than 350 audits performed by the nine firms subject to annual inspection, and portions of more than 600 audits performed by the remaining 245 inspected firms. During 2010, the PCAOB inspected aspects of audits for some of the largest public companies in the world, including many of the largest financial services and other companies with complex financial instruments and transactions and risks driven by market volatility.[2]

After completion of the inspections field work, PCAOB inspectors engage in a dialogue with firms, through written comments, and in certain cases, in-person meetings, about audit deficiencies they have identified. The PCAOB then issues a report after each inspection. The inspection report is not a complete report card on the firm's entire audit practice, but rather focuses on areas where inspectors found deficiencies. The public portion of an inspection report describes matters that inspectors have identified as significant audit deficiencies. These findings, presented in Part I of the report, generally involve situations in which PCAOB inspectors believe that the auditor failed to obtain sufficient evidence to support the audit opinion or failed to identify a material departure from generally accepted accounting principles. Consistent with restrictions in the Sarbanes-Oxley Act, however, the PCAOB does not publicly disclose the identity of the companies that are the subject of audits discussed in an inspection report.

Consistent with the Sarbanes-Oxley Act, the PCAOB discusses any criticism of or potential defects in a firm's system of quality control in Part II of its inspection reports. The Act affords inspected firms one year within which to remediate Board criticisms concerning firm quality controls. If the Board is not satisfied with a firm's

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. No. 111-203 (Dodd-Frank), authorized the Board to establish, by rule, a program of inspection of auditors of brokers and dealers. On December 14, 2010, the Board proposed a temporary rule that, if adopted, would establish an interim inspection program while the Board considers the scope and other elements of a permanent inspection program. Under the temporary rule, the Board would begin to inspect auditors of brokers and dealers and identify and address with the registered firms any significant issues in those audits. The Board expects that insights gained through the interim program would inform the eventual determination of the scope and elements of a permanent program. During the interim program, the Board at least annually would provide public reports on the progress of the program and significant issues identified, but the Board would not expect to issue firm-specific inspection reports before the scope of a permanent program is set. For more information about the proposed interim inspection program, see PCAOB Release No. 2010-008 (December 14, 2010).

remediation efforts, the portion of the report containing the discussion of the quality control deficiencies becomes public. The Board transmits full inspection reports, including the nonpublic portions of such reports, to the SEC and appropriate State boards of accountancy. The Board is also permitted to share full reports with certain other U.S. and non-U.S. authorities. In addition, the Board sends a special report to the SEC when, as a result of information developed in an inspection, it appears that financial statements filed with the Commission, and on which the public is relying, may be materially inaccurate.

2007–2009 Inspection Cycles

Last fall, the Board issued a report to inform the public about the audit risks and challenges that PCAOB inspectors had found in connection with the economic crisis.[3] That report discussed audit deficiencies inspectors uncovered during the 2007 through 2009 inspection cycles related to the impact of the crisis. Among other things, the report described deficiencies relating to auditing fair value measurements, especially related to financial instruments; impairment of goodwill, indefinite-lived intangible assets, and other long-lived assets; allowance for loan losses; off-balance-sheet structures; revenue recognition; inventory valuation; and income taxes.

We have observed that firms have produced internal guidance and training to address the deficiencies. They have not, however, been consistently applied by individual engagement teams.

The report does not evaluate the root causes of the crisis. Most postmortems to date have pointed to the failure of corporate risk management and financial institution liquidity structure or capital adequacy as root causes of the crisis. Other contributing factors have been cited as well, such as the behavior of the credit rating agencies, the role of the Government-sponsored housing finance entities, regulatory gaps and failures, and even unintended consequences of legislative and regulatory incentives related to home ownership, to name just a few.

The PCAOB has neither the authority nor the resources to look back at the crisis with the broader view necessary to develop an informed opinion on all of the different factors that caused the crisis. The PCAOB has, however, inspected and considered the role of auditors of financial institutions and other public companies affected by the crisis. As described in our public report, inspectors identified multiple instances where auditors failed to perform the work mandated by PCAOB standards. Firms must do a better job in adjusting to emerging audit risks as economic conditions change so that investors will have reliable information about the performance and financial position of public companies during periods of economic volatility. The PCAOB intends to use these lessons in driving improvements through subsequent inspections and appropriate standards setting.

2010 Inspection Cycle

Most of the audits that the PCAOB inspected during 2010 were of financial statements for fiscal years ending in 2009. The PCAOB staff is currently considering firms' responses to the questions and comments our inspectors raised, and are preparing draft inspection reports based on and reflecting their evaluation.

Although the PCAOB's 2010 inspection reporting cycle is not yet complete, so far PCAOB inspectors have continued to identify significant deficiencies related to the valuation of complex financial instruments, inappropriate use of substantive analytical procedures, reliance on entity level controls without adequate evaluation of whether those processes actually function as effective controls, and several other issues. PCAOB inspectors have also identified more issues than in prior years.

In any event, the Board is troubled by the volume of significant deficiencies, especially in areas identified in prior inspections. The PCAOB is working on several initiatives to drive improvements in audit quality.

2011 Inspection Plan

In 2011, the PCAOB will continue to focus on high-risk audit areas posed by the ongoing effects of the crisis and any future similar events, including, for example, the financial statement effect of the obligation to repurchase mortgages previously sold and mandated modifications to certain mortgages at financial institutions.

The PCAOB also intends to enhance its consideration of root causes when PCAOB inspectors find audit deficiencies. As in past years, the PCAOB will also continue to press firms to identify root causes of deficiencies and address them.

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[3] PCAOB, Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis (Sept. 29, 2010), available at *http://pcaobus.org/Inspections/Pages/PublicReports.aspx.*

PCAOB inspectors will also look closely at corrective actions taken by firms when inspectors identify problems. A firm's failure to obtain sufficient evidence to support its opinion does not mean that the financial statements themselves are necessarily misstated. But it does mean that corrective actions are required, both to shore up the deficient audit as well as to better plan and perform future audits. Inspections can only protect investors from audit failures if firms act on inspection results. It is troubling to me that we do not see firms consistently going back and performing more work to address the significant audit deficiencies identified by inspections. Now, I will say, we have begun to see some firms going back quite recently, but I do not consider this problem to be resolved yet.

Moreover, my concern is compounded by the fact that we have received reports from members of audit committees that firms sometimes represent to audit committees that their PCAOB inspection reports raise merely minor concerns, typically attributable to documentation of procedures they claim—but just can't demonstrate—they performed. Therefore, we are exploring ways to encourage the firms to provide more faithful reporting to audit committees in the future.

Inspectors will also continue to examine firms' quality control systems to evaluate how they manage audit quality, so as to enhance the PCAOB's basis for assessing, in this year and in future years, whether that system is appropriately designed and implemented to achieve the goal of conducting independent audits that are objective and in compliance with applicable standards. To this end, inspectors will continue to assess firms' processes and controls in certain functional areas related to audit performance, including, for example, a firm's monitoring of compliance with auditor independence requirements.

In addition, the PCAOB plans to expand its examination of the quality control mechanisms of large firms that participate in global networks. As I will discuss later, the PCAOB's recent settlement with five Indian-based registered firms from PricewaterhouseCoopers' global network (PW India) highlights the risks inherent in these global networks. In particular, inspectors will examine firms' supervision of work performed by affiliated firms, including by assessing firms' controls over consultations on accounting and auditing standards, as well as engagement teams' use and evaluation of affiliates' work. We will also encourage firms to identify root causes and address them concomitantly throughout their global networks and not just within their U.S. member firms.

PCAOB inspectors will also examine how audit fee pressures might affect the conduct of audits. It has been widely reported that audit committees are expecting auditors to agree to fee reductions. At the same time, economic conditions are adding to the complexity of audits. While audit firms cannot be immune to economic downturns, the PCAOB will evaluate whether such pressures result in fewer hours being devoted to audits, thereby impairing audit quality.

Lastly, the PCAOB is developing a broker-dealer auditor inspection program to comply with Dodd-Frank. We expect to begin those inspections in 2011. The PCAOB's Office of Research and Analysis has worked closely with Financial Industry Regulatory Authority and the SEC over the last year to obtain critical data that will facilitate the broker-dealer auditor inspection program. [4]

B. PCAOB Access to Non-U.S. Registered Firms

Approximately 260 non-U.S. firms are subject to regular PCAOB inspection. To date, the PCAOB has inspected 197 non-U.S. firms in 35 jurisdictions, including countries where some of the largest foreign private issuers—whose securities also trade in U.S. markets—are located such as Brazil, India, Japan, Korea, Mexico, and the Russian Federation. As I mentioned earlier, in 2010 the PCAOB inspected 64 non-U.S. firms in 20 jurisdictions. Nineteen of these 64 inspections were performed on a joint basis with the local auditor oversight authority pursuant to negotiated cooperative arrangements. In each of the joint inspections, as well as the other foreign inspections not conducted on a joint basis, the PCAOB and its foreign counterpart have been able to resolve conflicts of law, sovereignty, and other issues that may arise when we are operating in another country.

It is no secret that we have not been able to inspect all of the non-U.S. firms we are required to, though. Approximately 70 firms in 24 jurisdictions—including in the European Union (EU), Switzerland and China—had inspection deadlines in 2010 or earlier that have not been met.

[4] On December 14, 2010, the PCAOB proposed a rule to establish an interim inspection program related to audits of broker-dealers. The comment deadline ended on February 15, 2011. The Board is considering those comments and expects to finalize the rule in the near future. See PCAOB, Proposed Temporary Rule for an Interim Program of Inspection Related to Audits of Brokers and Dealers (Dec. 14, 2010).

The PCAOB is working hard to reach accords that will allow PCAOB inspectors into those jurisdictions: it is one of our highest priorities. I am pleased to report that, in January, the PCAOB concluded an agreement with U.K. authorities. Based on this agreement, the PCAOB is planning joint inspections of two large U.K. firms beginning in May.

In addition, earlier this week, the PCAOB reached an agreement to conduct joint inspections with the authorities in Switzerland. We will commence joint inspections in Switzerland in May, with the goal of inspecting three Big Four affiliate firms by the end of the year.

The U.K. and Swiss agreements are a significant step forward for U.S. investors. They are not "mutual recognition" arrangements, but arrangements for joint inspections that will enable PCAOB inspectors to evaluate audit work in these countries that U.S. investors rely on.

These arrangements are the first cooperative agreements that the PCAOB has concluded since the passage of Dodd-Frank, which amended the Sarbanes-Oxley Act to permit the PCAOB to share confidential information with its non-U.S. counterparts under certain conditions. That amendment removed one of the obstacles to PCAOB inspections asserted by the EU.

We hope that these agreements will serve as a model for cross-border cooperation with other regulators in the European Union. We continue to make progress on this front and are encouraged by our discussions with authorities in several jurisdictions. However, the negotiations with other EU regulators continue to progress quite slowly.

The PCAOB continues to be unable to conduct inspections in China, based primarily on assertions by the Chinese of national sovereignty issues. Currently, three mainland Chinese firms are overdue for inspection, and inspections of eight Hong Kong firms have been commenced but not completed because we were denied access to documents relating to operations of their clients in mainland China.

The PCAOB's inability to gain access to PCAOB-registered firms in China is especially troubling given the growth in the number of Chinese companies seeking access to capital in U.S. securities markets. Last month, the PCAOB issued a research note on trends and risks related to reverse merger transactions involving companies from the China region.[5] This note followed a July 2010 staff audit practice alert on auditing public companies with operations in China and other jurisdictions that accessed the U.S. markets through reverse mergers.[6]

There are also significant risks associated with audits of operations of U.S. companies in China. For example, we are finding through our oversight of U.S. firms that even simple audit maxims, such as maintaining the auditor's control over bank confirmations, may not hold given the business culture in China.

If Chinese companies want to attract U.S. capital for the long term, and if Chinese auditors want to garner the respect of investors, they need the credibility that comes from being part of a joint inspection process that includes the U.S. and other similarly constituted regulatory regimes. In light of these risks, the PCAOB's inability to inspect the work of registered firms from China is a gaping hole in investor protection.

C. Enforcement

The PCAOB has broad authority to impose sanctions on registered firms and their associated persons that have violated applicable laws, rules and standards. The PCAOB is engaged in several investigations relating to audits of financial institutions and other public companies affected by the crisis. These investigations, and any contested disciplinary proceedings that may result, are confidential under the Sarbanes-Oxley Act.

As an example of the scope of the issues the PCAOB is addressing rigorously through enforcement, earlier this week the Board issued a settled order against five PW India firms in connection with the audit of the financial statements of Satyam Computer Services, an India-based, multinational IT service provider with securities traded on the New York Stock Exchange. The Board's order included a $1.5 million penalty against two of those firms for violations of PCAOB rules and standards that contributed to the firms' failure to detect an accounting fraud by Satyam management. The Board also found that all five firms violated the Board's quality control standards. In addition to the penalty, the Board (i) imposed significant limitations

[5] PCAOB, Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: January 1, 2007, through March 31, 2010 (March 4, 2011), available at http://pcaobus.org/News/Releases/Pages/03152011—ResearchNote.aspx.

[6] 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).

on the PW India firms' ability to accept new clients or issue audit reports, (ii) required the appointment of an independent monitor to ensure audit quality improvements, and (iii) censured the firms.

The Board-imposed sanctions are in addition to a $6 million penalty and other sanctions imposed on the firms by the Commission. The PCAOB closely coordinated its investigation of the PW India firms with the SEC. This coordination will continue, as the independent monitor will report its findings to both the SEC and the PCAOB.

IV. Auditing Standards

The PCAOB's standard-setting program responded to the financial crisis at various stages by reminding auditors how existing standards apply in the context of specific challenges. The PCAOB issued Staff Audit Practice Alerts to explain to auditors how applicable requirements bear on various issues raised by the crisis. For example, in December 2007, the PCAOB staff issued Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists, and in December 2008, the PCAOB issued Staff Audit Practice Alert No. 3, Audit Considerations in the Current Economic Environment (December 5, 2008). These alerts helped auditors to focus on applicable audit requirements. They covered several audit topics relevant to the crisis, including auditing fair value measurements and accounting estimates; auditing the adequacy of disclosures; the auditor's consideration of a company's ability to continue as a going concern; and additional audit considerations for selected financial reporting areas.

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

In December 2010, the PCAOB issued Staff Audit Practice Alert No. 7, Auditor Considerations of Litigation and Other Contingencies Arising from Mortgage and Other Loan Activities (December 20, 2010), to focus auditors on auditing liabilities and related disclosures resulting from issues arising from mortgage and foreclosure-related activities. As we continue to identify or anticipate new audit practice issues or challenges, the PCAOB will continue to issue timely guidance to auditors.

Practice Alerts remind auditors of existing requirements. The Board also uses information that it learns in its inspections and from other sources to change the underlying auditing standards. In developing new standards, the PCAOB casts a wide net to seek input from various interested people and groups on ways to improve audits.

The PCAOB has used insights gleaned from the crisis, including information from outside sources and from our oversight programs, to develop new standards to address risks that became apparent in the crisis, including standards for how auditors assess the risk of material misstatements in financial statements. The PCAOB meets quarterly with the representatives of the SEC and FASB to discuss and facilitate financial reporting and auditing initiatives. The PCAOB also is in the process of exploring potential improvements in standards that would address, among other things, the content of auditors' reports, how auditors evaluate management's estimates of fair values of assets and liabilities, and when an auditor should modify their report because of going concern uncertainties. These projects and others are described below.

A. Risk Assessment Standards

In 2010, after two rounds of public comment and several public meetings with our Standing Advisory Group (composed of investors, auditors, financial statement preparers and others), the Board adopted, and the SEC approved, a series of eight new auditing standards, effective for 2011 audits. These standards address fundamental aspects of the audit, including audit planning and supervision, the auditor's assessment of and response to the risks of material misstatement in the financial statements, and the auditor's evaluation of audit results and audit evidence. The standards require the auditor to consider more thoughtfully, throughout the audit, the risk of misstatement due to fraud. They also require auditors to perform procedures to evaluate the completeness and fairness of financial statement disclosures, which are critical to providing investors a fair understanding of many matters that became particularly important during the financial crisis, such as valuation of complex financial instruments.

B. The Auditor's Report

The auditor's report is the primary means by which the auditor communicates to investors and other users of the financial statements regarding its audits of financial statements. The form of the report has not evolved significantly from the pass-fail model of the early years; however, over the years, several committees and groups, such as the Cohen Commission, Treadway Commission, and the American Assembly, have suggested improvements or changes to the auditor's report. Similarly, in 2008, the Advisory Committee on the Auditing Profession convened by the U.S. Department of the Treasury (ACAP) recommended the PCAOB consider improvements to the auditor's reporting model and clarify in the auditor's report the auditor's role in detecting fraud. ACAP noted that the greater complexity in financial reporting supports improving the content of the auditor's report beyond the current pass-fail model.[7]

On March 22, 2011, the Board held an open meeting to hear from the PCAOB's Office of the Chief Auditor on the results of the staff's outreach on a project to take a fresh look at the auditor's reporting model. The staff presented views and advice they received over several months from numerous in-depth meetings with dozens of people experienced in using or preparing audit reports, including investors, auditors, preparers, audit committee members, researchers, and others.

Separately, the Board's Investor Advisory Group (IAG) discussed this issue at its March 16, 2011, meeting. At that meeting, the Board heard a presentation from a task force of the group's members about a survey they conducted to solicit views regarding changes to the auditor's report. The group surveyed institutional investors, including investment banks, mutual funds, pension funds, hedge funds, and others. Both the IAG survey and our staff's outreach underscore that investors believe they need more information from the auditor regarding the auditor's views on audit risk, management's judgments and estimates, and the quality of management's accounting policies.

The Board's outreach effort, especially at such an early stage in the project, was unprecedented. In addition, the PCAOB's open meeting to discuss the input received was the first of its kind. The PCAOB staff is now preparing a written concept release to describe several potential changes for Board consideration and, if agreed, public comment.

C. Fair Value

As noted in the Board's 2010 report on observations from audits during the crisis, PCAOB inspectors identified many audit deficiencies relating to auditing fair value estimates. In many cases, the deficiencies related to insufficient evidence gathered by the auditor when using third party pricing sources (*e.g.,* pricing services or broker quotes) when valuing financial instruments such as investment securities. The largest accounting firms are devoting substantial effort to these issues, and we have seen some audit teams do what we expect. We are also hearing that the work that is required to validate pricing service reports is more than management is doing. To give deeper consideration to ways to prevent such deficiencies, the PCAOB has organized an *ad hoc* task force of our Standing Advisory Group to include investors, auditors, preparers, broker-dealers, and pricing services. Staff of the SEC and FASB will observe this task force. The task force's work is expected to inform the Board's development of new auditing requirements.

D. Going Concern

Under the Board's standards, the auditor should modify the report if there is a significant doubt about a company's ability to continue as a going concern for a reasonable period of time.

Investors and others have raised questions about why more audit opinions expressing substantial going-concern doubt were not issued before companies affected by the financial crisis failed (or would have failed except for Government intervention). The FASB has a project on its agenda that is intended to improve the ability of investors to understand the risks and uncertainties about an entity's ability to continue as a going concern and to meet its obligations when they become due. Such improvements in the accounting standards could assist in providing an early warning for investors. The PCAOB is working closely with the FASB and the SEC on this matter. If the PCAOB determines to issue further guidance in this area, it will be closely coordinated with the FASB's efforts. The Board recognizes the importance of this subject to investors.

[7] An unqualified opinion indicating that the company's financial statements are presented fairly in accordance with the applicable financial reporting framework is considered the "pass" determination in the pass–fail model.

E. Related Parties and Significant Unusual Transactions

The Board is considering revising its standard on relationships and transactions with related parties, including financial relationships with executive officers and transactions that are outside the normal course of business. As part of that project, the Board is evaluating ways for the auditor to gain a deeper understanding of the risk of misleading financial statements or disclosures, by considering a company's financial relationships with its executive officers and evaluating how those relationships might affect management's financial reporting incentives. Transactions with related parties and significant unusual transactions can pose significant risks of material misstatement. Their substance might differ materially from their form. They might be structured to achieve desired accounting results inconsistent with the underlying economic substance. And they might include terms not available in third-party, arm's-length transactions.

V. Policy Changes for Congress To Consider

Under the Sarbanes-Oxley Act as it exists today, the PCAOB's disciplinary hearings—our version of trials and appeals—are nonpublic, unless the Board finds there is good cause for a hearing to be public and each party consents to public hearings.[8] 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. On the contrary, the fact that, absent consent, PCAOB disciplinary proceedings are required to be secret creates a considerable incentive to litigate. 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. 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. Interested parties, including investors, audit committees, issuers and other auditors, are kept in the dark about alleged misconduct, even after a hearing and adverse findings. Investors are unaware that companies in which they have invested are being audited by accountants who have been charged by the PCAOB. In addition, unlike the authority the Exchange Act provides the Commission 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.

This state of affairs is not good for investors, for the auditing profession, or for the public at large. It is unlike the disciplinary proceedings of other, comparable regulators. Indeed, decades ago, the SEC found that nonpublic proceedings in cases against auditors of public companies were not in the best interest of investors and opened their administrative proceedings against auditors to the public. The reasons cited by the Commission 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. Investors would be best served by similar transparency in PCAOB disciplinary proceedings.

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.

[8] Section 105(c)(2) of the Sarbanes-Oxley Act of 2002.

PREPARED STATEMENT OF LESLIE F. SEIDMAN

CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

APRIL 6, 2011

Introduction

Chairman Reed, Ranking Minority Member Crapo, 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 the role of accountants and auditors in helping to prevent another financial crisis, 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 be sure the Committee understands both the FASB's robust due process and how we remain accountable to our stakeholders. Then I would like to discuss some of the changes to accounting standards the FASB has made in response to the financial crisis. Finally, I want to update you on several of our pending convergence projects with the International Accounting Standards Board (IASB), which address issues related to the financial crisis.

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.

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 ensuring the strength of U.S. capital markets and providing 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 for the guidance and education of the public, including issuers, auditors, and users of financial information.

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. 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:

- Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;
- Keep standards current to reflect changes in methods of doing business and changes in the economic environment;
- Consider promptly any significant areas of deficiency in financial reporting that might be addressed through the standard-setting process; and
- 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, 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 on its Web site; recently, we decided to also videocast our education sessions to make it easier for our stakeholders to observe the process that precedes our decisions. 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 have also been proactively reaching out to meet with stakeholders, including a wide range of investors and reporting entities, to discuss our proposals which helps us to assess whether the proposals will lead to better information and also to assess the related costs. These 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 also meets regularly with the staff of the SEC and the PCAOB. Additionally, since banking regulators have a keen interest in 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 developments.

In short, the FASB actively seeks input from all of its stakeholders on proposals and processes and we are listening to them. The Board's wide consultation 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. Wide consultation also 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.

Additional information about the FASB and the FAF can be found in the 2010 Annual Report of the FAF, which will be available on the FAF Web site later this month.

FASB Oversight

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:

- Selecting the members of the FASB, the GASB, and their respective Advisory Councils;

- Overseeing the FASB's and the GASB's Advisory Councils (including their administration and finances);
- Overseeing the effectiveness of the FASB's and the GASB's standard-setting processes and holding the Boards accountable for those processes;
- Protecting the independence and integrity of the standard-setting process; and
- Educating stakeholders about those standards.

Second, the FASB is also 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 delegated this authority to the FASB. In 2003, the SEC issued a Policy Statement reaffirming this longstanding relationship.

FASB Activities

Response to the Financial Crisis

The financial crisis led to a reprioritizing of the FASB's work. In particular, financial market participants and policy makers raised questions about:

a. Fair value measurement of assets and impairments, especially when markets become illiquid;
b. Off-balance sheet risks, particularly those related to securitizations (derecognition) and special purpose entities (consolidation);
c. Disclosures about risk; and
d. Complexity in accounting for financial instruments.

Accordingly, the FASB has undertaken projects to improve and simplify the accounting standards in each of these areas, which are described in further detail below.

Fair Value Measurement and Impairments

As the credit and financial crisis deepened and broadened in late 2008 and early 2009, significant attention was placed on "mark-to-market," or fair value, accounting, including the effect of applying the fair value standard to report the value of impaired securities. The controversy reflected, in part, the difficulty of determining the fair value of assets or liabilities in illiquid markets. It also reflected the concern that the accounting for problem assets held by financial institutions, including loans, was "procyclical" and may have exacerbated the crisis (even though loan losses are generally not measured at fair value).

While such determinations had been required in previous downturns, this was the first occasion in which a new standard for determining fair value, FAS 157,[1] was in effect. It is important to note that FAS 157, issued in 2006, did not introduce mark-to-market or fair value accounting and did not expand the range of items that are required to be, or permitted to be, measured at fair value. Rather, FAS 157 improves the consistency and comparability of fair value measurements within GAAP by more clearly defining fair value, establishing a framework for measuring fair value measurements, and expanding disclosures about a company's required fair value measurements.

In 2008, the SEC conducted a comprehensive study on mark-to-market accounting and submitted a report to Congress detailing its findings on fair value accounting. The report concluded that fair value accounting was not a primary cause of the crisis. The study also included recommendations on how to improve fair value requirements, including the need for improved guidance on the determination of fair value in illiquid markets and the reporting of impairments. The FASB made these improvements in late 2008 and early 2009 by issuing three FASB Staff Positions.[2]

Since April 2009, the FASB has made additional targeted amendments to fair value guidance to address the following:

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[1] FASB Statement No. 157, Fair Value Measurements (September 2006), as codified in Topic 820 of the FASB Accounting Standards Codification®.

[2] FASB Staff Position FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (October 2008); FASB Staff Position FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (April 2009); FASB Staff Position FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (April 2009). These staff positions have been codified in various topics of the FASB Accounting Standards Codification®.

a. How to measure liabilities at fair value; [3]

b. How to measure investments in certain companies that calculate Net Asset Value per Share; [4] and

c. How to improve disclosures about fair value measurements. [5]

In addition, in conjunction with the FASB and the IASB convergence efforts (discussed below), the FASB and the IASB have developed a converged definition of fair value and common requirements for measuring fair value and for disclosing information about fair value measurements. To that end, the FASB plans to issue minor amendments to existing GAAP requirements in April 2011. The amendments in this convergence project will explain how to measure fair value but will not expand the range of items that are required or permitted to be measured at fair value.

Off-Balance Sheet Financing

In 2008 and 2009, the FASB completed projects to improve accounting and disclosure requirements for the areas that caused the greatest concern about off-balance sheet financings. In 2008, the FASB completed a project that requires a company to make additional disclosures about the extent of its continuing involvement with assets no longer reported on its balance sheet and its involvement with special-purpose entities (SPEs). [6] Those disclosures became effective for calendar year end companies in 2008. The FASB then completed a project to amend the accounting guidance to provide greater transparency to investors about transfers (sales) of financial assets and a company's continuing involvement with such assets (FAS 166). [7] The FASB also improved disclosures of a company's involvements with SPEs and tightened the requirements governing when such entities should be consolidated (FAS 167). [8] FAS 166 and 167 were issued in June 2009 and became effective in January 2010.

In issuing Statements 166 and 167, the FASB provided necessary improvements to the accounting and reporting of securitizations and other involvements with SPEs. Before FAS 166 and 167, companies were required to consolidate an SPE only if they had the majority of risks and/or rewards of that entity. However, in making this determination, companies used complex mathematical calculations that often excluded key risks, such as liquidity risk. Consequently, some companies were able to structure transactions to avoid consolidating entities in which they retained significant continuing risks and obligations.

FAS 166 and 167 significantly improve the disclosure standards for companies involved with SPEs. Under the new standards, companies that control the most significant activities of the entity and are exposed to the benefits or losses of the entity are required to report the assets and liabilities on their financial statements. The improved accounting standards will put investors in a better position to determine who will ultimately bear the losses and reap the rewards of SPEs.

Since the issuance of FAS 166 and 167, the FASB has made one additional targeted amendment to consolidation guidance. As originally drafted, the new standards would have required investment managers and other similar entities to consolidate certain funds that they manage upon adoption of FAS 167. After considering all of the feedback received on this issue, the FASB decided to temporarily defer the effective date of FAS 167 for those entities in order to study the issue with the IASB. [9]

The FASB plans to issue a proposal in May 2011 that would amend the consolidation guidance, further clarifying when a company with decision-making power over a SPE should be required to consolidate. The proposal also would eliminate the deferral of the guidance in FAS 167 for investment managers and other similar entities.

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[3] FASB Accounting Standards Update No. 2009-05, Fair Value Measurements and Disclosures (Topic 820)__*Measuring Liabilities at Fair Value (August 2009).*

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

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

[6] FASB Staff Position FAS 140-4 and FIN 46(R)-8, Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities (December 2008).

[7] FASB Statement No. 166, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140 (June 2009), as codified in Topic 860 of the FASB Accounting Standards Codification®.

[8] FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) (June 2009), as codified in Topic 810 of the FASB Accounting Standards Codification®.

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

In addition to the projects outlined above, the FASB is revising the accounting standard for determining when a repurchase agreement should be accounted for as a sale or as a financing. The Board has determined that the existing criterion pertaining to an exchange of collateral should not be a determining factor when accounting for a repurchase agreement transaction. The FASB plans to issue this amendment in May 2011.

Disclosures About Risk

Disclosures are an integral part of a company's financial statements and provide information that is critical to an investor's ability to understand a company's risk exposures. The financial crisis revealed that disclosures about (a) fair value measurements, (b) credit risk, and (c) derivatives and other financial instruments needed to be enhanced to provide investors with a complete portrait of a company's risk exposure. To address this problem, the FASB issued several standards over the past few years.

Disclosures About Fair Value Measurements. Timely and transparent information about fair value measurements and asset impairments is critically important, especially in illiquid markets. To improve disclosures in those areas, the FASB issued three standards in early 2009. The first standard requires that the fair value disclosures previously made on an annual basis by public companies now be made on a quarterly basis. [10] Similarly, the second standard requires companies to make qualitative disclosures that give investors insight into how a company performs its fair value measurements on a quarterly instead of an annual basis. [11] Additionally, the third standard allows separate presentation of the credit-related and non- credit-related impairments of debt securities that were not intended to be sold and for which the entity could recover the decline in value by holding the securities. [12] These amendments also enhance the nature and frequency of information disclosed about debt and equity securities in unrealized loss positions and about whether or not an other-than-temporary impairment had been recognized. Together, this guidance ensures more frequent and detailed information reporting about fair value changes in securities.

In 2008 and 2009, FASB received many comments from users of financial statements requesting enhanced disclosures about a company's fair value measurements. Accordingly, the FASB issued guidance in January 2010 to address user concerns. [13] The guidance requires a company to disclose the following:

a. Significant transfers between Levels 1 and 2 (levels of fair value measurement based on availability of inputs);
b. Activity within Level 3 fair value measurements during a period (assets using significant unobservable inputs when measuring fair value are Level 3 assets); and
c. Valuation techniques and inputs to fair value measurements.

The guidance also requires a company to disaggregate its fair value measurement disclosures by class of asset or liability.

Disclosures About Credit Risk. Many banks voluntarily provide some disclosures about the credit quality of their loan portfolios. However, in the past, investors have commented to the FASB that many banks provide these disclosures too late in the credit cycle—after significant problems have been identified. In addition, the extent of these disclosures and their information content varies significantly. To address these concerns, the FASB issued guidance in December 2005 to emphasize that non-traditional loans, such as interest-only loans, option adjustable-rate mortgages, and loans with high loan-to-value ratios, could significantly increase an institution's exposure to credit risk and consequently must be disclosed under existing stand-

[10] FASB Staff Position FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments (April 2009), as codified in various Topics of the FASB Accounting Standards Codification®.

[11] FASB Staff Position FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (April 2009), as codified in Topic 820 of the FASB Accounting Standards Codification®.

[12] FASB Staff Position FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (April 2009), as codified in various Topics of the FASB Accounting Standards Codification®.

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

ards.[14] The FASB also issued a standard in July 2010 to enhance transparency about risks associated with traditional as well as nontraditional loans.[15] That standard requires banks to disclose information that enables investors to understand the nature of credit risk inherent in a bank's loan portfolio; monitor changes in the credit quality of a bank's loan portfolios over time; and understand how those changes are reflected in the bank's allowance for loan losses. That standard also requires a bank to disaggregate its credit quality disclosures by class of asset.

Disclosures About Derivatives and Other Financial Instruments. Both the use and complexity of derivative instruments and hedging activities increased significantly in the years leading up to the financial crisis. FAS 133,[16] which became effective in 2000, established accounting requirements for derivative instruments and hedging activities. While FAS 133 significantly improved the accounting for derivatives by requiring them to be measured at fair value, its disclosure requirements did not enable users to fully understand why a company uses derivatives and how those derivatives affect its financial statements. In March 2008, the FASB issued FAS 161[17] to address these concerns. Under FAS 161, a company must disclose qualitative and quantitative information about how and why the company uses derivative instruments, the volume of the company's derivative activity, and the impact of derivative instruments on the company's financial position, performance, and cash flows.

To further enhance the disclosure requirements in FAS 161, the FASB issued a FASB Staff Position in September 2008.[18] This additional guidance requires sellers of credit derivatives to disclose the nature of the credit derivative (including its term, the reason for entering into the credit derivative, the events that would require the seller to perform under the credit derivative, and the current status of its payment/performance risk), the maximum amount of potential future payments the seller could be required to make under the credit derivative, the fair value of the derivative, and the nature of any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and any related collateral held.

In May 2008, the FASB issued FAS 163[19] to address inconsistencies in accounting for financial guarantee contracts by insurance companies (for example, monoline insurers). In addition to addressing those inconsistencies, FAS 163 requires insurance companies to provide expanded disclosures about financial guarantee insurance contracts. Those disclosures primarily focus on the information used by the insurance company to evaluate credit deterioration in its insured financial obligations (for example, how a company groups and monitors its insured financial obligations and financial information about each grouping).

Convergence Efforts

The FASB is working with the IASB to develop converged accounting standards in several key areas through a collaborative due process. We agree with the G20 and many others that in a global economy, investors should be able to rely on one set of high-quality accounting standards. The FASB's and the IASB's target date to complete deliberations on three priority projects—financial instruments, leasing, and revenue recognition—is June 30, 2011. Although it is an ambitious target, we have recently prioritized our agenda and are redeploying resources to these high-priority convergence projects. While the FASB is committed to working hard to develop improved, converged, and sustainable standards quickly, we are equally committed to making sure that, first and foremost, 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.

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[14] FASB Staff Position SOP 94-6-1, Terms of Loan Products That May Give Rise to a Concentration of Credit Risk (December 2005), as codified in Topics 825 and 310 of the FASB Accounting Standards Codification®.

[15] FASB Accounting Standards Update No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses (July 2010).

[16] FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (June 1998), as codified in Topic 815 of the FASB Accounting Standards Codification®.

[17] FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133 (March 2008), as codified in Topic 815 of the FASB Accounting Standards Codification®.

[18] FASB Staff Position FAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161 (September 2008), as codified in Topics 815 and 460 of the FASB Accounting Standards Codification®.

[19] FASB Statement No. 163, Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60 (May 2008), as codified in Topic 944 of the FASB Accounting Standards Codification®.

With the comment period on those projects now closed, the FASB and the IASB are in the process of reviewing stakeholder input. The volume of feedback is impressive, and many issues have been identified. The FASB and the IASB plan to work through all of the issues methodically and thoughtfully. These standards go to the core of a company's key operating metrics, and we are committed to ensuring that stakeholders have ample opportunities to comment on proposed changes or possible implementation issues before the standards are finalized.

A brief update on the key convergence projects follows.

Accounting for Financial Instruments

One of the FASB's and the IASB's top priorities is improving, simplifying, and converging the accounting for financial instruments. In May 2010, the FASB published a proposal that aims to provide a more timely and full description of a company's involvement in financial instruments. Since the release of the proposal, the FASB has continued its deliberations about how (a) to classify and measure financial instruments, (b) to account for impairments (loan loss provisioning), and (c) to improve reporting of hedging activities.

The FASB and the IASB share a goal of issuing comprehensive improvements to the current standards that will foster international comparability of financial information about financial instruments. The Boards expect to achieve that goal by closely coordinating the deliberations of issues arising in their separate standard-setting projects.

In addition to the broader effort to converge financial instrument accounting standards described above, the Boards decided to undertake a discrete joint project to improve and converge the differences between International Financial Reporting Standards (IFRS) and GAAP requirements relating to balance sheet netting of derivative contracts and other financial instruments. This joint project was added in response to stakeholders' concerns (including those of the Basel Committee on Banking Supervision and the Financial Stability Board) about a major difference between the balance sheets of U.S. financial institutions and their international counterparts.

Classification and Measurement of Financial Instruments. The May 2010 proposal to amend the guidance on the classification and measurement of financial instruments proposed a much greater use of fair value measurement for financial instruments than exists under current accounting guidance. As part of its deliberative due process, the FASB is in the process of considering the comments it has received from stakeholders and redeliberating most aspects of the May 2010 Exposure Draft. The vast majority of investors, reporting entities, and other stakeholders did not believe 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.

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. The Board is also considering whether changes in the fair value of such assets should be recognized in other comprehensive income in certain circumstances. The FASB is continuing to discuss these issues and will continue to further refine the criteria for classifying financial instruments, as well as the application of those criteria to certain financial instruments (such as hybrid instruments). Once the FASB decides what changes, if any, it intends to make to its proposal, the FASB and the IASB will identify any differences that remain between IFRS and GAAP requirements and evaluate whether and how they might reduce the differences or otherwise enhance comparability. We believe that we will complete the deliberations on this phase of the project in the second quarter.

Impairments of Financial Instruments. The May 2010 proposal would require a company to recognize the total credit losses expected to occur over the life of a financial asset "immediately" or at the first reporting date at or after the financial assets are originated or purchased. Under current U.S. accounting requirements, an impairment loss is not recognized until it is probable. In other words, under the FASB's proposal, a company would not wait until a loss is probable before recognizing an impairment loss. Further, the proposal would require companies to assess credit losses based on all available information about past events and existing conditions but would not require consideration of potential future economic events beyond the reporting date.

The FASB received extensive input from stakeholders about the impairment proposal, most of which supported the development of a converged standard. Most commenters agreed with the proposal's elimination of the "probable" threshold. However, commenters expressed mixed views about the amount of the loss that should be recognized. Some comments supported recognizing total expected credit losses immediately, while others supported recognizing a portion of the credit losses expected to occur over the life of a financial asset. Additionally, a majority of commenters thought that the proposal should require all available information, including assumptions about future conditions and events, to be considered.

In response to this feedback, the FASB and the IASB issued a joint supplementary proposal in January 2011 that proposes a revised approach for an impairment model for financial assets. Under the revised proposal, the amount and timing of recognition would vary based on the credit characteristics of the financial asset, specifically the degree of uncertainty about the collectability of cash flows. The Boards' aim is to consider the comments received on the revised approach and substantially complete deliberations related to this phase of the financial instruments project in the second quarter.

Balance Sheet Netting

Balance sheet netting of derivative contracts and other financial instruments is typically the most significant apparent difference between the balance sheets of financial institutions that apply GAAP and the balance sheets of those that apply IFRS. In January 2011, the Boards published a joint proposal to align this reporting. Under the proposal, companies that apply GAAP would no longer be able to "net" derivatives and repurchase and reverse repurchase transactions in the balance sheet. Consequently, companies may report significant increases in total assets and total liabilities as a result of the proposed changes. The Boards plan to engage in extensive consultations with interested parties to ensure all views are considered, including holding public roundtables, after the end of the comment period on April 28, 2011. The Boards aim to substantially complete redeliberations by June 2011.

Conclusion

Thank you for the opportunity to provide a brief overview of the FASB and its many pending projects. I would be pleased to answer any questions.

PREPARED STATEMENT OF JAMES L. KROEKER

CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION

APRIL 6, 2011

Chairman Reed, Ranking Member Crapo, 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 appreciate the opportunity to testify today on behalf of the Commission regarding the role of the accounting profession in preventing another financial crisis.

Importance of Reliable Financial Reporting

Financial reporting plays a critical role in establishing and maintaining 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. Reliable financial reporting becomes even more important in a financial crisis, when concerns about a company's fundamentals are most acute.

The Federal securities laws mandate an independent audit according to specified standards by qualified professionals in order to provide assurance as to the faithfulness and integrity of the financial reporting presented. An audit by an independent public accountant is key to investor confidence and the functioning of our capital markets, and independent audits have long been recognized as important to credible and reliable financial reporting.

The Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB) under the Commission's oversight to supplement the Commission's role in overseeing the audits of public companies. The PCAOB registers, inspects, sets standards for, and, where appropriate, disciplines auditors in its focused mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

This enhanced and independent oversight of the auditing profession is intended to provide tangible investor benefits through improvements to the quality of audits and thus financial reporting as a direct result. The Commission recently appointed three new board members: Lew Ferguson, Jay Hanson and its new Chairman, Jim Doty, who I am pleased to be joining on this panel today. They join Dan Goelzer, who recently served as Acting Chairman prior to Chairman Doty's appointment, and Steve Harris. We are appreciative of the work of the outgoing Board members who recently finished their terms, and we look forward to the newly constituted Board continuing the mission of protecting investors.

The Financial Crisis

The recent financial crisis resulted in the deepest economic recession since perhaps the Great Depression. What started with defaults on subprime loans quickly spread to illiquid markets for many types of financial instruments and ultimately affected many companies around the world.

As the financial crisis unfolded, regulators responded to financial reporting issues and auditing developments as they arose. For example, the SEC's Division of Corporation Finance published several "Dear CFO" letters from 2008 to 2010 to remind preparers of their responsibilities on a wide range of issues from fair value accounting to loss accruals and related disclosure. In 2008, the SEC staff and FASB staff jointly issued guidance on the application of fair value measurements. In addition, the PCAOB issued several staff audit practice alerts between 2007 and 2010 highlighting emerging economic circumstances of the financial crisis that affected how auditors conduct audits. Topics raised in the practice alerts included auditing fair value measurements, financial estimates, adequacy of disclosures, and ability to continue as a going concern. The PCAOB also issued a report that detailed observations of PCAOB inspectors across firms on audit risk areas affected by the financial crisis.

As our Nation emerges from the financial crisis, we have both an opportunity and a responsibility to learn from it. This includes considering what lessons can be learned about the role of the independent auditor.

Role of the Auditor

A financial statement audit is designed to provide the auditor with reasonable assurance (which is a high level of assurance) that a company's financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP). The work performed in an audit enables the audit firm to opine on the company's financial statements taken as a whole. In exercising this vital function, auditors play a key role with respect to one particular type of risk: the risk of material misstatement in financial statements reported to investors, or "financial reporting risk."

When we look specifically at the role of the auditor, it is critical to distinguish between financial reporting risk and other risks, such as business and operational risks, which may affect a company and impact investment decisions. While auditors must understand these risks to the extent that they impact financial reporting risk, the auditor's procedures and communications are not designed to specifically address risks other than financial reporting risk or to make judgments about the merits of a company's business strategies. An audit is not designed, nor can it or should it be designed, to take all risk out of investing. Audits are instead designed to attest to the accuracy of financial statements in accordance with established accounting standards to provide investors with reliable financial information they can use in making investment decisions.

Focusing, then, on financial reporting risk, there is reason to consider the extent to which improper, fraudulent, or inadequate financial reporting relating to GAAP reported results or to disclosures outside of the audited financial statements played a role in the financial crisis. SEC enforcement teams continue to pursue cases stemming from actions that contributed to the financial crisis, following settled enforcement actions involving Countrywide Financial, American Home Mortgage, New Century, IndyMac Bancorp, and Citigroup.

When poorly performed audits contribute to or fail to detect financial reporting abuses, there are existing mechanisms for dealing with such misconduct, including SEC or PCAOB enforcement actions. For our part, we will continue to prosecute those who fail to comply with their obligations.

We are considering whether audits performed during the financial crisis complied with the current standards and rules. Particularly, given the lack of confidence expressed by some investors during the financial crisis, we and the PCAOB are actively working to determine how standards can be improved. Moreover, we are looking further to determine how the role of the auditor can be improved.

Improvements in Audits

Root Causes of Auditing Deficiencies

As I previously mentioned, the PCAOB issued a report detailing the observations of its inspectors on audit risk areas affected by the financial crisis. This report provided observations of financial reporting risk areas and related audit deficiencies across audit firms. While such reports represent a meaningful step to providing investors, auditors, audit committees, and others with information about audit quality, there is more work to be done to identify and address the underlying causes of the deficiencies.

One such area relates to identifying the root causes of auditing deficiencies. The PCAOB's inspection program has played an important role in improving audit quality at inspected firms. At the end of each firm inspection, the PCAOB issues a report that details audit deficiencies noted during the inspection. We continue to work with the PCAOB to support their efforts to identify and consider the root causes of recurring audit deficiencies. Being able to identify these causes has the potential to improve implementation and maintenance of appropriate quality controls, as well as to identify areas where auditing standards need to be improved.

Auditing Standards

The PCAOB has implemented processes, including the establishment of its Standing Advisory Group as contemplated by the Sarbanes-Oxley Act, where the Board performs regular outreach to investors, preparers, and auditors to seek input on a variety of topics, including its standard-setting activities. That outreach has been considered by the Board in adopting its recently issued standards, including eight standards that deal with the auditor's assessment and response to risks of material misstatement. The new risk assessment standards also emphasize considerations of fraud throughout the audit and the importance of auditing disclosures.

Auditor's Reporting Model

The project relating to the auditor's reporting model is a particularly important initiative of the PCAOB's standard-setting agenda. Some investors have raised questions about the sufficiency of information they receive from auditors, including whether investors could benefit from additional early warnings from auditors. The PCAOB's project, which also has been taken up by other standard setters around the world, is to look at the content of the auditor's report. The goal of this project is to understand whether there is information investors are not getting from auditors today that would be useful in making investment decisions. A related question is who should be the appropriate party to provide that information to investors. That is, is this information the auditor should be providing, or is this information from management or the audit committee that needs to be addressed? Other questions include the form and manner in which investors receive such information.

Auditing Considerations Around the Globe

International Inspections

The ability of the PCAOB to inspect foreign registered firms that audit issuers in the U.S. capital markets is a significant aspect of an effective auditor oversight regime. Section 981 of the Dodd-Frank Act allows the PCAOB to share information with its foreign counterparts. As a result of that statutory change, coupled with the hard work by the PCAOB and its counterpart in the United Kingdom, the PCAOB has been able to reach an agreement to resume inspections there. In light of the importance of inspections, we have been working with the PCAOB in their ongoing efforts to reach similar agreements with additional regulatory bodies in those locations where inspections are not currently being performed.

Other Standard Setters and Regulators

Interest in the role of auditors in the financial reporting system is not limited to U.S. regulators and standard setters. For example, the European Commission and the U.K.'s Financial Reporting Council also have projects underway to consider, for example, audit policy matters and the role of auditors and audit committees. Some of the ideas being explored are ideas that have been previously incorporated into the U.S. capital markets. For example, as a result of the Sarbanes-Oxley Act, the United States already has provisions for audit partner rotation and for listed companies to have an independent audit committee appoint the independent auditor. Nonetheless, these international undertakings have sparked interesting dialogue and debate, and it is important that we explore all reasonable ideas to improve audit quality for the sake of investor protection and the financial system as a whole.

Accounting

Because the role of the auditor is so directly tied to the accounting standards themselves, the recent financial crisis also provides us with the opportunity to examine whether accounting standards could be improved. I am pleased also to be here today with the FASB Chairman, Leslie Seidman. The financial crisis highlighted the type of information that investors, regulators, and other users of financial reports need to see reported on a company's financial statements. My office requested in January 2008 that the FASB improve financial reporting for many financings, securitizations, and other transactions that previously had not been consolidated on the balance sheet. This request was consistent with the leadership shown by this Subcommittee and Chairman Reed in the 2008 hearing on Transparency in Accounting and Proposed Changes to Accounting for Off-Balance Sheet Entities. The existing standards were in need of improvement regarding what companies should be reporting as their own assets and liabilities, and we believed immediate action was needed. The President's Working Group on Financial Markets made similar recommendations in March 2008.

In response, the FASB completed a major standard-setting initiative for the accounting of financial asset transfers and consolidation. These requirements became effective for reporting 2010 results. A critical component of these reforms was to eliminate the previous exemption for so-called "qualifying special purpose entities." This structure was used for many securitizations. This so-called "scope exception" had grown beyond its original purpose, and the FASB determined to place all securitization structures and other structured entities under a single accounting model.

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

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

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

Continuing Improvements to Accounting Standards

The FASB and the International Accounting Standards Board (IASB) are working on joint projects to improve financial reporting and eliminate unnecessary differences between U.S. GAAP and International Financial Reporting Standards (IFRS) in a number of key areas. The FASB has made significant progress towards completion of a project to improve and simplify accounting for financial assets and related impairments. As the FASB and IASB move forward, there are two fundamental issues that have been raised as a result of the crisis: (1) was there in fact compliance with existing accounting and disclosure requirements; and (2) what improvements could be made to what is required to be reported in an issuer's financial statements to assure that they reflect an entity's financial condition. The result of the FASB's and IASB's work also is extremely important to the Commission's own consideration of whether to incorporate IFRS into the financial reporting system for U.S. issuers.

The Commission staff will continue to review companies' accounting and reporting practices to determine if companies are complying with existing requirements and to determine whether changes to those requirements are warranted. As Chairman Schapiro testified last year before the full Committee, we will take appropriate action where we find that companies are improperly reporting their financial condition. We also will continue to consider whether existing disclosure requirements are adequate to provide full and transparent disclosure.

Conclusion

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

PREPARED STATEMENT OF ANTON R. VALUKAS

CHAIRMAN, JENNER & BLOCK LLP

APRIL 6, 2011

Dear Chairman Reed, Ranking Member Crapo, and Members of the Committee, I appreciate the opportunity to appear before you to address what role the accounting profession can play in helping to prevent another financial crisis. I address this question primarily from the perspective of my role as the Examiner in the Lehman Brothers bankruptcy proceeding.

I want to emphasize at the outset that I did not make any finding as to whether regulators or auditors necessarily could have prevented Lehman's collapse. Lehman failed in part because it was unable to retain the confidence of its lenders and counterparties and because it did not have sufficient liquidity. Lehman was unable to maintain confidence because it made a series of business decisions that left it with heavy concentrations of illiquid assets with deteriorating values, such as residential and commercial real estate. The extent to which Lehman's demise was, in part, the function of any act or failure to act by the auditors is a question we must leave for the courts.

Lehman's executives—not regulators or auditors—made the decision to load up on illiquid assets. Lehman's executives—not regulators or auditors—were responsible in the first instance for preparing fair and accurate financial reports. I found that Lehman's decision not to disclose to the public a fair and accurate picture of its financial condition gave rise to colorable claims against senior officers who oversaw and certified misleading financial statements.

Nevertheless, and wholly apart from the claims involving Lehman's auditors, we must recognize the general principle that auditors serve a critical role in the proper functioning of public companies and financial markets. Boards of Directors and audit committees are entitled to rely on external auditors to serve as watchdogs—to be important gatekeepers who provide an independent check on management. And the investing public is entitled to believe that a "clean" report from an independent auditor stands for something. The public has every right to conclude that auditors who hold themselves out as independent will stand up to management and not succumb to pressure to avoid rocking the boat.

