STATEMENT OF JAMES G. CASTELLANO

CHAIR, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

FEBRUARY 14, 2002

Thank you, Chairman Stearns, Ranking Minority Member Towns and other distinguished members of the committee for permitting me to testify today on the adequacy of current accounting standards. I am Jim Castellano, Chairman of the Board of the American Institute of Certified Public Accountants. Corporate accountability is of great importance to the continued strength of the American economy and confidence in our capital markets. In order for our capital markets to function effectively and for our economy to allocate resources efficiently, it is essential that business enterprises report accurately and fairly to investors and that investors perceive that they do so. Our economy needs both the fact and appearance of credible financial reporting.

The business collapse of Enron last year has shaken the faith of America, and of the world, in our financial markets. The personal tragedy to Enron's employees, retirees, and investors goes far beyond the dollars and jobs they have lost. And this tragedy occurred despite the fact that we have the freest, most open, transparent, and dynamic financial market in the world. The accounting profession has also been deeply disturbed by what has occurred. We are proud of our history of serving the public interest by providing assurance to the investors that the financial statements of public companies fairly present, in all material respects, the financial position of these companies'.

The Enron business failure has added additional pressures on our economy and raised questions concerning confidence in our capital markets. Legitimate questions are being asked about corporate ethics and governance, including the role of a company's board of directors and its audit and finance committees, internal controls, compliance with accounting and audit standards and other SEC reporting requirements, financial reporting transparency, the adequacy of the current financial reporting model, the auditor disciplinary and quality review process, how analysts use available financial information in making buy/sell recommendations to investors, and other issues.

While no one has all the facts and relevant information about the failure, it appears to be the result of many contributing factors, all of which need to be addressed to restore investor confidence in the system. Our profession has zero tolerance for those who do not adhere to the rules. The AICPA and its members are committed to the goal of assuring that investors and creditors have the highest quality of financial information. We will take the necessary steps to restore public confidence in the accounting profession and capital market system, and will work with Congress to develop meaningful public policy reform.

My goal today will be to touch on some of the reforms we have supported and will continue to support for the accounting and auditing system, and to suggest additional reforms which we as CPAs believe will strengthen the financial reporting system.

Capital should be deployed where it can be most productive. At the root of productive capital investment is the availability of timely, reliable and meaningful information. The success of our capital markets depends upon informative, reliable financial reporting – often referred to as "transparency." Three critical conditions must exist for investor information reporting to be meaningful. There must be:

1. Adequate reporting standards that provide full transparency of all meaningful and relevant information to investors;

2. Compliance with those reporting standards, including appropriate auditing;

3. Timely access to, and sufficient user understanding of, the information available.

ADEQUACY OF CURRENT ACCOUNTING STANDARDS AND REPORTING SYSTEM

The current accounting model has historically performed well. But to work for today's economy, it must be modernized. Economic change has moved much more swiftly than accounting for such changes has adapted. Intellectual capital has become the greatest engine for corporate growth. Yet, accounting is still based on hard assets – physical plant and related items for producing goods. Many companies, like those in advertising, produce revenues based almost exclusively from knowledge work. Knowledge work has become the key to all companies' effectiveness. Even companies producing tangible goods have become highly dependent on intangible sources of revenues and competitive advantage.

Changes in business prospects have made quarterly reports outdated. Timely information has always been prized, but the pace of change in corporate dynamics and earnings capabilities has made it much more important. Corporate diversification, alliances of all sorts, the rate and depth of economic change, and transnational relationships have enormously changed the risks facing modern corporations. The relative absence of up-to-date information with which to assess corporate earning capacity coupled with the pace of change, helps explain the volatility of today's share prices. Meanwhile, the use of the Internet for economic communications has been exploding. Real-time disclosure of selected financial information – that is, information that can be useful to investors without creating competitive disadvantage to companies – on the Internet is clearly foreseeable. Investors need more frequent corporate financial and non-financial disclosures (i.e. on-line, real-time) to make informed investment decisions.

