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Specialized industry accounting and reporting. Too much of a good thing?

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Thanks and congratulations to Bill Holder on organizing another wonderful conference again this year. It's always a pleasure to have the opportunity to speak here in beautiful Pasadena.

If you have heard some of my speeches over the past couple of years you probably heard me discuss what I view as one of the most significant issues in our financial reporting system - complexity. Last year at this conference I discussed complexity and how, in my view, it impedes transparent financial reporting. In that speech, I discussed efforts by the SEC, the PCAOB, as well as our efforts at the FASB, to improve upon our financial reporting system, which may be the best in the world, but which I believe can be even better. I also spoke about some critical challenges to our financial reporting system and efforts underway to respond to those challenges. Today, I would like to pick up on these themes and focus on a matter that has certainly added to the overall volume of U.S. accounting standards and SEC rules and regulations and that is the topic of specialized industry accounting and reporting, and ask ourselves whether it is possible to have too much of a good thing.

Before I plunge back into the history of U.S. accounting and reporting, I think it is important to note that our financial reporting system has changed significantly these past few years. The Sarbanes-Oxley Act of 2002, along with the associated steps by the SEC, the PCAOB, the FASB and many other key players has had a significant impact on our financial reporting system. The benefits seem clear with improved corporate governance, improved independence of advisors, auditors, and audit committees and a renewed focus on accurate and transparent financial reporting. Investors seem to have noticed, as all of the major stock indexes have risen sharply since their lows in 2002. While the link between financial reporting enhancements and the stock market may not be a direct one, I think it is fair to say that investors seem more confident nowadays in the U.S. capital markets than they did five years ago. And trust and confidence in our capital markets is a major national asset that we must continue to strive to maintain.

But of course, these benefits do not come without associated costs. Criticisms of the costs of compliance with Section 404 of the Sarbanes-Oxley Act and other aspects of our regulatory and reporting system, particularly for smaller registrants, have been raised by a number of parties. The SEC and PCAOB have worked hard to improve their guidance on the implementation of the internal control provisions of the Act to make it more risked based and more principled. I can attest that tweaks and more significant adjustments in standards are often necessary. I applaud the efforts of both organizations to improve the efficiency and the effectiveness of their guidance in this area.

These costs and perceived trends by some in terms of the competitiveness of our capital markets have also prompted broader discussion amongst the stakeholders in our system. The reports of study groups such as the Commission on Capital Markets Regulation, the U.S. Chamber of Commerce's Commission on Regulation of U.S. Capital Markets in the 21st Century and the study commissioned by New York City Mayor Bloomberg and New York Senator Schumer highlight both the strengths of our system along with concerns relating to the competitiveness of the U.S. capital markets. While the charge of these groups was broader than just financial reporting and extended to our whole system of financial services and capital markets structure, regulation, and conduct, their findings in terms of the broader challenges facing our capital markets do seem to echo some of the themes I have previously talked about in terms of fundamental, structural, institutional, cultural and behavioral issues in our financial reporting system. These reports point to perceptions by some of an overly-complex regulatory system that some believe has resulted in overlapping, inconsistent and competing rules, regulation, and enforcement. Indeed, I found it very interesting when I participated in Treasury Secretary Paulson's gathering this past March on U.S. capital markets competitiveness, that a good deal of the discussion focused on the desire for a more principles-based system in the U.S., not so much in terms of accounting and financial reporting (though that was also certainly covered), but more so in regard to our whole legal and regulatory system with, rightly or wrongly, a lot of the discussion focused on the trial bar and on regulators, including the SEC.

While I found that quite interesting, our role at the FASB is, of course, much narrower and confined to accounting and financial reporting standards. Nevertheless, we must continue to do all we can to do our part to address the issues relating to complexity in financial reporting. As Jim Kroeker may note, the SEC, the PCAOB and we have recently renewed discussions about establishing a committee consisting of representatives of the key constituency groups to address how collectively we might go about reducing the complexity and improving the overall transparency and usefulness of reported financial information. As I have said before, the issue of complexity is a complicated one that will require a cooperative and concerted effort by various parties to address the structural, institutional, and behavioral factors that have created complexity in our system and impeded transparent reporting.