I found that colorable claims exist against Lehman's external auditor in connection with Lehman's issuance of materially misleading financial reports. As I explained in my Report:

> [I]n this Report a colorable claim is one for which the Examiner has found that there is sufficient credible evidence to support a finding by a trier of fact. The Examiner is not the ultimate decision maker; whether claims are in fact valid will be for the triers of fact to whom claims are presented. The identification of a claim by the Examiner as colorable does not preclude the existence of defenses and is not a prediction as to how a court or a jury may resolve any untested legal, factual, or credibility issues.

If Lehman had earlier presented a fair and accurate picture of its financial condition, regulators and Lehman's Board may have had a fighting chance to make needed corrections or arrange for a smoother landing. As there is litigation pending against some of the individuals and entities covered by my findings, it would not be appropriate for me to comment directly on any issues that will have to be decided by the courts. There are, however, important lessons that can be gleaned as to how auditors can help prevent another financial crisis.

In Lehman's final months, two issues were of critical importance: leverage and liquidity. In both instances the system broke down. Information given to the investing public was misleading or inaccurate, and opportunities to identify severe problems were missed.

Leverage: Lehman's Balance Sheet Manipulation

Beginning in 2007, market observers began demanding that investment banks reduce their leverage. Lehman knew that if it did not reduce leverage it would suffer a ratings downgrade, which would have an immediate and tangible monetary impact. Paolo Tonucci, Lehman's Global Treasurer, recognized in 2007 that ratings agencies were "most interested and focused on leverage." In early 2008, Erin Callan, Lehman's CFO, noted that reducing leverage was necessary to "win back the confidence of the market, lenders, and investors."

Lehman's CEO Richard Fuld knew that Lehman had to improve its net leverage ratio by selling inventory, but by mid-2007, much of Lehman's inventory had become "sticky"—difficult to sell without incurring substantial losses. As detailed in my Report, Lehman opted to create a perception of reducing its net leverage ratio through increased use of a device known as "Repo 105."

Lehman repeatedly and heavily relied on Repo 105 transactions to temporarily remove—and I emphasize temporarily—some $50 billion off of Lehman's balance sheet right at quarter end. Lehman undertook $38.6 billion, $49.1 billion, and $50.38 billion of Repo 105 transactions at quarter end fourth quarter 2007, first quarter 2008, and second quarter 2008, respectively. Lehman executives described this accounting device as a "gimmick," "window dressing," and a "drug we r on." Martin Kelly, Lehman's former Global Financial Controller, stated unequivocally that there was "no substance to the transactions." $50 billion of transactions with no business purpose. I uncovered ample contemporaneous evidence that the sole purpose of these transactions was to make the published balance sheets look better than they actually were. To make matters worse, these transactions not only lacked any affirmative business purpose but required Lehman to pay a premium for the privilege of masking its true financial condition.

Without getting into specifics as to contested issues that might be involved in litigation, there is no serious dispute that Lehman's external auditor was aware of Lehman's Repo 105 accounting policy and was aware of an allegation that Lehman had used that policy to move $50 billion temporarily off the books at quarter end.

Lehman did not publicly disclose that it used $50 billion of these transactions at quarter end. Whether due to gaps in professional audit standards or a failure to follow those standards, the result is the same: the external auditor did not object when Lehman omitted any reference to these transactions in its public filings.

I found colorable claims that Lehman did not merely mislead by omission. Lehman represented to the investing public that it had worked to lower its net leverage ratio: Lehman stated in its Management Discussion and Analysis (MD&A) that net leverage is "more meaningful" than a simple leverage ratio. Lehman's statement that the net leverage ratio was a "more meaningful" measurement of leverage was misleading because that ratio was not an accurate indicator of Lehman's actual leverage, and in fact, understated Lehman's leverage significantly. I found that sufficient evidence exists for a judge or jury to find that Lehman's reported net leverage ratio was materially misleading.

In analyzing what steps could help avoid similar misstatements or omissions in the future, it should be noted that rules in place at the time required that an MD&A include an analysis of known material trends, events, demands, commitments, and uncertainties. Existing regulations required registrants to discuss known trends involving their liquidity and capital resources, specifically including off-balance sheet financing arrangements. The same regulations specified that a registrant should discuss, among other things, the "nature and business purpose to the registrant of such off-balance sheet arrangements." As we have seen, Lehman's off-balance sheet arrangement had no business purpose. Lehman did not so advise the public.

SEC guidance also stated that an MD&A should describe "unusual events and transactions" to help identify apparent trends. Lehman did not disclose the unusual nature of the Repo 105 transactions or the trend that Lehman's net leverage ratio only temporarily fell just when it was time to issue public reports.

Lehman's auditor maintained that Repo 105 transactions were but one of numerous end-of-quarter transactions that investment banks do to make their balance sheets look better. The auditor maintained that there is nothing remarkable about Repo 105 and that an auditor's only role with respect thereto is to make sure the accounting is correct. If the accounting is correct, the auditor maintained, it does not matter if the transactions are being done as a means to manipulate net leverage. The auditor further asserted that Lehman engaged in substantial volumes of other off-balance sheet transactions that a reader of Lehman's financial statements would not know about, and that those transactions dwarfed the Repo 105 transactions.

Lehman's external auditor further stated that net leverage ratio is not a GAAP measure expected to be included in financial statements and that disclosures of Repo 105 activity were not required at the time of Lehman's financial reports. With respect to MD&A issues, the external auditor stated that it is not responsible unless (i) the numbers contained in the MD&A were inconsistent with the numbers in the financial statements; (ii) there is a material inconsistency between the MD&A and financial statements; or (iii) the auditor knew that information in the MD&A was materially misleading. The auditor asserted that none of those scenarios applied to the Lehman MD&A, and that the MD&A is the responsibility of management and disclosure counsel.

Whether the auditor correctly understood its responsibilities is for a trier of fact to decide, but a few points are abundantly clear: Ratings agencies and senior Lehman executives well understood the critical importance of Lehman's leverage to the investing public; the auditor did not qualify its opinion in any way or advise the Board of the end-of-period Repo 105 transactions; and the public traded millions of Lehman's shares without knowledge of the extent or purpose of Lehman's end-of-period Repo 105 transactions.

Lehman's Liquidity Pool

The inadequacy of Lehman's liquidity pool—the cash, Government securities and other high-quality assets that Lehman set aside for its known funding needs—played a key role in Lehman's bankruptcy filing. Lehman represented in its regulatory filings and public disclosures that its liquidity pool was intended to cover expected cash outflows for 12 months in a stressed liquidity environment. Lehman reported that its liquidity pool contained $34 billion at the end of the first quarter of 2008, $45 billion at the end of the second quarter of 2008, and $42 billion at the end of the third quarter of 2008. In all cases, Lehman represented that its liquidity pool was unencumbered, meaning that it was composed of assets that could be "monetized at short notice in all market environments."

After Bear Stearns' near collapse in March 2008, regulators, lenders and the investing public all looked to Lehman's liquidity pool as a key indicator of Lehman's financial health. Though Lehman was well aware of this focus, it began to cut corners as clearing banks and overnight lenders sought increasing amounts of collateral. By the summer of 2008, Lehman began to count in its liquidity pool assets it had deposited or pledged to its clearing banks. In the days before Lehman's bankruptcy filing, encumbered assets that likely could not have been converted to cash quickly in a funding emergency comprised a significant portion of the pool.

Lehman never affirmatively advised its Board, the ratings agencies or the investing public of the billions of dollars of deposits and pledges that affected its liquidity pool. At the same time, Lehman did not attempt to hide from the regulators what it was doing. The SEC and the Fed each knew that significant amounts counted as liquidity were in fact posted as comfort deposits in order for Lehman to do business; the Fed knew that significant amounts counted as liquidity were in fact actually pledges to lenders. The agencies internally disagreed with Lehman's inclusion of these amounts as liquidity, yet took no action to require Lehman to adjust its public reporting of the numbers.

How could Lehman count deposits, pledged property and other encumbered assets in its liquidity pool? The fault lies, of course, with Lehman itself and to some extent with regulators for failing to regulate Lehman's practices, but it did not help that there was no consistent standard of what constitutes a liquid asset.

In the absence of a clear definition, Lehman and its regulators created their own. For example, Mr. Tonucci stated that an asset monetizable in five days was suitable for Lehman's liquidity pool, although Lehman did not always comply with this definition. Other Lehman managers said they were unaware of a five-day rule. The SEC applied a 24-hour test, meaning that to be considered liquid an asset had to be convertible to cash in one day; however, the SEC rarely questioned whether certain types of assets were appropriate for a liquidity pool. The Federal Reserve Bank of New York (FRBNY) had no set rule for determining what assets were appropriate for a liquidity pool; it evaluated pool assets on a case-by-case basis, noting that certain assets could be considered liquid if the clearing banks released their liens. When the FRBNY calculated the amount of Lehman's liquidity pool for its own purposes, the FRBNY subtracted assets pledged to Lehman's clearing banks from the total amount of the liquidity pool, even though Lehman continued to count these assets.

Lehman publicly discussed its liquidity pool because liquidity was essential to maintaining the confidence of Lehman's trading partners. On June 9, 2008—just three months before declaring bankruptcy—Lehman announced its liquidity pool was, at $45 billion, its "largest ever." That same month one of Lehman's clearing banks, Citibank, required that Lehman post $2 billion as a "comfort deposit," as a condition for Citi's continued willingness to clear Lehman's trades. Later in June, Lehman posted $5 billion of collateral to JPMorgan, Lehman's main clearing bank, in response to an earlier demand by JPMorgan. Lehman continued to count virtually all of these deposits in its reported liquidity pool.

On September 10, 2008—five days before it filed for bankruptcy—Lehman publicly announced that its liquidity pool was holding steady at approximately $41 billion. By Friday, September 12, however, Lehman actually had less than $2 billion of assets that could readily be turned into cash; it literally did not have sufficient cash to open for business on Monday, and it filed for bankruptcy protection on September 15. We now know that Lehman's report of a $41 billion liquidity pool on September 10 was off by tens of billions of dollars.

Lehman's auditor stated that it was highly involved in monitoring Lehman's liquidity pool. But when I asked if the auditor was aware of or had concerns with Lehman's inclusion of certain assets in the liquidity pool, the auditor stated that the composition of the liquidity pool was a matter for the regulators, not the auditor. Whether or not this description of responsibility is accurate, the bottom line is that the auditor apparently did not check whether Lehman's liquidity pool was in the least bit liquid. And anyone who tried would have been faced with widely disparate definitions of liquidity. Clear standards are needed to ensure that someone other than the party in interest provides a check on whether liquidity pools are liquid and can actually serve their intended purpose.

Lessons Learned

Lehman's auditors maintained that Repo 105 transactions were permissible under existing accounting rules and that existing accounting rules did not require any analysis of the content of liquidity pools. Whether they are right about what the rules did and did not require is a matter for litigation and is not for me to comment on. But I can say that if the existing rules did not require better disclosure, this Committee ought to consider filling that vacuum.

Lehman's collapse and misleading disclosures offer a tragic example of a silo mentality, with no one taking responsibility for the entire farm. The Fed and the Treasury were in a position to intervene but viewed the SEC as Lehman's primary regulator. Yet former SEC Chairman Cox told me that the SEC's jurisdiction was limited to Lehman's broker-dealer subsidiary, not Lehman itself. To be fair, Chairman Cox's successor, Mary Schapiro, took a different view and acknowledged that mistakes were made. But the point is that the consistent story I heard was that "it was not my job." It is important that someone be identified—with no ambiguity—and tasked with the job of taking responsibility for financial oversight.

Lehman's former Global Financial Controller Martin Kelly stated that he expressed his concern over Lehman's undisclosed Repo 105 activity to consecutive Lehman CFOs (Erin Callan and Ian Lowitt), and warned each of them of the "reputational risk" Lehman faced if its reliance on Repo 105 became known to the public. Yet Mr. Kelly contended that it was the job of more senior officers to limit or stop Lehman's Repo 105 activity. Lehman's outside disclosure counsel said he was never told of Lehman's Repo 105 activity, although some of the Lehman personnel he communicated with and relied upon knew about the Repo 105 transactions and their effect on net leverage.

Ms. Callan stated that it was the job of controllers and auditors to determine what came off the balance sheet at quarter-end. When she had to certify Lehman's financial statements, Ms. Callan said she relied upon subcertification by Chris O'Meara, the previous CFO. When it came time for Mr. Lowitt to certify financial statements, he said he relied upon Ms. Callan's subcertification. Richard Fuld, Lehman's former CEO, said that he relied upon Lehman's Chief Legal Officer and CFOs to inform him whether any information that should be in the financial statements was missing before he would certify them.

So to review the bidding, Lehman's senior executives weren't responsible because they relied on the auditors and other executives. The auditors weren't responsible because they relied on the executives and the lawyers. And the lawyers relied on the executives. But the public—who rely on the financial statements—who do they get to rely on?

Lehman's external auditor erected several of its own silos. Representatives of the auditor, including the lead auditor, stated the following:

- The auditor reviewed Lehman's Repo 105 accounting policy, but not Lehman's Repo 105 practice. The auditor reviewed Lehman's Repo 105 policy "on a theoretical level."
- The auditor was not required to look at either the volume or timing of Lehman's Repo 105 transactions at quarter end.

- The auditor does not have responsibility for the MD&A unless the numbers are inconsistent with the financial statements, there is a material inconsistency between the MD&A and the financial statements, or if the auditor actually knew that information in the MD&A was materially misleading. I understand this position to mean that, regardless of how apparent a materially misleading statement may be, an auditor has no responsibility for the MD&A if it has not actually put two and two together.
- If the accounting is technically correct, it does not matter to the auditor if the Repo 105 transactions were being done to manipulate net leverage. When I asked if technical adherence to an accounting rule could nevertheless lead to a material misstatement, the lead auditor stated, "You've got to ask an attorney."
- The auditor intended to perform additional tests regarding alleged balance sheet manipulation as part of the annual audit, and was not required to do so for the quarterly reviews.

I am not here to serve as judge and jury as to whether these interpretations of an auditor's duties are consistent with the professional standards. If they are, then this Committee should consider whether the standards need to be revised. But I can say that the end result was that Lehman's auditor did not question Lehman's nondisclosure of Repo 105 accounting transactions or consider whether these transactions were undertaken solely to dress up the balance sheet. Lehman's auditor never communicated anything about Repo 105 transactions to Lehman's Audit Committee members even though the Audit Committee instructed the auditor to investigate allegations regarding the balance sheet made by a whistleblower.

My Report cites rules that require financial statements to be fair, accurate, and not misleading, beyond including technically correct accounting. It is important to emphasize that in the world of financial reporting, the whole is supposed to be greater than the sum of the parts. If a mere recitation of numbers and technical accounting masks a trend (such as billions of dollars coming off and on the balance sheet at period end), the financial reports may not be fair and accurate. To the extent the existing rules are ambiguous, there should be rules that require the auditors, before they issue an unqualified report to accompany financial statements, to assure themselves that technical accounting procedures are not being used to manipulate material indicators like leverage. If the rules do not exist already, there should be rules that require the auditors, before they issue an unqualified report, to assure themselves that material issues like liquidity are accurately portrayed. If auditors are not already required to determine whether the specific assets held out to the public as liquid are in fact liquid, they should be. And to assist the auditors, a common, concrete definition of liquidity for accounting purposes is needed.

This is a subject deserving of careful study. Common sense dictates that fundamental concepts like "net leverage" and "liquidity" should not be a function of manipulation and subterfuge. We need to have clear and understandable rules if we are going to avoid these mistakes in the future.

Based on my experience from the Lehman investigation and several decades of civil and criminal litigation, and in addition to the points raised above, I offer the following suggestions for how auditors can help prevent the next financial crisis. I will defer to the accounting experts and this Committee whether existing rules need to be tightened in some of these areas or whether improvement lies in execution and enforcement.

1. *Do not marginalize the "whistleblower."* Auditors must take seriously and fully analyze allegations of financial impropriety. Auditors face intense pressures to conclude their analyses quickly in order to allow financial statements to be released on time but have an important responsibility to follow the facts wherever they may lead.
2. *Abandon the Quest for Immateriality.* When red flags arise, auditors must avoid the mindset of first and foremost finding a way to describe the issue as immaterial. Existing rules require analyses of qualitative materiality—particularly when management is trying to actively manage the financial statements—and not just number-crunching, to determine if an issue is material. These rules need to be tightened or enforced more aggressively.
3. *Management representations are one piece of evidence, not insurance policies for auditors.* External auditors cannot be expected to uncover every instance of fraud or other wrongdoing. But existing rules require auditors to assume neither that management is honest nor dishonest. Existing rules require auditors to approach their work with independence and professional skepticism and to rely on "competent" evidence rather than accepting whatever they may be told

by a bad egg in management. Auditors are certainly entitled to place some reliance on management representations, but as the engagement letter between Lehman and its auditor acknowledged, representations must be viewed as only one piece of evidence available to auditors. For example, Lehman's auditors could have, but did not, ask the relevant Lehman personnel the business purpose of the $50 billion of end-of-period Repo 105 transactions, and could have, but did not, examine any evidence of the volume, timing, and purpose of those transactions.

4. *The client is the Audit Committee.* Related to my prior observation, auditors must remember that their client is the company's Board of Directors and Audit Committee, not management. Auditors face immense pressure to be "team players" with senior management and not to rock the boat, but they must serve the Board as an independent check on management.
5. *The "review" process must have some teeth.* Auditors often emphasize the difference between a full audit of annual financial statements and more limited reviews of quarterly financial statements. Although it is not realistic or cost-effective to require full-blown audits every quarter, when red flags appear existing rules need to be tightened or enforced to ensure that an adequate analysis is performed even for quarterly filings.
6. *Existing rules must be tightened and enforced.* In some areas, the rules are not up to the task. For example, there are no clear rules for the measurement and reporting of the critical metric of liquidity; there should be. But one rule does exist that needs to be better enforced. Under existing rules, auditors are not permitted to stop at whether the individual pieces of a financial statement are in technical compliance with accounting principles—they must opine on whether the financial statements taken as a whole accurately and fairly portray the entity. In other words, the whole is greater than the sum of its parts, and the public does rely on auditors to perform this critical function. A clean audit report should mean that the financial statements fairly portray the company. When auditors fail to identify or find ways to excuse material misstatements—whether by classifying errors and misstatements as immaterial, placing undue reliance on management representations, or providing other explanations to avoid rocking the boat—they fail in their fundamental role. Unless we enforce these existing rules and standards, it will be difficult to count on the auditors to help prevent another financial crisis.

PREPARED STATEMENT OF CYNTHIA M. FORNELLI

EXECUTIVE DIRECTOR, CENTER FOR AUDIT QUALITY

APRIL 6, 2011

I. Introduction

Mr. Chairman and Members of the Subcommittee, my name is Cindy Fornelli and I am the Executive Director of the Center for Audit Quality (CAQ). I appreciate the opportunity to testify today on how the audit and independent auditors can aid in preventing a future financial crisis, an important topic for all of us who are committed to protecting investors and maintaining confidence in our capital markets.

The CAQ was formed in 2007 to serve investors, public company auditors and the markets by enhancing the role and performance of public company auditors. We are a membership organization with nearly 700 public company auditing firm members that are registered with the Public Company Accounting Oversight Board (PCAOB). Our member firms are committed to the public interest role that auditors play in our markets.

As a public policy organization, we strive to assure that our efforts are infused with a public interest perspective. Our three independent public board members strengthen our focus on the public interest and also bring us expertise in financial reporting, securities law and corporate governance. The members of our Governing Board (which includes the CEOs of the eight largest accounting firms and the AICPA) have a keen understanding and appreciation of the important role the public company auditing profession has in serving the public interest and honoring the public trust.

To realize our vision, the CAQ works with investors, academics, audit committee members, preparers, internal auditors, and policy makers to explore issues and collaborate on initiatives that can advance audit quality. The CAQ consistently has supported the implementation of the Sarbanes-Oxley Act of 2002 (SOX or Sarbanes-Oxley Act) and, working in collaboration with others with responsibility for financial reporting, has a number of initiatives underway to advance the deterrence and detection of financial statement fraud. We also support research on issues relating to investor confidence, public company auditing and the capital markets by issuing grants that fund independent academic research and other activities. In all that we do, we are particularly interested in investors' views, as they are the ultimate users of the audited financial statements.

My testimony today is on behalf of the Center for Audit Quality and speaks to the policy issues before us. I cannot speak to the circumstances of any particular public auditing firm. In my role as the Executive Director of the CAQ, I focus on the public policy issues impacting the profession. I have a background in securities law and was previously a senior official of the Securities and Exchange Commission (SEC).

Following the past several years of global economic turmoil, there have been extensive examinations by panels and commissions to identify the root causes of the financial crisis and determine what could be done to reduce the risk of a future similar crisis. While none of the panels or commissions found that auditing was a root cause of the financial crisis, auditors, like all participants in the capital markets, have a responsibility to examine their role in light of lessons learned from the crisis and consider what improvements can be made in audit standards and what more they can contribute to market integrity and investor protection.

In my testimony today, I thought it would be helpful to provide my perspectives on the financial crisis, a brief description of our current regulatory environment and, more specifically, some thoughts on what an audit is and its role in our system of investor protection. I then will describe current activities being explored by various stakeholders (including the profession) pertinent to the central question posed in this hearing, which is whether the auditor can play a role in helping to prevent another financial crisis. The public company auditing profession welcomes discussions about enhancing their role.

The PCAOB has been examining the need for changes to the current auditor reporting model, and CAQ member firms have participated fully in the PCAOB's outreach to stakeholders on this topic. We have suggested a number of areas to the PCAOB where the auditor's report could be clarified or expanded. These include providing assurance in connection with Management's Discussion and Analysis (MD&A) (including with respect to critical accounting estimates disclosed in MD&A); updating wording to include references to related disclosures in the notes to the financial statements and language related to the auditor's responsibility for information outside the financial statements; providing additional information relating to audit scope and procedures; and, providing for auditor's assurance or association with respect to an expanded report by the audit committee. As the PCAOB moves forward, we will continue to participate fully in the standard setting process. This effort may not fundamentally change the nature of the audit, but could offer additional information pertaining to the financial statements and the audit.

We believe strongly that the broader question of whether the auditor's role should be expanded beyond the boundaries of the financial statement audit should be explored fully by the full range of stakeholders, including investors, regulators, policy makers, preparers, boards and audit committee members, academics and the profession, as well as other interested parties. The public company auditing profession can play, and is committed to playing, a constructive role in how their role should evolve.

In this regard, in January of this year, the CAQ initiated a program to convene stakeholders in a number of cities around the country to consider a range of issues relating to the role of the auditor. Some of the issues to be considered include the auditor's current roles and responsibilities and whether they should evolve; the relationship and communication between the auditor and the audit committee, management and investors; and the role of standard setters, oversight bodies and regulators. A key focus of our effort will be identifying the information most needed by investors (including early warnings about business risks) and who can best provide that information.

II. Recent Financial Crisis

Much has been written about the causes of the recent financial crisis. Easy access to seemingly inexpensive credit to fund an increasing supply of residential housing, coupled with the proliferation of innovative financial instruments, as well as lax loan underwriting standards and documentation, led to an asset bubble that eventually burst the way asset bubbles tend to do. This was an economic reversal caused by a breakdown in risk management at many levels.

Consumers took on too much debt; lenders issued high-risk mortgages that were packaged and resold and those lenders held large amounts of risky, leveraged instruments; and investors purchased complex securities that they did not understand. The impact of the reversal was exacerbated by the interconnectedness of our financial system.

In response to the crisis, Congress adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)—a far reaching and comprehensive piece of legislation designed to respond to the root causes of the financial crisis and prevent a similar crisis in the future. The Dodd-Frank Act focused on risk management, leverage and capital at financial institutions, complex and unregulated financial instruments and industries, consumer protection, and substantially greater oversight and regulation of large, interconnected, and systemically important financial institutions.

Company management and the board of directors are responsible for setting the company's business strategies, including its risk tolerance and system of controls. Management also must prepare the company's financial statements that reflect transactions completed by the company and present the company's financial position as of a specific date. The role of the external independent auditor, under the oversight of the independent audit committee, is to determine whether the financial statements prepared by company management, taken as a whole, are fairly stated in all material respects in accordance with generally accepted accounting principles (GAAP). The auditor's report is based on facts and circumstances known at the time it is issued.

In October 2007, as the crisis began to unfold and liquidity in the subprime markets began to decline, the profession's response was to focus even more closely on appropriate fair value measures. With illiquid markets, financial institutions found it difficult to determine the fair value of highly leveraged and other assets because the relatively new and complex fair value accounting standards required the use of sophisticated modeling techniques to value their assets.

To help allay the considerable confusion on this issue, the CAQ Professional Practice Executive Committee prepared three white papers to assist auditors of public companies where the following topics might come into play: measurements of fair value in illiquid markets, consolidation of commercial paper conduits, and accounting for underwriting and loan commitments. While the white papers did not break new ground or establish new accounting or auditing standards, they had the effect of highlighting the valuation issues (*i.e.,* the need for asset impairments) and consolidation issues (*i.e.,* the need to consolidate structures because of changing risk characteristics) that needed to be addressed. These papers also reinforced consistency, skepticism and professional judgment by auditors working in this area and clarified the accounting for these instruments by financial institutions and other holders of these illiquid instruments and commercial paper conduits. But again, these efforts were focused on determining point in time valuations, not predicting market changes. And, many of the instruments that ultimately lost all of their value were actively traded right up to the collapse of the subprime mortgage market.

Annual reports (which include financial statements) of many financial institutions leading up to the financial crisis contained numerous warning signals about the leverage, falling asset values, and other information that served to alert users to the rising risk profiles of many of those institutions. A number of analysts and hedge fund managers reacted to the risks on a timely basis. But there were market participants and others who should have been among the first to recognize credit and liquidity risk within highly regulated financial institutions but did not.

III. Our System of Investor Protection

By law, a publicly traded company must provide information about its liquidity, operations and past financial results to the public, and must comply with Federal and State laws and requirements designed to protect investors and promote confidence in the U.S. capital markets. Ours is a system made up of a number of parties, laws, and requirements designed to assure that public companies meet their obligations. A company's CEO and CFO, the board of directors and the audit committee, internal auditors, external auditors, regulators, and standard setters all have responsibilities for assuring that financial reports are accurate and fairly present the company's financial position and operating results in accordance with GAAP. The SEC has authority to bring actions for fraud by any person in connection with the public securities markets, and specifically oversees publicly traded companies and sets their reporting requirements. A company must have an annual independent audit of its financial statements and the auditor's opinion must be in its annual report. The auditors who perform these audits are a key contributor to our system of investor protection. Since 2003, the PCAOB has regulated auditors of public companies.

Sarbanes-Oxley Act

The Sarbanes-Oxley Act was passed largely in reaction to serious financial reporting frauds at several large publicly traded companies. SOX placed significant responsibilities on company CEOs and CFOs, audit committees, auditors and regulators that were designed to strengthen corporate governance and assure the integrity of financial reporting by publicly traded companies. It also created a new independent regulator for public company auditors.

Oversight of Public Company Auditing Firms. SOX overhauled regulation of the audit profession, ending self-regulation relative to public company audits. Only accounting firms that are registered with and regulated by the PCAOB may perform audits of public companies. The PCAOB sets the standards for the audit process, audit firm quality controls and other professional standards. It also regularly inspects the firms (annually for any firm that audits more than 100 public companies) and the quality of their audits, and, in appropriate circumstances, may initiate disciplinary proceedings against a firm or professional.

SOX strengthened the independence standards for auditors to increase capital market confidence in the objectivity of auditors. In fact, SOX prohibits the auditor from offering nine specific categories of nonaudit services to a company that it audits and the PCAOB has imposed additional restrictions. As noted, an important aspect of assuring auditor independence is oversight of auditors by the audit committee, not company management. SOX also mandates audit partner rotation for lead and engagement quality review partners every 5 years to strengthen the auditor's independence from management. Every year, audit committees operating on behalf of investors make recommendations to shareholders on the appointment of a new auditor or the reappointment of the existing auditor.

Changes to the Role of Audit Committees. SOX mandated significant governance changes for all public companies, many of which had a direct impact on public company auditors. For example, prior to the enactment of SOX, company management often controlled the process for the selection of the auditor and management had the authority to hire or dismiss the auditor. This responsibility now lies with the audit committee. SOX placed on audit committees—a committee of the board of directors—particular responsibilities to investors. It placed responsibility for financial reporting and auditor oversight directly with the audit committee, rather than on the company's management. The audit committee must be completely comprised of individuals who are independent from the company and its management.

SOX changed the role of audit committees with respect to:

- Auditor selection and approval of fees;
- Audit and nonaudit services pre-approval;
- Review of critical accounting treatments; and
- Internal complaint procedures including "whistleblower" protections.

To fulfill its responsibilities, the audit committee meets regularly with financial management of the company and its external auditors to discuss issues related to accounting policies and judgments embedded in the company's financial reports and determine whether they are appropriate.

IV. The Value of the Audit

It is important to have an appreciation for what a financial statement audit represents today before one can reasonably consider whether the audit should be changed. The audit opinion, the form of which is prescribed by the PCAOB's auditing standards, is issued at the completion of the audit. The audit itself is a robust process, in which the audit team tests transactions and management's assertions and challenges the quality of the accounting, selection of accounting policies and, ultimately, the company's financial reporting.

The Financial Statement Audit Today

The financial statement audit examines a company's annual financial statements, which provide a point in time snapshot of the company's financial position at the end of its fiscal year and its results of operations and cash flows for that fiscal year. In essence, the auditor performs a series of tests to collect evidence that provide reasonable assurance whether the public company's financial statements, taken as a whole, are fairly presented in accordance with GAAP.

- The external audit firm is hired by and reports to the company's audit committee of the board of directors, which monitors the scope and performance of the audit, as well as the firm's continuing independence from the company;
- The audit team is made up of professionals led by a certified public accountant who is a partner of the firm. Members of the audit team are assigned based

on their individual skills relative to the specific requirements of the particular audit, including knowledge of the company's business and industry, and experience with the types of transactions and business operations covered in the financial statements;

- The auditor is required to conduct a risk assessment of the potential for the financial statements to contain a material misstatement due to error or fraud on the part of the company's management, personnel or reporting systems. As part of the risk assessment, auditors specifically consider the risk of fraud. The fraud risk assessment includes brainstorming by the audit team about how and where they believe the company's financial statements might be susceptible to misstatement due to fraud, with appropriate adjustments to the audit plan;
- The auditor must exercise professional skepticism in planning and conducting the audit. Professional skepticism requires objectivity and a questioning mindset in assessing the audit evidence. The auditor must be attentive to inconsistencies or other indications that something may not be right and challenge management when necessary. The audit team uses its experience and judgment in selecting the areas to be tested in light of the risks identified. The audit team's focus can include complex transactions, weak controls over the financial reporting process, and issues affecting the industry as a whole;
- Auditors are responsible for obtaining audit evidence through the testing of the assertions made by management and the amounts and disclosures included in management's financial statements. Based on its risk assessment, the audit team must gather sufficient and appropriate evidence to support its opinion as to whether the company's financial statements fairly present the company's financial position, and results of operations and cash flows in accordance with GAAP. The process includes reaching out to the audit committee to discuss accounting issues during and at the end of the process;
- The audit team documents its risk assessment, the work performed to address the identified risks and its conclusions. Prior to issuing an opinion, the audit team must consider whether there is substantial doubt about the company's ability to continue as a "going concern" for a reasonable period, generally interpreted as the next 12 months. The evaluation is based upon facts and circumstances in existence and known at the time the opinion is issued;
- Before the audit opinion is issued, an experienced auditor outside of the audit team reviews the scope of work and the judgments and conclusions made by the audit team to evaluate the quality of the audit. The engagement quality review is just one of the many processes firms implement to assure high quality audit work;
- If the financial statements comply with GAAP and fairly present the company's financial position, the auditor issues an unqualified or "clean" opinion; if the auditor concludes that the financial statements do not comply with GAAP in some respects or do not provide a fair presentation of the company's financial position, the auditor must issue a qualified or adverse opinion.

For companies with market capitalization greater than $75 million, the audit report also contains an opinion on the effectiveness of the company's internal control over financial reporting. We believe that the auditor's involvement in providing an opinion on the effectiveness of internal control over financial reporting has enhanced the reliability of financial statements.

V. Should the Auditor's Report Be Expanded?

The PCAOB has been examining the need for changes to the current auditor reporting model, which has not changed much over the years, while the size and complexity of companies and their annual reports and financial statements have grown exponentially. In recent months, the PCAOB staff and its Investors Advisory Group (IAG) each have canvassed a number of investors and other stakeholders to determine whether the audit opinion is still useful to users of financial statements. The IAG presented its findings to the PCAOB Board on March 16, 2011; PCAOB staff shared its findings with the Board at a public meeting on March 22, 2011, described below. Both found that investors value the independent audit and the current audit report.

According to this outreach, investors understand that the true value of the audit is not the opinion itself, but rather the very extensive amount of work that was performed in order for the auditor to provide reasonable assurance that the financial statements are free of material misstatement. They understand that in large global companies, audits can require teams made up of hundreds of individuals and partners, can take many thousands of hours, and can include audits of foreign subsidiaries.

Both PCAOB staff and the IAG did find, though, that investors want more information in addition to the auditor's opinion to help them assess the quality of financial reporting at the company and the scope and quality of the audit. We have heard this from investors as well.

It is clear to me that auditors can continue to enhance the role that they play and the value they provide to investors and the capital markets. Moreover, others with responsibility—particularly the audit committee, which has responsibility for overseeing the quality of the company's financial reporting and the external audit firm—also are in a position to improve the quality and relevance of information that they provide to investors. These changes should be made thoughtfully and should not merely result in a "piling on" of more disclosures that do not provide meaningful improvements to investors' ability to understand a company's financial results and other disclosures. Moreover, good public policy requires that a cost-benefit analysis of changes to the audit report or auditor's role be examined before additional requirements are put in place.

The Profession's Suggestions for Improving the Auditor's Report

The profession is actively engaged with the PCAOB and has suggested a number of areas where the auditor's report could be clarified or their role could be expanded to provide more information about the audit process and key areas of focus, some of which may require SEC action before being implemented. These areas include:

- Auditor association with critical accounting estimates disclosed in Management's Discussion and Analysis (or, alternatively, a separate supplemental auditor communication on critical accounting estimates);
- Auditor association with the entire Management's Discussion and Analysis;
- Additional wording in the standard audit report to include:
  - Reference to "related disclosures in the notes to financial statements" in both the scope and opinion paragraphs; and
  - New language related to the auditor's responsibility for information outside the financial statements;
- Additional information/communication relating to audit scope and procedures, including:
  - Providing a "link" within the auditor's report to a separate document that describes the audit process, including a discussion of the responsibilities of auditors, management and audit committees; and,
  - A discussion of specific audit procedures performed.

The PCAOB has stated that it plans to issue a Concept Release this June, followed by a roundtable discussion, with a proposed rulemaking in early 2012. Based on PCAOB staff comments during the recent PCAOB public meeting and a subsequent meeting of the PCAOB's Standing Advisory Group, the PCAOB may propose ways to provide more detail to supplement the current form of the opinion. Some options discussed include adding wording to the opinion indicating that the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement "whether caused by error or fraud"; explaining that reasonable assurance is a high level of assurance but is not absolute assurance; adding wording that the auditor is independent as required by applicable rules and regulations; and adding a requirement that the auditor's report be addressed to both the board of directors and shareholders. The profession supports these clarifying changes in addition to those I noted above.

We hope the PCAOB will consider the suggestions of the profession. We also hope that the PCAOB will work with the SEC to explore the benefits of an expanded audit committee report to investors and consider whether auditor association would be appropriate, which also was discussed with the PCAOB Board at its March 22 open meeting.

VI. Should the Role of the Auditor Be Expanded?

Even as the PCAOB's consideration of the auditor's reporting model continues throughout this year, the CAQ has for some time believed that the broader question—whether the auditor's role should be expanded beyond the boundaries of the financial statement audit—should be fully and openly discussed by the full range of stakeholders, including the profession, preparers, audit committees, investors, regulators, standard setters, policy makers, advisors, analysts, legal counsel, academics, and other interested parties.

The CAQ has informed the SEC and the PCAOB of its plan to convene stakeholders across the country to:

- Consider the public company audit profession's current roles and responsibilities, including obligations of professional objectivity and skepticism; and consider the roles of management and audit committees in the financial reporting process;
- Discuss whether there is a need for the role of the auditor to further evolve in order to improve the quality and delivery of information provided to stakeholders, and consider how such changes fit with the current reporting model and whether such changes would further improve audit quality and investor protection;
- Discuss how the role of the auditor intersects and relates with audit committees, management, advisors, analysts and others and examine the potential need for those roles to evolve as well given interdependencies in serving the interests of investors;
- Consider the role of policy makers (including standard setters and oversight authorities) in effecting improvements in the quality and delivery of information provided to stakeholders and consequential impacts on audit quality and investor protection; and
- Identify areas of consensus and open issues, and recommend short and longer term actions that would have a positive impact on the capital markets and the value of the audit to investors and other stakeholders.

Some of the issues we hope to discuss include identifying what information investors rely on most in making investment decisions and where they find that information; the extent to which annual reports and financial statements are useful; whether auditors should provide some level of assurance on nonfinancial information disclosed in the annual report, as well as whether auditors should provide some level of assurance on information disclosed outside of the annual report (such as press releases). We also want to explore whether auditors could—and should—provide some level of assurance around forward looking information provided by a company, and how auditors and other experts could manage the risks of being associated with such information. An important element of these discussions will be to consider what information will be truly useful to investors. Certainly the issues raised today will help to inform our discussions.

We will need to guard against changes to the role of the auditor that would undermine the legal and ethical responsibilities of CEOs and CFOs to assure the integrity of their companies' financial reporting processes, and of audit committees to oversee the company's financial reporting process and the performance of the auditors. Any exploration of the change in the auditor's role should strengthen and not undermine the responsibilities of these parties.

Finally, we will want to explore, as a practical matter, the extent to which auditors may be able to provide early warnings if they identify business risks as distinct from risks of material misstatement of the financial statement due to error or fraud.

Our hope is that these discussions will expose stakeholders to these potentially paradigm-changing issues in a way that encourages hard thinking around the cost-benefits of various proposals, and identifies areas of consensus. In this way, our work on the role of the auditor will inform policy decisions here, including the PCAOB's upcoming standard-setting on the auditor's reporting framework, and abroad, where the role of the auditor also is being examined.

VII. Recommendations

A number of major efforts are underway to implement the numerous requirements of the Dodd-Frank Act, which represent Congress's set of priority responses to the recent financial crisis. Assuring that the SEC is adequately resourced to meet its statutory objectives is critical to assuring investor confidence and participation in our capital markets. While Congress did not choose to streamline regulatory regimes over financial firms and markets, simplification of these regimes is of great importance to maintaining efficient markets that attract issuers and investors. We would like to see the SEC and the Financial Accounting Standards Board continue efforts to remove unnecessary complexity from accounting standards in the United States and move toward a single set of high-quality global accounting standards.

One final recommendation: given the global nature of our companies and markets, I strongly urge policy makers and regulators in all jurisdictions to work together to achieve consistency in approaches to allow the profession to meet the needs of investors.

VIII. Conclusion

I appreciate the opportunity to speak with the Committee today. I applaud you for recognizing that the role of the audit and the auditor is important. Our discussions today reflect a deep interest in finding the best way to serve investors and users of financial information. The CAQ will continue to participate in these discussions and work with all stakeholders to determine the best ways forward.

Thank you. I look forward to answering any questions you might have.

PREPARED STATEMENT OF THOMAS QUAADMAN

VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

APRIL 6, 2011

Chairman Reed, Ranking Member Crapo, and Members of the Securities, Insurance, and Investment 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 more than three million businesses and organizations of every size, sector, and region. We appreciate the opportunity to testify before the Subcommittee today on behalf of the businesses that the Chamber represents, investors, and our economy.

We are here to discuss the role of the accounting and auditing profession in preventing another financial crisis. This is a very timely and relevant topic and one that could be the subject of multiple hearings. For decades, standard setters have been operating under inadequate rules and guidance, resulting in the impairment of financial reporting and as a contributing factor that escalated the financial crisis. In order to prevent the next crisis we must address the fundamental flaws with the system.

Businesses need and want strong financial reporting policies. Companies require investors and capital to grow and create jobs. Capital will only go where it is welcome and can act with legal certainty, coupled with a disclosure of the knowable risks involved. All parties must enter into transactions with a full understanding of the facts, and financial reporting is a key disseminator of that information. Credible financial reporting is one of the indispensable active ingredients for capital formation, which fuels economic growth and job creation.

Therefore, the development of standards for credible financial reporting policies through the work of the Financial Accounting Standards Board (FASB), Public Company Accounting Oversight Board (PCAOB), and the Securities and Exchange Commission (SEC), are critical for accounting and auditing to effectively function in a free enterprise economy.

In short, 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 part.

Before I get too far, let me state that Jack Brennan, Chairman of the Financial Accounting Foundation (FAF) and Leslie Seidman, Chairman of FASB, have been making great strides to make FASB more inclusive and transparent. James Doty, the Chairman of the PCAOB has only recently come into office, and we have pledged to work with him, as we have with FAF and FASB. Nevertheless, we are concerned that standard setters have been operating with inadequate rules and guidance, which we shall go into greater detail later in this testimony. We believe that these inadequacies have prevented the standard setters from fulfilling their mission and undermine the ability of financial reporting to achieving its intended purpose.

The purpose of accounting and auditing is to reflect economic activity. Yet, over the past twenty years, we have seen some standards promulgated that reflect conceptual agendas rather than providing investors and businesses with useful information. As a result, financial reporting was under great stress before, during, and after the financial crisis. The performance of financial reporting during the crisis was symptomatic of systemic issues that remain unresolved.

CIFiR Report: The turn of the century saw an explosion in financial restatements. At the height of these events, the restatement rate was 10 percent a failure rate that clearly indicates a broken system. Though the rate has been decreasing over the past several years, the number of restatements indicates issues remain. In 2008, The SEC Advisory Committee on Improvements to Financial Reporting (CIFiR Report) made recommendations, including the concept of investor materiality to reduce restatements. The Chamber has supported those recommendations and encourages their implementation. While the regulators have not been willing or unable to fix the problem, Congress has looked to impose additional penalties for company restatements.

Fair Value Accounting: Fair value accounting was, in our opinion, an exacerbating factor to the financial crisis. The failure to recognize and correct the inability of standards to provide clarity for the valuation of assets in inactive markets, which were auditable, was a symptom of the failure of FASB, PCAOB, and to an extent the SEC, to recognize a problem and quickly correct it. This failure caused further damage to the economy. The Chamber proposed a compromise in October 2008 to fix the standard that was acted upon 6 months later following a Congressional hearing. Part of the problem was simply that some members of FASB believed in fair value as it existed and didn't want to make any changes. FAF Chairman Jack Brennan and FASB Chairman Leslie Seidman have, to their credit, made significant efforts to solicit as broad a range of opinions and positions as possible. That outreach and input has significantly assisted in the efforts to smooth over difficult issues in the convergence projects.

Understanding of Investors: The standard setters purport to represent investors, yet they often fail to identify the investor interests they seek to represent and cannot describe the breadth of the investor community that has been consulted. The investors that may be consulted appear to be narrow. Sometimes, the investor interest is even described as a potential investor, though nobody has been able to explain who or what that means. Indeed the standard setters do not seem to understand the role of businesses—who make investments in financial instruments everyday to facilitate operations and mitigate risk—as investors. The lack of understanding and consideration of all investors broadly harms stakeholders.

Financial Reporting Forum: CIFiR recommended the creation of a Financial Reporting Forum (FRF) made up of standard setters, regulators, and stakeholders to identify short-term and long-term financial reporting issues and propose solutions. The Chamber supported this concept as well as the Miller Amendment to the House financial regulatory reform bill creating such a forum. While the Financial Reporting Forum was in the original House passed bill, it was eventually deleted from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Today, we still do not have a safety valve to spot and prevent potential problems in financial reporting policy before a crisis unfolds.

Private vs. Public Companies: For decades, private companies have expressed frustration with public company accounting rules. These rules are sometimes incompatible with their investor needs. This year, a blue ribbon panel overwhelmingly recommended a separate standard setter to modify FASB standards for the 29 million private businesses in the United States, including many small business. It appears that this recommendation, which will help facilitate financial reports for America's entrepreneurs, faces an uphill battle at best.

Auditing Liability: From an audit standpoint, members of the Treasury Advisory Committee on the Auditing Profession (ACAP) agreed that liability threats to the audit firms can be destabilizing to financial reporting and the economy as a whole. Solutions, however, cannot be agreed upon. Indeed the Dodd-Frank Act mandates studies that are geared to lay the groundwork to overturn the *Stoneridge* and *Morrison* Supreme Court decisions potentially increasing liability for the audit firms.

We have also seen an uptick in prescriptive rule standard setting by the PCAOB that deprives the auditor of the judgment to call balls and strikes. This change endangers the role of the auditor and making it a rote exercise. Auditing is a profession with a long line of integrity and judgment, yet when we need that function the most, we are depriving them of the tools needed to do their job. Recognizing the importance of judgment, CIFiR also recommended that the PCAOB develop an audit judgment framework on how it evaluates the reasonableness of audit judgments in its inspection and enforcement activities.

New Proposals: With regard to accounting standards, at times, it seems that standards are developed, not to provide investors with relevant information but to satisfy the demands of a small group of activist investors. For example, imposition of recent proposals to revise FAS 5 related to loss contingencies, would not only endanger the ability of companies to defend themselves in court, the increase in litigation would actually harm investors in direct contradiction to the mission of FASB. New proposals, such as with leases, would drive up compliance costs, skew financial activity, and prevent companies from engaging in proven business practices, again to the harm of investors.

Convergence: Today, FASB and its international counterpart are working at a breakneck pace to converge accounting standards according to an arbitrary deadline set by the G20. The Chamber has called for an extension of time to get the projects completed without haste so that the end results stand the test of time. To facilitate this result and minimize unintended consequences, the Chamber has also proposed a formal review system to minimize unintended consequences. Furthermore, as the regulators are furiously working themselves to implement the provisions of Dodd-Frank, it seems as if the regulators and standard setters do not understand how the accounting rules and financial regulations interconnect and how accounting could in certain instances thwart the provisions of Dodd-Frank. In addition, discussions to determine the audibility of these new accounting standards, has not occurred.

APA: Another important issue is that FASB and PCAOB, whose job it is to promote transparency in financial reporting, are not transparent in their governance nor do they follow the open, orderly procedures that regulators must follow. FASB and PCAOB are not required to follow the Administrative Procedures Act (APA), nor are their advisory bodies required to follow the Federal Advisory Committee Act (FACA). Therefore, economically significant actions by FASB and PCAOB that can destroy billions in wealth for investors and kill thousands of jobs, do not have to follow minimal transparency requirements that Federal regulators must follow.

To summarize, for the past 20 years we have seen the 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. During this time we have seen:

1. A steady decline in the listing of public companies in the United States; and
2. American companies eschew the traditional form of public company financing and consciously avoiding the American capital markets to raise capital through private markets.

Despite these issues, financial reporting policies in the United States are still the best in the world, but we need to correct those problems in order to make our capital markets attractive for years to come. And we need to act before it is too late. The following are among the steps that need to be taken:

- *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.
- *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.
- *APA and FACA:* 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 APA and any advisory groups should be balanced in representation and open in process.
- *Formal Pre- and Post-Implementation Review by FASB:* Standards should be field tested and put through a rigorous process to identify unintended consequences before implementation and after. This process should include the following:
    1. Establish a 9-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. Establish 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. Hold 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. Commit to procedural transparency through adherence to the Administrative Procedures Act and disclosure policies established by U.S. financial regulators in the wake of the Dodd-Frank Act rulemaking;
5. Consult with appropriate financial regulators; and
6. Develop 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 for a business advisory group to understand the role of companies as investors and their use of investments. Such a group should be transparent and formed under 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.
- *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 Rulemaking:* 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.
- *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 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.

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.

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 and disclosures must be relevant and rational. The Chamber believes that significant reforms to the transparency of the standard setting process, a better understanding of the roles and empowerment of stakeholders, while addressing liability issues are important developments to make financial reporting policy an integral part of the 21st century economy.

We cannot and should not eliminate risk from the system. Risk provides for the growth opportunities our economy needs to thrive. While we can try to strengthen the system, we must also recognize that fraud can never be fully eliminated. Rational and enforceable financial reporting policies 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.

PREPARED STATEMENT OF LYNN E. TURNER

FORMER CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION

APRIL 6, 2011

Thank you Chairman Reed and Ranking Member Crapo, for holding this hearing on an important issue to investors in America's capital markets. Investors receiving credible financial information is the "lifeblood" to the capital markets. It is paramount to confidence and ability of those markets to attract capital. In fact, the turmoil in the markets in recent years has no doubt had a very real negative effect on capital formation in this country and the ability of companies to obtain that capital.

Before I start, it might be worthwhile to provide some background on my experience. I have held various positions in the accounting profession for some 35 years. I started my career with one of the world's largest international accounting and auditing firms where I rose to become an audit and SEC consulting partner. I served as a CFO and vice president of an international semiconductor company that had audited financial statements. I have had the good fortune to be the Chief Accountant of the Securities and Exchange Commission (SEC). In addition, I have been a member of chaired audit committees of corporate boards of both large and small public companies, a trustee of a mutual fund and a public pension fund, and a professor of accounting. I have also used and relied on audits as director of research of a financial and proxy research firm. In 2007, Treasury Secretary Paulson appointed me to the U.S. Treasury Advisory Committee on the Auditing Profession (ACAP). I have also served on various advisory committees and task forces of the Financial Accounting Standards Board (FASB), and the Standing Advisory Group (SAG) and Investor Advisory Group (IAG) of the Public Company Accounting Oversight Board (PCAOB).

Lessons Learned From the Crisis

Let me start by stating that if the financial system was working as intended, it is indeed scarier than the idea that the system failed. However, we hear some constantly repeating the theme of "Do No Harm" which is the equivalent of saying do nothing. And doing nothing would be the same as saying the system worked as intended.

The Subcommittee presented three very worthwhile questions to those testifying today. They in essence ask the question of what lessons have we learned from the crisis and what changes should be made to prevent a repeat of this horrific event resulting in the Great Recession. This is a question not only of interest here in the United States, but also abroad where the European Commission and the British Parliament have undertaken to study the issue.

It also brings to mind the first hearing of the full Senate Banking Committee on the Dodd/Frank legislation on February 4, of 2009. At that hearing, Senator Shelby stated:

> As I have said many times and will continue to say, I believe that before we discuss how to modernize our regulatory structure, or even before we consider how to address the current financial crisis, we need to first understand its underlying causes. If we don't have a comprehensive understanding of what went wrong, we will not be able to determine with any degree of certainty whether our regulatory structure was sufficient and failed, or was insufficient and must change . . . .this Committee should and must conduct a full and thorough investigation of the market practices, regulatory actions, and economic conditions that led to this crisis. The Committee should hear testimony from all relevant parties and produce a written report of its findings.