The accounting profession was first among those convinced the accounting model needed to be modernized. From 1991-1994, a special committee of the American Institute of Certified Public Accountants (AICPA) studied the state of business reporting.[1] The committee's greatest achievement was its research on the needs of investors and creditors. The research showed that investors have many unmet information needs. This evidence was new because investors and creditors do not actively make their information needs known to the accounting community.

The findings on information needs should have been a loud wake-up call to those who depend on the disclosure system or have responsibility for it. Investors and creditors

---

[1] AICPA Special Committee on Financial Reporting, *Improving Business Reporting – A Customer Focus*, 1994.

are, figuratively speaking, the customers of financial reporting. More precisely, because corporations seek capital from investors and creditors, investors and creditors are customers of the corporation's sale of securities. Monetary exchanges do not take place without information, and the better the information about a prospective purchase, the better the purchaser's chance to make a satisfactory pricing assessment. Putting the same point in terms of investors' purchases of securities, the better the information they have the lower the risk of poor investment or credit decisions.

The report concluded that investors' needs were not being fully met. It described needs that go far beyond what is required by the current financial reporting model. In fact, to capture the idea of reporting non-financial information, the report adopted the broader term "business reporting." The report contained an illustrated, comprehensive model of business reporting designed by the Special Committee, as well.

Business reporting is wider than financial statements. It should include non-financial information and presentations outside the financial statements. The Special Committee's business reporting model was not limited to financial statements, although it at all times includes them, in recognition of their importance to investors and creditors. The "accounting model" has in the past referred only to financial statements, but in the future it will refer as well to business reporting to investors and creditors.

It is very disappointing that the report was produced seven years ago and so little has been done in response. If investors' needs were not being met seven years ago, they are likely being met even less today. Calls for reform have come from many different sources, including nonaccountants. They include former SEC Commissioner Steven M. H. Wallman, economist Robert E. Litan, and Yale School of Management dean and former Under Secretary of Commerce for International Trade Jeffrey E. Garten. Wallman has written on his own and with Margaret Blair as part of a Brookings Institution project on intangibles. Litan joined Peter Wallison in a project for the AEI-Brookings Joint Center for Regulatory Studies.

Garten recommended that companies be given incentives to provide more information on intangible assets and performance metrics, in a report by a group commissioned by the SEC. Economists recognize the importance of intellectual capital as a source of economic growth, which means a source of revenue. For example, Brad DeLong wrote, "Economic development has become less and less about accumulating more and more physical capital and more and more about the creation and deployment of intellectual capital."[2] A 1996 United States General Accounting Office report said: "[T]he current reporting model does not provide information about important business assets. As a result, historical cost-based financial statements are not fully meeting users' needs."[3]

In the broadest sense, if we are going to modernize the accounting model, we must focus on these things:

- First, a broader "bandwidth" of information, such as was endorsed by the AICPA's Special Committee;
- Second, different distribution channels, namely, the Internet;
- And third, increased reporting frequency, ultimately, on-line, real-time reporting.

[2] A Framework for Understanding Our New Economy, part of a joint project with Stephen Cohen and John Zysman, http://econ161.berkeley.edu/OpEd/virtual/technet_outline.html.
[3] GAO, *The Accounting Profession: Major Issues: Progress and Concerns*, GAO/AIMD-96-98, September 1996,p.16.

The root problem is the mismatch between widespread agreement that users' information needs are not being met and the lack of consensus on how best to meet those needs. Efforts to modernize business reporting must be accelerated, but where should they start?

Reform should address unreported intangibles, off balance sheet activity, non-financial performance indicators, forward-looking information, enterprise opportunity and risk, and more timely reporting. These could become time-consuming projects. However, we support the following list of near term reforms.

NEAR TERM REFORMS:

The FASB should issue standards-level guidance on the location, form, and content of non-financial information that would supplement the historical financial statements. In particular, the FASB should address non-financial performance indicators, unrecorded intangible assets, and forward-looking information. The FASB should determine whether such supplementary reporting should be required, based on experience with voluntary reporting or any other relevant factors it chooses to bring to bear.