In the meantime, at the FASB we continue to try to do our part to both improve and simplify the U.S. accounting literature.

In that regard, you may recall that last year I spoke about our multi- pronged approach to address some of the complexity associated with accounting standards. First, we continue to systematically readdress accounting standards in major areas for which the existing complex and outdated rules fail to provide relevant and transparent financial information. I think our lease accounting project is good example of this. Current lease accounting is based on the view that when a lease transfers substantially all of the benefits and risks of ownership of the property, it should be accounted for as an asset and a corresponding liability by the lessee and the asset is derecognized by the lessor. A lease that does not transfer substantially all of the benefits and risks of the ownership is classified as an operating lease, which results in the lessee not recognizing any elements of the lease on its balance sheet (that is, no asset for the right to use the asset and no related liability for the future lease payments); rather, rental expense is recognized as amounts becomes payable.

While this may sound like a principle, the guidance is based on bright line tests and has been interpreted by volumes of literature subsequent to the original issuance of Statement

13 in 1976. Existing lease accounting has long been criticized by users of financial information as lacking transparency and as not representationally faithful of the underlying economics. We are working through these issues and other concerns regarding lease accounting with our counterparts at the IASB, closely consulting with interested parties as we explore the issues.

The second initiative is another major joint project with the IASB, and that is to strengthen and converge our respective existing conceptual frameworks. We have received some valuable input on a preliminary views document that we published last summer on objectives and qualitative characteristics and we are working toward our goal of an improved and converged framework which will hopefully provide a common basis for developing more principles-based accounting standards in the future. We have also begun work on the definitions of elements phase, on the reporting entity, and on the all important issue of measurement in accounting.

A third initiative we have undertaken attempts to respond to criticisms of the complexity of the reporting standards themselves, by improving the understandability, consistency and overall usability of the existing accounting literature. This effort includes developing more principled-based and objectives-oriented standards that are written with an increased focus on communicating the objectives and principles as simply and clearly as possible. We recently issued a proposal, *Accounting for Financial Guarantee Insurance Contracts*, which is our first exposure draft in a new format intended to improve the understandability of our documents. The most notable changes from formats used in previous documents is to use bold text at the beginning of each section to convey the accounting principle and the inclusion of examples in the body of the standard itself to illustrate the proposed accounting guidance for certain paragraphs. We are seeking input on this new format. See whether you think it is more understandable.

And, of course, there is the codification project in which we have been developing a comprehensive and integrated single source of all the existing U.S. non-governmental accounting literature organized in a standardized format by subject matter. The project is proceeding as planned and we currently expect to release it for use, in late 2007 for an extended “verification” period before we sprinkle holy water on it and make it the official GAAP.

Finally, in an effort to stem the proliferation of guidance from multiple parties, which brought about the need for us to undertake the codification, we have taken a number of steps over the past few years to try to rationalize the accounting standard setting structure in the U.S. This last point is important in the context of reducing complexity as historically accounting standards have emanated from multiple sources. While these different organizations had a similar overarching objective of providing accounting guidance to constituents, the underlying goals and influences on these organizations were not, in my view, always in sync.

And that now brings me to the subject of specialized industry accounting and reporting guidance. Having different accounting standard setting organizations has had another impact – the development of very extensive and detailed industry specific accounting and reporting guidance. Here in the U.S., we have a lot of industry specific guidance in areas such as insurance, banking, mortgage banking, broker dealers, real estate, mining, oil & gas, retail, heathcare, rate-regulated enterprises, and the list goes on and on. Having different organizations setting accounting standards is not the only reason for the proliferation of industry specific guidance but, in my view, it has been a significant contributor. Another significant contributor is the desire by some for what I call “build to suit” accounting, that is, an approach that tries to address and tailor the required accounting to accommodate perceived special needs and desires by different industry groups and types of enterprises. Additionally, concerns over being second guessed have resulted in constant requests for both industry specific and transaction specific guidance.