I believe Senator Shelby was right about the need for a comprehensive study and his comments are just as relevant today. I believe the PCAOB should undertake such a study of the role of the auditors and accounting profession in the financial crisis and issue a public report on its findings. Earlier this month, the Investor Advisory Group to the PCAOB urged such a study be undertaken citing a number of issues with respect to audits as set forth in the attached Exhibit A.

It is worth noting that in the past week, the House of the Lords in Britain issued such a report that was critical of the auditing profession and the ability to audit international accounting standards. In a good example of study in retrospective review of the crisis, the International Monetary Fund has also issued a self examining public report on the crisis which I believe is very valuable to addressing necessary changes. I believe such as retrospective review, in-depth study and report by not only the PCAOB, but also both the SEC and FASB should be undertaken and published.

At the same time, I have heard the calls from some in Congress to reopen the debate on the Dodd/Frank legislation. While there is debate between investors on one side, and the financial and business community on the other side about the need for, and impact of that legislation, I would urge Congress not to reopen the debate, until as Senator Shelby has suggested, an in-depth investigation by the Senate Banking Committee occurs to provide a basis for changes to be made.

Did the Profession Perform As Expected—Did It Protect Investors?

The first question asked by the Subcommittee is:

1. Did the accounting profession perform as expected leading up to and during the financial crisis? Specifically:
   a. Did auditors perform as expected during the financial crisis?
   b. Did the public company audit provide informative, accurate, and independent reports to investors?
   c. Should the auditors have provided advance warning to investors or others?
   d. Did the accounting standards and financial statements provide investors, creditors, and others with adequate protections and accurate and reliable disclosures?
   e. If not, what changes, if any, would you recommend.

The Role of the Auditor

The ultimate responsibility for the financial statements of a company rests with its management. In turn, audit committees of boards of directors are responsible for the oversight of the internal controls, financial reporting and audit process of a public company. It is important to state that auditors DID NOT create the financial crisis. They did not run the companies involved, did not make the uncollectible loans or enter into the toxic derivatives, and certainly did not prepare the financial statements issued to investors.

However, auditors did have an extremely important role as a gatekeeper to the capital markets both in the United States as well as abroad. Independent audits provide investors with reasonable assurance—that is high but not absolute assurance—the financial statements are correct and complete within the boundaries of materiality. It is the objectivity—the independence—of the auditor that creates the value of an audit. Without that independence and objectivity, an audit has no value. As the increasing complexity of business transactions, products and structures result in more subjective accounting standards, they also continue to create the need for judgment on the part of auditors. Subjective, very judgmental decisions by the auditor also greatly enhance the need for objectivity and professional skepticism on the part of auditors.

Unfortunately, as described later on, gatekeepers including the auditors did play a role in the financial crisis. They failed to act on and provide information available to them to investors. This left investors much like the ship Titanic as it approached an unforeseen iceberg, without any red flags or warnings of the imminent dangers. In doing so, the auditors helped contribute to a crisis in confidence.

Lax and Untimely Accounting Standards

The auditor does audit to accounting standards established by the accounting standard setters. The quality, or lack thereof in those standards can significantly impact the quality of financial information investors receive.

The failure of the FASB to issued timely standards that protect investors is not a new situation and exposes long standing fundamental flaws in its structure and mission. In early 2008, Chairman Reed very appropriately wrote the accounting standard setters citing concerns about the accounting standards for off balance sheet debt that yet again allowed companies to hide obligations from the view of investors, similar to what happened at Enron. One of those letters also noted that it is likely, despite lax standards the FASB issued in response to Enron, that some of the companies had likely not complied with the accounting standards raising questions as the quality of the audits that had been performed.[1] However, it is im-

[1] In a letter from then FASB chairman Herz, to Chairman Reed, it states: "The FASB is not responsible for auditing, regulating, or enforcing the application of accounting standards and disclosure requirements. Thus, the observations discussed herein regarding the application of existing requirements is solely based on our discussions with various constituents and our reading of published financial reports and press articles and may carry with them the benefit of hindsight. Based on these discussions and readings, we have questions about compliance with

portant to note the FASB originally issued its first standard creating the ability for companies to hide off balance sheet debt, FASB Standard No. 77, in December 1983, some 28 years ago. Prior to that, the applicable accounting standard required that financing transactions be reported as debt on balance sheets. And beginning soon after the issuance of the FASB's original standard, chief accountants of the SEC consistently warned the FASB that its standards needed significant change and improvement. Indeed, up to the very beginning of the financial crisis the FASB had been warned, and knew, its standard was deficient but failed to act promptly. Instead it chose to wait until after significant losses had been incurred by investors to take corrective action. And I for one am not yet convinced the most recent "fix" the FASB has put in place will be successfully in providing a remedy to the full extent of the problem.

In the past, the FASB also failed to issue other important standards on a timely basis. Some examples of this are:

1. In the 1990s, despite increasing volumes of derivatives, the FASB failed to update their standards in a timely manner for these transactions leading to large losses for such investors in such companies as Proctor & Gamble. After those losses had been incurred, the FASB did issue its standard No. 119 within a year, showing it can, act quickly. However, in this instance it was once again after the damage to investors had occurred.
2. In the 1990s, companies began to engage in inappropriate "earnings management" when the management of the business had failed, contributing to a number of corporate scandals at such companies as Waste Management, Xerox, and Rite Aid. Yet the FASB was slow to respond to the various schemes and .devices management was using to manage earnings resulting in tens of billions of losses for investors.
3. The FASB, when its independence was impacted by actions of some in congress, was slow to respond to abuses in accounting for stock options.
4. Despite serious, if not fatal flaws, in AICPA Statement of Position 94-6, Disclosure of Certain Significant Risks and Uncertainties, evidenced by lack of such disclosures during the financial crisis, the FASB has failed to update this standard. This failure directly contributed to the lack of timely disclosures in financial statements of many financial institutions.
5. In August, 2000, the Panel on Audit Effectiveness established at the request of the SEC, recommended the FASB develop a new standard highlighting management's responsibility to assess and disclose if a company is able to continue as a viable "going concern." Yet a decade later, investors are still waiting for such disclosures from management, especially in light of the number of financial institutions that required huge Government bailouts to remain afloat.
6. In their August 2009 report, as well as on other occasions, members of the TARP Congressional Oversight Panel have noted it was virtually impossible to decipher from existing disclosures, the amount and magnitude—and value—of troubled assets in the financial statements of financial institutions. In a discussion held just this month at the PCAOB SAG meeting, a member of the FASB was unable to describe which of their standards required disclosure of such information in a concise, transparent fashion.
7. The FASB's own Investor Technical Advisory Committee (ITAC) a couple of years ago requested the FASB to adopt a disclosure framework to help fill in the "holes" in the FASB's own disclosure requirements. For example, while the SEC has rules requiring that disclosure be made when information is material and is necessary to prevent disclosures from being misleading, the FASB has no such requirement for financial statements. However, at a meeting this month of the PCAOB SAG, a member of the FASB indicated such a project would not be forthcoming any time soon.
8. There are differing views as to whether the Lehman "Repo 105" transactions complied with the FASB's standards or not. I believe the courts will be the judge of this. But one thing is certain, and that is; if the standard was com-

the existing standards and requirements in the following areas: (a) The use of QSPEs to securitize assets for which decisions were required that may have extended beyond those specified in legal documents; (b) The completeness and reasonableness of probability assessments used in estimating expected losses for determining the primary beneficiary of a securitization entity; (c) Whether all involvements with a securitization entity were considered in determining the primary beneficiary (including, for example, implied guarantees and support arrangements); (d) The adequacy of disclosures made pursuant to the requirements.

plied with, it was an unacceptable standard. If it was not complied with, then one must ask where is the SEC enforcement action?

9. Investors have asked the FASB for many years to provide a standard that would provide greater and enhanced information with respect to the cash flows and liquidity of companies. No such standard has been forthcoming.
10. In the mid 1970s, the FASB issued a standard on how financings of assets using lease agreements should be accounted for. This has been considered a "flawed" standard almost from the date it was issued as it has allowed many financings to be hidden off balance sheet. The numbers of "fixes" the FASB has made, or attempted to make over the years, to this standard are too numerous to count. Decades late, the FASB is expected to issue within the next year a revised standard, but even that standard is currently going through revisions that some question.

The failure on numerous occasions of the FASB to issue timely standards that would provide the capital market participants with the information necessary to make informed decisions when allocating capital, has proven costly. Failed standards such as those related to off balance sheet debt and disclosures of risks and uncertainties have resulted in the capital markets being inefficient due to a lack of important information. It also has resulted in markets being unable to effectively discipline themselves. Any notion that "free markets" can and will regulate themselves has gone out the window.

At the same time, the FASB is about to issue several very significant new standards that are going to fundamentally change how companies do their accounting. Without appropriate consideration being given to the implementation dates, and whether the numbers resulting from those standards can be verified by the auditors, the quality of transparency and financial reporting in the U.S. capital markets and investors could suffer greatly. It is very important the FASB closely coordinate their work with that of the PCAOB in this regards.

Auditor Performance and Communication

On Monday of this week, the current chairman of the PCAOB stated in an address to investors:

> A deeper analysis of what motivates auditors' behavior is underway. Indeed, the PCAOB inspected the audits of many of the issuers that later failed or received Federal bail-out funds. In several cases—including audits involving substantial financial institutions—PCAOB inspection teams found audit failures that were of such significance that our inspectors concluded the firm had failed to support its opinion.
>
> Several of these audits are now also the subject of pending PCAOB investigations and may lead to disciplinary actions against firms or individuals. Under the Sarbanes-Oxley Act, our disciplinary actions must remain nonpublic (unless the respondent consents), until both our proceeding and any SEC appeal are finished.

It should be no surprise that investors both in the U.S. and abroad, are asking "where were the auditors?" The findings of the PCAOB and others have raised a question as to whether auditors were in fact acting as objective examiners of the financial reports. Some have also questioned whether the auditors maintained the requisite level of professional skepticism as they performed their audits. Others are questioning the fundamental value of an audit in today's digital world and whether audits are relevant.

As noted in Exhibit A, several financial institutions failed or required Government bailouts yet the companies received "clean" opinions from their auditors. "Going Concern" opinions in which auditors discuss the uncertainty of a company's ability to continue under the circumstances were in short supply, if not outright rare. The auditors also failed to give warnings with respect to off balance sheet debt that should have been on the financial statements. And they failed to warn of significant risks and uncertainties, albeit the disclosure standard in this regards is substandard at best.

Exhibit B sets forth the auditor reports on financial institutions that received significant amounts in the Government bailout. Yet as a reader can see, the auditor reports issued on these institutions in early 2009 at the height of the financial crisis, when we were warned the financial system was on the verge of a total meltdown, contained no additional information or "red flags" when compared to the very same audit reports for the fiscal year ending in 2006, just at the peak of the economy and as the financial crisis began to unfold.

But this is not the first time shortcomings in auditor's communication with investors have been noted. Surveys conducted by Chartered Financial Analysts (CFA) have shown on more than one occasion that investors believe auditors need to communicate more than what is currently communicated in the standard auditors boilerplate report. The PCAOB's own IAG conducted a survey that found: [2]

- 45 percent of respondents believe the current audit report does not provide valuable information that is integral to understanding financial statements (23 percent of respondents believe the current audit report provides valuable information)
- 73 percent of respondents skim the report quickly for departures from the standard unqualified report while 18 percent believe it is of no use to them at all (7 percent read the full report)

In 2007, then Treasury Secretary Henry Paulson established a bipartisan committee that included corporate board members, investors, auditors, lawyers, former regulators and academics to study the auditing profession. This U.S. Treasury Advisory Committee on the Auditing Profession is often referred to as the "ACAP" committee. Former SEC Chairman Arthur Levitt, Former Federal Reserve Chairman Paul Volcker, Rodgin Cohen the chairman of Sullivan & Cromwell LLP, the Chairman and CEO of Xerox Ann Mulcahy and the Chairman of KPMG LLP Timothy Flynn were all members of this committee. It spent over a year studying the auditing profession and firms, held numerous public meetings and hearings, requested significant and important information from the profession, some of which was provided and some withheld, received public testimony from dozens including the profession, investors, lawyers and representatives from the business community. The report of this committee highlighted shortcomings in the report used by auditors to communicate with investors; the standards auditors use to detect fraud; and the governance and transparency of the auditing firms. In fact, shortcomings cited by this report have become even more self evident as a result of the financial crisis.

What Changes Are Needed?

The Subcommittee has also asked the questions:

2. What, if any, improvements have been made or should be made by the U.S. Securities and Exchange Commission, the Financial Accounting Standards Board, or the Public Company Accounting Oversight Board as a result of the financial crisis?
3. What, if any, policy changes should Congress consider?

Improving Accounting Standard Setting and the FASB

The ongoing and continued inability of the FASB to issue timely standards that protect investors calls into question the fundamental structure and composition of the FASB. Its standards have become increasingly complex, in part due to the increasing complexity of structured and engineered financial transactions, and in part due to requests of the business community for "compromises." What is uncertain is whether or not in each instance, the increasing complexity is serving investors well. I believe this is in part because the end user of financial reports are under represented among the actual voting members of the FASB, as well as its Emerging Issues Task Force which also issues a significant amount of guidance.

In addition, in the past the FASB has failed to study on a timely basis, whether its new standards are achieving their stated objectives, have been implemented as intended, or require changes. As noted earlier, this has resulted in flawed standards existing that have led to investor losses. More recently the trustees of the FASB have instituted a process to review standards on a more timely and systematic basis. That process will be led by a former auditor. What is not readily transparent is what input investors will have into that process. In addition, it is vitally important that the SEC who has to oversee implementation of new standards, and the PCAOB who has to oversee the auditing of those new standards have a strong voice in that review process.

However, I believe it may be time to reconsider the recommendations of some who testified before the Senate Banking Committee that a better model would be to include both the accounting and auditing standard setting under the same oversight board, the PCAOB. This view was previously expressed by the former Comptroller of the U.S. and head of the General Accountability Office (GAO) and others. I believe it warrants serious study, if not adoption at this time.

[2] *See,* PCAOB Web site: *http://pcaobus.org/News/Events/Pages/03232011__SAGMeeting.aspx* for copies of the IAG presentations to the PCAOB.

In the meantime, the independence of the FASB needs to be fostered. Unfortunately, in recent years, some members of Congress have eroded that independence. This has resulted in numbers being reported by financial institutions being called into question, at a time when confidence in those numbers is vitally important. It seems as if Congress agrees the FASB's independence is important—but only so long as some constituency isn't being pushed towards greater transparency by the FASB. I would hope that someday Congress can find a better balance between its oversight responsibilities with respect to accounting standard setting, the need for millions of American investors to receive transparent information, and the demands of special interest groups.

Improving the Value of Audits

The PCAOB has several new board members and a new chairman. I believe this provides a new opportunity for the board to demonstrate its value to investors, the auditing profession, and the capital markets. I applaud their beginning efforts to act to improve the quality of audits and investor protection. However, much work remains.

The PCAOB should undertake the study of the auditing profession as urged to do so by its own IAG. This is consistent with past calls for a thorough investigation of the financial crisis by Senator Shelby.

In the meantime, a number of improvements can be made that will enhance the quality of audits. For starters, Congress can respond to requests of the current and past chairs of the PCAOB to allow the agency to make their investigations public in the same manner the SEC makes its proceedings against auditors' public. Transparency is important to the credibility of the PCAOB. Its dearth of announced enforcement actions against the large audit firms has challenged that credibility as has the PCAOB's reluctance to provide investors with information that would identify which audits have been substandard.

The recommendations of the U.S. Treasury ACAP Committee, included as Exhibit C, should be acted upon by the PCAOB and SEC in a timely manner. These recommendations to both the PCAOB and SEC have already been outstanding for over 2–1/2 years without results.

The PCAOB should also act on the recommendations of its own IAG which are included as Exhibit D. Many of these recommendations are also consistent with or similar to those in the ACAP report. This includes improving the standard auditor report so that it provides information of value to investors.

The auditing standard with respect to detection of fraud needs to be revisited. It also includes enhancing the transparency and governance of the auditing firms so that the PCAOB is not left in the dark, as they are now, with respect to the financial viability and stability of these large firms. That is not to say they firms should be treated as "too big too fail" which they should not, but that the PCAOB as their regulator should be in an informed position to proactively act if necessary when a firm has created systemic risk.

Finally, the PCOAB has described instances that call into question the objectivity of auditors, the very foundation upon which each and every audit rests. As the PCAOB studies the profession, is should consider whether as it own IAG has recommended, there are steps it should take to ensure that auditors continue to remain independent of those they are examining, with the requisite degree of professional skepticism. Recent findings by investors, the SEC and PCAOB with respect to audits of Chinese companies listed in the United States would strongly indicate auditors and audits are falling short of their target.

Improving the Transparency of Audit Committees

Some have expressed a view that the audit committees should play a key role in enhancing and improving the transparency of the audit process. I agree.

I was chief accountant at the SEC at the time the Blue Ribbon Panel on Improving the Effectiveness of Audit Committees issued its report well over a decade ago. At that time, this stellar and widely respected panel set forth recommendations which have improved audit committees. However, further enhancements are necessary especially with respect to what audit committees communicate to investors. For example audit committees should inform investors as to how the audit committee has overseen the audit and financial reporting processes. Others such as Warren Buffet have also recommended there be greater transparency with respect to the discussions between audit committees, auditors, and financial management, including with respect to internal controls, completeness of disclosures and whether adjustments are needed to reported numbers or not. As an audit committee chair, I have implemented these recommendations by Mr. Buffet and found them to be beneficial to the members of the committee as well as investors. As a result, I believe the SEC should undertake to update the rules with respect to reports by audit committees.

The SEC has also recently taken an enforcement action against members of an audit committee found to be derelict in a financial fraud. The SEC deserves credit for establishing accountability of these audit committees. However, given revelations of the Financial Crisis Inquiry Commission and the examiner's report on Lehman, one must ask why there haven't been more similar actions. Ultimately, it is important that audit committee members be held accountable for their actions, or lack of actions. Enhanced transparency will no doubt aid in establishing greater accountability.

Improvements at the SEC

With respect to the SEC, it needs to exercise greater oversight of the FASB standard setting process. This includes overseeing those appointed to both the FASB itself as well as its trustees. This requires balancing the need to observe the independence of the FASB with the fact it has consistently failed to put out a product that provides investor protection. Clearly the FASB has failed to develop quality and timely standards and this begins and ends with the members of its board, and those who oversee its efforts. One likely cause of this is the FASB has a very diluted mission and objective of trying to serve all—auditors, financial management who prepares financial statements as well as investors. When one is tasked to serve all, it often results in none being served. Changing the mission of the FASB to specifically state it serves investors would certainly clarify and help strengthen the Board.

The SEC also needs to ensure it enforces the standards that do exist. There appears to be a lack of enforcement cases related to financial reports these days, as evidenced by the lack of action discussed in the report of the examiner of Lehman. Without strong enforcement of standards, there are in fact, no standards.

While the SEC enforcement division has set up several task forces, it has failed to establish any task force to examine financial reporting fraud. I believe this indicates a lack of focus on an area of fraud that has cost investors large losses, and is necessary if investors are to believe that the agency is clearly the "investors advocate."

At the same time, the SEC needs the necessary resources and tools to do its job. I have met with staff at the SEC and found that they do in fact lack the tools for the job. They don't have the necessary information technology necessary for monitoring the markets and market participants. They lack many of the technologies and tools those they regulate have and use. And as the recent Boston Consulting Report confirmed, they do not have enough or the right people to do the job they have now been tasked to do.

This is not an issue of "balancing the budget" as the funding for the SEC does not involve any taxpayer dollars. Rather its funding comes from fees that ultimately investors bear the cost of. And time and time again, investors have stated they are willing to bear those costs. Accordingly, failure to fund the SEC can only be viewed as an intentional and deliberate effort to handcuff this law enforcement agency, thereby exposing investors to substantial harm, as in the past.

I have been at the SEC at times when it was "starved" by Congress, effectively ensuring a lack of regulation and exposure of millions of Americans to great risk of loss. Indeed, Congresses own GAO has stated in the past the SEC has been woefully underfunded. I believe the lack of such underfunding has directly led to a lack of confidence in the U.S. capital markets while tens of millions of investors watched trillions in value in their pensions and 401Ks disappear.

If Congress believes the SEC needs to become more efficient and effective, then Congress is obligated to hold oversight hearings to ensure the agency spends the resources it receives wisely and effectively. But this should not be an excuse to defund the agency, at a time when tens of millions of American investors need it more than ever before. I will also add the same is true for the CFTC.

What Is Not Needed

One of the key issues the ACAP committee deliberated and debated at length was the issue of further liability reforms requested by the audit firms. However, as the ACAP report aptly describes in detail, there was strong disagreement among the members of the committee as to whether such reforms were in fact necessary or not.

The audit firms cited the need for further reforms as they are required to exercise judgment. Yet auditors have been required to exercise significant judgments when performing audits for many decades. Unfortunately, some of those judgments on audits such as Waste Management, Enron, Lehman, and Xerox have been correctly called into question, not only by investors and their lawyers, but also by regulators and others.

What the evidence provided in reports by Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse demonstrate as set forth in Exhibit E, is that lawsuits naming the auditor as a defendant have dramatically declined since the passage of the Private Securities Law Reform Act (PSLRA) in 1995. Subsequent court cases have also further narrowed the ability of investors to recover from auditors through establishment of higher hurdles for proving loss causation and elimination of cases involving aiding and abetting of securities fraud. In fact, despite over 14,000 audit opinions issued on an annual basis by auditors of public entities, almost 4,900 restatements of financial statements being reported during the years 2005 through 2010, and a significant increase in the number of violations of the Foreign Corrupt Practices Act (FCPA), there has been on average less than one class action lawsuit brought each year against each of the ten largest auditing firms during that same period. As a result it is not surprising the ACAP was unable to reach a consensus that any further litigation reform is necessary for auditors.

Closing Comments

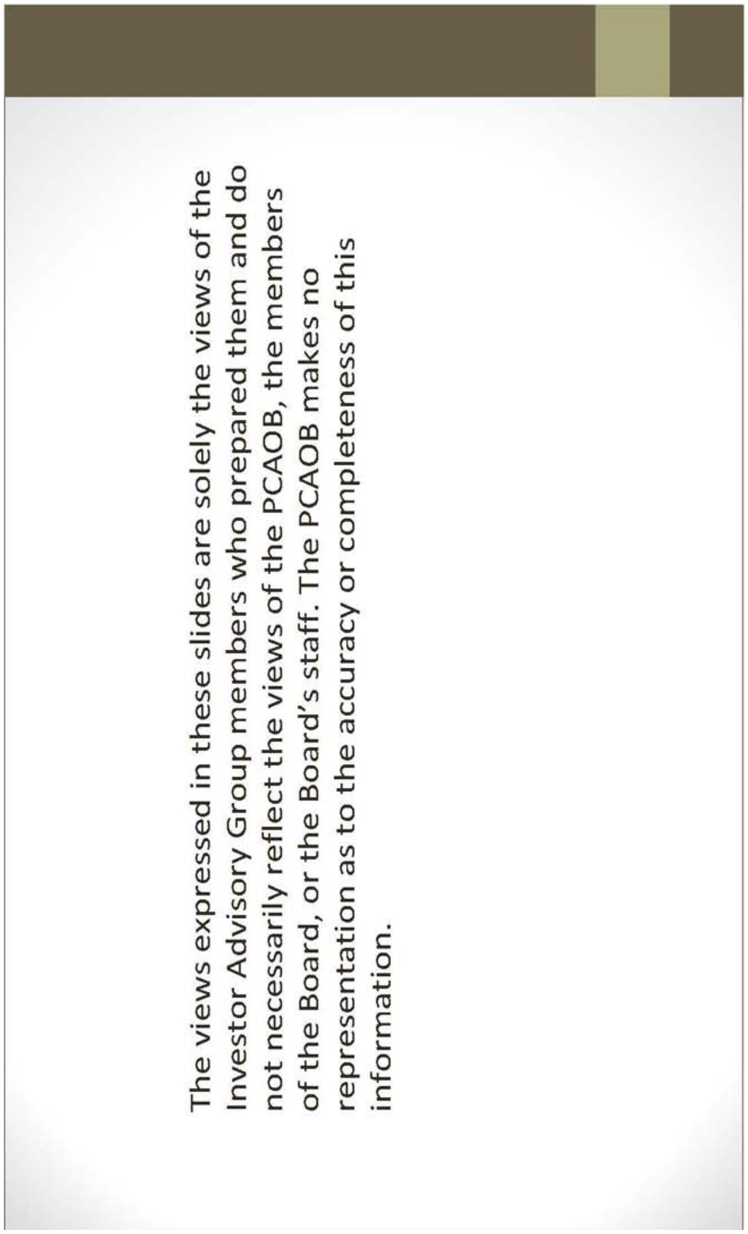
Audits, when properly performed by truly objective and independent auditors, provide the capital markets with confidence the financial statements can be trusted. However, investors are questioning the value proposition of audits today, including the information they are provided and how auditors communicate that information to them. As a result, it is important auditors provide a product to their real client—investors—that the customer believes is worth the price being paid. If on the other hand, investors continue to question the relevance of the audit, the audit report and the information being reported, it will only be a matter of time in this digital age before audits do indeed lose their value and relevance.

I would be happy to respond to any questions members of the Subcommittee might have.

EXHIBIT A

Presentation of the PCAOB Investor Advisory Group Subcommittee on Lessons Learned From the Financial Crisis

March 16, 2011



The Watchdog that Didn't Bark … Again

Presentation of the Working Group on Lessons Learned from the Financial Crisis

PCAOB Investor Advisory Group

March 16, 2011

The Sarbanes-Oxley Act

Roughly a decade ago, a series of massive corporate accounting scandals at some of the nation's most respected public companies rocked the markets, costing investors trillions of dollars in lost market value and leading to passage in 2002 of sweeping legislation to restore integrity to public company financial reporting practices and reliability to public company audits.

Central to the legislation were provisions to:

- Enhance auditor independence with an eye toward making auditors more willing to stand up to clients and insist on accurate financial reporting
- Create in independent audit oversight board responsible for raising audit standards and holding auditors accountable for meeting those standards

The common goal of these provisions was to restore auditors' credibility as public watchdogs dedicated to ensuring the accurate financial reporting on which the integrity and stability of the capital markets depend.

The Financial Crisis

The recent financial crisis presented auditors, and by extension the Sarbanes-Oxley Act audit reforms, with their first big test since these reforms were put into place. By any objective measure, they failed that test.

- Dozens of the world's leading financial institutions failed, were sold in fire sales, or were prevented from failing only through a massive government intervention – all without a hint of advance warning on their financial statements that anything might be amiss.
- Investors suffered devastating losses. Millions of Americans lost their homes or their jobs, and $11 trillion in household wealth has vanished, according to the Financial Crisis Inquiry Commission.
- As a result, serious questions have been raised both about the quality of these financial institutions' financial reporting practices and about the quality of audits that permitted those reporting practices to go unchecked.

A Sampling of Failed Financial Institutions

All of which received unqualified audit opinions within months of the failure

Company	Event	Event Date	Investor Losses ($m)*	Audit Firm
Lehman Bros.	Bankruptcy	9/15/2008	31,437.10	E&Y
AIG	TARP	9/16/2008	156,499.60	PwC
Citigroup	TARP	10/28/2008	212,065.20	KPMG
Fannie Mae	Gov't takeover	9/6/2008	64,100.00	Deloitte
Freddie Mac	Gov't takeover	9/2/2008	41,200.00	PwC
Wash Mutual	Bankruptcy	9/26/2008	30,558.50	Deloitte
New Century	Bankruptcy	4/2/2007	2,576.40	KPMG
Bear Sterns	Purchased	3/17/2008	20,896.80	Deloitte
Countrywide	Purchased	1/11/2008	22,776.00	KPMG

* Calculated based on decline in market capitalization from one year prior to the event and the event date. Fannie Mae and Freddie Mac data is from 10/9/07 and 9/12/08.

The Role of Auditors

While auditors did not cause the financial crisis, it is difficult to look at the list of failed institutions that received an unqualified audit just months before they failed and conclude that auditors didn't play a role. For example:

- Did auditors' failure to adequately test or challenge company valuation methods allow companies to hide their deteriorating financial condition from investors and regulators alike?
- Did auditors inappropriately allow companies to hide risks off-balance-sheet when the company remained exposed to the risks?
- Did auditors inappropriately agree to, or even help design, transactions whose sole purpose was to hide from investors the degree of leverage or other risks the company had taken on?

If the answer to these questions is yes, these practices not only deprived investors of important information, they encouraged companies to take on risks they might have avoided if those risks were required to be fully disclosed, and contributed to the freezing of the credit markets once the crisis struck. Moreover, if true, they revealed what the UK's FSA has labeled "a worrying lack of professional skepticism."

The Expectations Gap

In the wake of the crisis, investors and independent commentators have been highly critical of the auditors for these failures and of regulators for failing to hold them accountable.

"The public accounting firms and their hundreds of thousands of auditors should be an investor's first line of independent defense. But these firms turned a blind eye to the excesses, mismanagement, and fraud of executives managing their client firms. The public accounting firms issued clean financial opinions for all of the firms that eventually, most less than a year later, failed, were taken over, or nationalized. And the regulators slept."

-- Francine McKenna, blogger

"Here we had the greatest banking industry meltdown since the Great Depression. Hundreds of lenders failed. And yet the number of banks correcting accounting errors declined while the collapse was unfolding. There were no restatements by the likes of IndyMac, Washington Mutual or Lehman Brothers, for example. The obvious conclusion is the government has been giving lots of banks a free pass, as have their auditors."

-- Jonathan Weil, columnist

The Expectations Gap

In a recent blog, Tom Slee went so far as to ask, "Are Auditors Becoming Irrelevant?"

> "Now that we have had time to analyze the financial crisis and the post-mortems are over, one big question remains. Where were the auditors? These highly-paid watchdogs were supposed to be our first line of defense. Fat chance! They continued to reassure shareholders and investors even while we were going over the cliff. Bear Sterns, Carlyle Capital, Thornburg Mortgage, and Lehman Brothers all hit the buffers shortly after receiving clean bills of health..."

> "So why have we not heard a lot more about the auditors' role in the great crash? ... I think that one of the main reasons public auditors have been marginalized is because they are no longer regarded as independent professionals. Certainly most institutional investors see them as an extension of management, fiercely loyal to their employers, the boards of directors ... Moreover, auditors have lost a lot of credibility by hedging their opinions and making sure that management is solely responsible for the numbers ... Perhaps most important, auditors are no longer equipped to pass judgment on a great many aspects of financial statements..."

> "Where does this leave small investors? Well, I think we have lost another safeguard."

The Expectations Gap

But auditors have defended their performance in the crisis.

"We believe that auditors generally carried out their role effectively during the crisis and appropriately reached audit opinions within the context of the applicable accounting and auditing frameworks."

-- Center for Audit Quality

"When it comes to professional skepticism, the regulators' perspective appears to be different to the auditing profession's. We view our role as one of ensuring management has appropriate robust evidence to support its assumptions. It is not for us to present an alternative view and try to get management to accept it as better than theirs."

-- Richard Sexton
PwC's head of audit in the UK

"Let us be clear. The committee concluded last year that there was little evidence to suggest that auditors failed in their duties in the run up to the financial crisis."

-- Michael Izza
ICAEW chief executive

Auditors Escape Repercussions

At least in the United States, auditors have largely been let off the hook in the post-mortems that examined the causes of and appropriate policy responses to the 2008 financial crisis. To the degree that Congress weighed in on financial reporting issues during the Dodd-Frank Act debate, it used its authority:

- To undermine the independence of the accounting standard-setting process by intimidating FASB into weakening its mark-to-market accounting standard
- To weaken protections against accounting fraud and errors at small public companies by repealing the SOX 404(b) internal controls requirements for companies with less than $75 million in market capitalization and requiring a study of whether further roll-backs are needed

Moreover, more than two years after the crisis broke, we've seen no major enforcement actions by the SEC or PCAOB holding auditors accountable.

The FCIC Report

The Financial Crisis Inquiry Commission report discusses the lack of transparency on financial institutions' balance sheets. The report notes, for example, that:

- Even as financial institutions were taking on disturbing amounts of leverage, "leverage or capital inadequacy at many institutions was even greater than reported when one takes into account 'window dressing,' off-balance-sheet exposures ..., and derivatives positions ..."
- "Several investment banks artificially lowered leverage ratios by selling assets right before the reporting period and subsequently buying them back."

But the report focuses more on problems with these institutions' reporting practices than on the role of auditors in acquiescing to those reporting practices. On the other hand, the FCIC report and documents on the FCIC website do provide greater insight into two cases that raise disturbing questions about auditors' performance during the crisis – PwC's audits of AIG and KPMG's audits of Citigroup.

The FCIC Report

AIG, Goldman Sachs and Pricewaterhouse Coopers

The FCIC report describes at some length the collateral dispute that arose between AIG and its counterparties, bringing the company to the brink of collapse and resulting in a massive government bailout. Among the more telling items in that account:

- When the issue first arose in 2007, AIG Financial Products did not have its own model or otherwise try to value the CDO portfolio that it guaranteed through credit default swaps, nor did it hedge its exposure. This despite the fact that the company's $79 billion exposure equaled more than 80% of the parent company's $95.8 billion in total reported capital.
- One wonders how PwC, which audited both AIG and Goldman Sachs, could have signed off on AIG's financial statements or attested to the adequacy of AIG's controls over financial reporting when it had no independent basis for valuing an exposure of this magnitude. According to the FCIC report, PwC was apparently unaware of the CDS collateral requirements and thus concluded along with AIG that there were "no substantive economic risks in the portfolio."

The FCIC Report

- In November of 2007, with collateral demands piling up, AIG decided to use a "negative basis adjustment" to reduce its unrealized loss estimate from \$5.1 billion to about \$1.5 billion. It did so with the knowledge of PwC, which apparently raised no objections at the time.
- Meanwhile, in meetings during the same period with company management, the auditor laid out "significant concerns" about risk management practices, in particular practices related to valuation of the CDS portfolio as well as procedures for posting collateral. The auditor reportedly told AIG that these and other issues raised control concerns around risk management that "could be a material weakness."
- It wasn't until February 6, 2008 that PwC informed the chairman of AIG's board that the \$1.5 billion estimate disclosed on the December 5 investor call had been "improper and unsupported." PwC concluded that this constituted a material weakness and that the numbers AIG had publicly reported would have to be corrected. As the FCIC report states, "Why the auditors waited so long to make this pronouncement is unclear, particularly given that PwC had known about the adjustment in November."

The FCIC Report

Citigroup, OCC and KPMG

The FCIC report does not mention issues that arose around KPMG's audit of Citigroup, but the Committee's website includes a document that raises serious questions.

- In February of 2008, the Office of the Comptroller of the Currency sent a letter to Citigroup's CEO summarizing the findings of the agency's special supervisory review. The letter was highly critical of Citigroup's internal controls and its valuation methods for subprime mortgage bonds.
- The OCC copied Citigroup's lead auditor on the letter, ensuring that KPMG was aware of the problems even if their own review of the company's internal controls had not uncovered the issues identified by OCC.
- Nonetheless, just eight days later, Citigroup filed its annual report stating that "management believes that, as of Dec. 31, 2007, the company's internal controls over financial reporting is effective." The annual report included a letter from KPMG attesting to the effectiveness of Citigroup's controls.

The PCAOB Report

The PCAOB issued a report in September 2010 based on the observations of PCAOB inspectors during inspections conducted during the critical years of the financial crisis. Although not really designed as a crisis post-mortem, the PCAOB report includes some valuable insights into practices that may have contributed to audit failures. To highlight just a couple:

- In the crucial area of fair value measurement, inspectors observed numerous short-comings, including failure to adequately evaluate whether fair value measurements were determined using appropriate valuation methods, the reasonableness of management's significant assumptions, and available evidence that was inconsistent with issuers' fair value estimates.
- In the equally important area of off-balance sheet structures, inspectors found that auditors failed to conduct adequate tests to determine whether the transactions were appropriately accounted for as off-balance-sheet arrangements or to test for the occurrence of events that would affect the accounting for these arrangements.

The PCAOB Report

While the PCAOB report offers valuable insights into audit practices at the height of the financial crisis, several factors limit its usefulness as a guide to policy failures.

- Its focus is on the effect of the financial crisis on audits rather than on how auditor failures may have contributed to the financial crisis.
- It presents its findings in the most generalized terms, without providing any sense of how pervasive the identified problems were and without providing a narrative of how these audit failures contributed to the financial crisis.
- It identifies areas where auditors failed to perform up to standards, but it does not attempt to analyze why these failures occurred or what needs to be done to prevent a recurrence.

In short, the PCAOB report provides a starting point, but a starting point only, for the careful examination that is needed of how auditors contributed to the financial crisis and why they failed to fulfill their watchdog functions.

The Way Forward

The financial crisis of 2008 raises significant questions about why the Sarbanes-Oxley reforms failed to bring about the promised improvements to the independence and quality of public company audits. In Europe and the United Kingdom, these questions are receiving significant attention from regulators and policymakers. But, so far at least, the United States has lagged behind in that evaluation.

The Working Group on Lessons Learned from the Financial Crisis strongly recommends that the PCAOB launch an in-depth study into the role auditors played in the financial crisis. The goal of that study should be to identify both the causes of and remedies for those pervasive audit failures.

In addition, we recommend that the PCAOB make this in-depth analysis of audit failures an on-going function of the Board, in order to ensure that changes in policy and oversight practices are adopted in a timely fashion to address correctable weaknesses in the audit process.

EXHIBIT B

Sample Audit Reports on Financial Institutions Receiving Federal Bailout Funds for Fiscal Years 2006 and 2008

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Bank of America Corporation:

We have completed integrated audits of Bank of America Corporation's Consolidated Financial Statements and of its internal control over financial reporting as of December 31, 2006, in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated Financial Statements

In our opinion, the accompanying Consolidated Balance Sheet and the related Consolidated Statement of Income, Consolidated Statement of Changes in Shareholders' Equity and Consolidated Statement of Cash Flows present fairly, in all material respects, the financial position of Bank of America Corporation and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. These Consolidated Financial Statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these Consolidated Financial Statements based on our audits. We conducted our audits of these Consolidated Financial Statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal Control Over Financial Reporting

Also, in our opinion, management's assessment, included in the Report of Management on Internal Control Over Financial Reporting, that the Corporation maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the COSO. The Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Corporation's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Pricewaterhouse Cooper, LLP,
Charlotte, North Carolina
February 22, 2007

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Bank of America Corporation:

In our opinion, the accompanying Consolidated Balance Sheet and the related Consolidated Statement of Income, Consolidated Statement of Changes in Shareholders' Equity and Consolidated Statement of Cash Flows present fairly, in all material respects, the financial position of Bank of America Corporation and its subsidiaries at December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Corporation's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the Report of Management on Internal Control Over Financial Reporting appearing on page 108 of the 2008 Annual Report to Shareholders. Our responsibility is to express opinions on these financial statements and on the Corporation's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 19—Fair Value Disclosures to the Consolidated Financial Statements, as of the beginning of 2007 the Corporation has adopted SFAS No. 157, "Fair Value Measurements" and SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities."

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Charlotte, North Carolina
February 25, 2009

Report of Independent Registered Public Accounting Firm—Consolidated Financial Statements

The Board of Directors and Stockholders of Citigroup Inc.:

We have audited the accompanying consolidated balance sheets of Citigroup Inc. and subsidiaries (the "Company" or "Citigroup") as of December 31, 2006 and 2005, the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the years in the 3-year period ended December 31, 2006, and the related consolidated balance sheets of Citibank, N.A., and subsidiaries as of December 31, 2006 and 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Citigroup as of December 31, 2006 and 2005, the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2006, and the financial position of Citibank, N.A., and subsidiaries as of December 31, 2006 and 2005, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, in 2006 the Company changed its methods of accounting for defined benefit pensions and other postretirement benefits, stock-based compensation, certain hybrid financial instruments and servicing of financial assets, and in 2005 the Company changed its method of accounting for conditional asset retirement obligations associated with operating leases.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Citigroup's internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 23, 2007, expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

KPMG LLP,
New York, New York
February 23, 2007

Report of Independent Registered Public Accounting Firm—Consolidated Financial Statements

The Board of Directors and Stockholders of Citigroup Inc.:

We have audited the accompanying consolidated balance sheets of Citigroup Inc. and subsidiaries (the "Company" or "Citigroup") as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the years in the 3-year period ended December 31, 2008, and the related consolidated balance sheets of Citibank, N.A., and subsidiaries as of December 31, 2008 and 2007. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Citigroup as of December 31, 2008 and 2007, the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2008, and the financial position of Citibank, N.A., and subsidiaries as of December 31, 2008 and 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, in 2007 the Company changed its methods of accounting for fair value measurements, the fair value option for financial assets and financial liabilities, uncertainty in income taxes and cash flows relating to income taxes generated by a leverage lease transaction.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Citigroup's internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 27, 2009, expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

KPMG LLP,
New York, New York
February 27, 2009

EXHIBIT C

Recommendations of the U.S. Treasury Advisory Committee on the Auditing Profession

Final ACAP Recommendations

Human Capital Recommendations

Recommendation 1. Implement market-driven, dynamic curricula and content for accounting students that continuously evolve to meet the needs of the auditing profession and help prepare new entrants to the profession to perform high quality audits.

a. Regularly update the accounting certification examinations to reflect changes in the accounting profession, its relevant professional and ethical standards, and the skills and knowledge required to serve increasingly global capital markets.
b. Reflect real world changes in the business environment more rapidly in teaching materials.
c. Require that schools build into accounting curricula current market developments.

Recommendation 2. Improve the representation and retention of minorities in the auditing profession so as to enrich the pool of human capital in the profession.

a. Recruit minorities into the auditing profession from other disciplines and careers.
b. Institute initiatives to increase the retention of minorities in the profession.
c. Emphasize the role of community colleges in the recruitment of minorities into the auditing profession.
d. Emphasize the utility and effectiveness of cross-sabbaticals and internships with faculty and students at Historically Black Colleges and Universities.
e. Increase the numbers of minority accounting doctorates through focused efforts.

Recommendation 3. Ensure a sufficiently robust supply of qualified accounting faculty to meet demand for the future and help prepare new entrants to the profession to perform high quality audits.

a. Increase the supply of accounting faculty through public and private funding and raise the number of professionally qualified faculty that teach on campuses.
b. Emphasize the utility and effectiveness of cross-sabbaticals.

c. Create a variety of tangible and sufficiently attractive incentives that will motivate private sector institutions to fund both accounting faculty and faculty research, to provide practice materials for academic research and for participation of professionals in behavioral and field study projects, and to encourage practicing accountants to pursue careers as academically and professionally qualified faculty.

Recommendation 4. Develop and maintain consistent demographic and higher education program profile data.

Recommendation 5. Encourage the AICPA and the AAA jointly to form a commission to provide a timely study of the possible future structure of higher education for the accounting profession.

Firm Structure and Finances Recommendations

Recommendation 1. Urge the SEC, and Congress as appropriate, to provide for the creation by the PCAOB of a national center to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies, and commission research and other fact-finding regarding fraud prevention and detection, and further, the development of best practices regarding fraud prevention and detection.

Recommendation 2. Encourage greater regulatory cooperation and oversight of the public company auditing profession to improve the quality of the audit process and enhance confidence in the auditing profession and financial reporting.

a. Institute the following mechanism to encourage the states to substantially adopt the mobility provisions of the Uniform Accountancy Act, Fifth Edition (UAA). If states have failed to adopt the mobility provisions of the UAA by December 31, 2010, Congress should pass a Federal provision requiring those states to adopt these provisions.
b. Require regular and formal roundtable meetings of regulators and other governmental enforcement bodies in a cooperative effort to improve regulatory effectiveness and reduce the incidence of duplicative and potentially inconsistent enforcement regimes.
c. Urge the States to create greater financial and operational independence of their State boards of accountancy.

Recommendation 3. Urge the PCAOB and the SEC, in consultation with other Federal and State regulators, auditing firms, investors, other financial statement users, and public companies, to analyze, explore, and enable, as appropriate, the possibility and feasibility of firms appointing independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency at auditing firms.

Recommendation 4. Urge the SEC to amend Form 8-K disclosure requirements to characterize appropriately and report every public company auditor change and to require auditing firms to notify the PCAOB of any premature engagement partner changes on public company audit clients.

Recommendation 5. Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model. Further, urge that the PCAOB and the SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards.

Recommendation 6. Urge the PCAOB to undertake a standard-setting initiative to consider mandating the engagement partner's signature on the auditor's report.

Recommendation 7. Urge the PCAOB to require that, beginning in 2010, larger auditing firms produce a public annual report incorporating (a) information required by the EU's Eighth Directive, Article 40 Transparency Report deemed appropriate by the PCAOB, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VI of this Report. Further, urge the PCAOB to require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements.

Concentration and Competition Recommendations

Recommendation 1. Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. Because smaller auditing firms are likely to become significant competitors in the market for larger company audits only in the long term, the Committee recognizes that Recommendation 2 will be a higher priority in the near term.

a. Require disclosure by public companies in their registration statements, annual reports, and proxy statements of any provisions in agreements with third parties that limit auditor choice.

b. Include representatives of smaller auditing firms in committees, public forums, fellowships, and other engagements.

Recommendation 2. Monitor potential sources of catastrophic risk faced by public company auditing firms and create a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms.

a. As part of its current oversight over registered auditing firms, the PCAOB should monitor potential sources of catastrophic risk which would threaten audit quality.

b. Establish a mechanism to assist in the preservation and rehabilitation of a troubled larger auditing firm. A first step would encourage larger auditing firms to adopt voluntarily a contingent streamlined internal governance mechanism that could be triggered in the event of threatening circumstances. If the governance mechanism failed to stabilize the firm, a second step would permit the SEC to appoint a court-approved trustee to seek to preserve and rehabilitate the firm by addressing the threatening situation, including through a reorganization, or if such a step were unsuccessful, to pursue an orderly transition.

Recommendation 3. Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible; require the PCAOB to monitor these indicators.

Recommendation 4. Promote the understanding of and compliance with auditor independence requirements among auditors, investors, public companies, audit committees, and boards of directors, in order to enhance investor confidence in the quality of audit processes and audits.

a. Compile the SEC and PCAOB independence requirements into a single document and make this document Web site accessible. The AICPA and State boards of accountancy should clarify and prominently note that differences that exist between the SEC and PCAOB standards (applicable to public companies) and the AICPA and State standards (applicable in all circumstances, but subject to SEC and PCAOB standards, in the case of public companies) and indicate, at each place in their standards where differences exist, that stricter SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements. This compilation should not require rulemaking by either the SEC or the PCAOB because it only calls for assembly and compilation of existing rules.

b. Develop training materials to help foster and maintain the application of healthy professional skepticism with respect to issues of independence and other conflicts among public company auditors, and inspect auditing firms, through the PCAOB inspection process, for independence training of partners and mid-career professionals.

Recommendation 5. Adopt annual shareholder ratification of public company auditors by all public companies.

Recommendation 6. Enhance regulatory collaboration and coordination between the PCAOB and its foreign counterparts, consistent with the PCAOB mission of promoting quality audits of public companies in the United States.

EXHIBIT D

Recommendations of the PCAOB Investor Advisory Group

1. Standard auditor's report should be revised to include more useful information to investors.
2. The PCAOB should launch an in-depth study into the role auditors played in the financial crisis. The goal of that study should be to identity both the causes of and remedies for those pervasive audit failures. The PCAOB should make such analysis of audit failures an ongoing function of the Board, in order to

ensure that changes in policy and oversight practices are adopted in a timely fashion to address correctable weaknesses in the audit process.

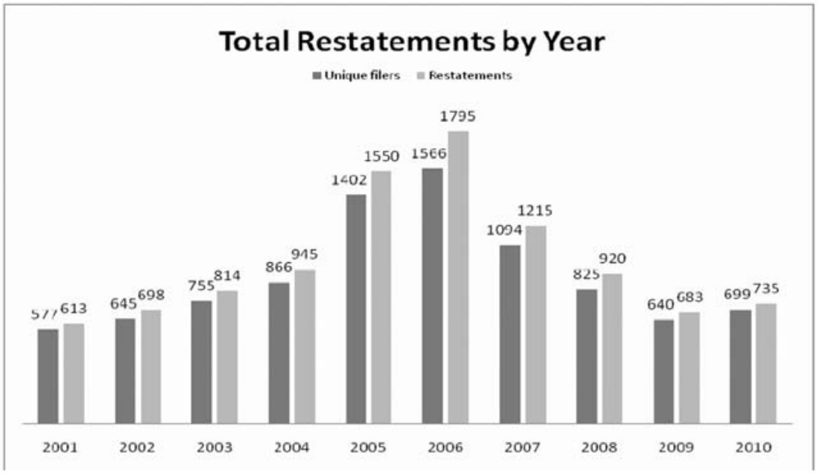
3. The firms should produce an annual report, including financial statements, which is filed with the PCAOB and made public and certified to by the executives of the firm. The annual report of the audit firm should include its key quality control factors, global quality control processes, and how it is structured and operates.
4. The PCAOB should require the governing boards of the firms, either on the board itself or on an advisory board, appoint no less than 3 independent members. These independent members should include in the annual report of the firm, a report on their activities for the year.
5. The PCAOB should continue to ask congress to pass legislation that will allow it to make its disciplinary proceedings public.
6. The PCAOB should undertake a project to establish mandatory rotation of the auditor, for example every ten years. During that time period, to strengthen auditor independence and avoid any "opinion shopping," any rules adopted should permit the auditor to be removed only for cause, as defined by the PCAOB.
7. The PCAOB as it updates its standards should undertake to study and strengthen the supervision by the lead audit partner, of the foreign audit work performed. Mere acceptance of foreign auditors "credentials" is insufficient to ensure high quality audits.
8. The auditor's report should be modified to state the amount or percentages of assets and revenues that have been audited by any auditors, who has refused to be inspected by the PCAOB. We support the PCAOB's efforts to negotiate joint inspection agreements with foreign regulators. However, we do not believe mere reliance on those regulators inspections, without first determining and monitoring their quality, is an acceptable protection for investors.
9. Consistent with the recommendations of the Panel on Audit Effectiveness, we recommend the PCAOB revise its standards to require forensic auditing procedures and include greater guidance on the forensic audit procedures that should be performed. This should include requiring auditors to understand the whistleblower programs and their independence and effectiveness.

