Statement
of the
U.S. Chamber
of Commerce

ON: **The role of the accounting and auditing profession in preventing another financial crisis.**

TO: U.S. Senate Subcommittee on Securities, Insurance and Investment

DATE: **April 6, 2011**

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Testimony of Thomas Quaadman

Vice President, Center for Capital Markets Competitiveness

U.S. Chamber of Commerce

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Before the U.S. Senate Subcommittee on Securities, Insurance and Investment

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% 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 six 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 G-20. 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 twenty 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 Rule Making:** Hand-in-hand with the appropriate use of judgment is avoiding a system that is overly prescriptive in the formulation and application of standards and rules. The danger of an ever increasing number of rules and regulations by which audit firms are required to operate and auditors are required to apply has a danger of limiting the perspective of audit firms and auditors by displacing the application of principles and the exercise of judgment.

- **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.