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SEC Commissioner Says Accounting Standards Must Be Clear and Effectively Enforced.

New accounting standards should make sense of rapidly changing financial markets, be useful to investors, and be “appropriately and consistently applied, and then effectively enforced,” SEC Commissioner Elisse B. Walter said in a May 30 speech.

Keynote Luncheon Speech

by

Commissioner Elisse B. Walter

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Introduction

Good afternoon and thank you, Dean Bill (Holder) for your kind introduction, and thanks to Randy (Beatty) for inviting me to share my views at the 32nd Annual SEC and Financial Reporting Institute Conference here at USC. I am delighted to be here with all of you today.

You may not hear this too often from people outside your profession, but I have always had a passion for accounting and auditing. I think this has its roots in the time I spent with my father, who was a CPA and the CFO of a publicly-held company; he helped me begin to understand just how important accounting is to business and the financial system. Of course, in my more than two decades with the SEC, which included close to a decade in the Division of Corporation Finance, I have developed a deeper and more complete understanding of the critical role accounting and auditing professionals play in our capital markets.

And today, I am pleased to see that we are working to adapt and expand that role to serve investors and other stakeholders even more effectively in the years ahead, by addressing critical issues at a moment of great change and important progress in the worlds of finance and accounting.

Before I go on, I have a disclosure requirement of my own. I need to remind you that the views I express today are my own, and not those of the Commission, my fellow Commissioners or the Commission’s staff.1

High-Quality Financial Reporting

Because financial information is the starting point for an investor’s decision-making process, high quality accounting standards are critical. Accurate and useful financial information creates the environment in which capital formation sprouts, grows and, sadly, sometimes withers. That is why, when developing accounting standards that will shape an increasingly complex financial environment, it is critical that they accurately reflect the underlying economics of the transactions they document.

Of course, as we know from the many standards-setting processes underway, there is often a diversity of views on how the economics of business transactions should be considered when developing accounting and disclosure requirements, and reconciling them is a primary task of any good standard setter — the development of high-quality accounting standards is certainly dependent upon it.

Reconciling diverse views on corporate finance issues is something I have spent a lot of time on as a Commissioner and regulator. And from my perspective, the most effective way to resolve these differences is to set a standard that expresses a transaction's economics in a fashion that meaningfully informs investors and resonates with them as they study a company's disclosures.

FASB/IASB Convergence Projects

We are seeing this dynamic play out in the FASB and IASB priority convergence projects. Earlier today, you discussed significant progress towards an alignment of accounting standards in four key areas — revenue, leases, financial instruments, and insurance.

This progress is a positive development, with both the FASB and the IASB showing great skill in working together to create common standards that will effectively serve investors the world over. However, as Paul [Beswick] noted this morning, publication of the standards is just the starting point. The challenge you face, as CPAs, is to successfully implement any new accounting standards, and thereby collectively protect investors in this evolving financial market.

And, finishing the convergence projects is, of course, not the end of the story for the United States and IFRS. I continue to look forward to a day when there is one set of global accounting standards, and we are taking a number of steps in that direction at the SEC, including soliciting views from U.S. publicly held companies regarding these issues. As Paul noted earlier, the IFRS already plays an important role in the U.S. capital markets. For example, today with US foreign private issuers already using IFRS, we have a significant public market — with approximately 450 companies with a market capitalization in the trillions — already trading on the basis of financial statements prepared in accordance with those standards.

I hope that, as these common standards come on line, you will work with accounting colleagues and corporate managers to ensure a successful transition resting on four pillars.

The first pillar of successful implementation is training, and these projects will require training across all constituents at all levels within the organization — from the staff accountant performing the filing review to the senior management. In addition, we all need to consider how we can make sure that investors understand the changes that are occurring. In order for that to happen, you and all of the other affected personnel at the entities you represent will first need to take as much time as necessary to fully understand the new standards yourselves.

The next pillar is resources. It is important that companies devote sufficient time and resources to updating their financial reporting systems in the wake of these changes. We can already see that the standard-setters understand the significance of the changes and the need for a sufficiently long implementation period. But companies themselves must also be sure to allot adequate time to amending processes and systems, and resources necessary to run parallel systems, until they feel fully comfortable reporting financial information using the new standards.

The third pillar is identification of interpretative issues. The standard-setters are spending a great deal of effort now to ensure that the new standards are as precise as possible. But there will always be areas that demand interpretation. It will be important to identify areas where there is diversity in application and address them through interpretative guidance so that investors are not harmed and financial statements are transparent. I expect the SEC staff will be fairly active in this space.