Exhibit E

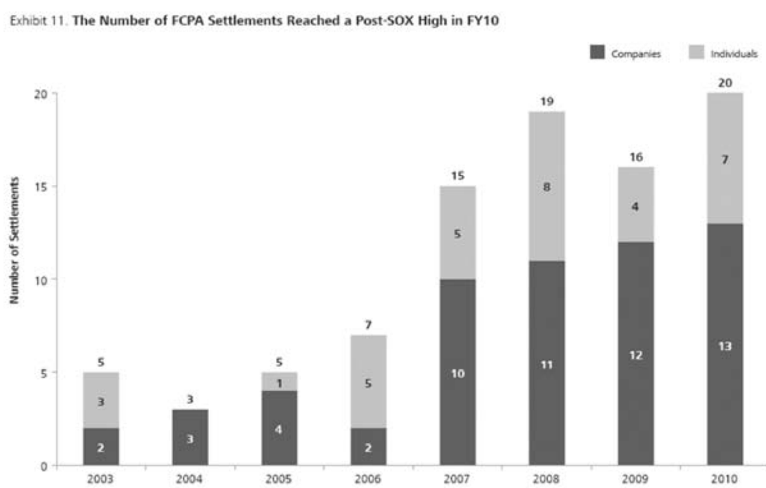
Data on Securities Litigation and Restatements

Class action filings naming auditors as defendant:

Year	Annual Number Of Class Action Filings	Percentage of annual filings Naming Auditor Defendant
2010	176	4%
2009	168	6%
2008	223	3%
2007	177	1%
2006	119	3%
2005	182	3%



Restatements: source Audit Analytics.



RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM JAMES R. DOTY

Q.1. In your remarks, you discussed the auditor's responsibility with respect to an entity's ability to continue as a going concern. Should this assessment be conducted during interim reviews? How could this be an early warning indicator? What work is the PCAOB doing with respect to this issue? What is the estimated timeline for completion or resolution of this issue or any related project on the PCAOB's agenda?

A.1. The financial crisis has highlighted the importance of an auditor's timely assessment of an entity's ability to continue as a going concern. The Board is sensitive to this issue and, as discussed below, its staff has been working with others on a project to consider improvements to Auditing Section 341, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern (AU 341).[1] AU 341 currently requires that certain audit procedures be performed on annual audits, not interim reviews, of issuers' financial statements.[2] The project underway is considering quarterly (interim) procedures as well as annual procedures.

The PCAOB has been working with the Financial Accounting Standards Board (FASB) and the Commission to coordinate changes to both accounting and auditing standards relating to a company's assessment and disclosure of its ability to continue as a going concern and an auditor's evaluation of that assessment. Possible changes under consideration include whether and how the current going concern model could be expanded to further discuss risks and uncertainties about an entity's ability to continue as a going concern, and thus serve as more of an early warning indicator.

It's important that the Board's actions are appropriately coordinated and sequenced with any actions the FASB and the Commission would need to take. The Board, however, recognizes the importance of the going concern project, and it remains a priority of the Board.

Q.2. Nearly all of the panelists addressed the issue of the necessary evolution of the auditor's report. What is the estimated timeline for consideration of this project? When do you anticipate Board action on any related standards?

A.2. The auditor's reporting model is a top standard-setting priority of the Board. On March 22, 2011, the Board discussed with its staff the results of the PCAOB's outreach to investors and others about potential changes to the auditor's reporting model, and directed the staff to prepare a concept release for publication this

[1] AU 341 was adopted by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) in the 1980s and was established by the PCAOB under section 103(a)(3) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7213(a)(3), as an initial auditing standard. *See,* PCAOB Rule 3200T. Under U.S. generally accepted accounting principles (GAAP), financial statements are prepared based on the assumption by management that the company is a going concern; that is, absent information to the contrary, there is an assumption that the company will continue in business. Accounting Research Bulleting No. 43, Restatement and Revision of Accounting Research Bulletins.

[2] AU §§341.01 and 341.02. Section 10A(a) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j-1(a), requires that each audit under the Exchange Act include an evaluation of whether there is substantial doubt about the entity's ability to continue as a going concern. The procedures for that evaluation, during the audit of annual financial statements, are found in AU 341.

summer. A recording of that meeting is available at *http://pcaobus.org/News/Webcasts/Pages/03222011_OpenBoardMeeting.aspx.*

The scheduled milestones for this project include issuing the above-mentioned concept release for public comments this summer, holding a roundtable discussion in the fall of 2011 and issuing a proposed standard for public comments in early 2012.

Q.3. The Investor Advocacy Group of the PCAOB recently discussed a survey and noted four areas of potential improvement in auditor communications:

a. an assessment of management's estimates and judgments;

b. areas of high financial statement and audit risk;

c. unusual transactions, restatement and other significant changes; and

d. an assessment of the quality of the issuer's accounting policies and practices.

What work is the PCAOB doing concerning each of the four areas?

A.3. As your question indicates, on March 16, 2011, the Board heard a presentation from members of a subcommittee of the Board's Investor Advisory Group (IAG) about the results of a survey conducted by the subcommittee to solicit views regarding auditors' communications to investors and possible changes to the auditor's report. The presentation of the results of the survey was followed by a discussion of related issues by all IAG members and the Board.

The results of the survey and the IAG discussion provided valuable investor feedback that, along with information provided by auditors and others, has informed the Board's project on the auditor's reporting model, which is noted above in response to Question 2. The views expressed by IAG members, including the results of the survey, were consistent with views by some investors expressed in response to broader PCAOB staff outreach about potential changes to the auditor's report. However, other constituents, including some audit committee members, expressed reservations about the extent of any possible additional reporting by auditors. The Board will carefully consider all of the views received as it moves forward on this project.

As noted above, the Board plans to issue a concept release on the auditor reporting model this summer. The concept release will seek public comment on not only the areas highlighted in the IAG survey, but also other potential ways to enhance the auditor's report and improve auditor communications to investors and other users of financial statements.

Q.4. What is your assessment of the report and each of the recommendations detailed in the Department of the Treasury's Advisory Committee on the Auditing Profession (ACAP) issued on October 6, 2008? What are the strengths and weaknesses of each recommendation? What further work is the PCAOB doing with respect to the issues discussed in the report and the related recommendations?

A.4. The Board considers the ACAP report as part of the total mix of information from serious and thoughtful sources that contain recommendations for possible policy, standards setting, and rule-making initiatives.

Generally speaking, the strengths of each recommendation stem from their being developed by thoughtful and committed experts with a common interest in improving audit quality. Any particular weaknesses could be viewed, in part, to arise from the limited access the ACAP had to the type of information which PCAOB inspectors have access to, and to the fact that the ACAP recommendations were made prior to the financial crisis.

During the past few years, the Board has focused its resources on significant issues that arose subsequent to the ACAP, such as audit issues highlighted during the financial crisis and the Board's ability to gain access to foreign countries to conduct inspections of audits of companies, or subsidiaries or affiliates of companies, with securities traded in the United States.

The Board has developed an active standard setting and regulatory agenda. Several of these initiatives are consistent with ACAP recommendations.[3] For example:

- The Board has created an Academic Fellow Program and the first academic fellow soon will complete his 1-year fellowship in the Board's Office of Research and Analysis.
- The Board also has created an outline for a possible national center on financial reporting fraud and solicited applications for the position of director of the center.
- The Board issued a concept release to explore issues related to engagement partners signing audit reports in their own names.
- The Board also has increased its efforts to act cooperatively with other regulators, such as the SEC, FASB, the Financial Industry Regulatory Authority, the Department of Labor, and the Federal Deposit Insurance Corporation.
- The Board's regulatory collaboration and coordination with its foreign counterparts has been enhanced by entering into agreements with foreign authorities that facilitate cooperation in the oversight of auditors.
- And, the Board has encouraged smaller accounting firms' participation by hosting numerous "Forums for Auditing in the Small Business Environment" in cities across the country and including small firm representatives in its advisory groups.

Most significantly, as noted above and consistent with an ACAP recommendation, the Board is considering revising the auditor's standard reporting model. The basic auditor report on a public company's financial statements has not changed significantly in over 60 years. During that period, investors and others have indicated that auditors have valuable insights into companies' financial statements and auditors, therefore, should communicate to investors more than a final conclusion on whether those financial statements comply with generally accepted accounting principles

[3] Further information about the ACAP recommendations is available on the Board's Web site in the briefing paper under "Update on PCAOB Developments", at *http://pcaobus.org/News/Events/Pages/10132010_SAGMeeting.aspx.*

(GAAP). ACAP, for example, referred to the growing complexity of global business operations and a growing use of judgments and estimates in accounting as reasons for the Board to consult with investors, other financial statement users, auditors, public companies, academics, and others about the need for and possible improvements in the auditor reporting model. As discussed above, on March 22, 2011, the Board discussed with its staff the results of the PCAOB's outreach to investors and others about potential changes to the auditor's reporting model, and directed the staff to prepare a concept release for publication this summer. The Board also is considering holding a roundtable on the auditor reporting model in the fall of 2011, and issuing a proposed standard for public comments in early 2012.

Q.5. Auditing firms and investors have publicly expressed the need for increased transparency into large firms and their complex networks. Foreign regulators have adopted transparency standards that exceed those in the U.S., such as the EU's Article 40 Transparency Report. Should audit firms publish annual audited financial statements? What do you believe are the strengths and weaknesses of such a proposal? What additional information should be disclosed? What work has the PCAOB done concerning the issue of increasing the transparency into large accounting firms? What additional work is being done?

A.5. The Board requires each registered firm to file an annual report that includes, among other things, information about audit reports issued, disciplinary histories of new personnel, and certain information about fees billed to issuer audit clients for various categories of services. Registered firms also are required to file special reports within 30 days after certain reportable events, which range from administrative matters such as changes in a firm's contact information to more substantive matters, including, for example, the institution of certain types of legal proceedings against a firm or its personnel. Each of these reports is posted to the Board's Web site and is available to the public at *http://pcaobus.org/Registration/rasr/Pages/RASR_Search.aspx.* These reports provide the public with information relevant to a registered public accounting firm's audit practice and performance. The Board, however, is continuing to evaluate the appropriate content of these reports in view of the authority recently granted to the Board to oversee the audits of brokers and dealers, and other current events.

Some auditing firms in the United States also have published reports that provide a high-level discussion of the firm's legal structure, global and U.S. governance structures, quality control framework, personnel headcounts, and the division of revenues among accounting and audit, tax, and consulting service lines. Little, if any, information that would appear in an entity's financial statements, however, generally is made part of such a report.

A PCAOB inspection team, in certain cases, requests that a registered public accounting firm provide the Board with financial information concerning the firm's practice. In appropriate circumstances, inspectors also request information related to potentially catastrophic risks facing the firm, such as the likelihood of significant losses or costs associated with pending litigation or the possible failure of quality controls in high risk areas. The Board, therefore, currently has sufficient access to a firm's financial information to conduct its inspections and other regulatory programs.

Q.6. Mr. Valukas urged reconsideration of the paradigm concerning an auditor's assessment of materiality. Mr. Valukas noted that transparency should be placed above conclusions of immateriality. What has the PCAOB done, or is currently doing, concerning this issue? What is the estimated timeline for completion?

A.6. Mr. Valukas raised an important, and profound, concern, which I share. That is, when an auditor or the company itself identifies an error or other unfavorable information, too often their reaction is to engage in an exercise to find a rationale for determining that the error or information is immaterial and need not be disclosed to the audit committee or investors.

The PCAOB's Auditing Standard No. 11, "Consideration of Materiality in Planning and Performing an Audit", discusses the concept of materiality for application in audits performed in accordance with PCAOB standards. The standard is based on the long-standing principle that materiality must be judged from the perspective of the reasonable investor.[4] It requires auditors to establish materiality levels for the financial statements taken as a whole. It also requires auditors to determine whether separate materiality levels should be established for certain accounts or disclosures.

To my mind, the problem Mr. Valukas cites would not be solved by requiring auditors to use lower materiality thresholds. Auditors find significant errors under existing standards. Rather, the problem is what auditors do about the error once they have found it.

In the face of strong incentives to conform to management's views, auditors must exercise their professional skepticism in the collection of real, objective, and credible evidence to support their opinions. Courage to stand up to management when this evidence shows it is the right thing to do is one of the most difficult challenges an auditor faces, but it is the fundamental purpose of the audit.

As I noted in response to your questions at the April 6 hearing, the PCAOB has emphasized this issue in its inspections program, and there are indications that auditors themselves are recognizing that real change is needed. The Board intends to continue in its inspections and through other means to encourage registered public accounting firms to avoid temptations to minimize problems based simply on management's representations and, when appropriate, to present those problems to audit committees and others.

Q.7. What additional information do you believe should be communicated by auditors to the audit committee? When should the communication occur (*e.g.,* during the performance of an audit or review, during the performance of an audit, after an audit has concluded, or at another time)?

[4] Specifically, Auditing Standard No. 11 states that, in interpreting the Federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries v. Northway,* Inc., 426 U.S. 438, 449 (1976). *See,* also *Basic, Inc. v. Levinson,* 485 U.S. 224 (1988).

On March 29, 2010, the Board proposed for public comment a new auditing standard to replace the existing standard on communications with audit committees, and a series of related amendments to other PCAOB standards. On September 21, 2010, the Board held a public roundtable, which provided additional input on the proposed standard from representatives of audit committees, investors, auditors, issuers, and others.

The proposed standard would strengthen the existing requirements for auditor communications with audit committees, and add several new requirements. The proposed standard includes a requirement for the auditor to establish a mutual understanding of the terms of the audit engagement with the audit committee and to document that understanding in an engagement letter. The proposal also includes requirements relating to:

- Communication of an overview of the audit strategy, including a discussion of significant risks, the use of the internal audit function; and the roles, responsibilities, and location of firms participating in the audit;
- Communication regarding critical accounting polices, practices, and estimates;
- Communication regarding the auditor's evaluation of a company's ability to continue as a going concern; and
- Evaluation by the auditor of the adequacy of the two-way communications between the auditor and audit committee to better achieve the objectives of the audit.

The proposed standard states that audit committee communications should occur in a timely manner, and that the appropriate timing of a particular communication depends on the significance of the matter to be communicated and the need for any corrective or follow-up action. As a backstop, the proposed standard also states, however, that all communications required by the standard should be made annually before the issuance of the auditor's report.[5]

The comment period for the proposal closed October 21, 2010. The Board's staff is evaluating comments received and preparing its recommendations to the Board.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JAMES R. DOTY

Q.1. We need to make sure that American investors can have confidence in audits performed on U.S.-listed companies whose operations might be located someplace other than in the U.S. For example, the PCAOB released a Research Note on March 15 detailing the extent to which hundreds of Chinese companies have listed on U.S. exchanges through "reverse mergers" with U.S.-based shell companies. Outside audits of these companies are often performed by audit firms based in China, and the Chinese Government has not allowed the PCAOB to inspect those firms to evaluate the quality of audit work being done.

[5] The proposed standard would provide certain exceptions for registered investment companies consistent with SEC Rule 2-07 of Regulation S-X, 17 CFR §210.2-07.

What more can the PCAOB be doing in this area to help give American investors the confidence they deserve and is there anything Congress can be doing to help you persuade the Chinese Government that it is in their own interest to have PCAOB inspectors evaluating the quality of audit work being done there?

A.1. The PCAOB takes seriously its obligation under the Sarbanes-Oxley Act (the "Act") to inspect non-U.S. public accounting firms that have registered with the PCAOB because they audit or play a substantial role in the audit of U.S. issuers, brokers, and dealers. To date, the PCAOB has conducted inspections in 35 jurisdictions around the world. In Asia in particular, the PCAOB has conducted inspections of firms located in India, Indonesia, Japan, Malaysia, Philippines, Taiwan, Thailand, Singapore, South Korea, and Hong Kong (albeit without access to the portions of the auditor's work papers covering mainland China operations and documents).

As your question acknowledges, the PCAOB is currently prevented from inspecting the U.S.-related audit work and practices of PCAOB-registered firms in China as well as Hong Kong to the extent their audit clients have operations in mainland China. These obstacles undermine the auditor oversight system put in place by the Act and, in turn, threaten the public interest by impeding the PCAOB's ability to detect conduct that violates U.S. law and professional standards. As long as these obstacles persist, investors in U.S. markets are deprived of the benefits of PCAOB inspections and, in some cases, may rely on the mistaken belief that these auditors have been inspected.

The PCAOB continues to work to resolve these obstacles and has been engaged in discussions with the relevant Chinese authorities for over 4 years. During that time, the PCAOB and Chinese authorities have participated in numerous bilateral meetings, dialogues, and workshops.

In addition, in order to provide transparency to investors and the public about its international inspection efforts and the challenges we face, the PCAOB periodically updates certain disclosures about the status of inspections of registered non-U.S. firms. Specifically, the Board has posted the following lists on its Web site:

- A cumulative list of the countries in which the PCAOB has conducted inspections in the past.
- A list of the countries in which there are registered non-U.S. firms that the PCAOB intends to inspect in the current calendar year. The Board also committed to publicly explaining the reason(s) for any difference between the announced plan and the countries in which inspections were actually conducted.
- A list of the registered firms for which the inspection fieldwork has not been completed even though more than four years have passed since the end of the calendar year in which the firm first issued an audit report while registered with the PCAOB.
- A list of the companies that, in 2009 or 2010 (through mid-April 2010), filed financial statements with the SEC that were audited by a non-U.S. auditor that is located in a jurisdiction where there are obstacles to PCAOB inspections. Issuers located in China (including Hong Kong issuers with significant

subsidiaries or operations in mainland China or audited by mainland Chinese auditors) comprise the largest group of issuers where the PCAOB has been denied access to conduct inspections.

In addition to these transparency measures, in July 2010, the PCAOB staff issued Staff Audit Practice Alert No. 6, "Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm" (Staff Alert No. 6), noting that some U.S. audit firms, which are issuing audit reports for companies with substantially all of their operations outside of the U.S. based on work performed by non-U.S. firms, are not properly applying PCAOB standards. The alert reminds U.S. auditors of their obligations in these circumstances. In addition, the Board has ongoing investigations relating to the audits of Chinese issuers.

Finally, in October 2010, the PCAOB announced that it was reevaluating its approach to new registration applications from firms in jurisdictions that deny access to PCAOB inspections. Going forward, the Board will no longer routinely register firms that are located in jurisdictions where the PCAOB cannot conduct inspections.

While the PCAOB is currently considering a range of options to resolve the inspections issue, we very much appreciate your attention to this matter as well as the interest shown by other members of Congress. I believe that it is critical that Congress continue to remain interested in this issue as we focus on resolving the impasse with China in a manner that best serves the public interest and investing community. I recognize that members of Congress have their own relationships with many Chinese Government officials, or might have occasion to travel to China and discuss a wide range of important issues with them. Given the importance of this issue to the protection of American investors, I encourage members of Congress to raise this topic with them, and stress to the Chinese that it is in their own interest to agree to a system of joint inspections with the PCAOB this year.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM LESLIE F. SEIDMAN

Q.1. During Wednesday's hearing on "The Role of the Accounting Profession in Preventing Another Financial Crisis", comments were made by a witness testifying on the second panel on which I would appreciate your response and assessment.

The comment dealt with the relative importance of materiality and transparency. The witness said, "you cannot hide behind materiality if something is not transparent. And the FASB has for years been urged to adopt a rule that says if additional disclosure is necessary to keep the financials from being misleading, you need to make it . . . [U]ntil we put that standard in place . . . we are going to have a problem."

What would be the potential and probable impacts of the implementation of such a rule? What has been the history of consideration of such a rule, which was mentioned? What is the applicable FASB guidance regarding the disclosure of information necessary to keep a material part of the financial statement from being misleading?

A.1. In 2009, the FASB added a project to its agenda to establish an overarching framework intended to make financial statement disclosures more effective, coordinated, and less redundant. That project was added in response to requests and recommendations received from several stakeholders, including the ITAC (an advisory group to the FASB) and the CIFiR committee. Some of the concerns expressed by the investor community were centered on materiality and transparency. In addition, issuers of financial statements have requested relief from unnecessary, duplicative, and burdensome disclosures that they believe do not provide or enhance transparency.

The project objective is not intended to be additive but, rather, to develop a framework for improved U.S. GAAP that promotes meaningful communication and logical presentation of disclosures and avoids unnecessary repetition. The project will also consider the need to specifically require a company to provide additional disclosures to keep its financial statements from being misleading. Notwithstanding the activities of the FASB to enhance transparency through the disclosure framework project, the SEC, in Exchange Act Rule 12b-20, already has a longstanding requirement for companies to disclose material information that may be necessary to make the required financial statements not misleading.[1] Rule 12b-20 is an SEC rule applicable to companies subject to the 1934 Exchange Act.

To date, the disclosure framework project team has completed its categorization of existing disclosures and is currently analyzing ways to eliminate those disclosures that are not deemed useful and to add those disclosures that users need to better understand the prospects and risks faced by an entity. The FASB expects to issue a Discussion Paper on that framework in the second half of 2011.

In recent standards, the FASB also has been identifying the objective of the disclosure requirements, rather than just enumerating specific disclosure items. Most recent standards include the notion that the objectives apply regardless of whether the standard requires specific disclosures. Those standards indicate that the specific disclosures required by the standard are minimum requirements and a company may need to supplement the required disclosures depending on the company's facts and circumstances.

It is the FASB's responsibility to develop recognition, measurement, and disclosure principles that appropriately portray the economics of transactions entered into by a company. While the FASB is responsible for establishing accounting standards, the FASB does not have the authority to determine whether a company's financial report is presented fairly. The SEC has the ultimate authority to analyze whether public companies have complied with accounting and disclosure standards.

[1] Exchange Act Rule 12b-20 states that "In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM LESLIE F. SEIDMAN

Q.1. In his written testimony, Mr. Valukas, noted that there are "no clear rules for measurement and reporting of the critical metric of liquidity . . . " What accounting pronouncements are in place or contemplated concerning the measurement and reporting of liquidity?

A.1. Several topic-specific pronouncements require companies to provide information about liquidity. For example, Topic 470 requires a company to provide information about the nature and timing of its debt obligations. Topic 840 requires a company to provide information about its lease commitments. Topic 860 requires a company to provide information about its obligations when a company has sold assets and has significant continuing involvement with those assets. The Securities and Exchange Commission (SEC) and the banking regulators require additional liquidity disclosures in "Management Discussion" and "Analysis and Call Reports", respectively.

One of the Financial Accounting Standards Board's (FASB or Board) current priorities is improving, simplifying, and achieving convergence of the accounting for financial instruments. As part of that project, the FASB staff is developing additional disclosures about risks relating to financial instruments, including liquidity risk, that would improve the information provided to users of financial statements about a company's financial instruments. When evaluating the need for additional disclosures, the FASB will consider existing reporting requirements established by other regulatory bodies, including the SEC and the banking regulators. The FASB plans to issue a proposal of these additional disclosures in 2011.

Q.2. Mr. Turner testified that the FASB has "constantly refused" to promulgate standards that address disclosures that may be necessary to provide financial statements that are not misleading. Has the FASB developed standards to address (1) the reporting of transactions that lack economic substance; and (2) whether the financial report is fairly presented? Are any such standards contemplated? If so, what is the estimated timeline for completion?

A.2. The FASB continually adds projects to our technical agenda that improve transparency of financial reporting for users of financial statements. The Board regularly solicits input from its advisory groups, including the Financial Crisis Advisory Group during 2009 and 2010, and through an annual survey conducted by our Financial Accounting Standards Advisory Council (FASAC). On the basis of that input, the Board has undertaken work in several specific areas that require transactions to be reported in accordance with their economic substance instead of their legal form (for example, standards on transfers of financial assets and consolidation of special-purpose entities (SPEs)). The Board completed a targeted project in 2009 to provide greater transparency about transfers (sales) of financial assets and a company's continuing involvement with such assets (FAS 166).[1] The final standards improve disclosures about a company's involvements with SPEs and tighten the requirements governing when such entities should be consolidated (FAS 167).[2]

As noted in our response to Question 4, the FASB recently revised FAS 166 to address accounting for repurchase agreements, and is proposing guidance to clarify certain provisions about consolidation in FAS 167. Our response to Question 4 also describes our lease accounting project that is currently under way.

With respect to a company's fair presentation of its economic condition in its financial reports, it is important to remember the FASB's role as an accounting standard setter. It is the FASB's responsibility to develop recognition, measurement, and disclosure principles that appropriately portray the economics of transactions entered into by a company. While the FASB is responsible for establishing accounting standards, the FASB does not have the authority to determine whether a company's financial report is presented fairly. Instead, 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 the 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. Finally, the SEC has the ultimate authority to analyze whether public companies have complied with accounting standards.

Additionally, the SEC, in Exchange Act Rule 12b-20, has a longstanding requirement for companies to disclose material information that may be necessary to make the required financial statements not misleading.[3] Rule 12b-20 is an SEC rule applicable to companies subject to the 1934 Exchange Act.

Q.3. A recent report of the Economic Affairs Committee of the House of Lords of the British Parliament expressed concerns that the International Financial Reporting Standards (IFRS) is an "inferior system" that encourages "box-ticking" and does not properly account for expected losses. What has the FASB done to evaluate this report and what impact does it have on the FASB's agenda?

A.3. We have read and considered the report issued by the Economic Affairs Committee (EAC). During the last several years, the FASB has aimed to improve its standards through a focus on clear objectives and principles, supported by a sufficient level of implementation guidance. We believe that this improved approach for establishing accounting standards further emphasizes the need for

[1] FASB Statement No. 166, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140 (June 2009), now codified in Topic 860 of the FASB Accounting Standards Codification®.

[2] FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) (June 2009), now codified in Topic 810 of the Accounting Standards Codification®.

[3] Exchange Act Rule 12b-20 states that "In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading"

practitioners to exercise professional judgment when applying U.S. generally accepted accounting principles (GAAP). The FASB's work on pending convergence projects with International Accounting Standards Board (IASB) is informed by this standard-setting philosophy.

With regard to the EAC's specific concerns about the accounting for a bank's expected losses under IFRS, the FASB has a project on its agenda to address the model for recognizing loan impairments. The FASB is working jointly with the International Accounting Standards Board (IASB) to develop a converged and improved impairment model in 2011. While the FASB is committed to working hard to develop converged standards, we are committed first and foremost to ensuring that the standards result in improved financial information for investors.

Q.4. With respect to off-balance sheet transactions, please indicate what accounting standards address the accounting for, and disclosure of, off-balance sheet transactions. Please include when the FASB initially promulgated related standards; when the FASB evaluated the implementation and assessed the effectiveness of such standards; and the current status of any projects. Please include a timeline of when the relevant issue was first added to the FASB's agenda and any anticipated activities through completion of the project.

A.4. There are a number of FASB standards that address the accounting for and disclosure of off-balance sheet transactions. The recent financial crisis revealed that accounting standards governing when a "true sale" has occurred and when a company must recognize and report interests in SPEs did not adequately reveal risks relating to transfers with continuing involvement, and various roles in securitization activities. To address these problems, the FASB in 2008 issued enhanced disclosure requirements,[4] which became effective immediately, and then proceeded to complete a targeted project in 2009 to provide greater transparency about transfers (sales) of financial assets and a company's continuing involvement with such assets (FAS 166). These standards improve disclosures about a company's involvements with SPEs and tighten the accounting requirements governing when such entities should be consolidated (FAS 167). Below we discuss the most significant accounting standards related to off-balance sheet disclosures.

Transfers of Financial Assets

Accounting standards applicable to transfers of financial assets and the use of SPEs have been in place for many years and have been revised as structured finance arrangements have evolved. In the 1980s, the FASB issued guidance to address diversity in practice for transfers of financial assets, including securitization transactions. However, as new securitization structures developed, diversity in accounting continued. FAS 77, issued in 1983, addressed the

[4] FASB Staff Position FAS 140-4 and FIN 46(R)-8, Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities (December 2008).

reporting of transferred loans.[5] FASB Technical Bulletin 85-2 was issued in 1985 to provide guidance on the securitization of collateralized mortgage obligations.[6] Other guidance was periodically issued through various audit and accounting guides of the American Institute of Certified Public Accountants (AICPA) and consensuses of the FASB's Emerging Issues Task Force (EITF).

In 1996, the FASB issued FAS 125 to improve the accounting for transfers of financial assets and to eliminate inconsistencies that resulted from the various guidance developed over the years.[7] After the issuance of FAS 125, stakeholders asked the Board to reconsider or clarify certain provisions. In 2000, the FASB issued FAS 140 to address those matters.[8] After the issuance of FAS 140, the FASB received a number of requests from financial statement users and regulators to reconsider or clarify certain provisions. The FASB issued three proposals to revise FAS 140, which resulted in the issuance of FAS 166 in 2009.

The FASB issued a narrowly focused revision to FAS 166 in April 2011.[9] That revision affects the accounting guidance for determining when a repurchase agreement should be accounted for as a sale or as a financing. The Board determined that the existing criterion pertaining to an exchange of collateral should not be a determining factor when accounting for a repurchase agreement transaction. This project is also discussed in the response to Question 2.

Consolidation of Special-Purpose Entities

Guidance issued in the mid-1980s addressed the consolidation of SPEs used in securitizations involving collateralized mortgage obligations.[10] However, securitization transactions continued to evolve and diversity in accounting continued when determining whether to consolidate SPEs. After the collapse of Enron, the FASB determined that the consolidation guidance as it related to securitization vehicles and other thinly capitalized entities was fragmented and incomplete. As a result, the FASB developed a new consolidation model applicable to such entities. That model was issued in January 2003 as FIN 46.[11] The FASB issued revisions to FIN 46 in December 2003. That revised guidance, FIN 46(R), remained in effect until the issuance of FAS 167 in 2009.[12]

Currently, the FASB has a narrowly focused project on our technical agenda to revise FAS 167. The FASB plans to issue a proposal in May 2011 that would amend the consolidation guidance to address concerns about applying FAS 167 to investment companies

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[5] FASB Statement No. 77, Reporting by Transferors for Transfers of Receivables with Recourse (December 1983).
[6] FASB Technical Bulletin No. 85-2, Accounting for Collateralized Mortgage Obligations (CMOs) (March 1985).
[7] FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (June 1996).
[8] FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125 (September 2000).
[9] Accounting Standards Update No. 2011-03, Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements (April 2011).
[10] FASB Technical Bulletin 85-2.
[11] FASB Interpretation No. 46, Consolidation of Variable Interest Entities—an interpretation of ARB No. 51 (January 2003).
[12] FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities—an interpretation of ARB No. 51 (December 2003).

and other similar companies. This project is also discussed in the response to Question 2.

Leasing

Lease obligations are widely considered a significant source of off-balance sheet financing. Under the current lease accounting guidance, a company leasing an asset will either recognize the entire leased asset on its books and a liability for all of its contractually required payments or recognize no asset and no liability. FAS 13, issued in 1976, established the current accounting guidance for leases for both lessors and lessees.[13] Following the issuance of FAS 13, the FASB, EITF, SEC, and AICPA issued numerous standards that addressed various issues relating to the application of that Statement.

Many of the FASB's stakeholders criticized the current lease accounting guidance and urged the FASB to undertake a lease accounting project. In July 2006, the FASB and the IASB decided to add a joint leasing project to their respective agendas because of their concern that the current accounting in this area does not clearly portray the resources and obligations arising from lease transactions. The FASB and the IASB (the Boards) have been working to revise the existing lease accounting guidance since that time. The Boards have issued proposed revisions to lease accounting guidance and are currently considering the feedback received from comment letters and the Boards' extensive outreach activities. We expect to issue guidance in the latter half of 2011.

The response to Question 7 more fully describes the FASB's processes for evaluating the effectiveness of its standards.

Q.5. The Financial Crisis Inquiry Commission refers to certain practices that occurred leading up to and during the financial crisis as "window dressing." What steps has the FASB taken to address this concept in the current financial reporting environment?

A.5. "Window dressing" results from a variety of actions that a company may take to affect its financial statements as of a particular reporting date. In its report, the Financial Crisis Inquiry Commission describes some companies that would sell assets before the end of a reporting period to reduce the amount of the company's assets and lower its leverage ratio. Those companies would buy those assets back at the beginning of the next quarter. The FASB has recently improved the accounting guidance for repurchase transactions. In June 2008, the FASB issued guidance to require a company to link together certain repurchase transactions when determining whether those transactions should be reported as sales or financings.[14] In 2009, the FASB issued FAS 166, which requires a company to disclose its continuing involvement, if any, with financial assets that it reports as having sold. In addition, in April 2011, the FASB revised the accounting standard for determining when such a repurchase agreement should be accounted for

[13] FASB Statement No. 13, Accounting for Leases (November 1976).

[14] FASB Staff Position 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (February 2008), now codified in Topic 860 of the Accounting Standards Codification®.

as a sale or as a financing.[15] The Board determined that one of the existing criteria pertaining to an exchange of collateral should not be a determining factor when accounting for a repurchase agreement transaction.

Q.6. What standards have been issued to address the need to eliminate or reduce accounting-motivated structured transactions? What has FASB concluded about the operating effectiveness of such standards?

A.6. During the last several years, the FASB has aimed to improve its standards through a focus on clear objectives and principles, supported by a sufficient level of implementation guidance. We believe that this improved approach for establishing accounting standards further emphasizes the need for practitioners to exercise professional judgment when applying U.S. GAAP and reduces opportunities for similar economic transactions to be reported differently.

Accounting-motivated structured transactions can take many forms. As noted above in the response to Question 4, a number of FASB standards address the accounting for and disclosure of off-balance sheet transactions. The recent financial crisis revealed that accounting standards governing when a "true sale" had occurred and when a company must recognize and report interests in SPEs did not adequately reveal risks relating to transfers with continuing involvement and various roles in securitization activities. As discussed in response to Question 4, in 2008, the FASB issued enhanced disclosure requirements to address these problems and imposed an immediate effective date for such enhanced disclosures. In 2009, the Board issued FAS 166, which provided greater transparency about transfers (sales) of financial assets and a company's continuing involvement with such assets. In 2009, the Board also issued FAS 167, which improved disclosures of a company's involvements with SPEs and tightened the accounting requirements governing when such entities should be consolidated.

Also noted in our response to Question 4, the FASB currently has a joint project with the IASB under way to develop improved lease accounting standards that are intended to minimize off-balance-sheet reporting of lease transactions.

The FASB actively seeks input from all of its stakeholders on proposals and processes. The Board's broad-based outreach helps us to assess each standard's effectiveness and whether the benefits to users of improved information from proposed changes outweigh the costs of the changes to preparers and others. Broad consultation also provides the opportunity for all stakeholder voices to be heard and considered, facilitates the identification of unintended consequences, and, ultimately, enables the widespread acceptance of the standards that are adopted. The response to Question 7 more fully describes the FASB's processes for evaluating the effectiveness of its standards.

Q.7. Some commentators have expressed concern about whether the FASB's focus on convergence has diverted attention away from

[15] FASB Accounting Standards Update No. 2011-3.

the timely assessment of U.S. GAAP. What is the FASB doing to ensure that U.S. GAAP is assessed in a timely fashion?

A.7. While the FASB is committed to working hard to develop improved, converged, and sustainable standards, we are equally committed to making sure that, first and foremost, U.S. GAAP standards continue to provide the highest quality of financial information to investors. The projects that we conduct jointly with the IASB include topics in U.S. GAAP that the FASB has identified as areas that need improvement. Those projects were added to the FASB's technical agenda as part of the FASB's commitment to improve the effectiveness of existing U.S. GAAP.

The FASB engages in extensive due process to ensure that U.S. GAAP is assessed in a timely fashion, including public meetings, public roundtables, field visits or field tests, liaison meetings with interested parties, and the exposure of our proposed standards for public comment. We proactively reach out to meet with stakeholders, including a wide range of investors and reporting entities, to discuss current and proposed standards. Those meetings with stakeholders help us to assess whether U.S. GAAP standards are providing useful information and also to assess the related costs. The FASB works diligently to conduct outreach on a frequent and regular basis with the FASB's eight 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 eight advisory groups, the EITF 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 was also 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 narrow 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. Make-up 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, because 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 at least on a quarterly basis and more frequently, if needed. The FASB's extensive due process ensures that U.S. GAAP is assessed in a timely and complete fashion.

Further, the Office of the Chief Accountant of the SEC is undertaking a new initiative involving a series of roundtable sessions (Financial Reporting Series) in its oversight capacity to facilitate a balanced discussion of existing pressures or emerging issues within the financial reporting system. The Financial Reporting Series is 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 chairs of the FASB and the PCAOB will attend all sessions as observers and will have the opportunity to make statements and ask questions of participants.

Q.8. What additional information do you believe should be communicated by auditors to the audit committee? When should the communication occur (*e.g.,* during the performance of an audit or review, during the performance of an audit, after an audit has concluded, or at another time)?

A.8. While the FASB is responsible for establishing accounting standards, the PCAOB ensures that auditors of public companies have performed an audit in accordance with generally accepted auditing standards. This includes oversight over an auditor's analysis of whether a public company has complied with appropriate accounting standards and whether they have made the appropriate communications to a company's audit committee. The FASB does not have the authority to oversee audit firms and does not make recommendations to the PCAOB on issues within the PCAOB's purview.

Q.9. Mr. Doty recommended that Congress consider changes to permit the PCAOB to disclose its decision to institute disciplinary hearings, which is currently prohibited by Section 105(c)(2) of the Sarbanes-Oxley Act of 2002. Please give us your detailed thoughts regarding the strengths and weaknesses of this proposal.

A.9. While the FASB is responsible for establishing accounting standards, the PCAOB ensures that auditors of public companies have performed an audit in accordance with generally accepted auditing standards. This includes oversight over an auditor's analysis of whether a public company has complied with appropriate accounting standards. The FASB does not have the authority to oversee audit firms and does not make recommendations to the PCAOB on issues within the PCAOB's purview.

Q.10. The Investor Advocacy Group of the PCAOB recently discussed a survey and noted four potential areas of improvement in auditor communications:

a. assessments of management's estimates and judgments;
b. areas of high financial statement and audit risk;
c. unusual transactions, restatement, and other significant changes; and
d. assessments of the quality of the issuer's accounting policies and practices.

What work has the FASB done to support transparency to financial statement users in each of the areas noted above?

A.10. The FASB's mission is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including users of financial information. However, the FASB does not have authority to oversee management's (or its auditor's) qualitative assessment of a company's financial reporting.

The FASB, however, does recognize the importance of improving transparency about a company's judgments and estimates and areas of high financial statement risk. Accordingly, the FASB has recently issued guidance to improve disclosures about the following:

a. Fair value measurements [16]
b. Asset impairments [17]
c. Credit risk [18]
d. Derivative instruments and hedging activities, including credit derivatives [19]
e. Transfers of financial assets and continuing involvement with those assets [20]
f. Involvements in SPEs [21]
g. Financial guarantee insurance products. [22]

Q.11. Auditing firms and investors have publicly expressed the need for increased transparency into large firms and their complex networks. Foreign regulators have adopted transparency standards that exceed those in the U.S., such as the EU's Article 40 Transparency Report. Has the FASB considered a project to promulgate accounting standards specific to accounting firms? If not, why not?

A.11. As discussed above, although the FASB is responsible for establishing accounting standards, it does not have authority to require an audit firm (or any other firm) to prepare its financial statements in accordance with U.S. GAAP. Additionally, the FASB also does not have the authority to oversee or regulate audit firms; such authority rests with the PCAOB and the State licensing boards.

Although, in limited circumstances, the FASB has issued industry-specific accounting guidance, the FASB is generally charged with establishing general purpose standards of financial accounting and reporting focused on the nature of the business activities and

[16] FASB Statement No. 157, Fair Value Measurements (September 2006), as codified in Topic 820 of the Accounting Standards Codification®; FASB Staff Position FAS 107-1 and APB28-1, Interim Disclosures about Fair Value of Financial Instruments (April 2009), now codified in various Topics of the Accounting Standards Codification®; FASB Staff Position FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (April 2009), now codified in Topic 820 of the Accounting Standards Codification®; and FASB Accounting Standards Update No. 2010-6, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements (January 2010).

[17] FASB Staff Position FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (April 2009), now codified in various Topics of the Accounting Standards Codification®.

[18] FASB Staff Position SOP 94-6-1, Terms of Loan Products That May Give Rise to a Concentration of Credit Risk (December 2005), now codified in Topics 825 and 310 of the Accounting Standards Codification®; and FASB Accounting Standards Update No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses (July 2010).

[19] FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133 (March 2008), now codified in Topic 815 of the Accounting Standards Codification®; and FASB Staff Position FAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161, now codified in Topics 815 and 460 of the Accounting Standards Codification®.

[20] FASB Staff Position FAS 140-4 and FIN 46(R)-8 and FASB Statement No. 166, now codified in Topic 860 of the Accounting Standards Codification®.

[21] FASB Staff Position FAS 140-4 and FIN 46(R)-8 and FASB Statement No. 167, now codified in Topic 860 of the Accounting Standards Codification®.

[22] FASB Statement No. 163, Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60 (May 2008), now codified in Topic 944 of the Accounting Standards Codification®.

not specific industries. General purpose standards are in most instances preferable to industry-specific standards because the same activities may be carried out by companies from different industries. This was reinforced in the Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission, in which the committee generally advocated a move away from industry-specific guidance in authoritative accounting literature.[23]

Q.12. Please describe the process whereby FASB reviews each new standard to determine whether it has met the needs of financial statement users or whether additional guidance should be promulgated. What assessments have been performed within the last 2 years and what additional assessments are scheduled?

A.12. In November 2010, the Financial Accounting Foundation (FAF) Board of Trustees, the oversight body of the FASB and the Governmental Accounting Standards Board (GASB), announced a process for conducting post-implementation reviews (PIR) of financial accounting and reporting standards issued by the FASB and the GASB.

The PIR process is part of the FAF Trustee's oversight activities and is independent of the FASB and GASB standard-setting processes. Accordingly, the PIR team reports directly to the FAF President & CEO, and the FAF Trustees.

The primary objective of the PIR process is to determine whether a standard is accomplishing its stated purpose and to provide feedback to the FASB that could improve the standard-setting process. The PIR team evaluates whether decision-useful information is being reported and if investors, creditors, and other users of financial statements are using the reported information as intended. The review team also evaluates whether there are any significant unintended changes to financial reporting and operating practices or any significant economic consequences that the FASB did not consider in setting the standard. The review process also evaluates the implementation and continuing compliance costs of a standard compared to the intended benefits of the standard.

The PIR team has initiated the review of its first selected standard and will be completing that review during the second half of 2011. Following completion of that review, the FAF will proceed with the review of additional significant standards that have been issued for a minimum period of 2 to 3 years. FAF intends to conduct post-implementation reviews of significant FASB standards. There are two principal criteria in deciding whether an FASB standard should be subjected to a post-implementation review. First, the standard should have represented a significant change from existing financial reporting when it was issued. Second, there should be a significant amount of stakeholder input requesting additional guidance or indicating that the standard may not be meet-

[23] The Advisory Committee on Improvements to Financial Reporting (CIFiR) to the SEC states the following in Recommendation 1.6 of their Final Report (August 2008): U.S. GAAP should be presumptively based on business activities, rather than industries. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB be scoped on the basis of business activities, except in rare circumstances. Any new projects should include the elimination of existing industry-specific guidance—particularly that which conflicts with generalized U.S. GAAP—in relevant areas as a specific objective of those projects, except in rare circumstances.

ing its stated objective(s). The PIR team will not review standards that are currently the subject of a significant technical project or are under reconsideration by the FASB.

It is important to note that the PIR function is in addition to the procedures that the FASB has in place to identify emerging issues and potential agenda items. Those procedures are described in response to Question 7. It was through those procedures that the Board added projects relating to securitizations, consolidation, repurchase agreements, credit quality disclosures, multi-employer pension plans, and numerous other matters in recent years.

Q.13. Please describe the Financial Accounting Foundation's policies and practices to evaluate the efficiency and effectiveness of the FASB. Please provide any reports that have been conducted within the last 2 years.

A.13. The FAF's Board of Trustees regularly monitors and evaluates the efficiency and effectiveness of the FASB. The full Board of Trustees undertakes these functions directly and also through its Standard-Setting Process Oversight Committee (Oversight Committee) and its Appointments & Evaluations Committee.

The full Board of Trustees formally meets a minimum of four times per year with the FASB Chairman and Technical Director for an in-depth review and understanding of the FASB's technical agenda, project plans, and priorities on both domestic projects and joint projects with the IASB. These reviews include discussion about, among other things: the timing of projects; the level, means, and scope of stakeholder outreach; and the FASB's due process. The Trustees also meet quarterly with the Chairman of the FASAC for, among other things, FASAC's views on the effectiveness and efficiency of the FASB.

Trustees and executives of the FAF also regularly engage in nontechnical stakeholder outreach activities, including meetings with the SEC, banking and finance regulators, members of Congress, investor organizations, business and trade associations, and audit firm leaders. These meetings are intended to educate stakeholders on the activities of the FAF and FASB, solicit stakeholder involvement in the FASB's due process, and enable the FAF to obtain an understanding of the issues and concerns of stakeholders and gain insights from them on the effectiveness of the FASB and how the FAF and the FASB can continue to meet the needs of financial statement users and fulfill our mission.

The Oversight Committee was formed as an advisory committee to the Board of Trustees in 2008. In 2009, the Oversight Committee was raised to a standing committee of the Board of Trustees and in 2011 became the first committee of the Board of Trustees designated with cochairs. The Oversight Committee meets as often as six times per year and, on most of those occasions, meets with the FASB Chairman and Technical Director. The primary responsibilities of the Oversight Committee are monitoring and fostering thorough and effective due process by the FASB and the GASB. As discussed in the response to Question 12 above, in 2010, the Board of Trustees formalized a post-implementation review team and procedures under the direction and supervision of the Oversight Committee. The Oversight Committee also reviews the cost-benefit procedures followed by the FASB and GASB in establishing standards.

The Appointments & Evaluations Committee conducts annual reviews of the performance of all FASB members.

Accompanying this response letter are the Annual Reports of the FAF for 2010 and 2009.


Communicating Values in Financial Reporting
2010 Annual Report
Financial Accounting Foundation

our core values

High-quality financial reporting increases investor confidence. Increased investor confidence leads to better capital allocation decisions and, by extension, a stronger economy. Six core values – integrity, objectivity, independence, transparency, listening, and leadership – guide the FAF, FASB, and GASB in their mission to develop accounting standards that result in high-quality financial reporting.

Important FASB outreach was under way in Norwalk, Connecticut with the Not-for-Profit Advisory Committee (NAC). The NAC was established in October 2009 to serve as a 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.

Financial Accounting Foundation

Inspiring Confidence in Financial Reporting

Integrity, transparency, and objectivity are vital to good financial reporting – and necessary for rebuilding confidence in the US capital markets.

A strong economy relies in part on the values that are practiced in good financial reporting. Since it was founded in 1972, the Financial Accounting Foundation (FAF) has been working to promote the values of integrity, transparency, and objectivity in financial reporting. Good financial reporting provides people, businesses, and other organizations the information they need to make decisions that affect how capital and other resources are allocated. Investors rely on financial reports to see how effectively a company is utilizing its resources, so they can decide whether to buy, sell, or hold stock in that company. Taxpayers use financial reports to decide whether elected officials are spending their dollars wisely, and consequently, if those officials should be reelected.

When values such as integrity, transparency, and objectivity are present in the preparation of financial reports, those reports are more likely to provide high-quality information. This creates confidence in financial reporting which, in turn, leads to stronger capital markets and a stronger economy.

Today, as the US economy continues to recover from one of the worst financial crises and deepest recessions in our history, the FAF's work, and that of our standard-setting Boards, is critical. As the organization charged with overseeing the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB), the FAF is responsible for ensuring the standard-setting process reflects and incorporates the values that will continue to rebuild trust in financial reporting.

In 2010, the FAF made significant changes that will advance our mission of establishing and improving financial accounting and reporting standards.

Improving Due Process

Independent, unbiased due process is at the heart of everything we do. Our commitment to due process enables FASB and GASB members to have the information they need to make informed decisions. It is a process driven by our constituents – users of financial statements, preparers of such statements, auditors, regulators, taxpayers, citizens, and others with an interest in high-quality financial reporting. Constituents tell us what issues in financial reporting they think need to be addressed. They recommend new projects or improvements to existing standards, based on their experience in business, government, and the capital markets.

Following research and consultation with Board members and others on these recommendations, and subject to the oversight of the FAF, the FASB and GASB chairs then decide what projects to add to their agendas.

Once a project is on the agenda, the issues are identified and researched by the staff and are deliberated by the Boards in public meetings. A Discussion Paper or Exposure Draft is issued, giving constituents an opportunity to weigh in on the Boards' proposed solutions to the issues identified. Depending on the project and the type of feedback received, the Boards may also host public roundtables or public hearings to gather more input. Information gathered during this stage of the process, including comment letters, public discussions, and other feedback, is then analyzed by staff and presented to the Boards. The Boards then redeliberate all of the issues, including proposed changes or other provisions, at public meetings before a final standard is issued.

In 2010, the FAF launched another component of due process. Our new formal Post-Implementation Review process collects information on the effectiveness of final FASB and GASB standards after they have been implemented by constituents. Last July, the FAF appointed Mark Schroeder, a newly retired senior partner from Deloitte & Touche, LLP, to lead the development, implementation, and management of the post-implementation review of standards issued by the FAF's standard-setting Boards.

As part of this process, an FAF review staff studies significant accounting standards to assess whether the intended financial reporting objectives underlying those standards are being met. This involves examining the effects of a standard that has been implemented in the "real world," and then asking whether, in fact, the standard is achieving what it was intended to achieve. The review staff reports to the FAF president and meets regularly with the Standard-Setting Process Oversight Committee of the Board of Trustees. The review team includes experienced members of the FASB and GASB staffs who have been released to the FAF staff to devote full-time efforts to the post-implementation review function. This promotes a collaborative review aimed, ultimately, at improving the standard-setting process. At this writing, the review staff is conducting a "beta" test of the review process on one FASB standard. The FASB test is expected to be completed by the middle of 2011, at which time a GASB standard will be selected for review.

Listening Leads to Improvements

Hearing what our constituents have to say with thoughtful attention is a prerequisite of our ability to come to the right answers on issues. While our constituents may not always agree on the outcome, the standard-setting Boards weigh their input very carefully within the context of all available information, including research, cost-benefit analyses, and opposing viewpoints.

During the FAF's 2009 "Listening Tour," groups of FAF Trustees and senior FAF leadership met with diverse groups of constituents to hear and understand their views on the independent standard-setting process and key issues affecting financial reporting. During this tour, constituents told us they fully support the robustness and the independence of the processes followed by the FASB and GASB in setting standards.

The insights gleaned during the Listening Tour were the inspiration for important projects in 2010. For example, we heard that some constituents are concerned about the cost and complexity of standards for nonpublic entities. The FAF listened to these concerns and took immediate steps to get more information. The FAF collaborated with the American Institute of Certified Public Accountants and the National Association of State Boards of Accountancy to create a Blue-Ribbon Panel charged with studying and making recommendations to the Trustees about how to improve the standard-setting process for private companies. Chaired by FAF Trustee Rick Anderson, the panel met five times in 2010 to discuss issues of concern to private companies, culminating in a report submitted to the Trustees in January 2011 with recommendations for addressing financial reporting challenges in this sector.

