Speech by SEC Commissioner: Remarks at the 35th Annual AICPA National Conference on Current SEC and PCAOB Developments

by

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Thank you, Cindy. I am honored to have been invited to speak to you today. Before I continue and perhaps say something too controversial, let me make the standard disclaimer that the views I express this morning are my own and do not reflect the views of the Commission or my fellow Commissioners.

As regulators, it seems we have given you plenty to discuss over the next few days. Indeed, I suppose I could not start my remarks without highlighting the great understatement of the day, which is that the accounting and auditing profession is undergoing a period of significant change. I think it is also fair to note that for many, it may seem that this change is occurring at an accelerated pace, making it even harder to predict what the future for the profession holds.

As financial professionals and auditors, you are on the frontlines of these important developments, and as gatekeepers, you perform an extremely important function that is critical to maintaining investor confidence in our financial reporting system and our markets. The good news is that I believe that many of the changes afoot, some driven by market forces and developments, others a product of the regulatory and legal landscape and the SEC and PCAOB's efforts on a variety of fronts — all have the promise of a new and improved paradigm in financial reporting, accounting, and auditing standards.

The bad news is that there are always costs that come with such change — as I am sure you know only too well. So, for many in this room, five years after the passage of the landmark Sarbanes-Oxley Act, the question must be: When do all the benefits of change catch up to the costs? And so too for policymakers and regulators, the question must be: How can we be sure that all the benefits of change that we sought and continue to seek are achieved and are not outweighed by the costs? These are fair, proper and necessary questions. And ones that many people, including many who will be joining you at this conference, are engaged in trying to answer on a variety of fronts.

Clearly, the SEC plays a key role and I'd like to touch on some of the important initiatives we are working on as well as mention what I view as the complementary efforts being undertaken by others to consider beneficial improvements to the financial reporting system and the auditing and accounting profession.

As you are fully aware, the goal of the Commission's issuance of its interpretive release on management guidance last summer, taken together with the PCAOB's adoption of new Auditing Standard No. 5, was to reduce the costs and burdens on public companies of complying with the internal control requirements. First of all, we wanted to make clear that the check-the-box procedures and burdensome documentation requirements that characterized some previous 404 compliance efforts were a thing of the past. Second, we wanted to empower companies and their auditors to exercise judgment in assessing the appropriateness of internal control systems, in light of the nature and extent of particular business operations, and to focus on the areas of greatest risk.

We hope that, as a result of our actions, the accelerated filers will see a reduction in the costs and burdens of the internal control requirements. We recognize that these filers have been subject to Section 404 for the past three years and have already created their compliance infrastructure, but we continue to hope to see a reduction in costs, and therefore fees, associated with this audit function. We further hope that savings in costs and resources will be experienced by smaller public companies as, for the first time this year, they conduct their management assessment of internal controls over financial reporting and, ultimately, at some point, come into compliance with the auditor's attestation under Section 404(b) of the Act.

Chairman Cox and I have met with the leaders of the large accounting firms on multiple occasions over the last six months to develop support for the new approach to Section 404 compliance and to emphasize the need to re-educate the audit community. The Commission has also translated our management guidance into "plain English" in the recently issued guide to Section 404 compliance for smaller reporting companies, which we hope will be helpful.

But, only time will tell whether these efforts have succeeded in better aligning the costs and benefits of Section 404. Even though the Commission has pledged to monitor the costs and benefits of our efforts to scale the application of the internal control provisions, and we are considering how best to carry out such a study, it is my personal view that it would make sense to analyze some empirical evidence of the effectiveness of our efforts to reduce compliance costs for larger companies before determining the timetable for full compliance with Section 404 for smaller public companies. We also continue to work with the PCAOB to make sure that its inspection process is consistent with our new approach and remain sensitive to concerns that our compliance and enforcement regimes similarly reflect our changes in 404 implementation.

While I remain hopeful of our ultimate success, I am also realistic about our ability to fully achieve our stated goals. Even in a perfect world, where we can assume that the regulatory changes we made to Section 404 were carefully crafted to achieve the proper balance, can they truly be effective in altering behavior?