But having all this guidance doesn’t necessarily enable people to avoid using judgment in the preparation and auditing of financial statements, rather it changes the nature of the judgments that need to be applied. Instead of preparers and auditors having to make judgments on the economics of the transaction, they are now making judgments on whether they are in or out of the scope of specific industry or transaction guidance. And the decision of whether an entity is in or out of a narrowly scoped industry standard may result in very different accounting and reporting depending on the outcome of the scoping determination. For example, take a large financial services company that includes various subsidiaries and divisions that do banking, mortgage banking, investment banking, broker-dealers, venture capital, mutual funds and insurance. It will have to apply specialized accounting guidance for each of these parts of its business. But what if there are similar activities in the different parts of the business, for example, what if the insurance subsidiary does some lending, or the banking parts of the business do some broker-dealer types of activities? And can the company change the accounting for a transaction by changing which subsidiary or division does it? If so, how do users of these financial statements understand and evaluate those differences in reporting? Can they recast the numbers to achieve comparability and consistency?

In fact, one of the reasons cited for having industry specific guidance is to achieve greater comparability and consistency in the accounting and reporting across all the companies in a particular industry. And indeed, I believe it has generally had that effect, which would seem like a good thing particularly to preparers, auditors, regulators, and users that focus on a particular industry. And, of course, there are a number of professional investors and many financial analysts that do focus on a particular industry or sector. Furthermore, industry specific disclosures of both financial information and key nonfinancial performance indicators can be very useful and informative.

Indeed, in some instances, industry specific guidance or requirements may provide for more detailed and relevant information than other literature. For example, SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others,* has specific disclosure requirements including off-balance sheet credit risks and certain types of capital disclosures for enterprises the are within its scope and considered financial institutions. If an enterprise has similar activities but is not within the scope of that SOP, I would think that the investors of that enterprise would find the incremental disclosures useful. But the determination of whether or not it is considered a Financial Institution, as defined, will determine whether or not these disclosures are required. In this instance the industry specific requirements may be perceived as better information, but the scoping assessment impacts which users are getting the information.

So, as I just noted in connection with my hypothetical example of a large company that operates in and across many areas of financial services, there is the possibility that having different specialized industry standards, rules, and regulations may actually impede comparability and the overall understandability and transparency of the financial information it reports. Moreover, to the extent that industries for which there is different specialized industry accounting are converging or overlapping in terms of engaging in similar transactions and activities, the existing industry specific accounting standards can create a barrier to more comparable and transparent reporting.

Thus, we have to ask ourselves if and to what extent industry specific accounting guidance is a good thing. From my perspective it is good if it reflects the special nature of the activities in a particular industry, that is when there are important underlying differences in the economics of that industry such that different accounting is needed to faithfully portray its activities. It is not so good when the guidance doesn't reflect real underlying differences. An example of specialized accounting guidance that does seem necessary to properly reflect underlying differences is that for not-for-profit entities. These types of organizations clearly do have different objectives than typical for-profit businesses and the users of the financial statements, such as donors, are looking for different types of information. So I think that guidance tailored for not-for-profit organizations is clearly a situation where specialized accounting guidance is justified. And though I am not an expert in governmental accounting and reporting, differences between such entities and for-profit enterprises and differences in user needs would also seem to warrant differences in the accounting in this area. But when it comes to many industries in the for-profit world, I think the analysis gets much more subjective and more difficult to assess whether and to what extent there needs to be specialized accounting. Again, to me, the key question to ask is whether the industry specific guidance better reflects true underlying business and economic differences.