We recently announced the formation of a Trustee Working Group as the next phase of our process to broadly examine the needs of nonpublic entities. The Working Group will reach out to our constituents to obtain their input on the scope of the issues and concerns to be addressed, and also will seek input on potential improvements, including those recommended by the Blue-Ribbon Panel. As the comprehensive evaluation of potential improvements for these entities continues, the FASB has also taken a number of important steps to improve its own processes, among them, assigning private company and not-for-profit staff liaisons to each of its project teams in order to better provide input on how proposed FASB standards would impact nonpublic entities.

Transparency Inspires Confidence

The ability for constituents to see what the FASB and GASB are doing at any given time is critical to the standard-setting process because it enables greater constituent involvement in that process and fosters confidence in that process. We are dedicated to making our process transparent and our information accessible.

Over the past year, the FAF has taken a number of steps to increase transparency and foster more constituent engagement. In December 2010, the FAF introduced video webcasting of FASB decision-making meetings to make it easier for our constituents to see and hear the standard-setting process in action. The videocasts replaced the audio-only webcasts that our listeners told us were challenging to follow and understand. The success of these video webcasts has led to the recent launch of video webcasting of FASB public education sessions. In 2011, we will explore expanding the number and types of meetings available by videocast.

Transparency is also enhanced by our constituents' ability to see the type of feedback the Boards receive and follow a written record for each project. Over the years, we've tried to improve constituents' access to the public project files, including comment letters. Close followers of the standard-setting process know that we have a room here in Norwalk, Connecticut – the public reference room – dedicated to public project files, where people can review comment letters, meeting minutes, and other relevant information about each Board's projects. During 2010, we launched the FASB Online Public Reference Room, a virtual library containing the documents that comprise the FASB public project file. In addition, 2010 saw the GASB join the FASB in posting all comment letters received, by project, to the GASB website.

Late in 2010, the FAF launched its own dedicated website, www.accountingfoundation.org. The new website is intended to raise awareness of the FAF, its mission, and its activities, and to promote greater involvement in our processes. The homepage features a new column, "From the President's Desk," which provides an overview of the latest Foundation news and activities. It also provides a means for two-way communications with us – our constituents have the opportunity to contact us directly with their feedback, questions, and concerns about the Foundation and its standard-setting Boards.

Finally, in 2010, the FAF expanded its repertoire of communications outreach tools. We're now using Twitter to provide real-time alerts to constituents regarding the latest FAF, FASB, and GASB news. Podcasts featuring FASB and GASB members and staff discussing major standard-setting issues have also become a regular feature on our websites. The FASB is also using live, hour-long webcasts to educate constituents on major issues while giving them the opportunity to direct questions to Board members and staff.

Leadership for New Accounting Realities

Our constituents expect the FASB to remain a world leader in setting high-quality accounting standards. They also expect the GASB to lead the way in setting standards that give users of state and local government financial reports a clear picture of how public officials are using tax dollars.

On an organizational level, the FAF Trustees succeeded in filling a number of leadership roles with dynamic, experienced individuals with a deep knowledge of financial reporting issues. The most significant changes in leadership occurred at the FASB. In December 2010, after a national search conducted by a leading executive search firm, the FAF appointed Leslie Seidman as chairman of the FASB. First appointed to the FASB in 2003, Leslie's diverse and distinguished career in financial reporting includes founding and managing a financial reporting consulting firm, serving as vice president in the accounting policies department of J.P. Morgan & Co. Inc., and starting her career as a member of the audit staff of Arthur Young & Co. The FAF Trustees are delighted to have Leslie leading the FASB at such a crucial time in our history. Leslie assumed the role of acting chairman upon the October 2010 retirement of Bob Herz, who served with distinction as FASB chairman since 2002. Bob's vision, leadership, and strong commitment to the goal of improving and converging accounting standards for the benefit of the global and US capital markets brought the FASB to a new level of excellence. His tenure at the FASB set the direction for the future of financial reporting, and we thank him for his leadership and considerable contributions to the organization and its mission during a critical period in the history of the US capital markets. We will always be grateful for his strong leadership of the FASB.

In October 2010, the Trustees appointed Russ Golden to the FASB. Prior to his appointment, Russ was technical director of the FASB, with primary responsibility for overseeing FASB staff work on all standard-setting projects, including major global and domestic projects and technical application and implementation of financial accounting and reporting standards. He also served as chair of the FASB's Emerging Issues Task Force (EITF). Earlier in his career, Russ was a partner at Deloitte & Touche, LLP, in the National Office Accounting Services department, where he was responsible for providing timely and accurate accounting consultations to partners and clients throughout the US and globally. His vast technical accounting experience, combined with his big-picture view of the issues, makes him an ideal addition to the Board.

The FAF also made the decision to enhance the FASB's leadership abilities by returning to a seven-member structure. The FASB operated under that structure from its inception in 1973 until 2008. The decision to return the FASB to seven members demonstrates the FAF Trustees' commitment to investing resources in the standard-setting process at a critical time.

In early 2011, the FAF announced the appointment of the two new FASB members, completing the process to bring the FASB to seven members. Daryl Buck and Hal Schroeder officially joined the FASB on February 28, 2011. Prior to his appointment to the FASB, Daryl was senior vice president and CFO of Reasor's Holding Company in Tahlequah, Oklahoma. He brings years of private company experience in financial reporting, planning, and analysis to the FASB. Hal, previously a senior portfolio manager with Carlson Capital, LP, has a diverse investor and financial reporting background and has served over the last 30 years as a senior equity analyst, a CFO, and an audit partner at Ernst & Young. We look forward to benefiting from their experience and expertise on all of the challenging issues that will confront the FASB during their terms.

In addition, the FAF appointed four new Trustees who possess strong and varied expertise in finance and accounting. John Davidson is senior vice president, controller, and chief accounting officer of Tyco International. Steve Howe is Americas managing partner of Ernst & Young and a member of the Americas Executive Board and Global Executive Board. Mack Lawhon is chairman of Weaver, LLP, one of the largest independent accounting firms serving private companies in the Southwest. Mary Stone is director and Hugh Culverhouse Endowed Chair of Accountancy at the Culverhouse College of Commerce & Business Administration at the University of Alabama. We welcome them to the Board of Trustees. They replace retiring Trustees Rick Anderson, Tim Flynn, and Susan Phillips, whose insights and expertise were invaluable to the FAF during their terms. On behalf of the FAF and its Trustees, we thank each of them for their distinguished service.

FAF took a leadership role in another vital program in 2010, when it assumed responsibility for the ongoing maintenance of the US GAAP Financial Reporting Taxonomy applicable to public issuers registered with the US Securities and Exchange Commission (SEC). The US GAAP Financial Reporting Taxonomy is a list of computer-readable tags in eXtensible Business Reporting Language (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. The enhanced role of the FAF in Taxonomy maintenance and development will help to further enhance the integrity of the reporting process for public companies.

Continuing Our Mission

The FAF made significant progress in advancing our mission in 2010. In 2011, the Foundation will leverage these enhancements to continue our work on our major strategic issues. We'll continue to monitor the FASB's progress on its Memorandum of Understanding projects with the International Accounting Standards Board, as they reach a critical point in converging standards. As noted earlier, we'll focus on the issues and concerns of nonpublic entities and the standard-setting process. We are nearing implementation of an independent funding method for the GASB through the Dodd-Frank bill, thanks to collaborative and cooperative efforts with various state and local government organizations and others.

In closing, while the FAF, FASB, and GASB each focus on unique aspects of our overall organizational mission, we are united by the same goal: developing high-quality accounting standards that, in turn, strengthen confidence in our capital markets. Achieving this goal is only possible when values such as integrity, transparency, and objectivity drive all of our activities. On behalf of the FAF, FASB, and GASB, we thank all of the individuals and organizations that support the independent standard-setting process by contributing their feedback, time, and ideas to improving financial reporting. We also thank the FAF, FASB, and GASB members and staff who work so hard to make high-quality standards a reality.

John J. Brennan	**Teresa S. Polley**
Chairman	*President & Chief Executive Officer*
FAF Board of Trustees	FAF

integrity

For the FAF, FASB, and GASB, integrity means adherence to our due process. It encourages all stakeholders with an interest in financial reporting to participate in the development of standards. Our due process is central to our mission.

Key insights were gathered by the FASB at a meeting of The Pathways Commission in Atlanta. The Pathways Commission is a joint initiative of the American Accounting Association and the American Institute of Certified Public Accountants focused on surfacing recommendations on future paths of higher education for the accounting profession.


STANDARD &POOR'S
The Standard Sellers and Auditor's Perspectives

objectivity

Our due process ensures that diverse views are heard and carefully considered. Objectivity requires us to evaluate and consider differing views – with no stake in any particular viewpoint or outcome – in order to arrive at the best solution.

The perspectives of both standard setters and auditors on International Financial Reporting Standards and other accounting developments were delivered and discussed at a Standard & Poor's conference in New York.

Financial Accounting Standards Board

2010 was certainly a year full of activity and change at the FASB. The FASB team adapted to and embraced the challenges of the dynamic financial reporting environment, ranging from our standard-setting projects, enhancements to our due process procedures, "Xpanded" responsibilities, and changes in key personnel. Our former chairman, Bob Herz, initiated and accomplished many of these positive changes, and we are all very grateful for his years of service to the FASB and to the global financial reporting community. I am honored and excited to be leading the FASB at this moment in time and look forward to working with this great group of people to advance these important initiatives.

Despite all of the changes in the environment, our commitment to following a robust and open process has not wavered. In fact, in recent years, we have significantly improved our ability to engage with our constituents in a variety of ways so that we obtain the feedback we need to make informed decisions about how to improve financial reporting standards. In the paragraphs that follow, there is an underlying theme: we are actively seeking your input on our proposals and processes and we are listening to you. We may not always agree on the answer, but I assure you we are carefully considering your concerns and suggestions.

Listening

Let me briefly summarize some of the enhancements we have made to make it easier for you to share your views with us. Late last year, we started videocasting our Board meetings on our website; recently, we decided to also videocast our education sessions, to make it easier for constituents to observe the process that precedes our decisions. We have also created podcasts and held webcasts to provide short summaries of our proposals and new standards so that people can quickly assess whether they have an interest and want to weigh in. We've also been reaching out proactively to meet with constituents, including a wide range of investors and reporting entities, to discuss our proposals and help us assess whether the proposals will lead to better information, and to assess the related costs. I particularly like these interactive meetings, because we can ask questions to better understand why a person holds a particular view, which can accelerate the identification of issues and possible solutions.

We continue to use a variety of other techniques to gather information, including surveys, field visits, project resource groups, and workshops that generally include investors, auditors, reporting entities, and regulators. And of course, we continue to ask for formal comment letters and hold roundtables as "tried and true" ways to obtain feedback on our proposals.

Focusing

Many of these new forms of outreach were designed to better capture the views of investors, especially with respect to investors in public companies. However, we also set standards for private companies and nonprofit organizations and the users of their financial statements. In recent years, we have taken steps to enhance our ability to assess the unique needs of these nonpublic constituents, including the establishment of the Private Company Financial Reporting Committee in 2006 and the Nonprofit Advisory Committee last year. We also augmented our staff that focuses on nonpublic entities, and have been conducting targeted outreach to obtain the views of private companies, nonprofits, and the users of their financial statements. Our staff is also developing a "white paper" to identify the different needs of the users of private company financial statements. It is crucial that our private company constituents and the FASB have a common understanding of when differences are warranted and why they are warranted before we can successfully approach these issues. We plan to establish a resource group to help us with this effort and expose for comment any conclusions that we reach.

Reflecting

We are still interested in your feedback, even after a standard is issued and incorporated in the Codification. The Codification celebrated its one-year anniversary in July, and we conducted a survey to see whether there are ways to enhance the utility of this powerful reference tool. With respect to the content of the standards, or potential new issues, I am very pleased that the staff of the Securities and Exchange Commission is moving forward with a Financial Reporting Series, a new forum where constituents can raise concerns about financial reporting. Panels of experts will be assembled who can evaluate the nature of the issues raised – that is, does the issue represent an interpretation about a standard (or lack of a standard), an audit issue, or perhaps an enforcement issue? The panel will then identify which organization is best suited to address the issue, including the SEC, the PCAOB, the FASB, or possibly another organization. I will be a standing Observer at these meetings, and we plan to ask for input about possible discussion topics.

On a related note, the Financial Accounting Foundation announced last year that, as part of its oversight responsibilities, the FAF is establishing a process to conduct post-implementation reviews of FASB and GASB standards. The purpose of the process is to assess whether the standard is functioning as the Boards intended. I welcome this new form of oversight but wish to emphasize that it will not replace the FASB's ongoing efforts to facilitate the smooth implementation of standards; we will continue to respond quickly to any issues that arise.

Converging

Speaking of standards, we have been hard at work on several joint projects with the International Accounting Standards Board (IASB). Last year, we identified the projects that were our highest priorities: Concepts Statements about the objectives of financial reporting and qualitative characteristics, a converged definition of fair value, presentation of other comprehensive income (OCI), financial instruments, leasing, revenue recognition, and insurance. These are the areas that we believe are most in need of an improved global standard. We deferred work on some other important projects so that constituents could provide input on a more manageable number of projects, and so that the Boards could focus and deploy resources accordingly.

We issued converged and improved Concepts Statements last year, and we plan to issue converged and improved standards on fair value measurement and OCI early this year. We are in full swing on our deliberations of the extensive comments we received on our proposals to improve the accounting for financial instruments, leasing, revenue recognition, and insurance.

We received extensive commentary on each of these proposals, in a variety of ways, as I mentioned before. We carefully evaluate the feedback we receive in a qualitative manner, meaning that even if just one person raised a concern about a particular issue, we might change the proposal. Likewise, just because many people disagree with a proposal, it does not necessarily mean that we will change the proposal. In those cases, we are looking for the rationale behind the disagreement, and the balance of the input among all of our constituents. Our mission is to provide useful information to the users of financial statements to help them make informed decisions about how to deploy their capital or other resources. Therefore, the views of investors and other users of financial statements are weighted heavily in our analysis of the comments received. However, often, the users of financial statements don't agree among themselves on the best way to present information. Also, the Boards must consider the costs of providing the information and determine whether there are less costly approaches that would also represent a significant improvement. This is often a very subjective evaluation, but we are working hard to gather robust data, through our various means of outreach, to help us with this assessment.

In our discussions to date, we have already decided to make several changes to the proposals, and we have many issues left to debate. These changes are the result of our open and robust due process procedures, whereby we listen to the concerns and suggestions that have been raised by our constituents. We are evaluating whether additional field work is necessary to determine whether the revised approach is an improvement that is cost-effective. For example, we decided to reexpose a revised approach on impairment of financial assets because it represented a significant change from the previous positions of both the IASB and the FASB. Another example is on the leasing project, where we have asked the staff to meet with constituents to discuss our tentative changes to the accounting for contingent rentals and renewal options.

The FASB and IASB are working very hard to conclude on these matters as expeditiously as possible. We have added several joint meeting dates to the calendar and have added staff members to each team to help with the analysis and also conduct outreach activities, as needed. The June 2011 target dates (for most projects) signal our strong commitment to work as hard as we can to develop final standards on these projects as efficiently as we possibly can. Both organizations have said in the most recent progress report on the Memorandum of Understanding that those target dates are subject to the nature and extent of feedback that we receive. Because these projects address core issues for many companies and nonprofit organizations, it is essential that these standards provide useful information, are easy to understand, and can be implemented at a reasonable cost. If it takes a little longer for us to meet these crucial objectives, we will take that time.

Responding

The FASB issued standards last year on disclosures about the credit quality of receivables and the allowance for loan losses, enhanced fair value disclosures, subsequent events, and several other topics. The EITF issued guidance on a number of issues including revenue recognition, deferred acquisition costs for insurance companies, and several issues relating to health care entities. We are also moving forward on several other projects, including disclosures about multiemployer benefit plans, a clarification of what represents a troubled debt restructuring, a revision of our guidance on consolidation, and guidance on investment properties. Another important initiative relates to our disclosure framework project, which offers great promise to streamline and enhance existing disclosures, and to approach future disclosure requirements in a more consistent, disciplined way.

Modernizing

The FASB recently assumed responsibility for prescribing the Taxonomy for the eXtensible Business Reporting Language (XBRL). Having consistent tagging of information that is based on generally accepted accounting standards (GAAP) will enhance the quality and consistency of information that companies provide in this flexible format. In 2011, the XBRL team is continuing to enhance the Taxonomy with a review of the extensions that companies are using to communicate about their businesses.

Expanding

In September 2010, Russ Golden, who previously served as our technical director and senior technical advisor, joined the Board. In February, we welcomed our new Technical Director, Sue Cosper, and our two newest Board members, Daryl Buck and Hal Schroeder. I am confident that all of these individuals will add unique and valuable perspectives to our discussions at the Board table, and enable us to expand and enhance our outreach to constituents, especially private companies and investors.

Acknowledging

I am very grateful for the significant amount of time and effort that our constituents make to be active participants in the standard-setting process. I am especially grateful to the numerous volunteers who serve on our advisory committees and councils. I am keenly aware of the other demands on your time, including your day-to-day responsibilities, changes in regulation, and the difficult economic environment. I am heartened by the strong number of responses to our proposals, volunteers for field work, and ongoing invitations to meet. I urge you continue to stay involved as we move forward on several important initiatives. We will remain mindful of the other demands on your time and continue to pursue ways to facilitate broad participation in the standard-setting process. I encourage you to visit our website (www.fasb.org), which is a portal for all of these forms of engagement.

Leslie F. Seidman
Chairman
FASB

independence

Accounting standards must be developed in an environment free of special interests, one that is focused on bringing investors, citizens, and other users of financial reports the highest quality financial reporting information possible.

The FASB engaged in a broad dialogue about accounting issues with the Central Florida Chapter of Financial Executives International in Orlando, which represents the top financial executives of many prominent companies in Central Florida.


FACTS
GASB

transparency

The ability for constituents to see what the standard-setting Boards are doing at any given time fosters greater constituent involvement and confidence in the process.

In a discussion led by senior staff at the Governmental Accounting Standards Board (GASB), students at the University of New Hampshire gain insights about the Board's actions and current agenda activities.

Governmental Accounting Standards Board

GASB Core Values

Since the creation of the Governmental Accounting Standards Board in 1984, its mission has been to establish standards for financial reporting that are designed to provide decision-useful information that assists individuals in assessing a government's accountability to the public. Four core values are encoded in the DNA of the GASB and its standard-setting processes: independence, integrity, objectivity, and transparency. These values underlie everything the organization is engaged in and guide our efforts to achieve the GASB's mission:

Independence: The autonomy to pursue the best accounting or financial reporting answer for all constituents, free from undue influence or pressure from those with vested interests.

Integrity: Honest, ethical, and forthright behavior in relationships with all constituents.

Objectivity: Impartial decisions informed by credible research and thorough deliberations, including due consideration of the views of constituents and the work of other standard setters.

Transparency: An open process that encourages and values direct engagement with constituents regarding standard-setting decisions that are thoroughly vetted in public meetings.

Our core values are more than a set of words. Our Board members and staff embrace the true meaning of these words, incorporating them as guiding values in their work. Together, these four values comprise the philosophy that grounds the judgments we make in resolving each accounting and financial reporting issue that comes before us.

2010 Accomplishments

A recent biography on George Washington noted that one of the characteristics of his leadership style that allowed him to be so effective first as the commander of the Continental Army and then as the first president of the United States, was his penchant for listening to diverse points of view, weighing those views in his decision making, and then acting from an informed position. While the GASB's accomplishments may not have such historical implications, I cannot overstate the importance of constituent input to the GASB's due process, or our willingness to consider that input during our standards-setting activities. It is the lifeblood of our due process, and we thank all those who participated in our process in 2010. You can rest assured the GASB is listening and carefully considering the views expressed by constituents during due process.

The work the GASB engages in is always done in keeping with efforts to promote greater transparency and accountability for state and local governments and to support well-informed decision making by users of financial statements. The Board, with the assistance and support of our staff, made meaningful progress toward those ends in 2010.

Over the course of the past year, the GASB finalized five documents – including a Statement that significantly reduces the need for practitioners to search through various sources outside of the GASB literature to locate the necessary accounting guidance for the governmental environment, and new suggested guidelines for governments that voluntarily report on their service performance results.

The final documents issued in 2010 promote greater transparency and accountability for state and local governments in the following areas:

Financial Instruments

Sometimes the issues addressed by the GASB are narrow in scope but lead to significant improvements for our constituents. Statement No. 59, *Financial Instruments Omnibus*, for example, is a narrow-scope Statement that updates and enhances our existing standards regarding financial reporting and disclosure requirements for financial instruments and external investment pools. By increasing the consistency of related measurements and providing clarification of our existing standards, the guidance in Statement 59 offers real benefits to financial report preparers, in terms of providing greater clarity and minimizing uncertainty, and to users of financial reports by equipping them with more complete information on which to base their related decision making.

Service Concession Arrangements

Keeping pace with change is a continual challenge in the dynamic governmental environment. GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, addresses a type of transaction that is becoming increasingly popular among governments as a means of generating additional cash. The Statement establishes reporting guidance for service concession arrangements (SCAs), which are a type of partnership between governments and public or private operators for the provision of public services.

Through SCAs, governments, as transferors, convey the rights and obligations to public or private operators to provide services through the use of infrastructure and other capital assets – for example, a toll road or public hospital – for which the operators then collect fees from third parties.

Statement 60 provides guidance on the accounting and financial reporting for the capital assets and any up-front payments from operators, and on how to record the transferor government's SCA related obligations. By requiring governments to account for and report these transactions in the same way, the comparability of financial statements should be improved and the confusion regarding what guidance was applicable should be eliminated.

The Financial Reporting Entity

A central way the GASB has endeavored to maintain high-quality accounting and financial reporting standards is by periodically reexamining its existing standards to see if modifications are needed to improve their effectiveness. Statement No. 61, *The Financial Reporting Entity: Omnibus*, grew out of a reexamination of Statement No. 14, *The Financial Reporting Entity*. The new Statement amends the GASB's accounting and financial reporting standards for including, presenting, and disclosing information about governmental component units that, together with the primary government, constitute the financial reporting entity.

GASB research indicated that while Statement 14 had been working effectively to support public accountability and provide decision-useful information, certain technical issues had arisen since its issuance that warranted the Board's attention.

Statement 61 is designed to improve the standards for defining and presenting the financial reporting entity by providing guidance that will enable governments to include organizations that should be included, exclude entities that should be not be included, and display and disclose financial information about component units in the most appropriate and useful way.

Codification of Applicable FASB and AICPA Pronouncements

From my perspective, preparers and auditors of state and local government financial statements for far too long have had to refer to the literature of multiple organizations to locate and interpret relevant accounting and financial reporting standards. They have had to refer not only to the GASB's literature, but also to literature of the Financial Accounting Standards Board (FASB) and of the American Institute of Certified Public Accountants (AICPA).

Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, specifically identifies and makes available the accounting and financial reporting provisions that apply to state and local governments in a single pronouncement and modifies them where necessary for the governmental environment. The need for the Statement became more urgent with the launch of the *FASB Accounting Standards Codification*®, which made identifying the specific provisions applicable to governments no longer practical within the restructured FASB authoritative literature.

We expect that Statement 62, which addresses more than 120 FASB and AICPA pronouncements dating back several decades and covers more than 30 accounting and financial reporting areas, will help auditors and preparers identify the relevant literature with greater certainty and clarity, lead to more consistent application, and ultimately, enhance comparability.

Service Efforts and Accomplishments Reporting

Last summer, the GASB issued its first Suggested Guidelines, which addresses the reporting of information about a government's service efforts and accomplishments (SEA) for those entities that choose to do so. I believe this kind of information is needed to provide users of governmental financial reports with a more comprehensive picture of how well governments are accomplishing their objectives and utilizing the financial resources with which they are entrusted.

The Suggested Guidelines address the essential components of an effective SEA report, the associated qualitative characteristics that represent the attributes SEA performance information needs to possess, and the keys to effective communication of this information. The GASB believes these suggested SEA reporting guidelines will help governments that choose to report this information communicate effectively with their constituents about how successfully they are meeting their performance goals and objectives.

In addition to the final documents issued in 2010, the GASB also issued a number of proposals over the course of the year – some of which led to the documents described above. The Board also issued proposals in its ongoing reexamination of its existing pension accounting and financial reporting standards, and regarding elements of net position in a statement of financial position.

Pension Accounting and Financial Reporting

In 2010, a significant portion of the GASB's time and energy was focused on the review and proposed improvement of existing pension accounting and financial reporting standards. In June 2010, the GASB issued a second due process document in that reexamination, which is a part of the Board's broader effort to examine the effectiveness of its standards of accounting and financial reporting for postemployment benefits, including other postemployment benefits (OPEB).

The Preliminary Views proposes a number of changes to improve the effectiveness of the existing pension accounting and financial reporting standards for state and local governments. The document emphasizes that how governments fund their pension plans is a seperate issue from how they account for and report the related costs and obligations in their financial reports.

Statement of Net Position

In November, the GASB issued an Exposure Draft that proposed new standards for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position.

Since recent GASB pronouncements address transactions requiring the use of deferrals, the need for related guidance has become more immediate. For example, Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, provides for the deferral of changes in the fair value of hedging derivative instruments. Statement 60 requires the deferral of inflows resulting from certain up-front payments a government receives from an operator in an SCA.

The need for this reporting guidance becomes all the more urgent considering the Board's current deliberation of other projects that may result in the recognition of deferrals. If the proposals in the Exposure Draft ultimately are adopted in a final Statement, they would standardize the presentation of deferrals and their effect on a government's net position.

Looking Ahead

The GASB continues with a full slate of projects to address in 2011. Establishing the financial reporting requirements for deferred outflows of resources and deferred inflows of resources in a statement of net position as described above begs the question: are there other amounts currently being reported as assets or liabilities that should instead be recognized as deferred outflows or deferred inflows? The Board has begun deliberations on a project to address this question.

In the pension project discussed above, the Board has carefully reviewed the input received in response to the Preliminary Views, reconsidered proposals in light of that input, and, in addition, is deliberating issues not addressed in the Preliminary Views. The GASB is expected to issue one or more Exposure Drafts on employer and pension plan accounting and financial reporting issues in June 2011.

The Board is scheduled to issue a due process document for public comment in late 2011 regarding its project on fiscal sustainability as it relates to economic condition reporting. This project, it is important to note, is not about predictions about what will happen in the future; instead, it is intended to furnish financial statement users with information that will better enable them to assess a government's financial standing now and its ability to continue to meet its obligations as they come due.

Project deliberations are also now under way in the GASB's effort to consider financial reporting requirements for government combinations accomplished through annexation, consolidation, acquisition, and by other means. The project will also address government spinoffs. Government combinations are becoming an increasingly popular means of achieving efficiencies by reducing duplication in the provision of services. However, a significant amount of uncertainty exists regarding appropriate accounting and financial reporting for combinations. The establishment of authoritative guidance would help reduce uncertainty and increase consistency and comparability across governments.

The GASB is currently engaged in a conceptual framework project addressing recognition and measurement attributes that could significantly impact the type of information that is presented as part of governmental fund financial statements. The conceptual framework is made up of Concepts Statements that provide boundaries to guide the Board's development of accounting and financial reporting standards and enable it to maintain a consistent approach from standard to standard. This project, which will ultimately lead to a Concepts Statement, is designed to develop recognition criteria for what information should be reported in governmental financial statements and when that information should be reported and to consider the measurement attributes that should be used in government-wide and fund financial statements. A Preliminary Views is planned for mid-2011 to solicit constituent feedback regarding recognition and measurement concepts.

In closing, I would like to express my gratitude to my fellow Board members, our FAF Trustees, the members of the GASB and FAF staff, and the GASAC members for their dedication to our process and their outstanding contributions to it in 2010. In addition, I'd like to extend my thanks to those who volunteer their time and expertise to serve on GASB task forces and advisory committees, and to those who volunteer to field test proposed standards, and to all those who read and respond to our due process documents and share their views. The input you provide us is both essential to the process of improving accounting and financial reporting and is greatly appreciated.

R. H. Attmore

Robert H. Attmore
Chairman
GASB

listening

Hearing what our stakeholders have to say with thoughtful attention is a prerequisite of our ability to come to the right answers on issues.

An important part of the standard-setting process for both the FASB and the GASB is the collection of feedback and data "post-implementation." The FAF's post-implementation review leader Mark Schroeder (top right) assesses viewpoints during a meeting in the UK with the International Accounting Standards Board's Advisory Council.

leadership

Our constituents expect the FAF, FASB, and GASB to lead the way in developing high-quality accounting standards that, in turn, strengthen confidence in our capital markets, both domestically and abroad.

Elected officials, regulators, and other key stakeholders of the FASB, GASB, and FAF join FAF Trustees at their annual meeting in Washington, DC to engage in expansive dialogue about standard-setting issues.

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Financial Information

Management's Discussion and Analysis

2010 Summary

The mission of the Financial Accounting Foundation (Foundation) and its standard-setting Boards, the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB), is to establish and improve standards of financial accounting and reporting for private sector and state and local governmental entities. Financial accounting and reporting standards help foster and protect investor confidence, facilitate efficient operation of capital markets, and enable citizens to assess the stewardship of public resources by their state and local governments. The Foundation is committed to the development of high-quality financial accounting and reporting standards through an independent and open process that results in useful financial information, considers all stakeholder views, and ensures public accountability.

The Foundation is responsible for the oversight, administration, and finances of the FASB, the GASB, and their advisory councils, the Financial Accounting Standards Advisory Council (FASAC) and the Governmental Accounting Standards Advisory Council (GASAC). The Foundation obtains its funding from sales and licenses of FASB and GASB related publications, accounting support fees for FASB-related operating and capital expenses pursuant to the Sarbanes-Oxley Act of 2002, as amended (Sarbanes-Oxley Act), and voluntary cash contributions in support of the GASB. In 2011, pursuant to the provisions of Section 978(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), the Foundation expects to receive accounting support fees to fund GASB-related operating and capital expenses as further described in the Section entitled "Outlook for 2011." In fulfilling its mission, a fundamental principle of the Foundation is to obtain and deploy prudently the resources needed for the operations of the Foundation, the standard-setting Boards, and the advisory councils, all in a transparent and accountable manner.

The Foundation's net assets of $68.3 million as of December 31, 2010 increased $8.9 million (or 15%) from December 31, 2009, primarily due to increases in net subscription and publication revenue of $5.5 million, and a $1.7 million return on Reserve Fund investments. The increase in net subscription and publication revenue was primarily attributable to the full year effect of product offerings related to the *FASB Accounting Standards Codification®* (FASB Codification), which officially became the source of authoritative nongovernmental US generally accepted accounting principles (GAAP) on July 1, 2009. The FASB Codification is accessible through a specially designed state-of-the-art online platform and retrieval system and can be viewed either through a free *Basic View* or as an online annual paid subscription through the *Professional View*, which provides significantly more advanced navigation and system functions. In 2010, subscriber levels continued to grow for the *Professional View* of the FASB Codification. In addition, the Foundation licenses the content of the FASB Codification to commercial publishers and other licensees for inclusion on their proprietary comprehensive online research systems. Revenue in 2010 from these license agreements increased from 2009 reflecting, (1) the full year effect of a new pricing structure for the FASB Codification licensed product offerings, and (2) an increase in the number of sublicensees. The 2010 results also reflect initial sales of the first edition of the hard copy bound format of the FASB Codification.

Several new and ongoing important initiatives contributed to the 2010 increase in total program and support expenses of $4 million. In early 2010, the Foundation and the FASB began its work on maintenance of the US GAAP Financial Reporting Taxonomy applicable to public issuers registered with the US Securities and Exchange Commission (SEC). This project included establishing a dedicated technical staff and enhancements to the Foundation's information technology infrastructure related to the project. In January 2011, the Foundation made available, pending final acceptance by the SEC, the 2011 US GAAP Taxonomy.

Also in 2010, the Foundation established a process for conducting post-implementation reviews of financial accounting and reporting standards issued by the FASB and the GASB and began to assemble a team that is responsible for this initiative.

Other areas of strategic importance also contributed to the overall increase in expenses in 2010, including: FASB's commitment to achieving convergence of nongovernmental GAAP and International Financial Reporting Standards (IFRS), including work toward completing major projects as outlined in the Memorandum of Understanding issued in 2006 and updated in 2008 (MoU); the establishment of the Blue-Ribbon Panel on Standard Setting for Private Companies to assist the FAF in its review of how accounting standards can better meet the needs of users of private company financial statements; the Foundation's Board of Trustees enhanced oversight of the standard-setting process of the FASB and GASB and continued focus on constituent outreach; and continued efforts to implement GASB funding under the Dodd-Frank Act.

Financial Results

The Foundation's financial statements are presented in accordance with GAAP and reflect the specific reporting requirements of not-for-profit organizations. The following is a discussion of the key highlights of the activities and financial position of the Foundation as presented in the accompanying audited financial statements.

Overview

- Net operating revenue increased to $49.1 million in 2010 from $38.5 million in 2009, reflecting a $5.2 million increase in accounting support fees and a $5.5 million increase in net subscriptions and publications revenue.
- Total program and support expenses increased $4 million to $40.9 million. Program expenses represent approximately 78% and 77% of total expenses in 2010 and 2009, respectively.
- The Foundation ended the year with net operating revenues exceeding expenses by $8.2 million in 2010, compared to $1.6 million in 2009.
- Net assets increased to $68.3 million in 2010 from $59.4 million, an $8.9 million increase primarily resulting from an operating surplus of $8.2 million and investment return on the Reserve Fund of $1.7 million offset by a decrease in net assets for the recognition of non-operating pension related changes of $1.2 million.

Statements of Activities

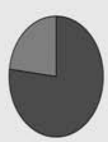
The following charts display the sources of operating revenues and program and support expenses for 2010 and 2009:

	Sources of Operating Revenues	2010
■	Accounting Support Fees	69%
■	Net Subscriptions and Publications	28%
□	Contributions	3%

	Sources of Operating Revenues	2009
■	Accounting Support Fees	75%
■	Net Subscriptions and Publications	21%
□	Contributions	4%

	Expenses	2010
■	Program – Standard Setting	78%
■	Support	22%

	Expenses	2009
■	Program – Standard Setting	77%
■	Support	23%



Accounting Support Fees

The Foundation's most significant source of revenue consists of accounting support fees assessed against issuers of securities, as such issuers are defined in the Sarbanes-Oxley Act. Accounting support fees under the Sarbanes-Oxley Act fund the expenses and other cash requirements for the FASB's standard-setting activities that are included in the Foundation's operating and capital budget for each year – the recoverable expenses. Accounting support fees for 2010 and 2009 totaled $34.1 million and $28.9 million, respectively. The fees assessed to equity and investment company issuers registered with the SEC are based on their relative average monthly US equity market capitalization. Equity issuers with an average market capitalization of over $25 million, and investment company issuers with an average market capitalization or net asset value over $250 million, are assessed a share of the accounting support fees. The Foundation has designated the Public Company Accounting Oversight Board (the PCAOB) as its agent for invoicing and collection of FASB accounting support fees. The Foundation paid approximately $200,000 in both years to the PCAOB for this service.

Contributions

Contributions consist almost entirely of GASB contributions. Sources of these contributions are illustrated below (dollars in thousands).

	Contributions	2010	
■	State Governments	$ 1,000	74%
■	Local Governments	111	8%
■	Other GASB	91	7%
□	Contributed Services	142	11%
	Total	$ 1,344	100%

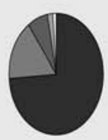
	Contributions	2009	
■	State Governments	$ 1,000	69%
■	Local Governments	162	11%
■	Other GASB	64	4%
□	Contributed Services	236	16%
	Total	$ 1,462	100%

State governments contributed $1 million in both 2010 and 2009, representing the largest source of GASB contributions. Contributions from local governments decreased in 2010, attributable, in part, to the sluggish economy. Contributed services include the value of waived compensation for members of the Board of Trustees. In addition, 2009 results include $40,000 in contributed consulting services relating to the development of the FASB Codification.

Subscriptions and Publications

Subscription and publication revenues of the Foundation in 2010 and 2009 are presented by FASB and GASB product offerings in the charts below. The Foundation's publications revenues are presented in the statements of activities on a combined basis.

FASB Publications	2010	
License Fees	$ 12,068	74%
Subscription Fees	2,711	16%
Codification Bound Volumes	1,098	7%
Pre-Codification Publications	350	2%
Other	244	1%
Total	$ 16,471	100%

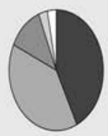


FASB Publications	2009	
License Fees	$ 8,476	68%
Subscription Fees	1,632	13%
Pre-Codification Publications	1,830	15%
Other	521	4%
Total	$ 12,459	100%

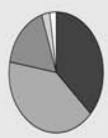
FASB subscription and publication revenues totaled approximately $16.5 million and $12.5 million in 2010 and 2009, respectively. The overall increase in FASB subscription and publication revenues in 2010 is due primarily to the first full year of availability of FASB Codification offerings, as follows:

- License fees continue to represent the largest portion of total FASB subscription and publication revenue, comprising 74% of total subscription and publication activity in 2010. License fee revenue, which is generated based on agreements with commercial publishers and other licensees, increased by 42% in 2010, due to the full year effect of the offerings and associated pricing model for the FASB Codification implemented in July 2009 as well as an overall increase in the number of sublicensees.
- Revenue from subscription plans increased from $1.6 million in 2009 to $2.7 million in 2010. Subscription plans include online access to the *Professional View* of the FASB Codification and *The FASB Subscription*, an annual service that includes a monthly distribution of printed copies of FASB Accounting Standards Updates (ASUs), the vehicle by which the FASB Codification is amended. The increase in 2010 reflects the growth in subscribers to the *Professional View* of the FASB Codification, the first full year of service since inception on July 1, 2009.
- Sales of the initial four-volume bound edition of the FASB Codification began in January 2010 and amounted to $1.1 million for the year.
- Pre-Codification publications included loose-leaf services, which decreased from $1.8 million in 2009 to $318,000 in 2010. The FAF has phased out these services with a final distribution completed in 2010. In addition, this category also included the sales of the bound volumes for the FASB's *Current Text, EITF Abstracts,* and *Original Pronouncements,* which decreased from $754,000 in 2009 to $32,000 in 2010.
- Other publication revenues include the sales of hard copy versions of ASUs, which decreased from $301,000 in 2009, to $75,000 in 2010, and are not expected to be a significant component of revenue going forward, as they are available for free on the FASB website.

GASB Publications	2010	
License Fees	$ 858	43%
Subscription Plans	788	39%
Bound Editions	252	12%
Final Documents	56	3%
Other	68	3%
Total	$ 2,022	100%



GASB Publications	2009	
License Fees	$ 747	37%
Subscription Plans	824	41%
Bound Editions	338	17%
Final Documents	52	3%
Other	49	2%
Total	$ 2,010	100%



In 2010, GASB subscription and publication revenues remained steady at approximately $2 million. License fees increased $111,000 (approximately 15%) to $858,000 in 2010, primarily due to an increase in prices. This increase was offset by decreases in subscription plans and bound editions of $36,000 and $86,000, respectively, reflecting a decrease in demand attributable to the economic environment.

Direct Costs of Subscriptions and Publications
Foundation subscription and publication revenues are reported net of direct costs in the accompanying statements of activities. Direct costs of subscriptions and publications were $4.8 million and $6.3 million in 2010 and 2009, respectively. The decrease in these costs is primarily due to reduction in the level of development costs related to the FASB Codification after it was launched on July 1, 2009.

Program expenses
The Foundation's program expenses totaled $32.0 million in 2010, an increase of $3.5 million, compared to $28.5 million in 2009. Program expenses include salaries, benefits, occupancy, depreciation, professional fees, and certain other operating expenses for the members and research staffs of the FASB and the GASB and their advisory councils, as well as expenses for library services and external relations and communications activities of the Foundation that support the standard-setting Boards. Other operating expenses include domestic and international travel for Board members and staff, costs for holding advisory group and other meetings, library subscriptions and other reference materials, and miscellaneous expenses.

Reflecting the importance of our personnel to achieving the missions of the FASB and the GASB, salaries and employee benefits comprise approximately 83% of the Foundation's program expenditures. In total, salary expense increased by $2.4 million in 2010, primarily due to the increase in staff related to the US GAAP Financial Reporting Taxonomy project (Taxonomy project), other FASB technical positions, and post-implementation review. In addition, program expenses in 2010 include $1.5 million in non-salaried operating costs related to the Taxonomy project.

Support expenses
The Foundation's support expenses totaled $8.9 million in 2010 compared to approximately $8.4 million in 2009. Support expenses include costs for accounting and finance, human resources, facilities management, technology and information systems, legal, development, and general administrative operating assistance provided by the Foundation to its standard-setting Boards and their advisory councils. Support expenses also include amounts related to the Foundation's Board of Trustees' oversight responsibilities. Other operating expenses include travel, meetings, subscriptions, office supplies and miscellaneous expenses.

The overall increase of approximately $500,000 is primarily driven by the Foundation's Board of Trustees increased focus on oversight, governance and constituent outreach.

Pension-related changes not reflected in operating expenses
The Foundation recorded a non-operating decrease in net assets of $1.2 million for 2010, primarily as a result of the increase in the actuarially-determined obligation due to a decrease in the discount rate. In 2009, the Foundation recorded a non-operating increase in net assets of $1.1 million reflecting an increase in the value of plan assets partially offset by a decrease in the discount rate and other actuarial adjustments. Effective December 31, 2008, the Foundation implemented several changes to its pension plans to reduce the Foundation's long-term defined benefit funding and investment risk, and to better position the Foundation to meet its future retirement benefit obligations. As more fully discussed in Note 5 to the financial statements, the Foundation is phasing out all benefit accruals under the defined benefit plans by December 31, 2013.

Investment income
The Foundation's Reserve Fund investments, held in money market and fixed income mutual funds, experienced net investment gains of $1.7 million in 2010, relating primarily to the fixed income fund, compared to a net gain of $3.7 million in 2009. Investment gains in 2009 reflected a significant rebound from a very poor market in 2008, while the 2010 returns reflect a more consistent and expected return for the Reserve Fund investments. The Supplemental Executive Retirement Plan assets, invested approximately 80% in equity and 20% in fixed income mutual funds, experienced net gains of $70,000 and $61,000 in 2010 and 2009, respectively. The Foundation's short-term investments, invested entirely in money market mutual funds in 2010 and 2009, had net gains of $32,000 and $44,000 in 2010 and 2009, respectively.

Statements of Financial Position

Cash, cash equivalents and short-term investments
Cash and cash equivalents include demand deposits with financial institutions and short-term, highly liquid investments. Short-term investments include money market mutual funds. Cash and short-term investments totaled approximately $12.4 million and $10.6 million as of December 31, 2010 and 2009, respectively.

Reserve Fund investments
The Reserve Fund is intended to: (1) provide the Foundation, the FASB and the GASB with sufficient reserves to fund expenditures not funded by accounting support fees or subscription and publication revenues; (2) fund the operations of the Foundation, the FASB, and the GASB during any temporary or permanent funding transition periods; and (3) fund unforeseen contingencies. The Foundation's Trustees have adopted a policy establishing a targeted year-end Reserve Fund balance equal to one year of budgeted expenses for the entire organization, plus a working capital reserve equal to one quarter of net operating expenses for the entire organization (collectively, the target Reserve Fund). If the projected year-end Reserve Fund balance, which is net of short-term investments, exceeds the year-end target Reserve Fund, then the excess is made available to fund the FASB recoverable expenses for the budget year that otherwise would be funded by accounting support fees under the Sarbanes-Oxley Act.

Reserve Fund investments are unrestricted assets of the Foundation and totaled $63.2 million and $54.4 million as of December 31, 2010 and 2009, respectively. The Reserve Fund's assets were invested equally in a money market mutual fund and a short-term, high-credit quality, fixed-income mutual fund. Reserve Fund investments are maintained in accordance with investment policies and guidelines established by the FAF Trustees' Finance and Compensation Committee.

The overall increase of approximately $500,000 is primarily driven by the Foundation's Board of Trustees increased focus on oversight, governance and constituent outreach.

Pension-related changes not reflected in operating expenses

The Foundation recorded a non-operating decrease in net assets of $1.2 million for 2010, primarily as a result of the increase in the actuarially-determined obligation due to a decrease in the discount rate. In 2009, the Foundation recorded a non-operating increase in net assets of $1.1 million reflecting an increase in the value of plan assets partially offset by a decrease in the discount rate and other actuarial adjustments. Effective December 31, 2008, the Foundation implemented several changes to its pension plans to reduce the Foundation's long-term defined benefit funding and investment risk, and to better position the Foundation to meet its future retirement benefit obligations. As more fully discussed in Note 5 to the financial statements, the Foundation is phasing out all benefit accruals under the defined benefit plans by December 31, 2013.

Investment income

The Foundation's Reserve Fund investments, held in money market and fixed income mutual funds, experienced net investment gains of $1.7 million in 2010, relating primarily to the fixed income fund, compared to a net gain of $3.7 million in 2009. Investment gains in 2009 reflected a significant rebound from a very poor market in 2008, while the 2010 returns reflect a more consistent and expected return for the Reserve Fund investments. The Supplemental Executive Retirement Plan assets, invested approximately 80% in equity and 20% in fixed income mutual funds, experienced net gains of $70,000 and $61,000 in 2010 and 2009, respectively. The Foundation's short-term investments, invested entirely in money market mutual funds in 2010 and 2009, had net gains of $32,000 and $44,000 in 2010 and 2009, respectively.

Statements of Financial Position

Cash, cash equivalents and short-term investments

Cash and cash equivalents include demand deposits with financial institutions and short-term, highly liquid investments. Short-term investments include money market mutual funds. Cash and short-term investments totaled approximately $12.4 million and $10.6 million as of December 31, 2010 and 2009, respectively.

Reserve Fund investments

The Reserve Fund is intended to: (1) provide the Foundation, the FASB and the GASB with sufficient reserves to fund expenditures not funded by accounting support fees or subscription and publication revenues; (2) fund the operations of the Foundation, the FASB, and the GASB during any temporary or permanent funding transition periods; and (3) fund unforeseen contingencies. The Foundation's Trustees have adopted a policy establishing a targeted year-end Reserve Fund balance equal to one year of budgeted expenses for the entire organization, plus a working capital reserve equal to one quarter of net operating expenses for the entire organization (collectively, the target Reserve Fund). If the projected year-end Reserve Fund balance, which is net of short-term investments, exceeds the year-end target Reserve Fund, then the excess is made available to fund the FASB recoverable expenses for the budget year that otherwise would be funded by accounting support fees under the Sarbanes-Oxley Act.

Reserve Fund investments are unrestricted assets of the Foundation and totaled $63.2 million and $54.4 million as of December 31, 2010 and 2009, respectively. The Reserve Fund's assets were invested equally in a money market mutual fund and a short-term, high-credit quality, fixed-income mutual fund. Reserve Fund investments are maintained in accordance with investment policies and guidelines established by the FAF Trustees' Finance and Compensation Committee.

Statements of Activities

Years Ended December 31 (dollars in thousands)	2010	2009
Net operating revenue:		
Accounting support fees (Note 2)	$ 34,085	$ 28,854
Contributions:		
FAF (contributed services)	142	236
GASB	1,202	1,226
Total contributions	1,344	1,462
Subscriptions and publications (Note 3)	18,493	14,469
Less - Direct costs of subscriptions and publications (Note 3)	4,786	6,291
Net subscriptions and publications	13,707	8,178
Total net operating revenue	**49,136**	**38,494**
Program expenses:		
Salaries and wages:		
FASB	17,070	14,884
GASB	3,829	3,594
Total salaries and wages	20,899	18,478
Employee benefits (Note 5)	5,505	5,447
Occupancy and equipment expenses (Note 7)	1,069	1,025
Depreciation and amortization	457	180
Professional fees	1,097	1,115
Other operating expenses	2,942	2,291
Total program expenses	**31,969**	**28,536**
Support expenses:		
Salaries and wages	2,639	2,418
Employee benefits (Note 5)	1,116	1,220
Occupancy and equipment expenses (Note 7)	695	675
Depreciation and amortization	573	458
Professional fees	2,585	2,500
Other operating expenses	1,315	1,130
Total support expenses	**8,923**	**8,401**
Total program and support expenses	**40,892**	**36,937**
Net operating revenue greater than expenses	**8,244**	**1,557**
Short-term investment income (Note 4)	32	44
Supplemental Pension Plan investment income	70	61
Reserve Fund investment income (Note 4)	1,719	3,708
Pension-related changes not reflected in operating expenses (Note 5)	(1,169)	1,097
Increase in net assets	**8,896**	**6,467**
Net assets at beginning of year	**59,394**	**52,927**
Net assets at end of year	**$ 68,290**	**$ 59,394**

See accompanying notes to these financial statements.

Statements of Financial Position

As of December 31 (dollars in thousands)	2010	2009
Current assets:		
Cash and cash equivalents	$ 4,237	$ 2,835
Short-term investments (Note 4)	8,158	7,758
Pledged contributions receivable	25	25
Subscription, publication and all other receivables (net of allowance for doubtful accounts of $93 and $94)	3,174	2,564
Inventories	96	73
Prepaid expenses and all other current assets	358	234
Total current assets	**16,048**	**13,489**
Noncurrent assets:		
Reserve Fund investments (Note 4)	63,215	54,409
Supplemental Pension Plan investments (Note 5)	819	478
Furniture, equipment and leasehold improvements, net (Note 6)	2,576	2,094
Total noncurrent assets	66,610	56,981
Total assets	**$ 82,658**	**$ 70,470**
Current liabilities:		
Accounts payable and accrued expenses	$ 2,313	$ 1,172
Accrued payroll and related benefits	827	771
Unearned publication and other deferred revenues	6,642	3,363
Total current liabilities	**9,782**	**5,306**
Noncurrent liabilities:		
Accrued pension costs (Note 5)	2,954	3,424
Accrued postretirement health care costs (Note 5)	623	893
Accrued rent expense (Note 7)	973	1,412
Unearned publication and other deferred revenues - long-term	36	41
Total noncurrent liabilities	**4,586**	**5,770**
Total liabilities	**14,368**	**11,076**
Net assets - unrestricted	**68,290**	**59,394**
Total liabilities and net assets	**$ 82,658**	**$ 70,470**

See accompanying notes to these financial statements.