As part of the its standards-level guidance, the FASB should make explicit that for purposes of its mandate, disclosures that supplement the financial statements can be desirable to meet users' needs, even if the disclosures go beyond what some believe is necessary to understand the financial statements. The broader criterion of information useful for making investment and credit decisions should apply. In addition, in the same guidance, the Board should make more explicit the tension between the desirability of comparability and of relevance in business reporting, making clear that users' needs can at times be satisfied best by relevant information that is not comparable across a population of companies.[4]

The FASB, working with the SEC, should begin a project to consider revising the frequency of reporting based upon the needs of users utilizing the capabilities of modern accounting software and telecommunications.

The accounting profession stands ready to sponsor projects to help the FASB and the SEC complete the projects recommended above in the shortest reasonable timeframe.

These recommendations to the FASB are compatible with its adoption of its project on intangibles.[5] The project would establish standards for disclosures about intangible assets not recognized as assets in the financial statements. The proposed project follows the publication of a study by the FASB staff which identified four possible intangibles projects.[6] We strongly support the FASB's adoption of the proposed agenda item. Although the project will entail some difficult subjects, it should be put on a fast track.

OTHER REFORMS

---

[4] Statement of Financial Reporting Concepts No. 2, Qualitative Characteristics of Accounting Information (FASB 1980), states: "Improving comparability may destroy or weaken relevance or reliability if, to secure comparability between two measures, one of them has to be obtained by a method yielding less relevant or less reliable information" (par. 116).

[5] Available at the FASB's website: http://www.fasb.org.

[6] Wayne Upton, *Business and Financial Reporting, Challenges from the New Economy* (April 2001). Available at the FASB's website: www.fasb.org. Upton's potential projects were as follows: "Address" the format and content of non-financial metrics, in notes or elsewhere (5 issues are set out, including whether standard setters should develop a standard format); the format and content of disclosure about recognized and unrecognized intangible assets; recognition of intangible assets created as the result of a "project" effort (e.g., R&D); and recognition and measurement of embedded intangibles and service obligations (e.g.,

Support for reform should not be limited to standard setters, regulators, and those whose oversight can take on formal qualities. All interested parties – including but not limited to the accounting profession, the investment community, registrants, creditors, and the financial industry – should be actively and constructively engaged. They should be united by the common goal of improving the national welfare by empowering investors with better information and thereby spurring growth-creating capital allocation.

For example, we recommend reforms in the following areas:

OFF BALANCE SHEET DISCLOSURES:

We encourage FASB to reprioritize its project agenda and move quickly on its consolidation project to address off-balance sheet disclosure transparency issues. Existing accounting rules for special purpose entities should be reviewed for possible accounting abuses and new types of financing vehicles.

REPORTS ON EFFECTIVENESS OF INTERNAL CONTROLS:

In the near term, company management should be required to make an analysis and assertion as to the effectiveness of the company's internal control apparatus. The auditor should be required to attest to and report separately on the effectiveness of the management assertion. Management and auditor's reports on internal controls could make a positive and cost effective contribution to the assurance system and will improve

---

a bank's core-deposit intangible and an insurer's claim-handling obligation). The list is in Appendix A, pp.111-113, of the website version.

investor confidence in the integrity and reliability of financial statements issued by those who access the capital market. In the wake of the savings and loan collapse, congress placed similar requirements on depository institutions and their auditors.

DISCLOSURES BY COMPANY MANAGEMENT:

Stock Options: The FASB working with the SEC should require expanded disclosure of stock options received by the company management.

Insider Trading: Currently, company insiders do not have to disclose stock sales on the open market until the month after the transaction at the earliest. We believe it would make more sense to require disclosure of the intent to sell shares PRIOR to the transaction. In addition to the SEC, all other interested parties such as employees, shareholders, retirees, and pension fund managers should be notified.

Other Disclosures: We encourage the SEC to initiate additional rulemaking action to enhance disclosures in public company filings related to other management disclosure issues. The AICPA recently endorsed a petition to the SEC calling for more disclosure in a company's proxy statement about a company's liquidity, off-balance sheet entities, related party transactions and hedging contracts.