In some cases, this may be so, for example, insurance would seem clearly very different than oil and gas production. But within insurance, is life insurance that different from property and casualty insurance and from reinsurance that we need different standards with different accounting methods for each of those types of insurance? That is a live issue as the IASB has been developing an overall approach to accounting for insurance contracts that does not make these differentiations, an approach that is very different from our current U.S. accounting for insurance, and that we will soon be seeking input on from U.S. constituents in the form of an invitation to comment. And why is it that in the U.S. we have over 200 separate pronouncements dealing with revenue recognition, many of which relate to specific industries and, that by the count of our staff, has resulted in over 50 different models for revenue recognition under U.S. GAAP? Does that result in better, more understandable, more transparent and more comparable financial reporting? Or could we get by with just a handful of more conceptually based approaches, something that our joint project on revenue recognition with the IASB has as its objective? And with respect to the subject of impairment of long-lived assets, how many different approaches do we need? For while Statement 144 provides the basic guidance, it is not applicable to a number of specialized industries such as broadcasting, records and music, and motion pictures or to computer software under Statement 86, or to rate-regulated enterprises.

The existence of specialized industry accounting guidance also adds to the costs in our financial reporting system in terms of training costs, to the costs and efforts of standard setting needed to maintain all this guidance and to provide guidance on emerging transactions and changing business practices within the confines of the particular specialized industry accounting standards and rules, and to the need for narrowly focused specialists at the accounting firms, at the SEC, at the FASB, and at companies that operate in several industries. It has been a complicating factor in developing the codification and in developing a U.S. GAAP taxonomy for XBRL reporting by significantly increasing the number of different data tags that need to be created. And how does this all relate to the possibility of the SEC allowing U.S. companies to use

IFRS? For example, could companies continue to follow specialized U.S. industry accounting guidance for which there is no specific IFRS guidance and claim to be in compliance with IFRS? If not, what would they do? If yes, that is if they can continue to use specialized U.S. industry accounting, does this mean that there will effectively be a special U.S. brand of IFRS? Would that be a good thing or a bad thing?

The existence of a multitude of specialized industry accounting standards, rules and regulations is also viewed by some as one of the impediments to our system moving to more of a principles-based approach based on consistent concepts. As noted in the 2003 SEC report to Congress on the adoption in the United States of a principles-based accounting system, "The proliferation of specialized industry standards creates two problems that can hinder standard setters' efforts to issue subsequent standards using a more objectives-oriented regime:

- The existence of specialized industry practices may make it more difficult for standards setters to eliminate scope exceptions in subsequent standards (e.g., many standards contain exceptions for insurance arrangements subject to specialized industry accounting)
- The specialized standards may create conflicting GAAP, which makes it more difficult for accounting professionals to determine the appropriate accounting."

So without judging whether and to what extent having lots of specialized industry accounting and reporting guidance is a good or bad thing, we might ask how we got to this current state in the U.S. For while there is a certain degree of industry specific accounting and reporting guidance in other parts of the world and in IFRS, it is no where as extensive and as differentiated as it is in our country. For example, UK GAAP does not include very much of it, relying instead on broader principles and practices that have evolved, in Australia and New Zealand they have deliberately tried to avoid special accounting for different industries, focusing instead on what they term "sector neutral" accounting, and while IFRS encompasses some industry specific accounting and disclosures, such as that relating to financial institutions and for agriculture and they are working on accounting for insurance contracts and on accounting for extractive activities (oil and gas and mining), the IASB clearly does not intend to develop U.S. style industry specific guidance nor do I think they believe that it is generally a good thing.