Statements of Cash Flows

Years Ended December 31 (dollars in thousands)	2010	2009
Cash flows from operating activities:		
Cash received from contributors	$ 1,202	$ 1,227
Cash received from publication sales	21,157	13,392
Cash received from accounting support fees	34,101	28,807
Cash received from interest and dividends on investments	1,174	1,375
Cash paid to vendors, employees and benefit plans	(45,587)	(42,115)
Net cash provided by operating activities	**12,047**	**2,686**
Cash flows from investing activities:		
Proceeds from sales of Reserve Fund investments	16,913	18,438
Purchases of Reserve Fund investments	(25,147)	(19,453)
Proceeds from sales of short-term investments	1,000	8,250
Purchases of short-term investments	(1,400)	(8,980)
Proceeds from sales of Supplemental Pension Plan investments	1	102
Purchases of Supplemental Pension Plan investments	(284)	(156)
Purchases of furniture, equipment and leasehold improvements	(1,728)	(793)
Net cash used in investing activities	**(10,645)**	**(2,592)**
Net increase in cash and cash equivalents	1,402	94
Cash and cash equivalents at beginning of period	2,835	2,741
Cash and cash equivalents at end of period	**$ 4,237**	**$ 2,835**
Reconciliation of increase in net assets to net cash provided by operating activities:		
Increase in net assets for the period	$ 8,896	$ 6,467
Adjustments required to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	1,247	1,093
Net realized and unrealized gains on Reserve Fund investments	(573)	(2,386)
Net realized and unrealized gains on Supplemental Pension Plan investments	(58)	(51)
(Credit) provision for losses on accounts receivable	(19)	31
Increase in contribution, subscription and all other receivables	(591)	(164)
(Increase) decrease in inventories	(23)	99
(Increase) decrease in all prepaid expenses	(124)	54
Increase (decrease) in accounts payable and employee benefit accruals	457	(1,952)
Increase (decrease) in unearned publication and other deferred revenues	3,274	(131)
Decrease in accrued rent expense	(439)	(374)
Total adjustments	**3,151**	**(3,781)**
Net cash provided by operating activities	**$ 12,047**	**$ 2,686**
Supplemental Information		
Noncash charges (credits) included in the Statements of Activities:		
Pension-related changes not reflected in operating expenses	$ 1,169	$ (1,097)

See accompanying notes to these financial statements.

Notes to Financial Statements

1. Nature of Activities and Summary of Significant Accounting Policies

Activities

The Financial Accounting Foundation (the Foundation), organized in 1972, is an independent, private-sector non-stock corporation which is responsible for the oversight, administration, finances and selection of the members of:

- The Financial Accounting Standards Board (FASB), which establishes standards of financial accounting and reporting for private-sector enterprises, and the Financial Accounting Standards Advisory Council.
- The Governmental Accounting Standards Board (GASB), which establishes standards of financial accounting and reporting for state and local governmental entities, and the Governmental Accounting Standards Advisory Council.

The Foundation is incorporated under Delaware General Corporation Law to operate exclusively for charitable, educational, scientific and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, as amended. The Foundation presently obtains its funding from accounting support fees pursuant to the Sarbanes-Oxley Act of 2002, as amended (the Sarbanes-Oxley Act) in support of the FASB, subscription and publication revenues, and voluntary cash contributions in support of the GASB.

Summary of Significant Accounting Policies

Presentation

The accompanying financial statements have been prepared in accordance with US generally accepted accounting principles.

The statements of activities are based on the concept that standard setting is the sole program of the Foundation. These statements set forth separately, where appropriate, revenues, costs of sales and certain program expenses of the FASB and the GASB, giving recognition to their distinct responsibilities as described in the Foundation's Certificate of Incorporation and By-Laws. Program expenses include salaries, benefits and other direct operating expenses for the members and research staffs of the respective Standards Boards and Councils, as well as costs for the library services and external relations and communications activities of the Foundation which support the Boards. Additional Foundation services for accounting and finance, human resources, facilities management, technology and information systems, legal, development and general administrative operating assistance have been reflected as support expenses in the accompanying statements of activities. Fund-raising expenses included in these statements totaled approximately $59,000 in 2010 and $92,000 in 2009.

The Foundation is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted, temporarily restricted and permanently restricted net assets. None of the net assets of the Foundation are subject to any donor-imposed restrictions, and therefore they have all been classified as unrestricted.

Use of Estimates

The preparation of financial statements requires management to formulate estimates and assumptions that may affect the reported amounts of assets and liabilities at the dates of those statements and revenues and expenses for the reporting periods. Significant estimates made by management include actuarially-determined employee benefit liabilities and fair value of investments. Actual results could differ from those estimates.

Accounting Support Fees

The Foundation recognizes accounting support fee revenue in the year for which those accounting support fees have been assessed to issuers as prescribed by the Sarbanes-Oxley Act. See Note 2 for further information regarding accounting support fees.

Contributions

The Foundation has reported all contributions as an increase in unrestricted net assets. Temporarily restricted contributions, if any, whose restrictions are met in the year the contributions are received, are reported as unrestricted contributions. Many individuals contribute significant amounts of time to the activities of the Foundation, the Standards Boards and their Advisory Councils without being compensated. These individuals include certain members of the Foundation's Board of Trustees and participants of the following groups: FASAC and GASAC, the FASB's Emerging Issues Task Force and various other FASB and GASB councils, committees, task forces and working groups on technical projects. Many others participate in the Standards Boards' processes by sending comment letters, appearing at public hearings and roundtable meetings, and taking part in field visits and field tests. Members of the Board of Trustees are eligible for compensation for their services, with each having the ability to waive such compensation. The accompanying financial statements reflect the value of waived Trustee compensation, which meets the recognition criteria for contributed services. The other services described above have not been deemed to meet the recognition criteria, and therefore, are not reflected in the accompanying financial statements. The value of contributed services for the Foundation recognized in the accompanying statements of activities was approximately \$142,000 and \$236,000 in 2010 and 2009, respectively.

Subscription Plans, Loose-Leaf Subscription Services and Electronic License Agreements

Revenues from these publication sources are recognized over the life of the applicable subscription service or license period, typically one year. Costs for the production of updates and for fulfillment are charged to expenses as incurred.

Cash and Cash Equivalents

For financial statement purposes, the Foundation considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. The carrying value of these investments approximates fair value due to the nature of the investments and the maturity period. Cash and cash equivalents do not include any money market mutual fund investments included in short-term investments and the Reserve Fund portfolio at December 31, 2010 and 2009.

Investments

The Foundation's investments are recorded at fair value. Investments in shares of mutual funds are valued according to the quoted net asset values of the funds on the basis of fair values of the assets and liabilities thereof. Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis and dividends are recorded on the ex-dividend date. Net appreciation (depreciation) includes gains and losses on investments bought and sold as well as held during the year.

Concentration of Credit Risk

Financial instruments that potentially subject the Foundation to concentrations of credit risk consist principally of cash and cash equivalents, short-term investments and Reserve Fund investments. The Foundation's short-term investments and Reserve Fund investments are held in various money market and fixed income mutual funds with a single high credit quality financial institution. The Foundation has not experienced, nor does it anticipate, any credit risk related losses in such accounts.

Subscription, Publication and All Other Receivables

Subscription, publication and all other receivables are carried at the amount billed, net of the allowance for doubtful receivables. The allowance for doubtful accounts is estimated based on management's review of historical experience and current economic conditions.

Inventories

Certain publications and other related items held for resale are included in inventories and carried at the lower of cost or market, with cost determined by the first-in, first-out method.

Employee Benefit Plans

The Foundation sponsors a postretirement health care plan and two defined benefit pension plans. See Note 5 for a full description of these plans.

Sponsors of single-employer defined benefit pension or other postretirement plans are required to recognize the funded status of those plans as an asset or liability in the statement of financial position, and to recognize changes in the funded status in the statement of financial position in the year in which the changes occur. In the case of a not-for-profit organization (such as the Foundation), those changes are reflected in unrestricted net assets. Information with respect to the funded positions of each of the Foundation's pension and other postretirement plans at December 31, 2010 and 2009 can be found in the accompanying statements of financial position.

Furniture, Equipment and Leasehold Improvements

Furniture, equipment and leasehold improvements are reported in the financial statements at cost, less accumulated depreciation and amortization determined under the straight-line method. Furniture and equipment are depreciated over their estimated useful lives, ranging from 3 to 10 years. Leasehold improvements are amortized over periods not extending beyond the termination dates of the leases for office space.

Income Taxes

The Foundation is a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code. Tax positions for open tax years were reviewed and it was determined that no provision for uncertain tax positions is required. The Foundation is currently open to audit under the statute of limitations by the Internal Revenue Service and state taxing authorities for the years ending December 31, 2007 through 2009.

Reclassifications

Certain reclassifications have been made to prior year amounts to conform to the current year's presentation.

Subsequent Events

The Foundation has evaluated subsequent events through March 28, 2011, the date through which the financial statements are available to be issued, and determined that no subsequent events have occurred that require adjustment or disclosure in the financial statements.

2. Accounting Support Fees

The Sarbanes-Oxley Act provides for funding of FASB's recoverable expenses through accounting support fees assessed against and collected from issuers of securities, as those issuers are defined in the Sarbanes-Oxley Act. The accounting support fees provide funding for expenses associated with FASB's standard-setting activities as identified in the Foundation's operating and capital budget for each calendar year. The calculation of FASB's recoverable expenses also reflects adjustments for non-cash expenses and certain cash requirements not reflected in the statements of activities. The accounting support fees recognized and related FASB expenses included in the statement of activities for the past two years are as follows (dollars in thousands):

Years ended December 31	2010	2009
Accounting Support Fees:		
For US-based entities	$ 32,678	$ 27,642
For non-US-based entities	1,407	1,212
Total Accounting Support Fees	**34,085**	**28,854**
FASB Program expenses:		
Salaries and wages	17,070	14,884
Employee benefits	4,410	4,314
Occupancy and equipment expenses	845	807
Depreciation and amortization	450	172
Professional fees	950	1,058
Other operating expenses	2,637	2,006
Total FASB Program expenses	**26,362**	**23,241**
FASB Support expenses:		
Salaries and wages	2,136	1,945
Employee benefits	899	977
Occupancy and equipment expenses	552	541
Depreciation and amortization	525	421
Professional fees	1,403	1,284
Other operating expenses	956	737
Total FASB Support expenses	**6,471**	**5,905**
Total FASB Program and Support Expenses	**$ 32,833**	**$ 29,146**
Operating revenue greater (less) than FASB Program and Support Expenses	**$ 1,252**	**$ (292)**

The expenses described above include the FASB's allocable share of Foundation program and support expenses. Foundation expenses are incurred for the common benefits of the FASB and GASB.

The amounts by which total FASB recoverable expenses, as defined, exceed accounting support fees are funded from Reserve Fund balances. Any differences between FASB recoverable expenses and the amount of accounting support fees recognized as revenues for an applicable calendar year (to the extent that the differences were not financed from Reserve Fund balances) would be incorporated into the calculation of accounting support fees in subsequent years. The amount of accounting support fees is established annually based upon the Foundation's budgeted recoverable expenses for the FASB, and any projected Reserve Fund balance for that budget year deemed available to fund those expenses. The accounting support fees are also subject to review by the United States Securities and Exchange Commission each year.

3. Subscriptions and Publications

Subscription and publication operating revenues and costs consist of the following (dollars in thousands):

Years ended December 31	2010	2009
Subscription and Publication Revenues:		
FASB Publications	$ 16,471	$ 12,459
GASB Publications	2,022	2,010
	$ 18,493	**$ 14,469**
Direct Costs:		
FASB Publications	$ 2,357	$ 4,780
GASB Publications	206	179
Foundation administrative support	2,223	1,332
	$ 4,786	**$ 6,291**
Net Subscription and Publication Revenues:		
FASB Publications	$ 14,114	$ 7,679
GASB Publications	1,816	1,831
Foundation administrative support	(2,223)	(1,332)
	$ 13,707	**$ 8,178**

4. Investments and Investment Income

Investments

The following table presents investments measured at fair value, all of which are measured using Level 1 inputs, which are defined as quoted market prices in active markets for identical investments at the measurement date (dollars in thousands):

At December 31	2010	2009
Short-term:		
Money market mutual fund	$ 8,158	$ 7,758
Reserve Fund:		
Fixed income mutual fund	$ 31,656	$ 27,178
Money market mutual fund	31,559	27,231
	$ 63,215	**$ 54,409**

Investment Income (dollars in thousands):

Years ended December 31	2010	2009
Short-Term:		
Interest and dividends	$ 32	$ 44
Reserve Fund:		
Interest and dividends	$ 1,129	$ 1,322
Net realized and unrealized gains	590	2,386
Total Reserve Fund Investment Income	**$ 1,719**	**$ 3,708**

Changes in the Reserve Fund balance for the past two years are as follows (dollars in thousands):

Years ended December 31	2010	2009
Fund balance, beginning of year	$ 54,409	$ 51,008
Transfers from operations, net	9,365	290
Transfers for retirement benefit plans	(2,278)	(597)
Investment income	1,719	3,708
Fund balance, end of year	**$ 63,215**	**$ 54,409**

Reserve Fund assets are unrestricted and maintained within the investment policies and guidelines for the Fund established by the Finance and Compensation Committee of the Board of Trustees.

5. Employee Benefits

Employee benefits expense consists principally of employer payroll taxes, health care benefits for active and retired employees, and pension costs.

Pension Plans

The Foundation sponsors a contributory defined contribution plan (the Employees' Tax Sheltered Annuity Plan), and two defined benefit pension plans (the Employees' Pension Plan and the Supplemental Executive Retirement Plan, collectively the Defined Benefit Plans). Employees do not contribute to the Defined Benefit Pension Plans.

Employee benefits expense in the accompanying statements of activities includes $2,102,000 and $1,894,000 for 2010 and 2009, respectively, related to the defined contribution plan. Employer contributions to the plan vest after 1.5 years of service and are based on the employee's earnings level, with incremental increases based on the employee's age.

The Defined Benefit Plans were amended effective January 1, 2008, to close the plans to all new hires and to phase out accruals thereunder for all participating employees by no later than December 31, 2013.

Postretirement Health Coverage Plan

The Foundation sponsors a postretirement health coverage plan (Postretirement Plan) for all eligible retirees of the Foundation with benefits varying based on retirement age and years of service. The Foundation funds retiree health care benefits through a Grantor Trust.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Prescription Drug Act) established a prescription drug benefit under Medicare as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. The Foundation's accumulated postretirement benefit obligation in 2009 includes the effect of the Medicare Part D subsidy of approximately $373,000, reflected as a decrease in the accumulated postretirement benefit obligation in 2009. The reduction in the obligation has been treated as an actuarial gain and is included in pension related changes in 2009.

The following table sets forth the amounts recognized in the statements of financial position, the change in benefit obligations, the change in plan assets, funded status, and other information for the pension plans and postretirement benefit plan:

	Defined Benefit Plans		Postretirement Plan	
	2010	2009	2010	2009
Change in benefit obligations				
Benefit obligation, beginning of year	**$ 17,972**	**$ 14,490**	**$ 6,909**	**$ 6,872**
Service cost	525	460	304	329
Interest cost	1,012	882	390	422
Actuarial (gains) losses	1,241	3,182	702	(423)
Benefits paid	(638)	(1,042)	(414)	(424)
Retiree contributions	–	–	124	133
Benefit obligation, end of year	**$ 20,112**	**$ 17,972**	**$ 8,015**	**$ 6,909**
Change in plan assets				
Fair value of plan assets, beginning of year	**$ 14,548**	**$ 11,083**	**$ 6,016**	**$ 4,483**
Employer contributions	2,942	1,655	826	766
Retiree contributions	–	–	124	133
Actual investment income on plan assets	306	2,750	840	1,058
Benefits paid	(638)	(940)	(414)	(424)
Fair value of plan assets, end of year	**17,158**	**14,548**	**7,392**	**6,016**
Funded Status at end of year	**(2,954)**	**(3,424)**	**(623)**	**(893)**
Amounts recognized in the financial statements	**$ (2,954)**	**$ (3,424)**	**$ (623)**	**$ (893)**
Amounts recognized as pension related changes not reflected as operating expenses:				
Net actuarial (gains) losses	$ 2,053	$ 1,271	$ 335	$ (1,061)
Amortization of net actuarial gains	(1,066)	(1,008)	(281)	(417)
Amortization of net prior service costs (credits)	166	176	(38)	(58)
	$ 1,153	**$ 439**	**$ 16**	**$ (1,536)**
Amounts not yet recognized as components of net periodic benefit costs				
Net actuarial losses	$ 10,461	$ 9,474	$ 3,260	$ 3,205
Net prior service costs (credits)	(1,126)	(1,293)	170	208
	$ 9,335	**$ 8,181**	**$ 3,430**	**$ 3,413**
Amounts expected to be recognized during the year ended December 31, 2011:				
Amortization of net actuarial losses	$ 1,200	$ 1,067	$ 38	$ 38
Amortization of net prior service costs (credits)	(166)	(167)	286	281
	$ 1,034	**$ 900**	**$ 324**	**$ 319**

The Foundation has established a Grantor Trust pursuant to Section 457(f) of the Internal Revenue Code, as amended, for the benefit of its Supplemental Executive Retirement Plan. During the years ended December 31, 2010 and 2009, employer contributions of $271,000 and $146,000, respectively, were made to the Trust. Grantor Trust assets of $819,000 and $478,000 as of December 31, 2010 and 2009, respectively, have been classified as Supplemental Plan investments on the accompanying statements of financial position, and accordingly, are not included in the change in plan assets table above due to the nature of the assets. The investments include mutual funds with asset allocations substantially the same as the Postretirement Plan, as described in the Plan Assets section below, and are considered all Level 1 fair value measurements, as defined.

Assumptions

The principal actuarial assumptions used to determine periodic benefit costs and benefit obligations for the Defined Benefit Plans and Postretirement Plan are as follows:

Defined Benefit Plans	2010	2009
Discount rate (benefit obligations)	5.25%	5.75%
Discount rate (net periodic expense)	5.25%	5.75%
Expected return on plan assets	6.00%	7.50%
Rate of compensation increase	3.50%	3.0% for 2010 4.5% 2011-2013

Postretirement Plan	2010	2009
Discount rate (benefit obligations)	5.25%	5.75%
Discount rate (net periodic expense)	5.25%	6.25%
Expected return on plan assets	7.50%	7.50%
Health care cost trend rate	8.00%	8.50%

The current health care cost trend rate assumption reflects market conditions, historical health care inflation, future expectations of that inflation and the Foundation's most recent cost experience. The assumed health care rate declines gradually to an ultimate level of 5.0 % after 2017.

The expected long-term rate of return on plan assets assumptions was based upon a review of historical returns and expectations and capabilities of future market performance.

Plan Assets

Investment objectives and policies for the plan assets are established by the Finance and Compensation Committee (the Committee) of the Foundation. The overall long-term investment strategy for the Employees' Pension Plan and Postretirement Plan is to generate returns sufficient to meet obligations of beneficiaries at acceptable levels of risk by maintaining a high standard of portfolio quality and achieving proper diversification. The Committee has retained a professional investment manager for the assets of the Foundation employee benefit plans that maintains discretion over investment decisions, within asset allocation ranges recommended by the Committee.

In 2010, the Committee revised the asset allocation policy for the Employees' Pension Plan. Decisions regarding the asset allocation will be based upon the funded status of the plan, valuation of the liability, and the returns and risks relative to the liability. The target allocations for the Employees' Pension Plan were 20 percent equities and 80 percent long-term fixed income as of December 31, 2010. The asset allocation ranges for the Postretirement Plan, which remain unchanged from 2009, are 65 to 80 percent of the portfolio's market value in equity investments (which includes a 15 to 25 percent range for international stocks of the equity holdings) and 20 to 35 percent in fixed income investments.

The assets under the Employees' Pension Plan and Postretirement Plan were invested in mutual funds at December 31, 2010 and 2009, the majority of which were indexed. The following table presents the fair value of major categories of plan assets, all of which are measured using Level 1 inputs, as defined (dollars in thousands):

Fair Value of Plan Assets at December 31 (all Level 1)	Employees' Pension Plan 2010	2009
Mutual Funds:		
US equity funds (a)	$ 1,527	$ 8,250
International equity index fund (b)	1,937	2,222
Fixed income funds (c)	13,638	2,598
Balanced fund (d)	–	1,425
Cash held by investment manager	56	53
Total	**$ 17,158**	**$ 14,548**

Fair Value of Plan Assets at December 31 (all Level 1)	Postretirement Plan 2010	2009
Mutual Funds:		
US equity funds (a)	$ 4,104	$ 3,363
International equity index fund (b)	1,077	891
Fixed income funds (c)	1,478	1,172
Balanced fund (d)	733	590
Total	**$ 7,392**	**$ 6,016**

Descriptions of Funds

(a) These funds invest in small, mid, and large-cap companies from diversified industries using a blend of growth and value strategies and index sampling.

(b) This fund is passively managed and seeks to track the performance of international composite indexes. It has broad exposure across developed and emerging non-US equity markets. Approximately 50% is invested in European companies.

(c) These funds are passively managed using index sampling and consist of short-term, intermediate-term, long-term and extended duration mutual funds.

(d) This fund invests in S&P 500 Index stocks, long-term US Treasury bonds, and money market instruments.

Net Periodic Benefit Expense

The components of net periodic benefit expense for the past two years are as follows (dollars in thousands):

Defined Benefit Plans	2010	2009
Service cost	$ 525	$ 460
Interest cost	1,012	882
Expected return on plan assets	(1,118)	(840)
Amortization of prior period actuarial losses	1,066	1,008
Amortization of prior service costs	(166)	(176)
Net periodic benefit expense	**$ 1,319**	**$ 1,334**

Postretirement Plan	2010	2009
Service cost	$ 304	$ 329
Interest cost	390	422
Expected return on plan assets	(472)	(420)
Amortization of prior period actuarial losses	281	417
Amortization of prior service costs	37	58
Net periodic benefit expense	**$ 540**	**$ 806**

Gains and losses that result from changes in actuarial assumptions, and from actual experience which differs from that assumed, are amortized over the employees' estimated average future working lifetime. Any prior service costs due to plan amendments are also amortized over the estimated average working lifetime.

The following benefit payments, which reflect expected future service, are projected to be paid under the Foundation's benefit plans, including the amounts of Medicare Part D subsidies for the Postretirement Plan (dollars in thousands):

		Postretirement Plan		
Year ended December 31	Defined Benefit Pension	Gross	Medicare Part D	Net
2011	$ 936	$ 265	$ 14	$ 251
2012	1,221	297	16	281
2013	1,329	321	17	304
2014	1,426	344	18	326
2015	1,114	382	20	362
2016 – 2020	6,770	2,517	112	2,405

The Foundation expects to contribute approximately $1,014,000, $177,000 and $570,000 to its Employees' Pension Plan, Supplemental Executive Retirement Plan and Postretirement Healthcare Plan, respectively, during 2011.

6. Furniture, Equipment and Leasehold Improvements

At December 31 (dollars in thousands)	2010	2009
Furniture and equipment	$ 11,396	$ 9,676
Leasehold improvements	3,662	3,655
	15,058	13,331
Accumulated depreciation and amortization	(12,482)	(11,237)
	$ 2,576	**$ 2,094**

7. Lease Commitments

The Foundation occupies office space under an operating lease that expires on September 30, 2012. Total rental expense for office space and equipment amounted to $1,581,000 and $1,532,000 in 2010 and 2009, respectively. Accrued rent expense attributable to escalating minimum lease payments, initial rent abatement and a leasehold improvement allowance totaled $973,000 and $1,412,000 at December 31, 2010 and 2009, respectively, and is reflected in liabilities in the accompanying statements of financial position. The rent expense liability is being amortized over the remaining term of the applicable operating lease.

Future minimum payments under operating leases for office space, including the Foundation's current share of real estate taxes and other operating costs, are as follows (dollars in thousands):

Year ended December 31	
2011	$ 2,079
2012	1,584
Total minimum lease payments	**$ 3,663**

Management's Report on Financial Responsibility and Internal Controls

Management of the Financial Accounting Foundation is responsible for the preparation of the accompanying financial statements, and for the fairness and accuracy of the financial information included in this annual report. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Management is also responsible for establishing and maintaining an adequate internal control structure and adequate procedures for financial reporting. The Foundation maintains a system of internal controls designed to ensure the integrity, objectivity and overall effectiveness of the accounting and financial reporting process.

The Board of Trustees of the Foundation, through its Audit and Compliance Committee, oversees: (1) the organization's financial and accounting policies and reports; (2) the organization's internal control over financial reporting; (3) the system of accounting and related internal controls and the competence of persons performing key functions within that system; and (4) the scope and results of independent audits, including any comments received from auditors on the adequacy of internal controls and quality of financial reporting. The Foundation's auditors render an objective, independent opinion annually on the organization's financial statements, and they have free and direct access to discuss matters with the Audit and Compliance Committee, with and without the presence or knowledge of management. The auditors are engaged by and report directly to the Audit and Compliance Committee.

The Foundation's Audit and Compliance Committee has chosen to follow requirements issued for public companies by the New York Stock Exchange, the Securities and Exchange Commission and other securities regulators by developing and maintaining a charter governing its operations. Although the Foundation is not a public company, the Committee has concluded that the organization should voluntarily comply with public company recommendations and regulations where appropriate. The Audit and Compliance Committee charter identifies the key objectives, functions, operating practices, membership requirements, and duties and responsibilities of the Committee. The responsibilities include regularly reviewing the charter to identify areas in need of enhancement, expansion and/or clarification. The voluntary compliance effort has continued with respect to the audit committee and internal control provisions of the Sarbanes-Oxley Act of 2002, and the related Securities and Exchange Commission and Public Company Accounting Oversight Board guidance. The Foundation has completed its compliance plan with respect to internal controls over accounting and financial reporting (as addressed for public companies by Section 404 of the Sarbanes-Oxley Act). The Audit and Compliance Committee's charter is available through the office of the Foundation's President.

Management of the Foundation is responsible for establishing and maintaining adequate internal control over financial reporting. The Foundation's internal controls are designed to provide reasonable assurance as to the reliability of the entity's financial statements for external purposes. Internal control over financial reporting does have inherent limitations and may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable, and not absolute, assurance with respect to financial statement preparation and presentation. Also, due to changing conditions, the effectiveness of internal control over financial reporting may vary over time, and certain controls may prove to be inadequate.

Under the supervision and with the participation of other members of management, we have evaluated the effectiveness of the Foundation's internal control over financial reporting as of December 31, 2010. In making this assessment, we have utilized the internal control framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control — Integrated Framework. We have concluded that, based upon our evaluation, the Foundation's internal control over financial reporting was effective as of December 31, 2010.

The Trustees have also adopted, and regularly monitor, personnel policies designed to ensure that employees of the Foundation are free of conflicts of interest. Finally, to facilitate open communication, the Trustees, through the Audit and Compliance Committee, have adopted, and regularly monitor, an ombuds policy designed to provide an independent resource for reporting integrity or compliance concerns.

John J. Brennan	**Teresa S. Polley**
Chairman	*President &*
FAF Board of Trustees	*Chief Executive Officer*
	FAF

Independent Auditor's Report

To the Board of Trustees of the Financial Accounting Foundation

We have audited the accompanying statements of financial position of the Financial Accounting Foundation as of December 31, 2010 and 2009, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Financial Accounting Foundation as of December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

McGladrey & Pullen, LLP

McGladrey & Pullen, LLP
New Haven, Connecticut
March 28, 2011

Financial Accounting Foundation

Financial Accounting Standards Board

www.fasb.org

Governmental Accounting Standards Board

www.gasb.org

Financial Accounting Foundation

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800.748.0659
fasbpubs@fasb.org (for FASB publications)
gasbpubs@gasb.org (for GASB publications)

Students at Florida State University's College of Business in Tallahassee take advantage of an outreach opportunity to debate accounting issues affecting academia with FASB member Tom Linsmeier.

Design: The Wyant Simboli Group, Inc. **Interior Photography:** Bruce Ando, Mike Geissinger, Alex Griffiths, Chris Hamilton, Michael LeGrand, John Simboli

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www.accountingfoundation.org

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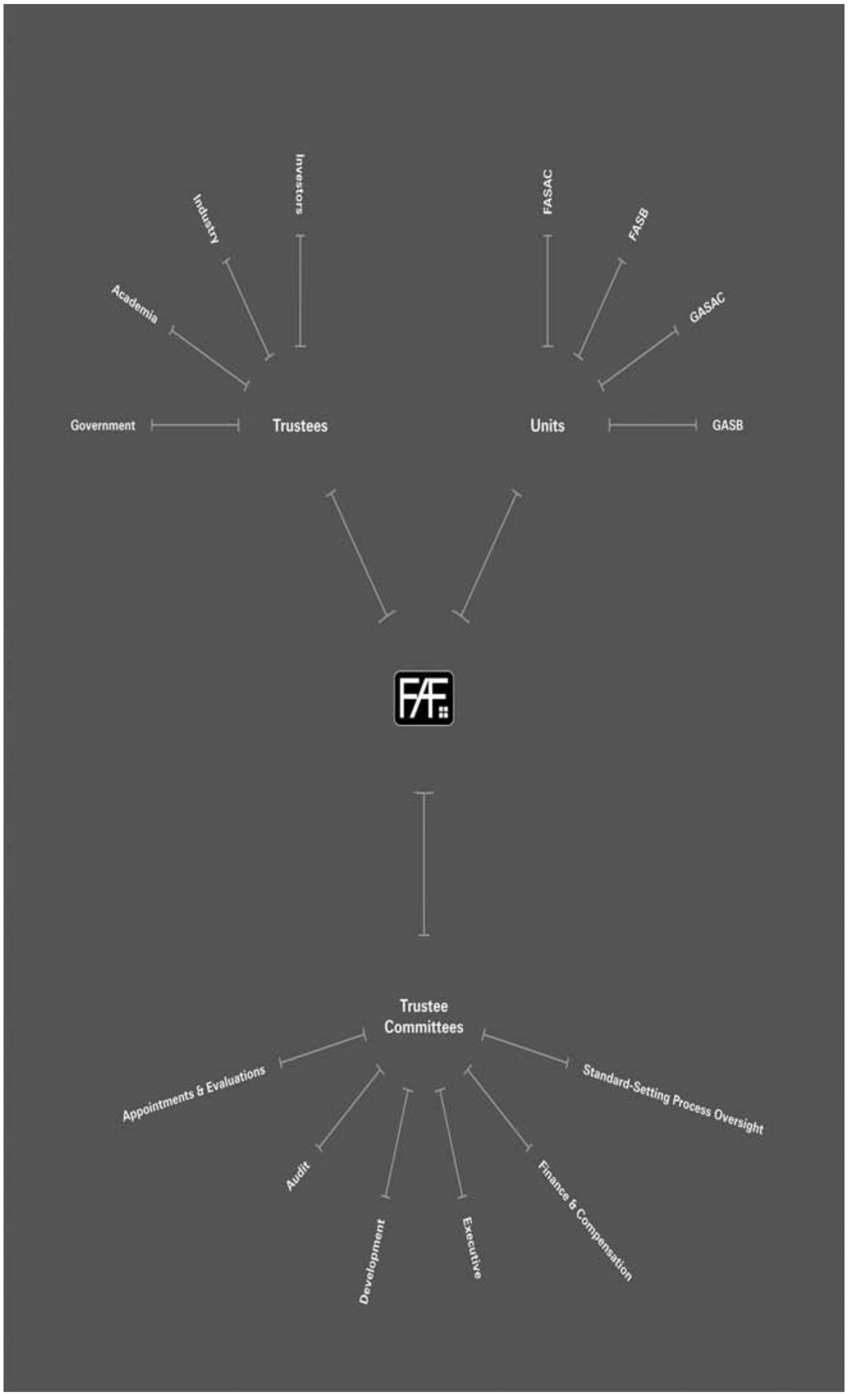
Financial Accounting Foundation

2009 Annual Report


Investors
Industry
Academia
Government
Trustees
FASAC
FASB
GASAC
Units
GASB
Trustee Committees
Appointments & Evaluations
Audit
Development
Executive
Finance & Compensation
Standard-Setting Process Oversight

Organization

The Financial Accounting Foundation (FAF) is at the center of the mission to protect the independence and integrity of the standard-setting process. The adjoining chart (left) illustrates the interaction between FAF and its organizations.

Organized in 1972, FAF is a non-stock Delaware corporation that operates exclusively for charitable, educational, scientific, and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code. Based in Norwalk, Connecticut, the FAF is responsible for the oversight, administration, and finances of its standard-setting Boards and their Advisory Councils (the "Boards and Councils"):

Financial Accounting Standards Board
The Financial Accounting Standards Board (FASB), which began operations in 1973, establishes standards of financial accounting and reporting for private sector entities, including businesses and not-for-profit organizations. Those standards are recognized as generally accepted and authoritative.

Governmental Accounting Standards Board
The Governmental Accounting Standards Board (GASB), organized in 1984, establishes standards of financial accounting and reporting for state and local governmental entities. GASB pronouncements are recognized as generally accepted and authoritative.

Financial Accounting Standards Advisory Council
The Financial Accounting Standards Advisory Council (FASAC) enhances the standard-setting process by consulting with the FASB on technical issues, project priorities, and other matters likely to concern the FASB.

Governmental Accounting Standards Advisory Council
The Governmental Accounting Standards Advisory Council (GASAC) enhances the standard-setting process by consulting the GASB on technical issues, project priorities, and other matters likely to concern the GASB.

The capital markets and state and local governments are comprised of many participants with both overlapping and disparate requirements and proprietary interests. As independent entities without a political or commercial stake in a particular outcome, the FAF's standard-setting Boards provide objectivity and integrity to our country's financial reporting system. Independence is fundamental to the standard-setting Boards' activities because their work is intended to provide investors and other users of financial reports with unbiased standards free of influence from special interests.

The FAF consists of a 14-to-18-member Board of Trustees (the current Board stands at 16 members). Three members of the Board serve as "Governmental Trustees" and have extensive experience as financial officers or as elected officials of state or local governmental entities. The remaining Trustees serve as "At-large Trustees," with backgrounds in investment, industry, public accounting, and academia.

As part of their five-year terms, FAF Trustees serve on at least one of six Committees that are an important part of FAF's administrative responsibilities. Committees include:

- Appointments & Evaluations
- Audit
- Development
- Executive
- Finance & Compensation
- Standard-Setting Process Oversight

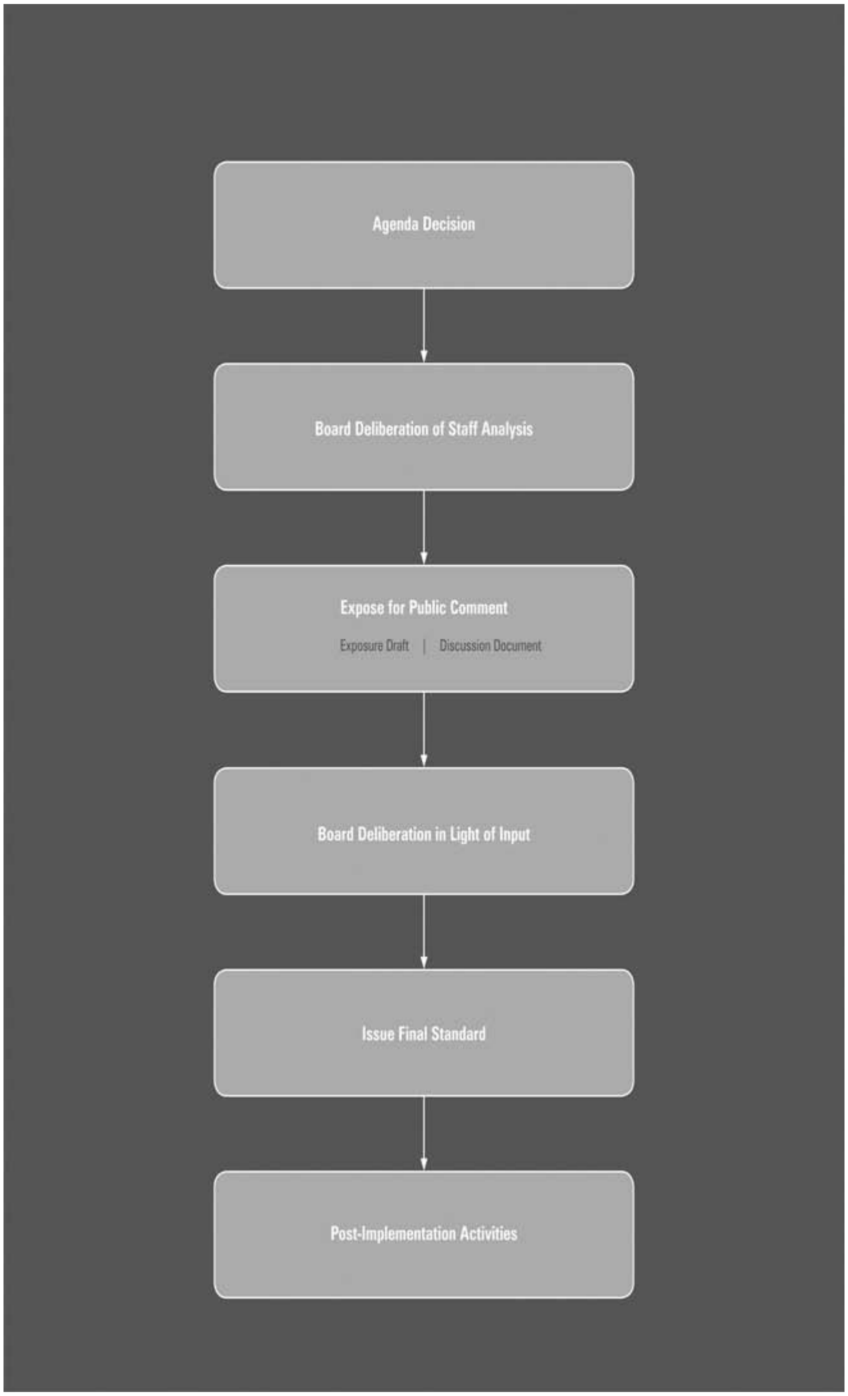
The Standard-Setting Process

Our process ensures that Board members have the information they need to make informed judgments. The FASB and GASB have established the following procedures for developing accounting standards. These procedures are used for major projects. Not all of the steps may be necessary for projects focused on narrower application and implementation issues. Many other steps are followed during the course of the project that are not specifically required by the Board's Rules of Procedure.

- The FASB/GASB receives requests/recommendations for possible projects and reconsideration of existing standards from various sources.
- Following research and consultation with Board members, the FASB/GASB Chairman decides whether to add a project to the technical agenda, subject to oversight by the Foundation's Board of Trustees and after appropriate consultation with FASB/GASB members and others.
- The Boards deliberate at public meetings the various issues identified and analyzed by the staff.
- The Boards issue an Exposure Draft. (In some projects, a Discussion Document may be issued to obtain input at an early stage that is used to develop an Exposure Draft.)
- The Boards hold public roundtable meetings on the Exposure Draft, if necessary.
- The staff analyzes comment letters, public roundtable discussions, and any other information. The Boards re-deliberate proposed provisions at public meetings.
- The FASB issues Accounting Standards Updates and the GASB issues Statements and Interpretations describing the new or amended accounting standards.
- The Boards conduct post-implementation activities on issued standards, including responding to technical inquiries and discussions with advisory groups and other constituents.

Note:

- GASB issues invitations to comment and preliminary views documents versus the FASB's "discussion" documents.
- GASB holds public hearings and forums versus the FASB roundtables.
- GASB issues pronouncements (statements and interpretations) versus the FASB Codification updates.


Agenda Decision
Board Deliberation of Staff Analysis
Expose for Public Comment
Exposure Draft | Discussion Document
Board Deliberation in Light of Input
Issue Final Standard
Post-Implementation Activities

Scott Logan, ***FAF Manager, Research Systems***

Scott manages development, production, and technical support of electronic delivery systems for FASB and GASB pronouncements, including the FASB Accounting Standards Codification™, the Financial Accounting Research System, the Governmental Accounting Research System, and components of the FASB and GASB websites. During 2009, Scott and his team focused on Accounting Standards Codification, processing nearly all of the new XML content for the Codification in preparation for a successful July 1 launch.

Ragan Vincent, ***GASB Supervisor, Administration***

For Ragan Vincent, 2009 activities included editorial review of GASB documents and publications, as well as planning for regular Board and GASAC meetings. In keeping with the FAF emphasis on outreach, Ragan also coordinated a public hearing and three liaison meetings. Ragan's area of responsibility also extends to oversight of the GASB administrative staff.

FAF: Independence and Accountability

2009 was an eventful and successful year for the FAF and the two organizations under its oversight, the FASB and the GASB. It was also a year when the attention garnered by accounting standard setting was unparalleled.

This visibility was the natural result of an environment that was both challenging and perplexing for investors and regulators. As U.S. and global leaders strived to cope with – and understand the causes of – the worst financial crisis since the Great Depression, accounting standards and oversight of the process to set those standards became a focal point in the broader public debate.

While remaining attentive to any attempts to compromise the independent nature of the Boards' work, the FAF Trustees began an important strategic planning process to set the future agenda for the organization.

Listening to Our Constituents

The first stage of this process was an unprecedented listening tour. This outreach effort was accomplished by small groups of Trustees and senior FAF leadership holding a series of meetings across the nation to listen to and understand our constituents' thoughts about the independent standard-setting process and the key issues affecting financial reporting for both private and public sector entities. In New York, Dallas, Chicago, San Francisco, and Washington, D.C., we met with controllers, CFOs, auditors, accounting professors, investors, analysts, lenders, regulators, city managers and finance directors, state auditors and comptrollers, and citizen and taxpayer advocates. We met with each of the FASB and GASB's main advisory bodies – FASAC, GASAC, Investors Technical Advisory Committee (ITAC), Small Business Advisory Committee (SBAC), and Private Company Financial Reporting Committee (PCFRC). We also met with the senior leadership of key constituent organizations, including the American Bankers Association, the U.S. Chamber of Commerce, and many others.

Constituents were consistent and unwavering in support of the strength and robustness of the processes followed by the FASB and GASB in setting standards. We heard strong support for the independence of the process and concern about political intervention. We also clearly heard a complementary message: the Boards' independence must be earned. At the same time, concerns were raised about uncertainty with respect to where the U.S. is headed with convergence; about complexity in standards from the perspective of smaller private companies and also from smaller governmental entities; and about how to balance the needs of investors and other users of financial reporting with the constraints on preparers of those financial reports, again both from private and public sector perspectives.

As we move into 2010, the Trustees are working to finalize their strategic planning efforts. Our broad-based outreach activities last year provided an even deeper understanding of the concerns of our constituents as well as the necessary insights we'll need to strategically realign ourselves to serve them more effectively in the future.

Preserving Independent Standard Setting

The issue of accounting standard-setting independence came to a head in the third quarter. In late October, as the House Financial Services Committee was preparing to finalize its financial regulatory reform bill, an amendment was offered calling for a financial services oversight body with power to change accounting standards. The measure, which was first proposed in

"Our broad-based outreach activities last year provided an even deeper understanding of the concerns of our constituents and provided the necessary insights we'll need to strategically realign ourselves to serve them more effectively in the future."

(l. to r.) Terri Polley, *FAF President*; Jack Brennan, *FAF Chairman*

the spring, would have given the Financial Stability Oversight Council the authority to modify, suspend, or eliminate accounting principles and standards in the event that any member of that Council believed that an accounting principle or standard threatened the stability of the U.S. financial system. While primarily focused on issues relating to federal financial regulatory agencies, the proposed amendment would have afforded the opportunity for any accounting standard to be subject to suspension by a political body, without the benefit of an open due process and without the other checks and balances that define the standard-setting processes of the FASB and GASB, as overseen by the Board of Trustees.

The reaction from stakeholders was swift and impressive. Constituent organizations, public and private companies, accounting firms, regulators, investor groups, academics, and others sent letters to the House Financial Services Committee citing concerns about politicizing the process of setting accounting standards and the resulting harmful implications for the U.S. capital markets – weakening of accounting standards, lack of transparency in financial reporting, erosion of investor confidence, and higher costs of capital. Additionally, the Trustees engaged directly with Congress with a strong message emphasizing the highly effective oversight and accountability of the standard-setting process by virtue of the Board of Trustees, the Securities and Exchange Commission (SEC), and the openness of the process itself.

As a result of this effort, on December 11, 2009, the House passed H.R. 4173, the "Wall Street Reform and Consumer Protection Act of 2009," which included a substantially amended and revised version of the amendment that actually, and importantly, would reinforce the independent accounting standard-setting process. Specifically, the provision provides authority for the newly created Financial Services Oversight Council to review and submit comments to any standard-setting body with respect to an existing or proposed accounting standard. The provision leaves intact the independence of the standard-setting process – with appropriate oversight by the Board of Trustees. Moreover, the provision reinforces the openness and thoroughness of the due process itself. The new Council has the ability to provide its input, as do all stakeholders in the process, and the standard-setting Boards consider that input in reaching decisions on standards intended to meet the needs of users of financial reports.

Appointments

One important and ongoing role of the Trustees is to make appointments to the Board of Trustees as well as to the standard-setting Boards. To that end, the Trustees made several key appointments. The Foundation appointed three new members to the Board of Trustees, including: Douglas A. Donahue, managing partner of Brown Brothers Harriman; Edward E. Nusbaum, the chief executive officer and executive partner of Grant Thornton International; and Luis M. Viceira, the George E. Bates Professor at the Harvard Business School. Those new members replaced W. Steve Albrecht, James H. Quigley, and Paul C. Wirth, each of whom served with distinction during his time on the Board of Trustees. We extend our thanks to them for their dedicated service to the FAF.

The Trustees also made several key appointments with respect to the GASB. David E. Sundstrom, auditor-controller for Orange County, California, began his term as a GASB member on July 1, 2009, replacing Richard C. Tracy, who completed two terms of service.

"Throughout 2009, our employees put forth tremendous efforts to address the challenges confronting the Foundation, FASB, and GASB. Our success in meeting the challenges posed by the economic, financial, and political environment was the result of their energy, dedication, and passion for the mission of this organization."

Jack Brennan, *FAF Chairman*

We thank Richard for his distinguished service on the GASB. Marcia L. Taylor, assistant manager of Mt. Lebanon, Pennsylvania, was reappointed to a second term on the GASB, effective July 1, 2010. Most recently, Michael H. Granof, Ernst & Young Distinguished Centennial Professor of the McCombs School of Business, University of Texas, was appointed to the GASB effective July 1, 2010. Dr. Granof will replace William W. Holder, who will complete 10 years of service on June 30, 2010.

Focusing on Key Areas in 2010

In 2010, the Trustees will focus on several areas of strategic importance, including enhanced oversight of the standard-setting processes of the FASB and GASB, global convergence of accounting standards, progress on resolving the issue of GASB funding, and the issue of standard setting for private companies.

With respect to enhanced oversight, the Trustees recently voted to make the Standard-Setting Process Oversight Committee a standing committee of the Board of Trustees, rather than an advisory committee. One of the key areas of focus for that committee will be the establishment of a formal process for the post-implementation review of standards.

Global convergence of accounting standards continues to be a key area of focus for the FAF and FASB. We have been working with the International Accounting Standards Board (IASB) since 2002 to develop a common platform for international standard setting through convergence of International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (U.S. GAAP), defining common objectives in the Norwalk Agreement issued in 2002 and a subsequent Memorandum of Understanding (MoU) in 2006 that was updated in 2008. At a joint session held in Norwalk in October 2009, the FASB and IASB reaffirmed their commitment to improving IFRS and U.S. GAAP and achieving their convergence. The FAF Trustees and our counterparts at the International Accounting Standards Committee (IASC) Foundation agreed to interact formally and monitor progress on convergence goals. Several meetings of both groups of Trustees were held in 2009 and more meetings are planned for 2010.

As reported last year, an ongoing challenge for the Trustees is the funding of the GASB. The importance of the role of the GASB has been highlighted in the difficult financial environment facing state and local governments, with stories circulating in the media nearly every day about uncertainty with respect to the measurement and magnitude of pension and other post-retirement benefit liabilities, among many other issues. We are hopeful that a funding solution is within reach and will continue to focus on this issue until its resolution.

Also in connection with our constituent outreach efforts, we heard the concerns of private companies and auditors and users of private company financial statements, with respect to whether U.S. GAAP as it exists today is meeting their needs. In response, we announced in December the creation of a blue-ribbon panel, sponsored jointly with the American Institute of Certified Public Accountants (AICPA) and the National Association of State Boards of Accountancy, and chaired by FAF Trustee Rick Anderson, to take a fresh look at private company issues in 2010. The panel will include a cross-section of private company

financial reporting constituencies, including lenders, investors, and owners, as well as preparers and auditors. The FAF Trustees look forward to receiving a report from the panel, with its recommendations, by early next year.

A discussion of 2009 would not be complete without mention of the FASB Accounting Standards Codification™ (FASB Codification). Prior to the development of the FASB Codification, non-governmental U.S. GAAP had evolved into a sprawling collection of thousands of standards created by a number of different authorities during the past 50 years. The debut in July of codified U.S. GAAP was both an industry milestone and a moment of pride for the FAF and the FASB. Fully functional online access to the FASB Codification ushered in a new era of modern accounting research to accounting and financial reporting professionals, as well as to analysts and investors. The FASB Codification was further enhanced by the inclusion of XBRL (eXtensible Business Reporting Language) functionality – making it easier for users of the Codification to access information about the U.S. GAAP financial reporting taxonomy elements that link to the Codification. On a related note, early in 2010, the FAF announced its new responsibility for the ongoing maintenance of the U.S. GAAP financial reporting taxonomy. We will be assembling a small team dedicated to maintenance activities, including updates for changes in U.S. GAAP, reviews of best practices, and technological enhancements.

Throughout 2009, our employees put forth tremendous efforts to address the challenges confronting the Foundation, FASB, and GASB. Our success in meeting the challenges posed by the economic, financial, and political environment was the result of their energy, dedication, and passion for the mission of this organization. This dedication proudly extended into our local community as well, as our employees rallied to be of service by spending a series of Friday afternoons helping to prepare and serve meals to clients of the Manna House of Hospitality Soup Kitchen in Norwalk. Our dedicated staff members made a difference during what was clearly one of the more transformative years in the history of the Financial Accounting Foundation. We thank them for their outstanding efforts throughout the year.

2009 was an eventful, challenging, and successful year for the FAF, FASB, and GASB, with many accomplishments and continual improvements in how we do our work on behalf of our constituents. We recognize, too, that the economic, market, and regulatory challenges resulting from the financial crisis of 2007 – 2009 will continue and we must adapt to ensure we accomplish our missions for our constituents within the context of that changed environment. We will adapt and we will do so with our long-standing commitment to independent processes and accountability to our stakeholders. We look forward to reporting continued progress next year and thank you for your continued support of the FAF, FASB, and GASB.

John J. Brennan	**Teresa S. Polley**
Chairman	*President*
FAF Board of Trustees	FAF

Chandini Smith, ***FASB Senior Investor Liaison***

In 2009, Chandy helped drive FASB's enhanced outreach initiative, engaging investors and other users of financial information on an unprecedented basis in the standard-setting process. Chandy's liaison activities helped the Board evaluate how standards might be changed to better meet user requirements.

Robert Kalina, ***FAF Vice President, Human Resources***

Attracting and retaining the best talent for the FAF, FASB, and GASB was a top priority in 2009. Under Bob's leadership, the most distinguished professionals in accounting, government, academia, and other industries were hired for key positions in each of the three organizations. He and his team also organized a number of events to enhance morale and community spirit among staff members. Employees supported a number of food and fundraising drives for local chapters of charities like the United Way and the American Cancer Society, and also volunteered their time on several Friday afternoons to serve lunch to clients at the Manna House of Hospitality Soup Kitchen in Norwalk, Connecticut.