It is clear to me that there are several fundamental, interrelated factors that will be dispositive of our ultimate success in this regard. One is the legal and regulatory environment in which companies and auditors operate. Two is the structure and concentration of the audit profession. And three is the sheer complexity of our financial reporting system. All of these work in concert, in my view, to reduce the proper incentives for the use of greater professional judgment and more focused attention on providing relevant and useful disclosure to investors.

I am, therefore, extremely pleased with the establishment of the Commission's Advisory Committee on Improvements to Financial Reporting as well as the Treasury Department's Advisory Committee on the Auditing Profession because both are considering these significant issues as well as many others, some of which were raised in several of the competitiveness studies published last year.

The audit function is absolutely essential to the effective functioning of our financial reporting system and the efficient operation of our markets. Therefore, it is critically important that issues of audit profession sustainability, audit firm concentration and the fear of the catastrophic consequences that would flow from the failure of one of the Big Four are thoughtfully considered. And this is not strictly a domestic concern. Indeed, the global nature of our capital markets makes the implications of a Big Four failure an international concern.

I am pleased that former Chairman Levitt and former Chief Accountant Nicolaisen have undertaken this important task. Their efforts are likely to be complemented by some of the work already undertaken by the U.K.'s Financial Reporting Council, under the leadership of Paul Boyle. The FRC has done extensive work in this area and made recommendations to enhance competition in the audit market and reduce uncertainty and disruption in the event of an audit firm failure. The FRC's recommendations deserve careful consideration, and I very much look forward to the findings and recommendations of Treasury's Advisory Committee on these matters as well.

An effective audit function necessarily requires companies and auditors to exercise judgment. This is a fundamental theme that runs through our new approach to Section 404 compliance as well as the adaptations that would be needed as we seek convergence of international accounting standards and in any move to transition to IFRS. These are principles-based initiatives that require companies and auditors to make judgments about accounting choices and give clear explanations.

Our current rules-based accounting system has advantages as well as disadvantages, but one of the challenges we currently face, given the level of complexity involved, is making financial information understandable. Accounting complexity makes it difficult to see the forest for the trees. And it can foster accounting-driven disclosure, rather than disclosure of the true economic nature of a transaction.

The simple truth is that there exists a legitimate fear of being second-guessed by regulators and private litigants and that this fear is a natural inhibitor to the proper exercise of professional judgment. In such an environment, practitioners want clear, specific guidance, not flexibility of judgment. Flexibility often means enhanced legal risk even when good faith judgments may lead to a different conclusion.

More principles-based frameworks may help to improve the quality of financial information. Lacking a body of detailed rules, principles-based systems necessarily emphasize qualitative disclosure. As companies and auditors become more comfortable with exercising judgment without fear of being second-guessed, and regulators back up the use of such judgment in a reporting regime through its compliance and enforcement programs, I believe that the quality of financial information for investors will improve.

I am pleased that the Commission's Advisory Committee on Improvements Financial Reporting, under the leadership of Bob Pozen, and through its five subcommittees, has undertaken to look at these issues comprehensively. I will be particularly interested in their work in considering what has driven the rise in restatements. There continues to be a variety of views on this matter, including the role that rigorous interpretation and enforcement, complexity, and materiality may play. But I believe it is particularly important to understand more clearly and empirically, as restatements are extremely costly to companies and investors. Further, there are real concerns that the volume of restatements may have the adverse effect of actually diminishing the significance of a restatement to the market. I, therefore, look forward to considering the work and recommendations of the Committee as it is an important complement to several of the Commission's other important priorities.

The convergence of international accounting standards — in pursuit of our ultimate goal of the development of a single set of high-quality global accounting standards — remains one of these key priorities. A single set of standards will make it easier for investors to compare companies across markets and reduce costs for issuers by eliminating the need to prepare financial statements under more than one standard.

We reached the end of the roadmap set out in 2005 just last month — a year ahead of schedule — when we adopted a proposal to eliminate the reconciliation requirement to U.S. GAAP for foreign private issuers that prepare financial statements on the basis of IFRS as issued by the IASB. We received numerous comments on the proposal, with many offering differing views on whether eliminating the requirement would act to further or impede the ongoing convergence efforts of the FASB and the IASB. It was critical, in my view, that the Commission be confident that our decision was consistent with our ultimate goal of creating a single set of high quality accounting standards. I strongly believe that it is and that it further signaled our commitment to this goal.