Well, I am not an accounting historian like say Steve Zeff or Gary Previts, but we can certainly see, for good or for bad, the early and strong influence of the SEC on the path our system took. For example, just look at Regulation S-X which governs the basic form and content of financial statements for SEC registrants and we see different rules covering commercial and industrial enterprises, insurance, bank holding companies, registered investment companies, public utilities, oil and gas producing activities, and so on. And the SEC staff early on and over time then provided highly specific guidance in the form of Staff Accounting Bulletins and Accounting Series Releases relating to these specific industries as well as others such as real estate and retailers. So it is not surprising that following the creation of the FASB in 1973 as the primary accounting standard setter in the U.S., the AICPA, eager to continue to have a role in accounting standard setting, would pick up on the industry specific guidance approach and take it to new heights by developing and issuing a seemingly endless series of Statements of Accounting Position and Industry Audit and Accounting Guides on a wide range of industries such as franchising, records and music, broadcasting, cable, motion pictures, title insurance, retail land sales, mortgage banking, casinos, airlines, etc, etc., many of which were subsequently "extracted" by the FASB and included in its literature. And it is also not surprising that the EITF literature includes scores of issues that provide guidance within the context of specific industry accounting standards in areas such as banking, insurance and real estate and that at the FASB as we address specific application and implementation issues we are often constrained by and need to frame FSPs and other documents in terms of existing industry specific standards, even though at times we may see great similarities between the transactions and arrangements under consideration and those occurring elsewhere in enterprises or parts of enterprises that are covered by different industry specific standards. For example, early on in the aforementioned project on financial guarantee insurance, our staff observed that financial guarantee, mortgage guarantee, and various forms of credit insurance all have similar features, but are accounted for differently under specialized industry guidance. And so, they asked us whether the project should encompass all of these or only financial guarantee insurance issued by insurance companies, which is what the SEC staff asked us to address because of the diversity in practice they were seeing amongst the players in that industry. We opted to focus at this stage only on financial guarantee insurance, in part because that was the area of concern to the SEC staff, and also because we felt that once we had developed a model in that area we could then consider whether it might also be appropriate to extend it to other similar forms of insurance. And so you'll find a question to that effect in the Notice to Recipients in the financial guarantee insurance exposure draft.

With all that said, I feel compelled at this point to quote the Spanish American philosopher George Santayana, "Those who cannot remember the past are condemned to repeat it."

For I hope I have laid out a case for asking ourselves whether and to what extent our historic approach in this country of developing highly specific industry accounting guidance is one we want to pursue in the future. As I have tried to explain, it clearly has added to the volume and overall complexity of the U.S. accounting literature, to the costs of implementing and maintaining that literature, and to other costs such as those relating to training accountants. And by its very nature, it may have helped engender a more rules-based approach to standard setting and regulation and may be an impediment to our developing a more principles-based approach based on consistent concepts. And, most importantly, it is not clear whether it has been a positive or a negative in terms of the overall understandability, transparency, comparability and usefulness of reported financial information in our system. Certainly, it is a factor we must deal with in the convergence of accounting standards, for as I said before, I do not believe the IASB and the constituents they represent want to replicate or embrace our system of detailed industry specific standards. And if IFRS is allowed to be used in this country, the existence of our specialized industry accounting would seem to raise some interesting issues in that regard.

I believe, therefore, that this is a very important topic, among many others, that should be addressed in connection with the complexity issue. In the meantime, at the FASB we will continue our efforts. My hope is that some of our major joint projects with the IASB such as those relating to the conceptual framework, to financial statement presentation, and to revenue recognition will provide a platform, not only for developing more principles-based standards in the future, but also for evaluating the extent to which different principles and standards are truly needed for different industry-based activities. For in my view, a key goal of accounting and reporting is to faithfully portray the underlying economics of transactions and events in a way that reports similar transactions and events in a similar manner and different ones differently, and conversely that doesn't result in reporting the same or similar transactions and events in a multitude of different ways. Whether and to what extent our current U.S. system, which as I have discussed today is in many cases based on highly specific industry accounting guidance, currently achieves this and whether and to what extent it provides transparent, comparable and useful information in a cost effective manner is, I believe, a key question that needs to be addressed as part of an examination of the complexity issue and in connection with international convergence.

Finally, in doing so I think it is important that we all look beyond the short-term, beyond our current areas of comfort, expertise, and vested interest and challenge ourselves to think about what the world of financial reporting could be, what it should be, and what it would take to get there.

Thank you.