Financial Accounting Standards Board

Throughout much of 2009, the impact of the global financial crisis continued to dominate the capital markets, business, and politics both in the U.S. and around the world. As the volume of the debate over causes and remedies intensified, the FASB swiftly addressed significant financial reporting issues affecting capital market participants while continuing to broaden and enhance our outreach to investors and other users of financial information and to other stakeholders in the financial reporting system.

Such outreach and constituent input have always been a vital part of our standard-setting activities and are particularly critical during a financial crisis. Thus, during 2009, we proactively engaged constituents via public roundtable meetings, through the work of our Financial Crisis Advisory Group with the IASB and discussion at meetings of the FASAC and other advisory groups, by participating in numerous financial and business forums, and through many face-to-face discussions with constituents to develop a greater appreciation for their perspectives and concerns on improving financial reporting. Further inside this annual report, you'll see a map depicting this broad outreach I've mentioned.

Arrival of Codification

In the summer, following an 18-month "verification" period of trial use by the public, we officially launched the *FASB Accounting Standards 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. It provided much-needed organization to the U.S. GAAP literature, giving constituents an easily accessible online research system.

Years in the making, the launch of the Codification can be traced to early constituent feedback indicating that U.S. GAAP was often unmanageable. We got the message! Something needed to be done to make it more accessible and user-friendly and we and the FAF invested in a major effort to completely restructure and reorganize the existing body of U.S. GAAP pronouncements.

I would like to take this opportunity to thank the hundreds of people inside and outside our organization who contributed their time and talents to the development of the Codification. Whether it was serving as a "mapper" of the existing GAAP pronouncements into the new format and structure, authoring Codification topics, providing technical and editorial review, or developing the state-of-the-art technology platform, all of these efforts were crucial to bringing this milestone project to successful completion.

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

"Years in the making, the launch of the Codification can be traced to early constituent feedback indicating that U.S. GAAP was often unmanageable. We got the message!"

Robert H. Herz, ***Chairman of the FASB***

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

Shortly after its introduction, we took the important step of linking the Codification to XBRL, thereby better enabling users to prepare XBRL financial statements using the U.S. Financial Reporting Taxonomy.

International Convergence of Accounting Standards

Codifying U.S. GAAP was also important to the FASB's pursuit of convergence – the goal of moving toward a common set of high-quality, globally accepted accounting standards. Responding to calls from the G20 leaders and others to "redouble" our convergence efforts, since October 2009 we are now meeting jointly with the IASB several days each month. The joint communiqué we issued in November 2009 details the shared principles and processes we intend to follow and our ambitious timelines as we work toward completion of the major projects included in our MoU with the IASB.

While the MoU includes a number of major projects, let me use two of them, Financial Statement Presentation and Revenue Recognition, to highlight the kinds of very extensive constituent outreach, input, and involvement we engage in on major projects.

The Financial Statement Presentation project was undertaken to improve the overall usefulness of information in financial statements, enabling investors, lenders, and other interested parties to better make informed decisions on the performance and financial condition of companies. An aim of this joint project is to provide financial information in a manner that is more intuitive to investors and allows them to relate the effects of transactions between the various financial statements. Also, having more disaggregated information will improve an investor's ability to forecast future cash flows and, ultimately, to make better capital allocation decisions.

During 2009, we carefully evaluated the comments we received on our 2008 Preliminary Views document and the field tests we conducted with numerous companies in a variety of industries from around the world in which they "recast" their financial statements using the proposed new formats. Additionally, under the auspices of our Financial Accounting Standards Research Initiative, we conducted field tests with users on differential methods of presenting particular sets of financial information. And we continued to discuss various aspects of the projects with the Joint International Group and the Financial Institutions Advisory Group, both of which are specifically advising us on this project, and with our other advisory groups. We also obtained relevant academic research and the results of user surveys relating to this project. All this input is being carefully considered as we work towards the issuance of an Exposure Draft in 2010.

> "From the outset of our organization over 35 years ago, the FASB's mission has been to establish and improve accounting and financial reporting standards for the benefit of investors and other users of financial information. We do this through an open, thorough, and independent process that provides for very extensive constituent input."

(l. to r.) Russ Golden, *FASB Technical Director*; Kevin Stoklosa, *FASB Assistant Director*

The Revenue Recognition project seeks to improve the existing guidance in both U.S. GAAP and IFRS with a revenue recognition model that will better represent economic reality and can be applied across various industries and transactions. It will also remove inconsistencies and weaknesses in existing revenue recognition standards and practices.

During 2009, the Boards carefully considered the extensive input we received on our December 2008 discussion document. We discussed the model with a broad array of constituents. We also began holding a series of "workshops" on the new revenue recognition approach with representatives of dozens of companies around the world covering numerous industries. Again, all this input will be invaluable as we work toward an Exposure Draft in 2010.

U.S. Achievements and Challenges

As we continued to address issues that emanated from the financial crisis, the FASB provided additional guidance in the U.S. on fair value measurements in inactive markets and on impairment of debt securities. Statements 166 and 167 addressed critical reporting issues relating to securitizations and the use of off-balance-sheet entities. We believe these standards will help curb the abuses that occurred in recent years and will help foster the development of sounder securitization markets and practices. While Statements 166 and 167 did not generally become effective until 2010, their effects were taken into account by the U.S. banking regulators in their 2009 "stress tests" of the nation's largest banking institutions.

From the outset of our organization over 35 years ago, the FASB's mission has been to establish and improve accounting and financial reporting standards for the benefit of investors and other users of financial information. We do this through an open, thorough, and independent process that provides for very extensive constituent input. However, during the financial crisis, the mission was challenged by certain parties who sought to alter the existing U.S. accounting standard-setting process. For example, in November 2009, a potential amendment to the financial services reform legislation in the U.S. House of Representatives would have enabled a systemic risk council dominated by banking regulators to override both the FASB and the SEC by changing accounting standards in the name of preserving financial stability. Fortunately, timely efforts by the FAF Trustees, together with strong opposition from numerous groups and individuals across the business, investment, governmental, and academic communities, were successful in deflecting this effort. That widespread support for our mission was very gratifying and we thank all those who rallied to the cause.

Private companies represent a vital segment of the U.S. economy. Our financial reporting system has been a "vertically integrated" one with GAAP accounting and reporting by public and private companies generally being based on the same concepts, principles, and standards. In recent years we have received focused input from our Small Business Advisory Committee and from our Private Company Financial Reporting Committee on specific areas where differences for private companies might be appropriate based on user needs and/or cost/benefit considerations.

And while there are some differences and exemptions from certain GAAP requirements for private companies, and additional SEC requirements and disclosures for public companies, we do not have the type of parallel system of "Big GAAP/Little GAAP" that is present in certain other countries. I believe this integrated approach to financial reporting has generally served our country well. However, a number of forces are now in play that challenge our traditional thinking and approach to private company reporting. These include the potential move to IFRS for U.S. public companies and the available use of IFRS for small and medium-sized entities by U.S. private companies, recent developments in other countries that have adopted or will adopt IFRS for their public companies but not for their private companies, and continuing concerns expressed by some constituents over the relevance and cost/benefit to private companies of certain U.S. GAAP requirements. These important issues will be examined in 2010 by the special committee being formed by the FAF together with the American Institute of Certified Public Accountants and the National Association of State Boards of Accountants.

The FASB also establishes accounting and reporting standards for U.S. not-for-profit entities. In late 2009 we began soliciting names of candidates to serve on our new Not-for-Profit Advisory Committee. This group will provide us with input on reporting issues in that sector, including issues that may arise if and when U.S. public companies move to IFRS as IFRS does not cover not-for-profit entities.

Looking to the future, the FASB and the whole U.S. reporting system face a number of challenges, opportunities, and uncertainties. Whether it relates to our convergence efforts, potential incorporation of IFRS into the U.S. reporting system, or reporting by private companies and not-for-profit entities, constituent input and participation in our standard-setting activities are absolutely critical, as is our ability to maintain a thorough, open, and independent due process.

In closing, and on behalf of my fellow Board members, I would like to thank the dedicated and hard-working staff of the FASB and FAF, our Trustees, the members of our Advisory Councils and groups, and the many other constituents who take the time and effort to respond to our proposals and requests for input and who participate in public roundtables, field tests, and visits. Your input and your support of our mission have been very important to our successfully addressing the challenges in 2009 and will continue to be critical as we look forward to 2010 and beyond.

Robert H. Herz

Robert H. Herz
Chairman
FASB

Kenneth Schermann, *GASB Senior Technical Advisor*

Ken joined the GASB in 1984 as one of its original staff members. Celebrating his 25th anniversary in 2009, he was the manager on three projects that resulted in the publication of GASB Statements 54, 55, and 56 during the year. Ken also served as an advisor on other projects at various stages on the GASB's agenda.

Upaasna Laungani, ***FASB Project Manager***

During 2009, Upaasna was a contributor to the Financial Instruments Project, which involved significant proposed accounting changes affecting a broad array of constituents. As the head of outreach for the project, Upaasna collected important input and listened to an extensive amount of constituent views during the first phase of the project, sharing her findings with the Board prior to the development and release of an all-important Financial Instruments exposure document. Her outstanding work led to her 2010 promotion to FASB Project Manager.

Governmental Accounting Standards Board

Without question, 2009 was a challenging year in all quarters, and the governmental environment was no exception. While no one expects the existing financial difficulties to right themselves immediately, positive economic signals did begin to appear in 2009. Unfortunately, however, not many of the improving economic indicators have matured yet to the benefit of state and local governments.

One bright spot for some was the American Recovery and Reinvestment Act of 2009, which included about $140 billion to help state and local governments maintain current programs as traditional revenues fell off significantly. However, many governments continue to face dire fiscal problems that do not appear likely to turn around any time soon. In difficult times like these, high-quality financial reporting is critical – to provide users of financial statements with understandable and transparent information that enhances public accountability regarding a government's handling of financial challenges.

Regardless of the particular economic backdrop of any given time period, the work the Governmental Accounting Standards Board engages in is done in an effort to promote greater transparency and accountability for state and local governments to support well-informed decision-making by users of financial statements. From my perspective, the GASB made significant progress toward those ends over the course of the year.

The GASB's accomplishments during 2009 include finalizing five pronouncements – including a new Statement on fund balance reporting and governmental fund type definitions and a Statement containing guidance for governments seeking Chapter 9 bankruptcy protection – and issuing six due process documents for public comment.

Fund Balance Reporting

Early in 2009, the GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which establishes new fund balance classifications that better communicate the financial flexibility of a government. Statement 54 sets in place a hierarchy of new fund balance classifications primarily based on the extent to which governments are bound to observe constraints imposed upon how they can spend their resources. I believe this Statement goes a long way toward improving clarity in the information provided and consistency in how governments interpret and implement the reporting requirements. This, in turn, will help make this information more useful to financial statement users due to greater consistency from year to year and enhanced comparability across governments.

Considering that fund balance information is widely used by state, county, and local legislators and their staffs, oversight bodies, the news media, taxpayer associations, and research organizations to assess a government's financial capacity and that it is central to the credit reviews conducted by municipal bond analysts, these changes should have a significant positive effect in how that information is used.

Chapter 9 Bankruptcies

Contrary to what might seem like a logical inference, Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, was not established based

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(l. to r.) David Bean, *GASB Director of Research and Technical Activities*; Robert H. Attmore, *Chairman of the GASB*

on any inside knowledge of anticipated bankruptcy filings. In fact, guidance on this issue had been in the works for some time.

The new Statement puts in place accounting and financial reporting guidance for the historically rare instance in which a government would seek protection from its creditors under Chapter 9 of the United States Bankruptcy Code while it develops and negotiates a plan for adjusting its debts. It is important to note that Statement 58 does not extend to either state or tribal governments, which are not eligible for Chapter 9 bankruptcy protection.

Even though Chapter 9 bankruptcies are rare, when they do occur they generally grab headlines. Because of the potential significance of these events, the GASB believed that it was important to address this issue at this time. Prior to the establishment of Statement 58, no authoritative guidance existed for such financially distressed governmental entities.

Because the Statement establishes consistent recognition, measurement, display, and disclosure guidance for municipal governments that file for Chapter 9 bankruptcy protection, I believe it will provide financial statement users with better information in the extraordinary situation in which these standards would be applied.

Pension Accounting and Financial Reporting

The pension standards issued by the GASB in the mid-1990s established a financial reporting framework for defined benefit pension plans, and laid out requirements for the recognition, measurement, and display of pension expenditure and expense information and related liabilities, note disclosures, and required supplementary information in the financial reports of state and local government employers and plans. The pension standards represented a major step forward in generally accepted accounting principles for the state and local government environment.

When the GASB staff examined the model of the GASB pension standards established more than a decade later and asked, "Can we make this better?" the answer came back loud and clear in the affirmative. I have no doubt that the effectiveness of the standards can be enhanced for the current environment.

Last spring, the GASB released an Invitation to Comment on the pension standards, which posed a series of key questions at a very early stage in our process. The questions addressed fundamental issues, including: (1) the proper focus of pension financial reporting, (2) recognition of liabilities and expenses, (3) measurement of pension obligations, and (4) use of actuarial methods. Before the comment period had come to a close, we had received more than 115 responses from constituents with an interest in public pension financial reporting. The Board is now in the process of deliberating the issues raised and is preparing to release its Preliminary Views on this important topic in June 2010 to solicit additional public feedback.

Over the course of the pension standards reexamination project, the Board will consider modifications designed to improve transparency in financial reporting, enhance the decision usefulness of pension information, and better assist financial statement users in assessing the accountability of state and local governments regarding the commitments governments have made to their employees related to pension benefits. Within this

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David Bean, ***GASB Director of Research and Technical Activities***

context, the Board has focused on how the concept of interperiod equity should be considered in the development of any proposed changes.

Interperiod equity can be described as the state at which current-year taxpayers and other resource providers have provided adequate resources to pay for the cost of current-year services. For example, are the contributions a government is making now toward pension benefits sufficient to pay for what has been promised, or is the burden being shifted to future taxpayers?

I am confident that the Board's efforts relating to the pension standards will ultimately result in meaningful improvements in financial reporting. We recognize that any proposed changes may spark some controversy; however, all GASB constituents can be assured that the final results of the GASB's work in the pension area will come only after an extensive public due process that will have solicited, received, and considered input from all of our constituencies.

SEA Reporting

Traditional financial statements provide information about a government's fiscal and operational accountability, but they do not provide all the information needed to create the full picture of how well a government is managing the financial resources entrusted to it. Supplementing the traditional financial statements with information about the service efforts and accomplishments (SEA) of a government goes a long way toward completing the picture. Not only can SEA information allow users of financial information to better assess how well a government is managing the resources entrusted to it, but it can also provide constituents with access to the information they need to more fully assess a government's performance and priorities.

The GASB issued Proposed Suggested Guidelines for Voluntary Reporting, *SEA Performance Information*, in the summer of 2009 and is scheduled to issue its final suggested guidelines in June 2010. After an extended period of experimentation and study, the GASB believes its suggested guidelines will assist those governments that choose to report this type of information to effectively communicate with their constituents about how well they are doing in meeting their performance goals and objectives.

Service Concession Arrangements

One of the key ways the GASB endeavors to keep pace with change is by issuing standards that address emerging transactions in the government environment. Last summer, the GASB issued an Exposure Draft, *Accounting and Financial Reporting for Service Concession Arrangements*, which would establish reporting guidance for service concession arrangements (SCAs), which are a type of public-private partnership agreement between governments and private entities for provision of services to the public. Under these agreements, the government conveys the rights and related obligations to the private entity to provide services through the use of infrastructure and other capital assets – operation of a toll road is a common example – which in turn collects the related fees from third parties (in this example, those who drive on the toll road).

As governments increasingly partner with private and other public entities to provide services to citizens, financial

statement users need clear, understandable, and comparable information about the costs, revenues, and obligations associated with these partnerships. The GASB is scheduled to issue a final Standard on SCAs in June 2010.

Looking Ahead

Earlier I indicated that one of the concepts that the Board is considering during its reexamination of the GASB's pension standards is interperiod equity. This notion ultimately allows users to assess whether a government is on a sustainable fiscal path – that is, whether the relationship between revenues collected and the cost of services provided is on a path that can be sustained into the future. The United States Treasury Department recently published a report that asserts that the federal government is currently on an unsustainable fiscal path. The Treasury report projects that if we remain on the current fiscal policy course, total government spending would exceed total revenues available by amounts that rapidly become less and less tenable and sustainable. Similarly, state and municipal governments that borrow now to pay for current operating expenses are not achieving interperiod equity and may be facing similar circumstances.

In late 2009, the GASB added a project to its current technical agenda to better address economic conditions, including fiscal sustainability reporting issues. Staff work has commenced on the project and the Board's deliberations on the Economic Condition Reporting: Fiscal Sustainability project are due to begin late this summer. It is important to note that this project is not about predicting the future; rather, it is about equipping users of financial reports with the information they need to assess a government's financial standing today as well as its ability to meet its obligations as they come due.

An overview of 2009 activities should not pass without noting that the GASB marked its 25th anniversary as the independent standard-setting organization for state and local governments this year. As much as the organization has achieved in establishing and improving standards of state and local government accounting and financial reporting during the past quarter century, there is still much to be done. The GASB's focus going forward is firmly fixed on improving accounting and financial reporting guidance in the ever-evolving state and local government environment, no matter what the economic backdrop.

In closing, I want to thank my fellow Board members, our Trustees, and the dedicated members of the GASB and FAF staff, as well as GASAC members, for their outstanding contributions in 2009. I also would like to express my gratitude to those who volunteer their time and expertise to serve on GASB task forces and advisory committees, and to all who respond to our due process documents and share their views. The input you provide to the GASB is both critical to improving financial reporting and greatly appreciated.

R. H. Attmore

Robert H. Attmore
Chairman
GASB

Michelle Czerkawski, ***GASB Project Manager***

Michelle served as co-lead project manager for the GASB's project on post-employment benefits accounting and reporting issues. She contributed to the issuance of an Invitation to Comment to elicit constituent feedback on a number of fundamental pension accounting issues for state and local governmental employers and pension plans.

Peter Proestakes, ***FASB Assistant Director***

Throughout 2009, Peter helped guide the FASB through major transitions. He was a major contributor to the revenue recognition project – a milestone for the accounting industry. Peter also plays a key role in the ongoing maintenance of the U.S. GAAP Financial Reporting Taxonomy. The U.S. GAAP Financial Reporting Taxonomy is a list of computer-readable tags in eXtensible Business Reporting Language (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.

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Outreach

Constituent feedback is important to the FAF and its standard-setting boards. Trustees, Board members, and other staff travel around the country (and also internationally) to participate in professional conferences, academic symposiums, and other events, sharing updates and receiving input from stakeholders with an interest in high-quality financial reporting.

This map shows where the FAF, FASB, and GASB have traveled to conduct constituent outreach in 2009 and early 2010.

2009 Engagements:

- Financial Accounting Foundation
- Financial Accounting Standards Board
- Governmental Accounting Standards Board

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Office of the Chief Accountant
U.S. Securities and Exchange Commission

Jay Hanson (AcSEC)
National Director of Accounting
McGladrey & Pullen LLP

James J. Leisenring
International Financial Reporting Interpretations Committee
IASB

*New members in 2010

Completed Service in 2009

James L. Kroeker
Deputy Chief Accountant for Accounting
Office of the Chief Accountant
U.S. Securities and Exchange Commission

Shea H. Malcolm
Practice Fellow
FASB

Private Company Financial Reporting Committee

Judith H. O'Dell, Chair
President
O'Dell Valuation Consulting, LLC

George W. Beckwith
Controller
National Gypsum Company

Stephen W. Bodine
Principal
LarsonAllen LLP

John Burzenski
Principal
Burzenski & Company, PC

Michael Cain
Senior Executive Vice President
Frost Bank

Thomas Grosropf
Director, Certified Valuation Analyst
Barnes Dennig

Mary Ann Lawrence
Senior Vice President
Key Corporation

David Lomax
Area Underwriting Manager
Liberty Mutual Surety

Chris Rogers
Vice President Finance and Administration
Infragistics, Inc.

Steven Shelton
President
Way, Ray, Shelton & Company, PC

James K. Smith
Vice President and CFO
Phonon Corporation

James Stevenson
CFO
ABS Capital Partners

*New members in 2010

Completed Service in 2009

Charles Bramley
Partner
Briggs Bunting & Dougherty

Daryl Buck
Vice President and CFO
Reasor's, Inc

Jerry Murphy
CFO
Todd and Sargent Inc.

Financial Information

Management's Discussion and Analysis

2009 Summary

The mission of the Financial Accounting Foundation (the Foundation) and its standard-setting boards, the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB), is to establish and improve standards of financial accounting and reporting for private sector, not-for-profit, and state and local governmental entities. Financial accounting and reporting standards help foster and protect investor confidence, facilitate efficient operation of capital markets, and enable citizens to assess the stewardship of public resources by their state and local governments. The Foundation is committed to the development of high-quality financial accounting and reporting standards through an independent and open process that results in useful financial information, considers all stakeholder views, and ensures public accountability.

The Foundation is responsible for the oversight, administration, and finances of the FASB, the GASB, and their advisory councils, the Financial Accounting Standards Advisory Council (FASAC) and the Governmental Accounting Standards Advisory Council (GASAC). The Foundation obtains its funding from accounting support fees pursuant to the Sarbanes-Oxley Act of 2002 (the Act), subscription and publication revenues, and voluntary cash contributions in support of the GASB. In fulfilling its mission, a fundamental principle of the Foundation's operations is to obtain and deploy prudently the resources needed for the operation of the Foundation, the standard-setting boards, and the advisory councils, all in a transparent and accountable manner.

The Foundation's net assets increased overall by $6.5 million in 2009, reflecting the improved financial markets, and resulting growth in investments held in the pension plans and the Reserve Fund. In addition, the Foundation realized operating efficiencies in 2009 that contributed to a decrease in total support expenses resulting from a reduction in force and restructuring of certain administrative departments, implemented in December 2008.

In 2009, the *FASB Accounting Standards Codification*™ (FASB Codification) officially became the source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP), superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF), and related literature. In this respect, the nature and pricing structure of the Foundation's publication and subscription product offerings for FASB pronouncements and related material has changed significantly. The FASB Codification is currently accessible through a specially designed state-of-the-art online platform and retrieval system and can be viewed either through a free Basic View or as an online annual paid subscription through the Professional View, which provides significantly more advanced navigation and system functions. The Foundation also licenses the content of the FASB Codification to publishers and other licensees that include those materials in comprehensive online research databases and product offerings.

Due to the Foundation's transition to the FASB Codification, the hard copy FASB publication offerings also have changed. Bound versions of the FASB Codification and print versions of official updates to the Codification, known as Accounting Standards Updates (ASUs), are expected to be the principal hard copy versions of FASB material that will be published by the Foundation going forward. Loose-leaf services for the FASB's *Current Text*, *Original Pronouncements*, and *EITF Abstracts* and subscription plans for the Financial Accounting Research System (FARS) on CD-ROM are no longer offered.

Financial Results

The Foundation's financial statements are presented in accordance with generally accepted accounting principles and reflect the specific reporting requirements of not-for-profit organizations. The following is a discussion of the key highlights of the activities and financial position of the Foundation as presented in the accompanying audited financial statements.

Overview

- Net operating revenue increased $3 million to $38.5 million in 2009, reflecting a $5.1 million increase in accounting support fees, offset by a $2 million decrease in net subscriptions and publications revenue, primarily due to the transition to the FASB Codification.
- Total program and support expenses increased $2 million to $36.9 million. Program expenses represent approximately 77% of total expenses in 2009, compared to 74% in 2008.
- The Foundation ended the year with net operating revenues exceeding expenses by $1.6 million in 2009, compared to $550,000 in 2008.
- Net assets increased to $59.4 million in 2009 from $52.9

million, a $6.5 million increase primarily related to: investment return on the Reserve Fund of $3.7 million; an operating surplus of $1.6 million; and an increase for the recognition of non-operating pension related changes of $1.1 million.

Statements of Activities

The following charts represent the percentage of the sources of operating revenues and program and support expenses for 2009 and 2008.

Sources of Operating Revenues	2009
Accounting Support Fees	75%
Net Subscriptions and Publications	21%
Contributions	4%

Sources of Operating Revenues	2008
Accounting Support Fees	67%
Net Subscriptions and Publications	28%
Contributions	5%

Expenses	2009
Program – Standard Setting	77%
Support	23%

Expenses	2008
Program – Standard Setting	74%
Support	26%

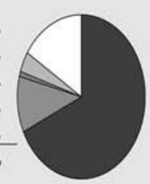
Accounting Support Fees

The Foundation's most significant source of revenue consists of accounting support fees assessed against issuers of securities, as those issuers are defined in the Act. Accounting support fees fund the expenses and other cash requirements for the FASB's standard-setting activities that are included in the Foundation's operating and capital budget for each year (the recoverable expenses). Accounting support fees for 2009 and 2008 totaled $28.9 million and $23.7 million, respectively. The fees are allocated to equity and investment company issuers registered with the U.S. Securities and Exchange Commission based on their relative average monthly U.S. equity market capitalization. Equity issuers with an average market capitalization of over $25 million, and investment company issuers with an average market capitalization or net asset value over $250 million, are assessed a share of the accounting support fees. The Foundation has designated the Public Company Accounting Oversight Board (the PCAOB) as its collection agent for the invoicing and collecting of accounting support fees. The Foundation paid approximately $200,000 in both years to the PCAOB for this service.

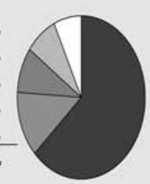
Contributions

Contributions consist almost entirely of GASB contributions. Sources of these contributions are illustrated below (dollars in thousands).

Contributions	2009	
State Governments	1,000	68%
Local Governments	162	11%
Bond Fee	12	1%
Other GASB	52	4%
Contributed Services	236	16%
Total	**1,462**	**100%**



Contributions	2008	
State Governments	1,000	63%
Local Governments	210	13%
Bond Fee	149	9%
Other GASB	132	8%
Contributed Services	110	7%
Total	**1,601**	**100%**

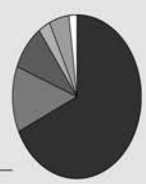


State governments contributed $1 million in both 2009 and 2008, representing the largest portion of GASB contributions. The decrease in total contributions was due primarily to lower residual contributions under the voluntary Municipal Bond Fee Assessment Program. The three-year trial period for that program concluded in 2007. Contributions from local governments and other GASB sources also decreased in 2009, primarily due to the financial crisis. Contributed services include the value of waived compensation for Members of the Board of Trustees, in addition to $40,000 in contributed consulting services in 2009 relating to the development of the FASB Codification.

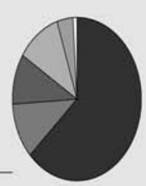
Subscriptions and Publications

Subscription and publication revenues of the Foundation in 2009 and 2008 are presented by product line for the FASB and the GASB product offerings in the charts below. The Foundation's publications revenues are presented in the statements of activities on a combined basis (dollars in thousands).

FASB Publications	2009	
License Fees	8,476	68%
Subscription Fees	1,623	13%
Loose-leaf Services	1,085	9%
Bound Editions	399	3%
Final Documents	656	5%
Other	220	2%
Total	**12,459**	**100%**



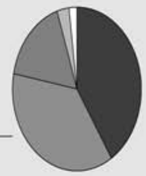
FASB Publications	2008	
License Fees	8,953	63%
Subscription Fees	1,532	11%
Loose-leaf Services	1,389	10%
Bound Editions	1,568	11%
Final Documents	531	4%
Other	129	1%
Total	**14,102**	**100%**



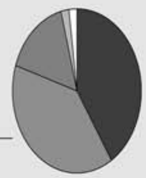
FASB subscription and publication revenues totaled approximately $12.5 million and $14.1 million in 2009 and 2008, respectively. The overall decrease in FASB subscription and publication revenues in 2009 is primarily due to the transition to the Codification, and its effect on the various product lines as follows:

- License fees continue to represent the largest portion of total FASB revenue, comprising 68% of total subscription and publication revenues in 2009. License fee revenue, which is generated based on agreements with publishers and other licensees, decreased by 5% in 2009, primarily due to a decrease in the number of sub-licensees resulting from the difficult economic environment.
- Revenue from subscription plans increased from $1.5 million in 2008 to $1.6 million in 2009. Subscription plans include the online access to the Professional View of the FASB Codification and the FASB Subscription, an annual service that includes a monthly distribution of printed copies of ASUs. As mentioned previously, the FARS Subscription was discontinued in 2009 with the transition to the FASB Codification on July 1, 2009.
- Revenue from loose-leaf services has decreased from $1.4 million to $1.1 million, as the FAF is phasing out these services. A final distribution under these services will be completed in 2010.
- Sales of bound editions decreased from $1.6 million in 2008 to $399,000 in 2009. The initial four-volume bound edition of the FASB Codification was not available for sale until late December 2009. The final editions of the pre-Codification bound volumes for the FASB's *Current Text*, *EITF Abstracts* and *Original Pronouncements* are expected to be available for sale in 2010.
- Prior to 2009, final document revenues only included sales of final FASB Statements. In 2009, this category includes revenues from sales of final FASB Statements and ASUs. The ASU format has subsumed prior formats of FASB documents, such as FASB Staff Positions and EITF consensuses, which were sold primarily through loose-leaf services that have been discontinued.

GASB Publications	2009	
Subscription Plans	824	41%
License Fees	747	37%
Bound Editions	338	17%
Final Documents	52	3%
Other	49	2%
Total	**2,010**	**100%**



GASB Publications	2008	
Subscription Plans	872	41%
License Fees	859	39%
Bound Editions	359	16%
Final Documents	45	2%
Other	47	2%
Total	**2,182**	**100%**



GASB subscription and publication revenues decreased 8% to approximately $2 million in 2009. License fees, which decreased $112,000 (or approximately 13%) to $747,000 in 2009, were the largest driver of the change and resulted from a decrease in the number of sub-licensees due to the difficult economic environment.

Direct Costs of Subscriptions and Publications

Foundation subscription and publication revenues are reported net of direct costs in the accompanying statements of activities. Direct costs of subscriptions and publications amounted to $6.3 million and $6.1 million in 2009 and 2008, respectively.

Program expenses

The Foundation's program expenses totaled $28.4 million in 2009 compared to $26.0 million in 2008. Program expenses include salaries, benefits, occupancy, professional fees and certain other operating expenses for the members and research staffs of the FASB and the GASB and their advisory councils, as well as expenses for the library services and external relations and communications activities of the Foundation that support the standard-setting boards. Other operating expenses include domestic and international travel for Board members and staff, costs for holding advisory group and other meetings, library subscriptions and other reference materials and other miscellaneous expenses.

Given the significance of our personnel to achieving the missions of the FASB and the GASB, salaries and employee benefits comprise over 84% of the Foundation's program expenditures. In total, salary expense remained fairly flat in 2009 compared to 2008. Employee benefits increased $1.3 million, primarily related to the actuarially determined increase in net periodic benefit expense for the Foundation's pension plans, due to the amortization of prior period actuarial losses, which were primarily related to a decrease in the value of plan assets.

Support expenses

The Foundation's support expenses totaled $8.6 million in 2009 compared to approximately $8.9 million in 2008. Support expenses include costs for the accounting and finance, human resources, facilities management, technology and information systems, legal, development and general administrative operating assistance provided by the Foundation to its standard-setting boards and their advisory councils. Support expenses also include amounts related to the Foundation's Board of Trustees oversight responsibilities. Other operating expenses include travel, meetings, subscriptions, office supplies and other miscellaneous expenses.

Salary expense for Foundation support services decreased year to year, reflecting a smaller staff size, while employee benefits increased due to the higher periodic benefit expense for the pension plans.

Pension-related changes not reflected in operating expenses

The Foundation recorded a non-operating increase in net assets of $1.1 million for 2009, reflecting the net effect of an increase in the value of plan assets and an inclusion of a Medicare Part D subsidy in the post-retirement health coverage plan, partially offset by a decrease in the discount rate and other actuarial adjustments. In 2008, the Foundation recorded a non-operating charge of $5.4 million primarily from the decrease in the value of plan assets due to the turbulent financial market, offset to some degree by the actuarial effect of several amendments to the pension plans. Effective December 31, 2008, the Foundation implemented several changes to its pension plans to reduce the Foundation's long-term defined benefit funding and investment risk and to better position the Foundation to meet its future retirement benefit obligations. As more fully discussed in Note 5 to the financial statements, the Foundation is phasing out benefit accruals under the defined benefit plans by December 31, 2013.

Investment income and losses

The Foundation's Reserve Fund investments, held primarily in money market and fixed income mutual funds, experienced net investment gains of $3.7 million in 2009 relating primarily to the fixed income fund, compared to net losses of $508,000 in 2008. The Supplemental Pension Plan assets, invested approximately 80% in equity and 20% in fixed income mutual funds, experienced net gains of $61,000 in 2009 compared to net losses of $188,000 in 2008. The Foundation's short-term investments, invested entirely in money market mutual funds in 2009 and 2008, had a net gain of $44,000 compared to a net gain of $279,000 in 2008, reflecting a decrease in interest rates in 2009.

Statements of Financial Position

Cash, cash equivalents and short-term investments

Cash and cash equivalents include demand deposits with financial institutions and short-term, highly liquid investments. Short-term investments include money market mutual funds. Cash and short-term investments totaled approximately $10.6 million and $9.8 million as of December 31, 2009 and 2008, respectively.

Reserve Fund investments

The Reserve Fund is intended to (1) provide the Foundation, the FASB and the GASB with sufficient reserves to fund expenditures not funded by accounting support fees or subscription and publication revenues; (2) operate the Foundation, the FASB and the GASB during any temporary or permanent funding transition periods; and (3) fund any other unforeseen contingencies. The Foundation's Trustees have adopted a policy establishing a targeted year-end Reserve Fund balance equal to one year of budgeted expenses for the entire organization plus a working capital reserve equal to one quarter of net operating expenses for the entire organization (collectively, the target Reserve Fund). To the extent the projected year-end Reserve Fund balance, which is net of short-term investments, exceeds the year-end target Reserve Fund, the excess is made available to fund the FASB recoverable expenses for the budget year that otherwise would be funded by accounting support fees.

Reserve Fund investments are unrestricted assets of the Foundation and totaled $54.4 million and $51 million as of December 31, 2009 and 2008, respectively. The Reserve Fund's assets were invested in a combination of a money market mutual fund and a short-term, high credit quality, fixed-income mutual fund. Reserve Fund investments are maintained in accordance with investment policies and guidelines established for the Fund by the Trustees' Finance and Compensation Committee.

Accrued pension and post-retirement health care costs

Accrued pension costs amounted to $3.4 million in 2009, consistent with 2008. Although the fair value of assets increased by $3.5 million, this was offset by a corresponding increase in the obligation due to the decrease in the discount rate and changes to census data and other actuarial adjustments. The accrued post-retirement health care costs decreased to $900,000 in 2009 from $2.4 million in 2008, which is primarily the result of an increase of $1.5 million in the fair value of plan assets. The obligation remained consistent with the prior year and reflects the net effect of inclusion of the Medicare Part D subsidy, changes in census and premium data, and a decrease in the discount rate. The components of the pension and post-retirement health care liabilities and assets are described more fully in Note 5 to the accompanying financial statements.

Outlook for 2010

The Foundation expects growth in 2010 in FASB Codification revenues from both its subscriptions for the Professional View and license fee agreements. Foundation management will continue to monitor these product lines as well as hard copy materials as the transition to the Codification continues.

In early 2010, the Foundation announced its new responsibility for the ongoing maintenance of the U.S. GAAP Financial Reporting Taxonomy applicable to public issuers registered with the U.S. Securities and Exchange Commission (SEC). The Foundation's maintenance activities will be focused on updating the taxonomy for changes in U.S. GAAP, best practices in taxonomy extensions, and technical enhancements. The Foundation and the FASB will assemble a small team of technical staff and enhance the Foundation's information technology infrastructure as we work toward the release of the next taxonomy update in early 2011. These are FASB recoverable expenses and are included as part of the accounting support fee assessment in 2010.

Statements of Activities

Years Ended December 31 (dollars in thousands)	2009	2008
Net operating revenue:		
Accounting support fees (Note 2)	$ 28,854	$ 23,710
Contributions:		
FAF (Contributed Services)	236	110
GASB	1,226	1,491
Total Contributions	1,462	1,601
Subscriptions and publications (Note 3)	14,469	16,284
Less - Direct costs of subscriptions and publications (Note 3)	6,291	6,133
Net subscriptions and publications	8,178	10,151
Total net operating revenue	**38,494**	**35,462**
Program expenses:		
Salaries and wages:		
FASB	14,884	14,809
GASB	3,594	3,535
Total salaries and wages	18,478	18,344
Employee benefits (Note 5)	5,447	4,119
Occupancy and equipment expenses (Note 7)	1,025	1,110
Professional fees	1,115	804
Other operating expenses	2,291	1,629
Total program expenses	**28,356**	**26,006**
Support expenses:		
Salaries and wages	2,418	2,875
Employee benefits (Note 5)	1,220	912
Occupancy and equipment expenses (Note 7)	675	775
Depreciation and amortization	638	466
Professional fees	2,500	2,700
Other operating expenses	1,130	1,179
Total support expenses	**8,581**	**8,907**
Total program and support expenses	36,937	34,913
Net operating revenue greater than expenses	**1,557**	**549**
Short-term investment income (Note 4)	44	279
Supplemental Pension Plan investment income (losses)	61	(188)
Reserve Fund investment income (losses) (Note 4)	3,708	(508)
Pension-related changes not reflected in operating expenses (Note 5)	1,097	(5,446)
Increase (decrease) in net assets	**6,467**	**(5,314)**
Net assets at beginning of year	52,927	58,241
Net assets at end of year	$ 59,394	$ 52,927

See accompanying notes to these financial statements.

Statements of Financial Position

As of December 31 (dollars in thousands)	2009	2008
Current Assets:		
Cash and equivalents	$ 2,835	$ 2,741
Short-term investments (Note 4)	7,758	7,028
Pledged contributions receivable	25	25
Subscription, publication and all other receivables (net of allowance for doubtful accounts of $94 and $74)	2,564	2,431
Inventories	73	172
Prepaid expenses and all other current assets	234	288
Total current assets	**13,489**	**12,685**
Noncurrent Assets:		
Reserve Fund investments (Note 4)	54,409	51,008
Supplemental Pension Plan investments (Note 5)	478	373
Furniture, equipment and leasehold improvements, net (Note 6)	2,094	2,394
Total noncurrent assets	**56,981**	**53,775**
Total assets	**$ 70,470**	**$ 66,460**
Current Liabilities:		
Accounts payable and accrued expenses	$ 1,172	$ 1,692
Accrued payroll and related benefits	771	724
Unearned publication and other deferred revenues	3,363	3,495
Total current liabilities	**5,306**	**5,911**
Noncurrent Liabilities:		
Accrued pension costs (Note 5)	3,424	3,407
Accrued post-retirement health care costs (Note 5)	893	2,389
Accrued rent expense (Note 7)	1,412	1,786
Unearned publication and other deferred revenues - long-term	41	40
Total noncurrent liabilities	**5,770**	**7,622**
Total liabilities	**11,076**	**13,533**
Net Assets – unrestricted	**59,394**	**52,927**
Total liabilities and net assets	**$ 70,470**	**$ 66,460**

See accompanying notes to these financial statements.

Statements of Cash Flows

Years Ended December 31 (dollars in thousands)	2009	2008
Cash flows from operating activities:		
Cash received from contributors	$ 1,227	$ 1,746
Cash received from publication sales	13,392	15,236
Cash received from accounting support fees	28,807	23,688
Cash received from office lease agreement	—	985
Cash received from interest and dividends on investments	1,375	2,237
Cash paid to vendors, employees and benefit plans	(42,115)	(41,321)
Net cash provided by operating activities	**2,686**	**2,571**
Cash flows from investing activities:		
Proceeds from sales of Reserve Fund investments	$ 18,438	$ 38,433
Purchases of Reserve Fund investments	(19,453)	(37,220)
Proceeds from sales of short-term investments	8,250	27,365
Purchases of short-term investments	(8,980)	(29,758)
Proceeds from sales of Supplemental Pension Plan investments	102	184
Purchases of Supplemental Pension Plan investments	(156)	(77)
Purchases of furniture, equipment and leasehold improvements	(793)	(1,383)
Net cash used in investing activities	(2,592)	(2,456)
Net increase in cash and equivalents	94	115
Cash and equivalents at beginning of period	2,741	2,626
Cash and equivalents at end of period	**$ 2,835**	**$ 2,741**
Reconciliation of increase (decrease) in net assets to net cash provided by operating activities:		
Increase (decrease) in net assets for the period	$ 6,467	$ (5,314)
Adjustments required to reconcile increase (decrease) in net assets to net cash provided by operating activities:		
Depreciation and amortization	1,093	927
Net realized and unrealized (gains) losses on Reserve Fund investments	(2,386)	2,412
Net realized and unrealized (gains) losses on Supplemental Pension Plan investments	(51)	200
Provision for losses on accounts receivable	31	20
Increase in contribution, subscription and all other receivables	(164)	(331)
Decrease (increase) in inventories	99	(3)
Decrease in all prepaid costs	54	483
(Decrease) increase in accounts payable and employee benefit accruals	(1,952)	4,037
Decrease in unearned publication and other deferred revenues	(131)	(504)
(Decrease) increase in accrued rent expense	(374)	644
Total adjustments	(3,781)	7,885
Net cash provided by operating activities	**$ 2,686**	**$ 2,571**
Supplemental Information		
Noncash (credits) charges included in the Statements of Activities:		
Pension-related changes not reflected in operating expenses	$ (1,097)	$ 5,446

See accompanying notes to these financial statements.

Notes to Financial Statements

1. Nature of Activities and Summary of Significant Accounting Policies

Activities

The Financial Accounting Foundation (the Foundation), organized in 1972, is an independent, private-sector non-stock corporation which is responsible for the oversight, administration, finances and selection of the members of:

- The Financial Accounting Standards Board (FASB), which establishes standards of financial accounting and reporting for private-sector enterprises, and the Financial Accounting Standards Advisory Council.
- The Governmental Accounting Standards Board (GASB), which establishes standards of financial accounting and reporting for state and local governmental entities, and the Governmental Accounting Standards Advisory Council.

The Foundation is incorporated under Delaware General Corporation Law to operate exclusively for charitable, educational, scientific and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, as amended. The Foundation presently obtains its funding from accounting support fees pursuant to the Sarbanes-Oxley Act of 2002 (the Act), subscription and publication revenues, and voluntary cash contributions in support of the GASB.

Summary of Significant Accounting Policies

Presentation

The accompanying financial statements have been prepared in accordance with U.S. generally accepted accounting principles.

The statements of activities are based on the concept that standard setting is the sole program of the Foundation. These statements set forth separately, where appropriate, revenues, costs of sales and certain program expenses of the FASB and the GASB, giving recognition to their distinct responsibilities as described in the Foundation's Certificate of Incorporation and By-Laws. Program expenses include salaries, benefits and other direct operating expenses for the members and research staffs of the Standards Boards and Councils, as well as costs for the library services and external relations and communications activities of the Foundation which support the Boards. Additional Foundation services for accounting and finance, human resources, facilities management, technology and information systems, legal, development and general administrative operating assistance have been reflected as support expenses in the accompanying statements of activities. Fund-raising expenses included in these statements totaled approximately $92,000 in 2009 and $93,000 in 2008.

The Foundation is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted, temporarily restricted and permanently restricted net assets. None of the net assets of the Foundation are subject to any donor-imposed restrictions, and therefore they have all been classified as unrestricted.

Use of Estimates

The preparation of financial statements requires management to formulate estimates and assumptions that may affect the reported amounts of assets and liabilities at the dates of those statements and revenues and expenses for the reporting periods. Significant estimates made by management include actuarially determined employee benefit liabilities. Actual results could differ from those estimates.

Accounting Support Fees

The Foundation recognizes accounting support fee revenue in the year for which those accounting support fees have been assessed to issuers as prescribed by the Act. See Note 2 for further information regarding accounting support fees.

Contributions

The Foundation has reported all contributions as an increase in unrestricted net assets. Many individuals contribute significant amounts of time to the activities of the Foundation, the Standards Boards and their Advisory Councils without being compensated. These individuals include certain members of the Foundation's Board of Trustees and participants of the following groups: FASAC and GASAC, the FASB's Emerging Issues Task Force and various other FASB and GASB councils, committees, task forces and working groups on technical projects. Many others participate in the Standards Boards' processes by sending comment letters, appearing at public hearings and roundtable meetings, and taking part in field visits. Members of the Board of Trustees are eligible for compensation for their services, with each having the ability to waive such compensation. The accompanying financial statements reflect the value of waived Trustee compensation, which meets the recognition criteria for contributed services. The other services described above have not been deemed to meet the recognition criteria, and therefore, are not reflected in the accompanying financial statements. The value of contributed services for the Foundation recognized in the accompanying statements of activities was approximately $236,000 and $110,000 in 2009 and 2008, respectively.

Subscription Plans, Loose-Leaf Subscription Services and Electronic License Agreements

Revenues from these publication sources are recognized over the life of the applicable subscription service or license period, typically one year. Costs for the production of updates and for fulfillment are charged to expenses as incurred.

Cash and Equivalents

For financial statement purposes, the Foundation considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. The carrying value of these investments approximates fair value due to the nature of the investments and the maturity period. Cash and equivalents do not include any money market mutual fund investments included in the Reserve Fund portfolio at December 31, 2009 and 2008.

Investments

The Foundation's investments are recorded at fair value and are measured using Level 1 inputs, which are defined as quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Inventories

Certain publications and other related items held for resale are included in inventories and carried at the lower of cost or market, with cost determined by the first-in, first-out method.

Employee Benefit Plans

The Foundation sponsors a post-retirement health care plan and two defined benefit pension plans. See Note 5 for a full description of these plans.

Sponsors of single-employer defined benefit pension or other post-retirement plans are required to recognize the funded status of those plans as an asset or liability in the statement of financial position, and to recognize changes in the funded status in the statement of financial position in the year in which the changes occur. In the case of a not-for-profit organization (such as the Foundation), those changes are reflected in unrestricted net assets. Information with respect to the funded positions of each of the Foundation's pension and other post-retirement plans at December 31, 2009 and 2008 can be found in the accompanying statements of financial position.

Furniture, Equipment and Leasehold Improvements

Furniture, equipment and leasehold improvements are reported in the financial statements at cost, less accumulated depreciation and amortization determined under the straight-line method. Furniture and equipment are depreciated over their estimated useful lives, ranging from 3 to 10 years. Leasehold improvements are amortized over periods not extending beyond the termination dates of the leases for office space.

Income Taxes

The Foundation is a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code. Tax positions for open tax years were reviewed and it was determined that no provision for uncertain tax positions is required. The Foundation is currently open to audit under the statute of limitations by the Internal Revenue Service and state taxing authorities for the years ending December 31, 2007 through 2009.

Reclassifications

Certain reclassifications have been made to prior year amounts to conform to the current year's presentation.

Subsequent Events

The Foundation has evaluated subsequent events through March 26, 2010, and determined that no subsequent events have occurred that require adjustment or disclosure in the financial statements.

2. Accounting Support Fees

The Act provides for funding of FASB's recoverable expenses through accounting support fees assessed against and collected from issuers of securities, as those issuers are defined in the Act. The accounting support fees provide funding for expenses associated with FASB's standard-setting activities as identified in the Foundation's operating and capital budget for each calendar year.

The accounting support fees recognized and related recoverable expenses incurred for the past two years are as follows (dollars in thousands):

Years ended December 31	2009	2008
Accounting Support Fees:		
For U.S.-based entities	$ 27,642	$ 22,759
For non-U.S.-based entities	1,212	951
Total Accounting Support Fees	**28,854**	**23,710**
FASB Program expenses:		
Salaries and wages	$ 14,884	$ 14,809
Employee benefits	4,314	3,262
Occupancy and equipment expenses	807	873
Professional fees	1,058	695
Other operating expenses	2,006	1,358
Total FASB Program expenses	**23,069**	**20,997**
FASB Support expenses:		
Salaries and wages	1,945	2,350
Employee benefits	977	742
Occupancy and equipment expenses	541	618
Depreciation and amortization	593	433
Professional fees	1,284	1,584
Other operating expenses	737	790
Total FASB Support expenses	**6,077**	**6,517**
Total FASB recoverable expenses	**$ 29,146**	**$ 27,514**
FASB recoverable expenses in excess of Accounting Support Fees	**$ (292)**	**$ (3,804)**

The recoverable expenses described above include the FASB's allocable share of Foundation program and support expenses. Foundation expenses are incurred for the common benefits of the FASB and GASB.

The amounts by which total FASB recoverable expenses exceed accounting support fees are funded from Reserve Fund balances. Any differences between FASB recoverable expenses and the amount of accounting support fees recognized as revenues for an applicable calendar year (to the extent that the differences were not financed from Reserve Fund balances) would be incorporated into the calculation of accounting support fees in subsequent years. The accounting support fee calculations also reflect adjustments for non-cash expenses and certain cash requirements not reflected in the statements of activities. The amount of accounting support fees is established annually based upon the Foundation's budgeted recoverable expenses for the FASB, and any projected Reserve Fund balance for that budget year deemed available to fund those expenses. The accounting support fees are also subject to review by the United States Securities and Exchange Commission each year.

3. Subscriptions and Publications

Subscription and publication operating revenues and costs consist of the following (dollars in thousands):

Years ended December 31	2009	2008
Subscription and Publication Revenues:		
FASB Publications	$ 12,459	$ 14,102
GASB Publications	2,010	2,182
	$ 14,469	**$ 16,284**
Direct Costs:		
FASB Publications	$ 4,780	$ 3,607
GASB Publications	179	223
Foundation administrative support	1,332	2,303
	$ 6,291	**$ 6,133**
Net Subscription and Publication Revenues:		
FASB Publications	$ 7,679	$ 10,495
GASB Publications	1,831	1,959
Foundation administrative support	(1,332)	(2,303)
	$ 8,178	**$ 10,151**

4. Investments and Investment Income and Losses

Investments:

The following table presents investments measured at fair value, all of which are measured using Level 1 inputs (dollars in thousands):

At December 31	2009	2008
Short-term:		
Money market mutual funds	$ 7,758	$ 7,028
Reserve Fund:		
Fixed income mutual funds	$ 27,178	$ 22,224
Cash and money market funds	27,231	28,784
	$ 54,409	**$ 51,008**

Investment Income (Losses) (dollars in thousands):

Years ended December 31	2009	2008
Short-Term:		
Interest and dividends	$ 44	$ 279
Reserve Fund:		
Interest and dividends	$ 1,322	$ 1,943
Net realized and unrealized gains (losses)	2,386	(2,412)
	3,708	(469)
Less: Management fees	—	(39)
Total Reserve Fund Investment Income (Losses)	**$ 3,708**	**$ (508)**

Changes in the Reserve Fund balance for the past two years are as follows (dollars in thousands):

Years ended December 31	2009	2008
Fund balance, beginning of year	$ 51,008	$ 54,633
Transfers from (to) operations, net	290	(2,000)
Transfers for retirement benefit plans	(597)	(1,117)
Investment income (losses)	3,708	(508)
Fund balance, end of year	**$ 54,409**	**$ 51,008**

Reserve Fund assets are unrestricted and maintained within the investment policies and guidelines for the Fund established by the Finance and Compensation Committee of the Board of Trustees.