In determining to end reconciliation, the Commission considered three threshold issues. First, whether the process towards convergence was sufficiently robust; second, whether IFRS was being consistently and faithfully applied; and third, whether the processes of the IASB as the international standard-setter were fair and transparent. After analyzing the progress that has been made in all three areas, the Commission was satisfied with moving ahead. In addition to the staff's review of IFRS filings, the Commission has worked collaboratively with our international counterparts to monitor the consistent application of IFRS across jurisdictions and enhance the oversight of the IASB and the stability of its funding.

I do not underestimate the complexity of the challenges ahead. Nor do I underestimate the challenges we would face in a financial reporting environment in which two different accounting systems might co-exist. However, overall, I believe the benefits of achieving our ultimate goal of developing a single set of high-quality standards exceeded the potential costs of postponing our decision on reconciliation until greater convergence was achieved between the FASB and the IASB.

The incontrovertible fact is that IFRS is gaining worldwide acceptance at a rapid pace. Over 100 countries have or are in the process of adopting IFRS, including the 27 members of the EU and much of the rest of the non-U.S. capital markets. As IFRS continues to expand worldwide, it is critical that the Commission be involved in decision-making for the future. I do not believe that the Commission would serve the interests of U.S. issuers or investors were we to remain isolated from the process of shaping future developments in IFRS.

Closely following on the heels of our proposal to eliminate the reconciliation requirement to U.S. GAAP, the Commission also put forward a concept release querying whether U.S. issuers should have the choice of filing in IFRS, and if so, how such a choice would be implemented. The comment period has recently ended, and we have begun the process of analyzing the comments received. We will hold two roundtable sessions in mid-December to gather information on the degree of interest that U.S. investors and issuers have in IFRS and explore the policy and practical issues associated with such a proposition for the U.S. markets and U.S. investors. How we proceed will be determined in part by the feedback we receive.

Interestingly, many of the comments I have reviewed so far reflect the same difference of views that we saw in comments on eliminating the reconciliation requirement. No one questions the benefits of convergence or of a single set of global standards. People differ, however, and differ strongly, on the best plan for getting there.

It is my impression that most U.S. issuers are not yet fully engaged with the concept of IFRS. This is not at all surprising. Based on the current lack of familiarity with the costs and benefits of such a choice, U.S. companies that do not have international operations or international competitors may have little incentive to change their accounting systems. I would expect, however, that as IFRS continues to gain acceptance worldwide, U.S. interest will naturally increase. And just as IFRS has not fully registered with some U.S. companies, so too is it only now appearing on the radar screen for many U.S. market participants and investors.

Reading through many of the comments, I have been struck by the intensity and diversity of opinions on the issue, but I would emphasize that as with any important policy discussion, our consideration has just begun and I would expect that we will proceed deliberately and thoughtfully on the issue.

I would also note that convergence in auditing would arguably complement the benefits of international accounting standards. I was pleased therefore with the roadmap discussions between Chairman Olson and Commissioner McCreevy earlier this year on auditing oversight and with the PCAOB's recent proposal that establishes a framework for cooperation and reliance with foreign jurisdictions in inspections of non-U.S., PCAOB-registered auditing firms. I strongly support these efforts and view them as an important corollary to our efforts on accounting convergence.

The global move to international standards will require us to find creative and innovative ways to communicate financial information to investors, for this is no less important than the preparation and auditing of financial information. Beyond its other benefits, moving to a single set of accounting standards has the potential to make financial information easier for investors to use to compare a wider range of companies.

A key part of the Commission's work to maximize the effectiveness of financial reporting is the development of eXtensible Business Reporting Language or XBRL. I know that the AICPA has taken an early leadership role in developing and promoting XBRL. This has become a top priority of Chairman Cox and one that I also strongly support. XBRL's facilitation of interactive data has the potential to improve the accuracy of financial statements, improve audit quality, and drive down issuer costs. Last week, the Commission released the newly-completed U.S. GAAP taxonomies for public comment, and we encourage you to experiment with the taxonomy review tool on our website.