We are encouraged by the SEC's desire to make rapid progress on business-reporting reform and its desire to achieve timely and more informative filings that can help better inform investors without harm to the SEC's investor-protection mission. It should consider carefully the relevant recommendations of the ABA Committee on Federal Regulation of Securities[7] and revisit the proposals made in 1996 by the SEC's own Advisory Committee on the Capital Formation and Regulatory Processes. The Congress should support these efforts.

MANAGEMENT DISCUSSION AND ANALYSIS OF OPERATIONS:

As auditors, we also stand ready to provide additional assurances over management's discussion and analysis ("MD&A"). Our responsibility, under a traditional audit, is to read the MD&A and consider whether such information is materially inconsistent with the financial information presented in the audited financial statements. We are not required to render a report on our findings; rather we are only required to inform management of our findings if we believe the information is materially inconsistent. Because as a profession we believed that audit committees and boards of directors may want additional assurances relative to MD&A, we introduced, in June 2001, a new audit level service to examine the MD&A. This service, which is separate from our traditional audit, examines MD&A for the purpose of expressing an opinion as to whether:

a) The presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC.

[7] A letter with relevant proposals, in the context of reforming the regulatory regime under the 1993 Securities Act, was sent to the SEC Division of Corporation Finance on August 22, 2001. See www.abanet.org/buslaw/fedsec/comments.html.

b) The historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements.

c) The underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein.

While the demand for this additional voluntary examination has been slow to develop, we hope that more audit committees and board members will avail themselves of this added assurance.

AUDITOR RESPONSIBLITY:

We also need new audit strategies and technologies. In an ideal world, companies would be producing the new disclosures with the desired frequency over the Internet; auditors would be providing contemporaneous assurance that the information was reliable; investors would benefit from better decision making information; productive corporations would benefit from a lower cost of capital; and the economy would be growing with more stability and promise, even than now.

To accomplish this result, not only must the reporting model change but also the focus of auditing must change. Steps toward this new direction have already begun. Auditors in this new world would be reporting on information systems. They would be focusing heavily on preventive controls and providing assurance that information systems were operating effectively and sufficiently to produce reliable information. The transition is also going to demand personnel of the highest caliber. But there will still be pitfalls even in this scenario. While new disclosures could be produced, and the auditors could provide assurance over the systems producing the disclosures, there is still the threat of management overriding the systems and preparing fraudulent and untruthful disclosures. That is why our profession, even before these recent Enron events, has been working on improving auditing standards and guidance to help auditors better detect fraud. Two of the more noted proposed changes, among others, are explicit procedures addressing the risk of management override of controls and required procedures to evaluate the business rationale for significant unusual transactions. A draft of this new standard, intended to elicit public comments, will be issued by month's end with the expectation of issuing a final standard by the end of the year.

In addition to these changes, we are also looking at the following reforms:

We are reviewing the adequacy of professional auditing standards regarding all issues emanating from Enron, including audit procedures from related party transactions, special purpose entities, hedging contracts, internal controls established by the finance or audit committees, and working paper and record retention, and others. We will work with the SEC, FASB and Members of Congress on these recommendations.

We believe it should be illegal to lie to your auditor in the same way for example, that it is a illegal to lie to a prosecutor. We would support legislation or regulations that would accomplish that.

Public Participation:

The AICPA, is committed to working diligently with Congress and the SEC to develop a new regulatory model that improves and goes beyond the current self-regulatory processes. While the current self-regulatory model provides for significant public oversight over the existing peer review process, there is no public oversight over discipline. This new model would affect all firms doing SEC audits. We will diligently work to improve the profession's peer review and disciplinary process as it relates to auditors of SEC registrants. We strongly support moving from public oversight to public participation and increasing the transparency, effectiveness, and timeliness of the process. We will work with the Congress and the SEC to strengthen regulation of the profession as they implement a system that incorporates active public participation to enhance discipline and quality monitoring.