5. Employee Benefits

Employee benefits expense consists principally of employer payroll taxes, health care benefits for active and retired employees, and pension costs.

Pension Plans

The Foundation sponsors a defined contribution plan (the Employees' Tax Sheltered Annuity Plan), and two defined benefit pension plans (the Employees' Pension Plan and the Supplemental Executive Retirement Plan, collectively the Defined Benefit Plans). Employees do not contribute to the Defined Benefit Plans.

Employee benefits expense in the accompanying statements of activities includes $1,894,000 and $1,364,000 for 2009 and 2008, respectively, related to the defined contribution plan. Effective January 1, 2009, employer contributions to the plan vest after 1.5 years of service and are based on the employee's earnings level, with incremental increases based on the employee's age. Prior to January 1, 2009, employer contributions to the plan were based solely on the employee's earnings level and vested after three years of service for contributions made on or after January 1, 2007, and after five years of service for contributions made prior to January 1, 2007.

The Defined Benefit Plans were closed to new hires effective January 1, 2008. Subject to certain plan amendments effected in 2008, the Defined Benefit Plans operate as floor offset plans such that pension benefits are payable under those plans only to the extent that the employee's target annual annuity retirement benefit is not fully met by the defined contribution plan. As of December 31, 2008, benefits under the floor offset formula of the Defined Benefit Plans have been frozen, except for adjustments for increases in average final compensation for certain employees through no later than December 31, 2013. As a result of the plan amendment, a curtailment of the defined benefit pension plans was recognized as of December 31, 2008.

Post-Retirement Health Coverage Plan

The Foundation sponsors a post-retirement health coverage plan (Post-Retirement Plan) for all eligible employees with benefits varying based on retirement age and years of service. The Foundation funds retiree health care benefits through a Grantor Trust.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Prescription Drug Act) established a prescription drug benefit under Medicare as well as a federal subsidy to sponsors of retiree healthcare benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. The effect of the subsidy is included in the Foundation's accumulated post-retirement benefit obligation and expense calculations for the first time in 2009.

Assumptions

The principal actuarial assumptions used to determine periodic benefit costs and benefit obligations for the defined benefit pension and the post-retirement health coverage plans are as follows (not all assumptions are applicable to all plans):

At December 31	2009	2008
Discount rate (benefit obligations)	5.75%	6.25%
Discount rate (net periodic benefit expense)	6.25%	6.25%
Rate of increase in compensation levels:	3.0% for 2010 4.5% for 2011–2013	4.5%
Long-term rate of return on plan assets (benefit obligations)	7.5%	7.5%
Long-term rate of return on plan assets (net periodic expense)	7.5%	8.0%
Health care cost trend rate for following year	8.5%	9.0%

The current health care cost trend rate assumption reflects market conditions, historical health care inflation, future expectations of that inflation and the Foundation's most recent cost experience. The assumed health care rate declines gradually to an ultimate level of 5.0% after 2017.

The expected long-term rate of return on plan assets assumption was based upon a review of historical returns and expectations and capabilities of future market performance.

Plan Assets

The Foundation's overall investment strategy is to maintain an appropriate balance of actively managed and indexed investments, with the objective of optimizing longer-term returns while maintaining a high standard of portfolio quality and achieving proper diversification. The Finance and Compensation Committee (the Committee) has the responsibility to determine that the assets under the defined benefit pension and post-retirement plans are properly diversified. The Committee has retained a professional investment manager for the assets of the FAF employee benefit plans who maintains complete discretion over investment decisions, within asset allocation ranges recommended by the Committee.

The Committee has recommended asset allocation ranges to the investment manager of 65 to 80 percent of the portfolio's market value in equity investments (which includes a 15 to 25 percent range for international stocks of the equity holdings) and 20 to 35 percent in fixed income investments. All securities included in the Plans' investments are required to be marketable. Several types of investments are prohibited without the express consent of the Committee. The policies provide for a minimum investment quality rating for fixed income securities and certain other restrictions on investment concentrations.

The investment manager is prohibited from purchasing securities on margin or otherwise leveraging the portfolio, except as provided for in a prospectus document in the case of mutual or commingled funds. The assets under the defined benefit pension and post-retirement plans were invested in mutual funds at December 31, 2009 and 2008, the majority of which were indexed.

The following table presents the fair value of major categories of plan assets, all of which are measured using Level 1 inputs (dollars in thousands):

Fair Value of Plan Assets at December 31 (all Level 1)	2009	2008
Employees' Pension Plan		
Mutual Funds:		
U.S. equity funds (a)	$ 8,250	$ 6,045
International equity index fund (b)	2,222	1,673
Bond fund (c)	2,598	2,233
Balanced fund (d)	1,425	1,090
Cash held by investment manager	53	42
Total	**$ 14,548**	**$ 11,083**
Post-Retirement Plan		
Mutual Funds:		
U.S. equity funds (a)	$ 3,363	$ 2,465
International equity index fund (b)	891	674
Bond fund (c)	1,172	894
Balanced fund (d)	590	450
Total	**$ 6,016**	**$ 4,483**

Descriptions of Funds

(a) These funds invest in small, mid, and large-cap companies from diversified industries using a blend of growth and value strategies and index sampling.

(b) This fund is passively managed and seeks to track the performance of international composite indexes. It has broad exposure across developed and emerging non-U.S. equity markets. Approximately 50% is invested in European companies.

(c) This fund is passively managed using index sampling. It includes diversified exposure to investment-grade U.S. bonds with approximately 76% in Aaa bonds and all other bonds having a Baa rating or above.

(d) This fund invests in S&P 500 Index stocks, long-term U.S. Treasury bonds, and money market instruments.

Net Periodic Benefit Expense

The components of net periodic benefit expense for the past two years are as follows (dollars in thousands):

Net periodic benefit expense	2009	2008
Defined Benefit Plans		
Service cost	$ 460	$ 348
Interest cost	882	1,005
Expected return on plan assets	(840)	(1,292)
Amortization of prior period actuarial losses	1,008	504
Amortization of prior service costs	(176)	22
Curtailment charge	—	48
Net periodic benefit expense	**$ 1,334**	**$ 635**
Post-Retirement Plan		
Service cost	$ 329	$ 334
Interest cost	422	383
Expected return on plan assets	(420)	(458)
Amortization of prior period actuarial losses	417	215
Amortization of prior service costs	58	58
Net periodic benefit expense	**$ 806**	**$ 532**

Gains and losses that result from changes in actuarial assumptions, and from actual experience which differs from that assumed, are amortized over the employees' estimated average future working lifetime. Any prior service costs due to plan amendments are also amortized over the estimated average working lifetime.

Pension and Post-Retirement Assets and Liabilities

The changes in the Employees' Pension Plan assets and Post-Retirement Plan assets for the past two years are as follows (dollars in thousands):

Change in plan assets	2009	2008
Employees' Pension Plan		
Fair value of plan assets, beginning of year	$ 11,083	$ 16,193
Employer contributions	1,655	506
Actual investment income (losses) on plan assets	2,750	(5,092)
Benefits paid	(940)	(524)
Fair value of plan assets, end of year	**$ 14,548**	**$ 11,083**
Post-Retirement Plan		
Fair value of plan assets, beginning of year	$ 4,483	$ 5,002
Employer contributions	766	1,679
Retiree contributions	133	136
Actual investment income (losses) on plan assets	1,059	(1,959)
Benefits paid	(425)	(375)
Fair value of plan assets, end of year	**$ 6,016**	**$ 4,483**

In December 2005, the Foundation established a Grantor Trust pursuant to Section 457(f) of the Internal Revenue Code, as amended, for the benefit of its Supplemental Executive Retirement Plan. During the years ended December 31, 2009 and 2008, employer contributions of $146,000 and $64,000, respectively, were made to the Trust. Grantor Trust assets of $478,000 and $373,000 as of December 31, 2009 and 2008, respectively, have been classified as Supplemental Pension Plan investments on the accompanying statements of financial position, and accordingly, are not included in the change in plan assets table above due to the nature of the assets. The investments include mutual funds with asset allocations substantially the same as the Employees' Pension Plan.

The changes in defined benefit pension plan and post-retirement health care plan obligations, funded status of the plans, and reconciliation to amounts reported in the financial statements for the past two years are as follows (dollars in thousands):

Change in benefit obligations	2009	2008
Defined Benefit Plans		
Benefit obligation, beginning of year	**$ 14,490**	**$ 16,504**
Service cost	460	348
Interest cost	882	1,005
Plan amendments	—	(1,514)
Actuarial (gains) losses	3,182	1,262
Benefits paid	(1,042)	(708)
Curtailments	—	(2,407)
Benefit obligation, end of year	**$ 17,972**	**$ 14,490**
Funded status at December 31:		
Underfunded plans	$ (3,424)	$ (3,407)
Amounts recognized in the financial statements	**$ (3,424)**	**$ (3,407)**
Post-Retirement Plan		
Benefit obligation, beginning of year	**$ 6,872**	**$ 6,247**
Service cost	329	334
Interest cost	422	383
Actuarial (gains) losses	(423)	147
Benefits paid	(424)	(375)
Retiree contributions	133	136
Benefit obligation, end of year	**$ 6,909**	**$ 6,872**
Funded status at December 31:		
Underfunded plans	$ (893)	$ (2,389)
Amounts recognized in the financial statements	**$ (893)**	**$ (2,389)**

The Foundation's accumulated post-retirement benefit obligation in 2009 includes the effect of the Medicare Part D subsidy of approximately $373,000, reflected as a decrease in the accumulated post-retirement benefit obligation in 2009. The reduction in the obligation has been treated as an actuarial gain and is included in pension related changes and not reflected in operating expenses in the accompanying statement of activities.

The amounts recorded for the pension-related changes not reflected in operating expenses are as follows (dollars in thousands):

Year ended December 31, 2009	Defined Benefit Plans	Post-Retirement Plan	Total Employee Benefit Plans
Net actuarial (gains) losses	$ 1,271	$ (1,061)	$ 210
Amortization of net (gains) losses	(1,008)	(417)	(1,425)
	263	(1,478)	(1,215)
Amortization of net prior service costs (credits)	176	(58)	118
	$ 439	**$ (1,536)**	**$ (1,097)**

Year ended December 31, 2008	Defined Benefit Plans	Post-Retirement Plan	Total Employee Benefit Plans
Net actuarial losses	$ 7,647	$ 2,565	$ 10,212
Curtailment	(2,407)	—	(2,407)
Amortization of net (gains) losses	(504)	(213)	(717)
	4,736	2,352	7,088
Net prior service costs (credits)	(1,515)	—	(1,515)
Curtailment	(47)	—	(47)
Amortization of net prior service costs (credits)	(22)	(58)	(80)
	(1,584)	(58)	(1,642)
	$ 3,152	**$ 2,294**	**$ 5,446**

The following is additional information for the Foundation's employee benefit plans (dollars in thousands):

Year ended December 31, 2009	Defined Benefit Plans	Post-Retirement Plan	Total Employee Benefit Plans
Amounts not recognized as components of net periodic benefit costs:			
Net actuarial losses	$ 9,474	$ 3,205	$ 12,679
Net prior service costs (credits)	(1,293)	208	(1,085)
	$ 8,181	$ 3,413	$ 11,594
Amounts expected to be recognized during the year ended December 31, 2010:			
Net actuarial losses	$ 1,067	$ 38	$ 1,105
Net prior service costs (credits)	(167)	281	114
	$ 900	$ 319	$ 1,219

Year ended December 31, 2008	Defined Benefit Plans	Post-Retirement Plan	Total Employee Benefit Plans
Amounts not recognized as components of net periodic benefit costs:			
Net actuarial losses	$ 9,211	$ 4,683	$ 13,894
Net prior service costs (credits)	(1,469)	266	(1,203)
	$ 7,742	$ 4,949	$ 12,691

The following benefit payments, which reflect expected future service, are projected to be paid under the Foundation's benefit plans, including the amounts of Medicare Part D subsidies for the Post-Retirement Plan (dollars in thousands):

		Post-Retirement Plan		
Year ended December 31	Defined Benefit Pension	Gross	Medicare Part D	Net
2010	$ 756	$ 262	17	$ 245
2011	890	287	18	269
2012	1,149	312	20	292
2013	1,026	337	21	316
2014	1,155	358	22	336
2015–19	6,515	2,379	125	2,254

The Foundation expects to contribute approximately $1,014,000, $177,000 and $570,000 to its Employees' Pension Plan, Supplemental Executive Retirement Plan and Postretirement Healthcare Plan, respectively, during 2010.

6. Furniture, Equipment and Leasehold Improvements

At December 31 (dollars in thousands)	2009	2008
Furniture and equipment	$ 9,676	$ 9,043
Leasehold improvements	3,655	3,752
	13,331	12,795
Accumulated depreciation and amortization	(11,237)	(10,401)
	$ 2,094	$ 2,394

7. Lease Commitments

The Foundation occupies office space under an operating lease that expires on September 30, 2012. Total rental expense for office space and equipment amounted to $1,532,000 and $1,670,000 in 2009 and 2008, respectively. Accrued rent expense attributable to escalating minimum lease payments, initial rent abatement and a leasehold improvement allowance totaled $1,412,000 and $1,786,000 at December 31, 2009 and 2008, respectively, and is reflected in liabilities in the accompanying statements of financial position. The rent expense liability is being amortized over the remaining term of the applicable operating lease.

Future minimum payments under operating leases for office space, including the Foundation's current share of real estate taxes and other operating costs, are as follows (dollars in thousands):

Year ended December 31	
2010	$ 1,981
2011	2,079
2012	1,584
Total minimum lease payments	$ 5,644

Management's Report on Financial Responsibility and Internal Controls

Management of the Financial Accounting Foundation is responsible for the preparation of the accompanying financial statements, and for the fairness and accuracy of the financial information included in this annual report. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Management is also responsible for establishing and maintaining an adequate internal control structure and adequate procedures for financial reporting. The Foundation maintains a system of internal controls designed to ensure the integrity, objectivity and overall effectiveness of the accounting and financial reporting process.

The Board of Trustees of the Foundation, through its Audit Committee, oversee: (1) the organization's financial and accounting policies and reports; (2) the organization's internal control over financial reporting; (3) the system of accounting and related internal controls and the competence of persons performing key functions within that system; and (4) the scope and results of independent audits, including any comments received from auditors on the adequacy of internal controls and quality of financial reporting. The Foundation's auditors render an objective, independent opinion annually on the organization's financial statements, and they have free and direct access to discuss matters with the Audit Committee, with and without the presence or knowledge of management. The auditors are engaged by and report directly to the Audit Committee.

The Foundation's Audit Committee has chosen to follow requirements issued for public companies by the New York Stock Exchange, the Securities and Exchange Commission and other securities regulators by developing and maintaining a charter governing its operations. Although the Foundation is not a public company, the Committee has concluded that the organization should voluntarily comply with public company recommendations and regulations where appropriate. The Audit Committee charter identifies the key objectives, functions, operating practices, membership requirements, and duties and responsibilities of the Committee. The responsibilities include regularly reviewing the charter to identify areas in need of enhancement, expansion and/or clarification. The voluntary compliance effort has continued with respect to the audit committee and internal control provisions of the Sarbanes-Oxley Act of 2002, and the related Securities and Exchange Commission and Public Company Accounting Oversight Board guidance. The Foundation has completed its compliance plan with respect to internal controls over accounting and financial reporting (as addressed for public companies by Section 404 of the Sarbanes-Oxley Act). The Audit Committee's charter is available through the office of the Foundation's President.

Management of the Foundation is responsible for establishing and maintaining adequate internal control over financial reporting. The Foundation's internal controls are designed to provide reasonable assurance as to the reliability of the entity's financial statements for external purposes. Internal control over financial reporting does have inherent limitations and may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable, and not absolute, assurance with respect to financial statement preparation and presentation. Also, due to changing conditions, the effectiveness of internal control over financial reporting may vary over time, and certain controls may prove to be inadequate.

Under the supervision of the Board of Trustees and with the participation of other members of management, we have evaluated the effectiveness of the Foundation's internal control over financial reporting as of December 31, 2009. In making this assessment, we have utilized the internal control framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control–Integrated Framework. We have concluded that, based upon our evaluation, the Foundation's internal control over financial reporting was effective as of December 31, 2009.

The Trustees have also adopted, and regularly monitor, personnel policies designed to ensure that employees of the Foundation are free of conflicts of interest. Finally, to facilitate open communication, the Trustees, through the Audit Committee, have adopted, and regularly monitor, an ombuds policy designed to provide an independent resource for reporting integrity or compliance concerns.

John J. Brennan
Chairman
FAF Board of Trustees

Teresa S. Polley

Teresa S. Polley
President
FAF

Independent Auditor's Report

To the Board of Trustees of the Financial Accounting Foundation

We have audited the accompanying statements of financial position of the Financial Accounting Foundation as of December 31, 2009 and 2008, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Financial Accounting Foundation as of December 31, 2009 and 2008, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

McGladrey & Pullen, LLP

McGladrey & Pullen, LLP
New Haven, Connecticut
March 26, 2010

Financial Accounting Foundation

Financial Accounting Standards Board

www.fasb.org

Governmental Accounting Standards Board

www.gasb.org

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Doris Rogers, ***FAF Supervisor, Administration***

Doris marked her 27th year with FAF in 2009. Throughout the year, Doris ensured that the more than 100 public meetings in our Norwalk office ran smoothly for the FAF, FASB, and GASB. Doris helped to ensure that the administrative needs of all three organizations were met – from telephone service to meeting facilities to appropriate building security.

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RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM JAMES L. KROEKER

Q.1. During Wednesday's hearing on "The Role of the Accounting Profession in Preventing Another Financial Crisis", comments were made by a witness testifying on the second panel on which I would appreciate your response and assessment.

The comment dealt with the relative importance of materiality and transparency. The witness said, "you cannot hide behind materiality if something is not transparent. And the FASB has for years been urged to adopt a rule that says if additional disclosure is necessary to keep the financials from being misleading, you need to make it . . . [U]ntil we put that standard in place . . . we are going to have a problem."

What would be the potential and probable impacts of the implementation of such a rule? What has been the history of consideration of such a rule, which was mentioned? What is the applicable FASB guidance regarding the disclosure of information necessary to keep a material part of the financial statement from being misleading?

A.1. It is already a requirement under Securities Act Rule 408 (for filings under the Securities Act of 1933) and Exchange Act Rule 12b-20 (for filings under the Exchange Act) that, in addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.

In this context, it is useful to differentiate between FASB standards and SEC requirements. Generally, financial statements filed with the SEC must be prepared in accordance with generally accepted accounting principles. [1] The Commission has recognized the standards of the FASB as "generally accepted" for purposes of the Federal securities laws. [2] The SEC also has its own rules and requirements relating to the financial statements and to disclosures that must accompany the financial statements.

The Commission has brought enforcement actions where filings were materially misleading to investors even though the financial statements may have technically complied with GAAP. For example, in a settled matter involving Edison Schools Inc., the Commission alleged that Edison, a private manager of elementary and secondary public schools, failed to disclose significant information regarding its business operations. [3] The Commission alleged that Edison failed to disclose that a substantial portion of its reported revenues consisted of payments that never reached Edison. These funds were instead expended by school districts (Edison's clients) to pay teacher salaries and other costs of operating schools that were managed by Edison. The Commission did not find that Edison's revenue recognition practices contravened GAAP or that earnings

[1] *See,* Rule 4-01(a)(1) of Regulation S-X. Rule 4-01(a) also prescribes that "The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

[2] *See,* Rel. No. 33-8832 (Apr. 25, 2003).

[3] *See,* In re Edison Schools, Inc., A.A.E.R. No. 1555 (May 14, 2002).

were misstated. However, the Commission nonetheless found that Edison committed violations by failing to provide accurate disclosure, thus showing that technical compliance with GAAP in the financial statements will not insulate an issuer from enforcement action.[4]

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM JAMES L. KROEKER

Q.1. During your remarks, you noted that there are projects regarding assessing an entity's ability to continue as a going concern. What is SEC's role in these projects? What is the estimated timeline to completion?

A.1. Section 10A of the Securities Exchange Act of 1934 (Exchange Act) requires that each audit of the financial statements of an issuer include an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern.[5] The PCAOB's current auditing standards (*i.e.,* AU 341, "An Entity's Ability To Continue as a Going Concern") require auditors to evaluate, based on information obtained during the course of the audit, whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. If, after considering identified conditions and events that gave rise to the substantial doubt (and gathering additional information about them if appropriate), and management's plan to mitigate the effect of the conditions and events (as well as the likelihood that the plan could be effectively implemented), an auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period remains, then the auditor's report is required to contain an explanatory paragraph describing this condition.

These specific rules are directed only at an auditor; they do not speak to the duty that a company may have to make disclosures that are relevant to its ability to continue as a going concern. For example, the SEC requires that issuers disclose information about their financial circumstances, including negative trends in cash flows, liquidity, capital resources, or results of operations; risk factors; and various indicators of financial distress, such as loan defaults.[6]

Recognizing, however, that some investors have expressed a desire for additional or more focused disclosures in this area, the FASB has an active project on disclosures about risks and uncertainties.[7] The FASB originally undertook this project to determine what analysis and disclosures management should be required to make in financial statements about whether there is substantial doubt about an entity's ability to continue as a going concern. The FASB decided to broaden the scope of this project to address con-

[4] *See,* also In re Coca-Cola Company, A.A.E.R. No. 2232 (Apr. 18, 2005).
[5] Exchange Act §10A(a)(3).
[6] *See, e.g.,* Item 303 of Regulation S–K; Item 2.04 of Form 8-K; Codification of Financial Reporting Policies Section 501.01–.13.
[7] For a more detailed discussion, refer to the FASB Project Update on Disclosures about Risks and Uncertainties and the Liquidation Basis of Accounting (Formerly Going Concern) at *http://www.fasb.org.*

cerns about the ability of investors and other users of financial statements to understand the risks and uncertainties about an entity's ability to continue as a going concern and to meet its obligations when they become due. Some of the key considerations that the FASB is deliberating include the threshold for disclosure requirements, the nature of the disclosures, and the time frame of the evaluation period.

Given the existing requirements in the Exchange Act and PCAOB standards as well as the importance of the FASB's project, the SEC is working closely with both the FASB and the PCAOB to improve the provision of useful and reliable information to investors and other financial statement users in a timely manner and to ensure that the roles and responsibilities of preparers and auditors are properly aligned.

We anticipate that substantial progress will be made on this project before the end of 2011.

Q.2. Without providing specifics of the Commission's nonpublic investigations, how many cases has the Commission investigated concerning (1) the conduct of issuers and executives and (2) the conduct of auditors relating to financial reporting related to the financial crisis. When does the staff estimate that its investigative process will conclude with respect to all of the related financial crisis cases?

A.2. In the last 2 years, the SEC has assigned very high priority to cases arising from the financial crisis. During that time, the SEC has filed enforcement actions involving issues generally associated with the financial crisis against 20 corporate defendants, including related corporate entities, and 40 individual defendants, including 26 CEOs, CFOs, and other senior officers. Many of these cases have been resolved in whole or in part, resulting in more than $1.3 billion in penalties, disgorgement, and other monetary relief.

Specifically, the SEC has filed financial crisis-related matters involving conduct at:

- Bank of America;
- American Home Mortgage;
- Reserve Management Company, Inc.;
- Brookstreet Securities Corp.;
- Countrywide Financial;
- Evergreen Investment Management Co.;
- New Century Financial;
- State Street Bank and Trust Company;
- Morgan Keegan;
- Goldman Sachs & Co.;
- Taylor, Bean & Whitaker;
- Colonial Bank;
- ICP Asset Management;
- Citigroup;
- Charles Schwab & Co.;
- TD Ameritrade, Inc.;

- IndyMac Bancorp; and
- Wachovia Capital Markets LC (n/k/a Wells Fargo Securities LLC).

Although none of the filed cases described above resulted in charges against an auditor, several of those maters—including New Century Financial, Citigroup, and IndyMac Bancorp—alleged reporting violations related to exposure to losses from subprime mortgages and subprime mortgage-backed assets or false and misleading statements concerning capital and liquidity positions. Others—including Brookstreet Securities, State Street Bank and Trust Company, and Charles Schwab & Co.—alleged misrepresentations to investors describing certain subprime-related structured products or subprime-concentrated investment funds as safe and secure when in fact they were risky, illiquid, and highly leveraged. As part of their investigation of these filed matters, attorneys and accountants in the Division of Enforcement carefully scrutinized the role of auditors and coordinated, where appropriate, with the PCAOB to facilitate information sharing and analysis.

In addition to its filed cases, the Division of Enforcement has a number of active ongoing investigations related to the financial crisis, including investigations concerning mortgage foreclosure practices, practices related to the securitization and sale of residential mortgage backed securities (RMBS), the structuring and marketing of certain collateralized debt obligation (CDO) transactions, and the accuracy of issuer disclosures related to exposure to subprime mortgages or other subprime mortgage-backed assets. Auditor conduct certainly is within the scope of many of these ongoing investigations.

While it is difficult to estimate when the investigative process will conclude, the Division of Enforcement has designated financial crisis-related cases as national priority matters and will continue aggressively pursuing evidence of securities laws violations connected to the financial crisis.

Q.3. What additional information do you believe should be communicated by auditors to the audit committee? When should the communication occur (*e.g.,* during the performance of an audit or review, during the performance of an audit, after an audit has concluded, or at another time)?

A.3. An effective and engaged audit committee is a key component of our financial reporting system and much has been done over the past decade to strengthen the role and effectiveness of audit committees. To some extent, an audit committee relies on discussions and other communications with the auditor to become informed not only about the audit but also the financial reporting process of the company. Therefore, the more robust, timely, and effective the auditor's communications with the audit committee are, the better prepared the audit committee can be to perform its governance responsibilities.

Recently, the PCAOB has been working on a new auditing standard to update and replace its current standard on auditor communications with audit committees. The PCAOB has performed a significant amount of work pertaining to this project; in particular, it:

- proposed a new auditing standard for public comment in March 2010;
- held a discussion with the Board's Standing Advisory Group (SAG) in July 2010. Topics included existing communication requirements, best practices, potential additional requirements and responses received from the public on the March 2010 proposed standard; and
- held a roundtable in September 2010 with various audit committee members to explore further the proposed standard from the viewpoint of audit committee members.

The PCAOB is currently analyzing the information received from its outreach as part of its efforts to finalize the new standard. The SEC staff has worked closely with the PCAOB throughout its efforts and will continue to do so. I support and commend the PCAOB for the extent of its outreach and also believe that it is exploring areas where the provision of additional information might be useful.

Although the proposed standard builds upon existing requirements, the nature and extent of required communications in the proposed standard would, in my view, enhance the existing standard. The primary objectives of the new standard are: (1) to enhance the relevance and effectiveness of communication between the auditor and the audit committee; and (2) to emphasize the importance of effective two-way communication between the auditor and audit committee to achieve better the objectives of the audit.

Although this project is ongoing, I believe the items below, if included in the final standard, have the potential to improve audit quality and the audit committee's understanding of both the audit process and company-specific financial reporting exposures:

- improved communication about the auditor's assessment of significant risks;
- improved communication about the importance of accounting policies, practices and estimates as well as the underlying judgments and assumptions used by management;
- communication about situations where the auditor is aware of complaints or concerns raised regarding accounting or auditing matters; and
- an evaluation of the audit committee's communications with the auditor.

The additional requirements are designed to facilitate effective two-way dialogue, which would ultimately improve audit quality.

Further, the proposed standard discusses the timing of auditor communications. The proposed standard would require that all communications occur in a timely manner, which would be determined by factors such as the significance of the matter to be communicated and corrective or follow-up action needed, but never later than the issuance of the auditor's report.

The Board's intent is to finalize the standard during 2011 at which time the standard would be subject to approval by the Commission.

Q.4. Mr. Doty recommended that Congress consider changes to permit the PCAOB to disclose its decision to institute disciplinary hearings, which is currently prohibited by Section 105(c)(2) of the Sarbanes-Oxley Act of 2002. Please give us your detailed thoughts regarding the strengths and weaknesses of this proposal.

A.4. I take seriously the PCAOB's suggestion that its disciplinary system is not functioning as it should, and I support the further exploration of the PCAOB's proposal.

Since August 2010, the PCAOB has been advocating for a change to SOX that would make its disciplinary proceedings public.[8] The drafters of SOX made a policy choice to keep the PCAOB's disciplinary proceedings private.[9] But the PCAOB has several times articulated arguments why that policy choice should be revisited: (1) investors, audit committees, and other interested parties are kept in the dark about an auditor's alleged misconduct—no matter how serious; (2) nonpublic proceedings provide an incentive for respondents to litigate rather than settle Board cases, thus consuming considerable PCAOB resources; (3) because of the lack of transparency, the public cannot evaluate the Board's enforcement program; and (4) the nonpublic nature of contested proceedings limits the Board's ability to use its enforcement authority as a tool to improve audit quality and deter violations.

The SEC debated similar policy issues in the 1980s, when it adopted a change to its Rules of Practice to make public its formal proceedings against professionals.[10] Several of the factors in support of the change are similar to those articulated by the PCAOB in support of its proposal. The SEC at the time also considered the potential negative ramifications of the decision, including those that were raised by commenters at the time.

Further, it may be useful to consider the provisions governing the disciplinary processes of SROs (*e.g.,* FINRA) to determine if their rules would provide a helpful analogy for the PCAOB, as the regulation of SROs were, in many ways, a model for the structure of the PCAOB[11] and disciplinary proceedings of SROs and the PCAOB are both overseen by the SEC.[12]

I support the PCAOB's continued consideration of ways in which it can improve the effectiveness of its disciplinary system, as well as continued dialogue on the specific question of whether SOX should be amended to make the PCAOB's disciplinary procedures

[8] In August 2010, then-Acting Chairman Goelzer sent a letter to the Senate Committee on Banking, Housing, and Urban Affairs, urging that SOX be amended to make the PCAOB's disciplinary proceedings public. A letter was also sent to the PCAOB's oversight committee in the U.S. House of Representatives.

[9] Compare Section 203(c)(2) of S. 2004, the Investor Confidence in Public Accounting Act of 2002, with Section 105(c)(2) of S. 2673, the Public Company Accounting Reform and Investor Protection Act of 2002. S. 2673, which went on to become SOX, borrowed extensively from S. 2004. *See,* "Accounting Reform and Investor Protection", S. Hrg. 107-948, at 1213 (statement of Senator Sarbanes). However, while S. 2004 provided that "[a]ll hearings under this section shall be public, unless otherwise ordered by the Board on its own motion or after considering the motion of a party," S. 2673 incorporated the opposite rule: "Hearings under this section shall not be public, unless otherwise ordered by the Board for good cause shown, with the consent of the parties to such hearing" (emphasis added). *Cf. id.* at 1219 (statement of Senator Dorgan, hoping for an amendment to make disciplinary proceedings public).

[10] *See,* Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, Rel. No. 34-25893 (July 7, 1988) [53 FR 26427 (July 13, 1988)].

[11] *See, e.g.,* SOX 107(b)(4) and (c)(2).

[12] Existing FINRA rules govern the timing and extent of public disclosures of disciplinary proceedings. *See, e.g.,* FINRA Rules 8312 and 8313.

public. In the meantime, I encourage the PCAOB to explore actions and efficiencies using its existing authority to improve the disciplinary process.

Q.5. The Investor Advocacy Group of the PCAOB recently discussed a survey and noted four potential areas of improvement in auditor communications:

a. assessments of management's estimates and judgments;
b. areas of high financial statement and audit risk;
c. unusual transactions, restatement, and other significant changes; and
d. assessments of the quality of the issuer's accounting policies and practices.

Please give us your detailed thoughts concerning whether there should be increased communications in each of the areas noted. Has the SEC issued any guidance to increase the communication with respect to each of the above areas? If not, why not? What additional areas of communication should be improved?

A.5. The requirement to have an independent audit of financial statements has long been an integral part of our financial reporting system. The independent auditor's opinion that a company's financial statements are fairly presented in conformity with accounting principles generally accepted in the United States gives investors confidence that the company's financial statements—prepared by the company's management—are reliable.

However, the auditor's report has remained largely unchanged for several decades, except for changes to reflect the auditor's responsibility to report on internal control over financial reporting for companies that are subject to Section 404(b) of SOX. Some investors believe that the auditor's report could be enhanced to provide investors with additional information that may help them better understand either the financial statements or the audit of the financial statements. The PCAOB has therefore undertaken a standard-setting project to explore possible improvements to the auditor's reporting model. I am supportive of the PCAOB's efforts in this area, and I believe that changes to the auditor's reporting model may serve as an appropriate avenue to provide investors with at least some of that additional information.

The scope of the PCAOB's project includes consideration of each of the four potential areas of improvement noted by the Investor Advisory Group. I believe that these are the appropriate areas to be discussed as part of this project. For possible changes to the auditor's reporting model to be most effective, it will be key for the PCAOB and the SEC to obtain a fuller understanding of the nature of information investors would find most meaningful, the intended use of such information and whether that information is appropriately suited for its intended use, who the appropriate party is to provide such information (*e.g.,* auditors, audit committees, and/or management), and in what form the information should be provided.

Given the stage of the project, it is premature to reach a conclusion about which particular areas should ultimately require increased communications within the auditor's report. However, I believe that the PCAOB is exploring the appropriate areas for potential improvement and has been commendable in its extensive efforts to seek input from the appropriate constituencies. The PCAOB has announced that its next step is the issuance of a concept release that will offer an opportunity for the PCAOB to receive feedback from a wide range of constituents. The SEC staff will continue to work actively with the PCAOB as it pursues this project further.

Q.6. Auditing firms and investors have publicly expressed the need for increased transparency into large firms and their complex networks. Foreign regulators have adopted transparency standards that exceed those in the U.S., such as the EU's Article 40 Transparency Report. Should audit firms publish annual audited financial statements?

What do you believe are the strengths and weaknesses of such a proposal? What additional information should be disclosed? What work has the SEC done concerning the issue of increasing the transparency into large accounting firms? What additional work is being done? What additional work should be done?

A.6. Transparency is an important component of a well-functioning financial reporting system. The EU's Article 40 Transparency Report requires annual transparency reporting that includes many required items,[13] from a description of legal structure and ownership, to a description of the internal quality control system of the audit firm, to financial information comparing revenues from audit services compared to revenues earned from other assurance services, tax services, and other nonaudit services. I generally support this type of transparency and support many of the principles that underlie the specific reporting requirements set forth by Article 40.

In fact, certain aspects of the U.S. audit oversight regime already incorporate many of those same principles. For example, the PCAOB requires that registered firms report certain matters to it on at least an annual basis, and in the case of "reportable events" the PCAOB requires reporting within 30 days.[14] The reports that are filed by the firms with the PCAOB are made publicly available on the PCAOB's Web site. The reporting includes information about the firm's ownership, associated persons, disciplinary proceedings, issuers for which the firm issued audit reports, and information about the firm's quality controls, among other things. I believe that much of the reporting that is currently made public by the PCAOB has a linkage to consideration of audit quality. The linkage to audit quality is important to consider when weighing the strengths and weaknesses of proposals to increase further transparency into accounting firms. I believe that information that assists decision makers in drawing inferences regarding audit quality should be the primary focus of any effort to enhance transparency.

[13] For more detail about the items required by Article 40 of Directive 2006/43/EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts (May 17, 2006) (commonly known as the "8th Company Law Directive" or the "Statutory Audit Directive"), the text of the Directive is available at *http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:157:0087:0087:EN:PDF.*

[14] For more detail about reporting requirements and what constitutes a "reportable event," *see, http://pcaobus.org/Registration/rasr/Pages/RASR__Search.aspx.*

To address your specific question about requiring audit firms to publish annual audited financial statements, it is my understanding that the PCAOB has been provided access to a broad range of financial information, including the information required by Article 40, on a nonpublic basis in connection with its inspection process. This disclosure is consistent with the recommendation of the Advisory Committee on the Auditing Profession (ACAP).[15] ACAP studied the issue of whether to require firms to publish annual audited financial statements, and they received testimony on potential positive and negative effects of such a proposal. Although there were differing views on this topic which precluded ACAP from reaching consensus on this matter, ACAP ultimately recommended against requiring audit firms to publish annual audited financial statements and instead recommended that the PCAOB have access to such information.

The SEC staff will continue to work with the PCAOB to explore how to achieve greater transparency of information that informs the public about audit quality.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JAMES L. KROEKER

Q.1. Last year the SEC settled with the State of New Jersey regarding pension fraud charges and according to newspapers is investigating public statements by Illinois officials about the State's underfunded pension fund. What additional steps should the SEC and the Governmental Accounting Standards Board (GASB) be taking to reveal more about the status of public pension funds which some estimate have unfunded liabilities ranging from $700 billion to $3 trillion?

Should States have to follow similar forecasted rates of return as is required by private sector pension plans under ERISA?

A.1. While conceptually I see no compelling reason for a difference between the forecasted rates of return of State and private pension plans, the Commission does not have authority to oversee the GASB and plays no role in the GASB's standard-setting processes. Therefore, I do not have detailed comments about particular GASB standards or the GASB's rulemaking agenda.

Moreover, the Commission's statutory authority to regulate issuers and many other participants in the municipal securities market is closely circumscribed. Municipal securities themselves are exempt securities under both the Securities Act and the Exchange Act and, therefore, are not subject to the Securities Act registration requirements or the Exchange Act periodic disclosure obligations applicable to public companies. Furthermore, the Commission's statutory authority is limited with regard to securities offerings and other actions of many municipal market participants, including issuers, issuer officials, conduit borrowers, independent municipal financial advisors, and bond lawyers. While the Exchange Act gives the Commission regulatory authority over brokers and dealers who underwrite issuances or otherwise engage in mu-

[15] *See,* ACAP, Final Report, Recommendation 7 at §VII.20, available at *http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf.*

nicipal securities transactions, the Commission's authority over issuers of municipal securities is specifically limited by Section 15B(d) of the Exchange Act (commonly called the Tower Amendment).

Thus, in many circumstances, the Commission's only authority over persons engaged in the issuance or distribution of municipal securities is its authority to bring enforcement actions against any person or entity, including issuers of municipal securities, who violate the antifraud provisions of the Federal securities laws. If a particular accounting treatment for pension liabilities were determined to be fraudulent, the use of that treatment by an issuer would be subject to the Commission's antifraud jurisdiction.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM ANTON R. VALUKAS

Q.1. What additional information do you believe should be communicated by auditors to the audit committee? When should the communication occur (*e.g.,* during the performance of an audit or review, during the performance of an audit, after an audit has concluded, or at another time)?

A.1. Thank you for your e-mail requesting that Tony Valukas answer certain questions for the record. We have reviewed the questions, and we believe that they ask for opinions on issues and topics beyond the scope of Tony's assignment as Lehman Examiner. Tony has not actually formulated a opinion on some of these questions, and any opinions he does have or might come to are as a private citizen. Expressing those opinions might give the incorrect impression that they were informed by his work on the Lehman matter. We therefore respectfully believe that it is not appropriate for him to respond.

Please convey to the Chairman and Ranking Member, as well as all of the Committee Members, Tony's appreciation for the Committee's consideration of his testimony.

Sincerely,

Robert L. Byman
Jenner & Block LLP
Chicago, IL 60654-3456

Q.2. The Investor Advocacy Group of the PCAOB recently discussed a survey and noted four potential areas of improvement in auditor communications:

a. assessments of management's estimates and judgments;
b. areas of high financial statement and audit risk;
c. unusual transactions, restatement, and other significant changes; and
d. assessments of the quality of the issuer's accounting policies and practices.

Please give us your detailed thoughts concerning whether there should be increased communications in each of the areas noted.

A.2. Response not provided.

Q.3. Mr. Doty recommended that Congress consider changes to permit the PCOAB to disclose its decision to institute disciplinary hearings, which is currently prohibited by Section 105(c)(2) of the Sarbanes-Oxley Act of 2002. Please give us your detailed thoughts regarding the strengths and weaknesses of this proposal.

A.3. Response not provided.

Q.4. Auditing firms and investors have publicly expressed the need for increased transparency into large firms and their complex networks. Foreign regulators have adopted transparency standards that exceed those in the U.S., such as the EU's Article 40 Transparency Report. Should audit firms publish annual audited financial statements? What do you believe are the strengths and weaknesses of such a proposal? What additional information should be disclosed?

A.4. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM CYNTHIA M. FORNELLI

Q.1. Mr. Doty recommended that Congress consider changes to permit the PCAOB to disclose its decision to institute disciplinary hearings, which is currently prohibited by Section 105(c)(2) of the Sarbanes-Oxley Act of 2002. Please give us your detailed thoughts regarding the strengths and weaknesses of this proposal.

A.1. The Center for Audit Quality is committed to the public interest role that auditors play in our markets and supports effective independent oversight of public company audits. To be effective, it is, without question, important for regulators to be able to protect the public from a threat to the public interest. And we most certainly support independent audit regulators such as the PCAOB in their ability to intervene when they identify a threat to the public interest posed by the continuation of practice by an individual auditor or audit firm in situations in which potential harm to the public has been demonstrated. In addition, any abuse of process by regulated individuals and entities who engage in bad-faith, noncooperative conduct should not be tolerated or facilitated. We also agree with the PCAOB that there should be mechanisms for ensuring that substandard auditing is dealt with promptly and effectively. But we believe there are other and more expeditious means than amending the law to achieve the PCAOB's goals, particularly in instances when there is a threat to the public interest, including under the existing authority of the PCAOB and SEC.

Q.2. What additional information do you believe should be communicated by auditors to the audit committee? When should the communication occur (*e.g.,* during the performance of an audit or review, during the performance of an audit, after an audit has concluded, or at another time)?

A.2. The audit committee serves an important role in protecting investors by assisting the board of directors in fulfilling its responsibility to shareholders and others to oversee the integrity of a company's financial statements and in overseeing the independent audit. The PCAOB currently is considering a proposed auditing standard to enhance existing auditing standards relative to communications with audit committees. The Center for Audit Quality supports efforts to continue to strengthen the communications between auditors and audit committees given the important role audit committees play in protecting the interests of investors. Specifically, we believe effective two-way communications between auditors and audit committees is critical to the effective conduct of the audit committee's oversight responsibilities, and that improvements can continue to be made in this important area.

With respect to additional information that should be communicated by auditors to the audit committee, we believe the PCAOB's proposed requirements will generally result in information being provided to audit committees that is of more use. We support the efforts of the PCAOB to gather additional perspectives on its proposal from audit committee members, board members, and others on information that is meaningful to an audit committee's responsibilities. In addition, we believe it is important for the auditor to consider management's communications to the audit committee, and we believe that any new guidance should emphasize that the auditor's role should be focused on providing an objective evaluation of management's judgments involved in the preparation of the company's financial statements.

Timing of communications between the auditor and the audit committee is also an important factor to consider in any new guidance. The CAQ supports the PCAOB's proposal to require timely communication by the auditor to the audit committee of the matters required by the proposed standard prior to the filing of an entity's year-end or interim financial statements with the SEC. The CAQ and the profession are supportive of robust communications between auditors and the audit committee.

Q.3. The Investor Advocacy Group of the PCAOB recently discussed a survey and noted four potential areas of improvement in auditor communications:

a. assessments of management's estimates and judgments;
b. areas of high financial statement and audit risk;
c. unusual transactions, restatement, and other significant changes; and
d. assessments of the quality of the issuer's accounting policies and practices.

Please give us your detailed thoughts concerning whether there should be increased communications in each of the areas noted. Has the Center for Audit Quality issued any industry guidance to the auditing profession to increase communication? If not, why not?

A.3. A number of regulators and policy makers here and abroad are looking at the subject of auditor communication. With respect to work underway in the United States, the PCAOB has completed extensive outreach to stakeholder groups (including investors) on whether the PCAOB should modify the auditor's reporting model. The CAQ supports providing investors with more information about the audit. Toward that, the CAQ met several times with PCAOB staff and suggested a number of areas where the auditor's report could be clarified or expanded to provide more information to investors about the audit process and key areas of audit focus. These include:

- Auditor association with critical accounting estimates disclosed in Management's Discussion and Analysis (or alternatively a separate supplemental auditor communication on critical accounting estimates).
- Additional information communicating audit scope and procedures, such as providing a "link" within the auditor's report to a separate document that describes the audit process including a discussion of the responsibilities of auditors, management and audit committees.
- Additional wording in the standard audit report to include:
  - Reference to "related disclosures in the notes to financial statements" in both the scope and opinion paragraphs; and
  - New language related to the auditor's responsibility for information outside the financial statements.

The PCAOB will publish a concept release based on all of the feedback it received, and the CAQ plans to comment on the proposals and continue to provide the PCAOB input and support as it goes about this important initiative.

As a membership and public policy organization, the CAQ does not issue guidance. However, after the PCAOB and other regulators issue a new standard or regulation, the CAQ typically offers educational tools (via member alerts, white papers, and/or webcasts) for our approximately 650 member firms, and I envision that we would do the same with respect to any new PCAOB standard on the auditor's reporting model.

In addition, the CAQ is sponsoring a series of discussions with all stakeholders, including investors, to consider what additional work auditors might perform with respect to public companies separate from performing and reporting on the audit. A key issue is how the delivery of information can be improved without "piling on" more disclosures that overwhelm users. Some of the issues we plan to discuss are:

- What information, beyond current information provided by management and auditors, would be useful to assist users in assessing the quality of a company's financial accounting and who should provide it to users? For example, would it be useful to provide information relative to choice of accounting policies or the most important elements of the financial statements (*i.e.,* the company's key financial estimates and accounting judgments)?
- Should there be some form of auditor association with certain other information disclosed in the annual report or annual proxy statement (*e.g.,* MD&A, management's risk discussion)?
- Should there be some form of auditor association with matters outside of the annual report (*e.g.,* earnings press releases)?

Our hope is that these discussions will expose stakeholders to these potentially paradigm-changing issues, encourage hard thinking around the cost-benefits of various proposals, whether they require modification to current standards and regulatory frameworks, and, hopefully, find consensus.

Q.4. Auditing firms and investors have publicly expressed the need for increased transparency into large firms and their complex networks. Foreign regulators have adopted transparency standards that exceed those in the U.S., such as the EU's Article 40 Transparency Report. Should audit firms publish annual audited financial statements? What do you believe are the strengths and weaknesses of such a proposal? What additional information should be disclosed? What work has the Center for Audit Quality done concerning the issue of increasing the transparency into large accounting firms? What additional work is being done? What additional work should be done?

A.4. The CAQ supports increasing transparency of information that is relevant to particular audiences. The information needs of regulators, audit committees, and the public are all different and, the needs of particular audiences should dictate the type of information made available. In my mind, there are two basic categories of audit firm information, serving two basic needs. First, there is information that is relevant to the quality of audits performed by public company audit firms (of relevance to regulators, investors, and audit committees). The PCAOB currently requires audit firms to supply it with information of such a nature and in such a format as the PCAOB requests and that fits its needs. Second, there is additional information that may inform regulators charged with executing independent oversight in furtherance and protection of the public interest. To that end, the CAQ is supportive of a workable set of key indicators similar to those found in Article 40 of the European Union's Eighth Company Law Directive. We also believe it is appropriate for public company audit firms—particularly the largest firms subject to annual PCAOB inspections—to make information publicly available regarding firm quality controls, structure, governance, approach to audits, and the risk assessment regime.

With respect to the specific question of firms publishing audited financial statements, I do not believe that there is a compelling public policy reason for doing so, nor do I believe such information would inform readers about a firm's ability to provide quality audits. Audit firms are not public companies and do not access the public capital markets. There also could be adverse unintended consequences to smaller public company auditing firms that could exacerbate public company audit market concentration. Smaller audit firms with a public company auditing practice which also compete fiercely in the private company auditing space could be at a disadvantage with their competitors which do not perform public company audits and rather than comply, may opt out of the public company auditing arena altogether. This is especially likely because, unlike with large audit firms, public company auditing often represents a small portion of a smaller firm's revenue stream. The Treasury Department's Advisory Committee on the Auditing Profession heard testimony from representatives of smaller firms to this effect during its hearings.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM THOMAS QUAADMAN

Q.1. Auditing firms and investors have publicly expressed the need for increased transparency into large firms and their complex networks. Foreign regulators have adopted transparency standards that exceed those in the U.S., such as the EU's Article 40 Transparency Report. Should audit firms publish annual audited financial statements? What do you believe are the strengths and weaknesses of such a proposal? What additional information should be disclosed?

A.1. Response not provided.

Q.2. The Investor Advocacy Group of the PCAOB recently discussed a survey and noted four potential areas of improvement in auditor communications:

a. assessments of management's estimates and judgments;
b. areas of high financial statement and audit risk;
c. unusual transactions, restatement, and other significant changes; and
d. assessments of the quality of the issuer's accounting policies and practices.

Please give us your detailed thoughts concerning whether there should be increased communications in each of the areas noted.

A.2. Response not provided.

Q.3. What additional information do you believe should be communicated by auditors to the audit committee? When should the communication occur (*e.g.,* during the performance of an audit or review, during the performance of an audit, after an audit has concluded, or at another time)?

A.3. Response not provided.

Q.4. Mr. Doty recommended that Congress consider changes to permit the PCOAB to disclose its decision to institute disciplinary hearings, which is currently prohibited by Section 105(c)(2) of the Sarbanes-Oxley Act of 2002. Please give us your detailed thoughts regarding the strengths and weaknesses of this proposal.

A.4. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM LYNN E. TURNER

Q.1. What additional information do you believe should be communicated by auditors to the audit committee? When should the communication occur (*e.g.,* during the performance of an audit or review, during the performance of an audit, after an audit has concluded, or at another time)?

A.1. Response not provided.

Q.2. Mr. Doty recommended that Congress consider changes to permit the PCOAB to disclose its decision to institute disciplinary hearings, which is currently prohibited by Section 105(c)(2) of the Sarbanes-Oxley Act of 2002. Please give us your detailed thoughts regarding the strengths and weaknesses of this proposal.

A.2. Response not provided.

Q.3. Auditing firms and investors have publicly expressed the need for increased transparency into large firms and their complex networks. Foreign regulators have adopted transparency standards that exceed those in the U.S., such as the EU's Article 40 Transparency Report. Should audit firms publish annual audited financial statements? What do you believe are the strengths and weaknesses of such a proposal? What additional information should be disclosed?

A.3. Response not provided.

Q.4. The Investor Advocacy Group of the PCAOB recently discussed a survey and noted four potential areas of improvement in auditor communications:

a. assessments of management's estimates and judgments;
b. areas of high financial statement and audit risk;
c. unusual transactions, restatement, and other significant changes; and
d. assessments of the quality of the issuer's accounting policies and practices.

Please give us your detailed thoughts concerning whether there should be increased communications in each of the areas noted.

A.4. Response not provided.