In addition, I commend the FASB for proactively addressing this area by bringing together a broad spectrum of representative constituents into an implementation group that will raise practice interpretation issues related to the proposed revenue standard. This is about timely communication that allows thoughtful deliberation, and the goal is to do this in an open and transparent manner. I also think is it a positive sign that the IASB has agreed to participate in this initiative and that we, through the SEC staff, will be an observer. Perhaps this could serve as a pilot for all of the new standards in development and a new tool for the profession.

The final pillar is a focus on investor understanding. When there is an accounting policy choice, we should select the accounting that best reflects the basic economics of the transaction. With more principles-based standards, it is of the utmost importance to consider the substance of the transaction and the economics. Disclosure that is transparent and communicates the critical judgments will allow the investor to see transactions through managements' eyes, allowing them to better understand the motivations and the potential pitfalls or benefits of the transaction, and to make more informed decisions. Depending upon the transaction, this may mean going beyond the explicit disclosure requirements. Again, I encourage you to look beyond abstract accounting standards and disclosure checklists and think about what would be meaningful to an investor seeking to understand a transaction's importance. A check-the-box mentality may not produce the best financial information.

Increase Outreach to Investors Related to Financial Reporting

Increased investor understanding should always be a primary goal of new standards. But to end up with standards which support that goal, we need to start the standard-setting process with investor outreach. Finding out what is on investors' minds is a necessary step because this will improve the overall quality of the standards.

Recently, we have seen an increase in investor outreach, in large part thanks to a strong effort by FASB, but I believe there is still room for improvement. For example, the FASB, in its due process, should emphasize collecting feedback from users. We need to ask ourselves: "Do we really know what matters to an investor?" "What information is the investor looking for?" And "have we received feedback from a cross-section of the different types of investors?"

As the SEC looks to update its guidance as a result of final new accounting standards, we, too, will be seeking to understand the needs of investors in advance of any amendments.

Disclosures

One of the parts of my job that I enjoy most is the opportunity to interact with individuals who are devoted to providing investors with high-quality financial reporting. In these interactions, I get to hear all of the wonderful things that the Commission is doing well and, not surprisingly, what the Commission could do better. One issue that has been raised in these discussions is the level of required disclosures that are included in a company's filings with the Commission.

When I hear this sort of comment, I think the natural inclination is to be somewhat skeptical of a company not wanting to be as transparent as possible with their investors. But increasingly, we hear that the level of disclosures is interfering with a registrant's ability to communicate with investors. Of course, we need to investigate and evaluate that assertion. But, if for now, I accept this assumption to be a fact, then what are the appropriate next steps? In my view, there seem to be two potential next steps to research the issue and consider potential improvements. One path would be to rethink the entire regime. While this route may sound encouraging on first blush, it fails to acknowledge that our current disclosure regime has served investors well for decades. And, because of the enormity of the task, it runs the risk of taking too long while not being as impactful as it might otherwise be. A more targeted review of some of the areas where the information is not perceived to be as valuable has the advantage of being completed more quickly and therefore have a more immediate impact.

In addition to important areas of line item disclosure, I believe that the prime target for improvement is Management's Discussion and Analysis ("MD&A"). As I have said many times before, these disclosures about where a company's been and where it's going "should be made in a way that communicates — truly speaks — to shareholders. . . . [that] truly enables the owners [of the company], the shareholders, to view the company and its prospects through the eyes of its insiders."2 So I encourage you all to give us your thoughts on disclosure requirements; we really need to work together to ensure that disclosure truly serves to inform.

Role of the Auditor

Stepping back for a moment from front-line accounting, it is important that, as we shape the financial reporting structure of the future, we continue to emphasize and enhance the role of the auditors who serve as gatekeepers to the public securities markets. The integrity and reliability of the financial reporting system relies heavily on auditors having significant responsibility for the large volume of financial information that supports the Commission's full disclosure system.

Congress, in creating our system, granted the accounting profession an important public trust. This trust in auditors, combined with the vigilance of the Public Company Accounting Oversight Board ("PCAOB"), helps to form the foundation of the financial reporting process. We look to auditors not only to help detect problems, but, most importantly, to prevent problems from occurring in the first place, by deterring those who would fudge numbers, take shortcuts, or, more subtly, tolerate inappropriate biases that have the effect of making an otherwise reasonable estimate or judgment unreasonable.