Non-Audit Services

We will not oppose prohibitions on auditors of public companies from providing financial systems design and implementation and internal audit outsourcing**.** We believe such prohibitions will help to restore the public's confidence in the financial reporting system.

Preparing For the Future Now:

But there is another way of viewing this scenario. The disclosures could be produced, and auditors could find themselves inadequately prepared to provide assurance to investors about the information's reliability. The transition to new reporting and auditing models is going to demand not only new audit approaches but personnel of the highest caliber. With this in mind, the profession has been working actively in the following areas:

Continuous Auditing. Continuous auditing or continuous assurance involves reporting on short time frames and can pertain to either reporting on the effectiveness of a system producing data or more frequent reporting on the data itself. An AICPA task force has concluded that the enabling technologies, if not the tools, required to provide continuous assurance services, are, for the most part, currently available. Their actual implementation will evolve with progressive adoption of the concept and the emergence of appropriate specialized software tools. Work is needed, however, to better understand the market potential for continuous assurance. A clearer insight is needed into both users' needs as well as decision-makers' perceptions of the value of this service. A marketing study of user needs would help assess the types of key performance indicators, system reliability issues, and financial and non-financial information that would benefit users. Depending on corporate platforms and established monitoring processes used for other purposes the costs of providing continuous auditing or assurance will vary. Therefore, further research is also needed to better understand how the potential purchasers of these services, such as management, boards and institutional investors, perceive the value of continuous assurance relative to the current model of periodic assurance.

XBRL. XBRL (or Extensible Business Reporting Language) is a freely available internet-based language for business reporting. It is a framework that provides the business community a standards based method to prepare, publish, reliably extract and automatically exchange business reports of companies and the information they contain.

Whatever new reporting standards are considered appropriate, it is likely to be richer in disclosure than what we have today and will need XBRL to facilitate.

SysTrust. SysTrust is an assurance level service that independently verifies the reliability of a particular system (including a financial reporting system) against a framework of standards that address security, availability and integrity. Providing a freely available benchmark for what makes a system reliable, SysTrust is designed to provide assurance to boards of directors, corporate management, and investors that the systems that support a business or a particular activity are reliable.

Performance Measures and Value Measurement. The Value Measurement and Reporting Collaborative (VMRC) is the culmination of years of discussion about the need to change the reporting model. Numerous reports, white papers and books have cited the need for better information to be disclosed by publicly traded companies, not merely more information. Over the past year, the AICPA has been approached by a number of organizations that claim to have the solution to the need for better disclosure. While some companies are already taking steps to report information that investors want, currently these efforts are isolated and may not be comparable between companies. Rather than work with one organization, the AICPA and the Canadian Institute of Chartered Accountants are establishing the VMRC as a means to allow the various stakeholders to work together to determine the best methodology for reporting. Current suggestions include, but are not limited to, reporting of non-financial measures, intangible assets or a combined discounted cash flow and risk analyses. Specifically, the collaborative will:

- Understand the needs of the user community/stakeholder groups;
- Determine what is currently taking place in the field;
- Undertake an in-depth review of 7 or 8 alternative approaches to value measurement and reporting;

Further, this new framework, which will work in conjunction with the current model, will move the current reporting forward not in an incremental step, but in the revolutionary change that is needed today.

Student Recruitment. The AICPA has embarked on a new student marketing and recruitment plan, designed to attract more students - and the best students - to the accounting profession. This five-year, $25 million initiative is targeted toward late high school and college students, and is interactive in its approach, using web-based business simulations and games, college TV networks and other technology-based techniques to reach this important generation of young people. The campaign will help students understand the important role that CPAs play in all facets of the business world, and the important responsibilities CPAs have in helping businesses and individuals succeed.

In conclusion, I maintain that Congress and others should carefully consider these reforms as they are essential to restore investor confidence in the financial reporting system. I can assure you that the CPA profession wants, as I know you do, to assure that this future comes about for the benefit of shareholders, consumers, and indeed, all American citizens.

Thank you for this opportunity to express our views.