There is an interesting parallel between the work to converge accounting standards and the work to implement XBRL. While the IASB, FASB and other standard setters are working to converge international accounting standards, the U.S. GAAP and IFRS taxonomy teams are working to ensure that their taxonomies are aligned. In a future in which companies file their financial statements in XBRL, preparers and users of financial data should not need to build separate technologies for different accounting systems. XBRL will be especially useful here as it offers a way to compare disclosures under U.S. GAAP and IFRS and highlight differences. Independent of each other, XBRL and convergence efforts have the potential to reduce accounting complexity and help improve the usefulness of financial data for investors. Used together, they can be even a more powerful force.

Even as the Commission gives consideration to these important initiatives intended to improve the nature and quality of financial reporting for investors and the efficiency of our markets, the Commission also remains keenly focused on the state of our markets and current market turmoil. Through our supervisory, compliance, and enforcement programs, we continue to identify and address issues of concern to the liquidity, credibility and transparency of our capital markets.

In this regard, of obviously critical importance to the overall health of financial markets are the largest financial services firms. At present, the Commission supervises five securities firms on a consolidated, or group-wide, basis — Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley — known informally as consolidated supervised entities or CSEs. For such firms, the Commission oversees not only the U.S.-registered broker-dealer, but the consolidated entity, which may include other regulated entities such as foreign-registered broker-dealers and banks, as well as unregulated entities, such as derivatives dealers and the holding company itself.

The Commission's CSE program provides holding company supervision in a manner that is broadly consistent with the oversight of bank holding companies by the Federal Reserve. The program's aim is to monitor for financial and operational weaknesses at the holding company itself or in unregulated affiliates that would place regulated entities within the group, such as banks or broker-dealers, or the broader financial system, at risk.

Liquidity is essential to the viability of all financial institutions. A firm's ability to withstand market, credit, and other types of stress events is linked not only to the amount of capital the firm possesses, but the amount of liquid assets available to meet obligations as they arise. Unlike commercial banks, securities firms do not take deposits or have direct access to a liquidity provider of last resort. Thus, the Commission seeks to determine that each CSE has adopted and follows funding procedures designed to ensure that the holding company has sufficient stand-alone liquidity to meet its expected cash outflows in a stressed liquidity environment for a period of at least one year.

Given the recent events in the mortgage and credit markets and their potential impact on financial institutions, the Commission is monitoring the liquidity available to the CSE parent with greater frequency and, in some cases, on a daily basis. This oversight of the firms' liquidity positions complements other ongoing components of the supervisory regime, including computation of the Basel Standard, examination of the holding company and regular review of financial and risk information.

At the same time, the Corporation Finance staff is reviewing issuer disclosure related to developments in the subprime space through its normal review of periodic reports. Through the regular comment process, the Division is also conveying to companies that it believes will be impacted disclosure considerations that may be useful in preparing year-end MD&As. Clearly, disclosures to investors in financial reports must provide appropriate and adequate information regarding the impact of subprime, CDO and commercial paper exposures and market conditions on an issuer's financial statements as required by the MD&A rules — in particular, the off-balance sheet and liquidity sections of MD&A. The staff will be outlining some of these points later in the conference and I would commend their comments to you.

The Commission also continues to exercise its newly acquired powers to recognize and examine credit rating agencies as nationally recognized statistical rating agencies or NRSROs. Using this new authority, the Commission is looking closely at the agencies' methodologies and procedures for determining ratings for residential mortgage-backed securities as well as their procedures for managing conflicts. Further, our enforcement division has formed a working group to consider subprime market issues. I believe that this ongoing comprehensive review and response will enhance our ability to gauge more fully any lessons learned as well as whether any changes are necessary to address outstanding concerns arising from the subprime turmoil.

The credibility of our markets rest heavily on your profession and they rely on your professional good judgment. Such an important position of trust comes with a great deal of responsibility. And you have borne it faithfully. The many initiatives I have highlighted this morning recognize your important role, while also appreciating the legitimate challenges you face in continuing to meet the high expectations of investors and our markets.

I look forward to considering many of these issues and, I hope, reforms during my tenure on the Commission. I commend you for the work that you do in support of our markets and investors. We need more of you.

Thank you again for allowing me to join you today and my best wishes for an informative and successful conference.

http://www.sec.gov/news/speech/2007/spch121007klc.htm