Role of the PCAOB

Experience teaches us that there is value in auditing the auditors as well, and, since its creation 10 years ago, the PCAOB has grown into an important regulatory body with a significant investor protection role in this area.

The PCAOB is in a unique and fortunate position of having its standard setting, inspections, and enforcement all under one roof. The potential benefits of this structure are remarkable because they are all critical components of what some have called the "audit performance feedback loop" — the processes of, for example, leveraging the information gathered during inspections and enforcement actions to develop high quality standards.

More than 2,300 accounting firms are registered with the PCAOB, about 900 of them based overseas. As you know, one of the PCAOB's most important mandates is to conduct inspections of accounting firms registered with the Board. And since 2002, it has conducted inspections of thousands of audits of U.S. public companies in the U.S. and abroad.

One area that has been nearest and dearest to my heart in overseeing the PCAOB is auditor performance standards.

As I have often said, I would like to see the PCAOB devote more attention to updating and maintaining their performance standards and quality control, which have the most direct effect on how audits are performed. High quality audit standards that set clear expectations for auditor performance are absolutely critical to our financial system.

I'm encouraged that standards regarding the auditing of related parties and significant unusual transactions, as well as auditing accounting estimates, including fair value measurements, are on the PCAOB's current standard setting agenda. However, I think more can be done to enhance the development and maintenance of high quality auditing standards. There are also a number of very important auditing matters under consideration globally, such as the considerations for changes to the auditor's reporting model. It is important that the PCAOB be a leader in advancing the continuing improvement of audit quality, including by sharing experiences, knowledge and views between regulators. This also includes monitoring the activities of other regulators, standard setters, and legislative bodies as they explore changes to the way audits are conducted or auditors are overseen.

A second priority is expanding the PCAOB's ability to perform inspections in certain jurisdictions outside the U.S. The Board has made remarkable progress over the past year in advancing new cooperative agreements and developing relationships with non-U.S. regulators, enabling advancements of inspections of audits around the globe. A strong, global inspection program is critical to evaluating audit performance and provides important information necessary for the PCAOB to improve their auditing and quality control standards as well as for firms to improve their own quality controls.

Audits of Broker Dealers

The Dodd-Frank Act gave the Board explicit authority over the audits and auditors of broker-dealers' financial statements. Currently, the Board has an interim broker/dealer inspection program in place, and it issued its first public progress report on that program last year. The initial results were concerning. The Board plans to continue inspections under the interim program until rules for a permanent program take effect. Its next progress report is expected later this year and will cover a much larger number of firms and audits. I will be very much interested in the results.

In addition, in June 2011, the Commission proposed amendments to Rule 17a-5, the rule that contains the financial reporting requirements for brokers and dealers. Among other things, the proposed amendments are intended to increase focus on certain financial and custodial requirements and facilitate the PCAOB's implementation of its oversight of broker-dealer audits. In July 2011, the PCAOB proposed new auditing and attestation standards that would apply to the audits of broker and dealers. I am hopeful that the Commission will move forward to finalize its rules in the near future and that, once we do, the PCAOB will likewise move forward expeditiously.

PCAOB Inspection Reports — Enhancing Inspection Report Content

I understand that one of the PCAOB's new near term priority projects is directed at improving the content and readability of inspection reports and that the Board is in the early stages of conducting outreach as part of this efforts. I'm encouraged by this development — higher quality inspection reports will promote better understanding of the issues and help to prevent similar problems going forward. In particular, I believe that PCAOB inspection reports should include citations to aspects of the relevant standards or rules and an evaluation of how the auditor's performance compared to such requirements.

Conclusion

We are all charged with creating and implementing an accounting and audit foundation that will allow investors to make sense of the rapidly changing financial markets, and ensure that the results are not only timely and accurate, but also comprehensible and useful to investors. The new standards that are developed should be informed by thoughtful and robust analytical thinking and with the needs of investors uppermost in our minds. These new standards need to be clear, appropriately and consistently applied, and then effectively enforced. Timely communication between all players leading up to the effective date will be critical to help pave the road to success.

Thank you for your time, and I look forward to answering your questions.

FOOTNOTES

1 The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publications or statements by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission, other Commissioners, or the Commission staff.

2 Commissioner Elisse B. Walter, Remarks before WESFACCA, "Let the Story Shine Through" (March 5, 2010), available at http://www.sec.gov/news/speech/2010/spch030510ebw.htm.