



U.S. Securities and Exchange Commission

Speech by SEC Staff:

The Accounting Profession's Obligation to Global Investors: Quality Investor Information Through Quality Audits

Remarks by

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Greetings to all of you, and thank you to Professor Gebhardt for making this fine program possible for this third year. As a matter of Commission policy, the views I express will be my own, and do not necessarily reflect the views of the Commission or other members of the Commission's staff.

Today, the capital markets around the world face numerous challenges in an ever-changing environment. The largest economies of the world are experiencing fast paced change all too similar at times to a roller coaster ride. Changing technologies, business restructurings, consolidations and alliances, and fierce global competition all have an impact on how the markets work and react.

All of us are a product of the environment in which we live and operate. That is no less true for the businesses and capital markets of the world. And in this environment, I am often asked why I think the United States capital markets have traditionally been the deepest, most liquid, and most efficient markets in the world. In no small part, I believe it is because of the transparency of the information investors receive; that in turn results in more efficient investment decisions, higher returns, and greater investor confidence.

Without that confidence, investors quite simply will find other places to invest their money.

Financial markets that have high quality, investor-oriented, and transparent financial reporting attract both seekers and providers of capital. High quality financial information reduces uncertainty and facilitates the best resource allocation decisions. This leads to liquidity and the lowest cost of capital, which fuels growth.

All the important players in the financial market process – standard setters, preparers, and users of financial statements, independent auditors, supervisory boards and audit committees, regulators, and international organizations – need to be vigilant and active in protecting and continuously improving investor information. To not do this would be a mistake and would mean a lost opportunity to learn from the lessons of the past.

The year 2001 presents a great opportunity for the accounting and auditing profession: at this juncture we have a new International Accounting Standards Board that has pledged to work with national standards setters, such as the FASB and others, to create new high quality global accounting standards. We have a process that has been specifically designed to promote communication and cooperation among the world's accounting standards setters.

On the auditing side, more attention is being paid to finding ways to improve the quality of audits globally by developing better standards, improving the governance and public oversight process, and enhancing enforcement and discipline. Successful, tangible efforts on both the accounting and auditing fronts will do much to enhance the five elements that make up an effective global financial reporting infrastructure:

- Effective, independent, high quality accounting and auditing standard setters;
- High quality accounting and auditing standards;
- Audit firms with effective quality controls worldwide;
- Profession-wide quality assurance; and
- Active regulatory oversight

Accounting Standards

Let me congratulate Sir David Tweedie and the other newly appointed Board members of the new International Accounting Standards Board (IASB). That Board will begin its technical work this month. I believe the IASB holds the potential to make major improvements in the quality of investor information, worldwide.

If standards can be developed for the accounting areas needing attention in a way that will provide investor information of the highest quality, these new standards will reduce or eliminate the need to reconcile differences in accounting frameworks. I firmly believe that national standard-setters,

auditing firms, and regulators from around the world should support and contribute to the work of the IASB. By bringing the brightest minds together, we can create convergence to a "best of breed" set of global standards that promote and sustain investor confidence. In this way, I believe we can see the elimination of the need for reconciliations in the future.

But of course, that will be contingent on the IASB demonstrating to its various constituents, including investors and securities regulators, that it will develop enforceable standards of high quality that provide investors with a clear picture of the true economics of a business. Compromises that form a shroud, clouding investors' transparent view of the economics of the companies they invest in, will continue to necessitate regulators requiring additional disclosures, so as to adequately protect the capital markets and investors.

We do believe that over the years the FASB, as an independent private standard setter, has served investors well by developing standards that increase transparency. Perhaps this is why many major American corporations responded to the Commission's International Concept Release by recommending that the Commission maintain the current reconciliation requirements until further improvements are made in the quality of international accounting standards. Those commentators also indicated that they believe U.S. GAAP is of a higher quality than IAS standards.

But I also want to point out that I believe the world's highest quality standards are not all resident in the United States. For example, many commentators, including investors, analysts, auditors, and preparers have expressed significant concerns regarding the quality and operation of the recent proposal by the FASB for testing the impairment of goodwill. They also challenged the use of impairment triggers as opposed to an annual test, the adequacy of proposed disclosures, and whether purchase price allocations will result in intangible assets being properly identified and valued. Based on my own experience as a CFO, an audit partner in an international firm, and as the Chief Accountant at the SEC, I share those concerns. I believe the standards adopted by the U.K. Accounting Standards Board in Financial Reporting Standard No. 11 contain significant points that I hope FASB will consider when addressing the concerns of its constituents and ensuring that investors receive quality, transparent information.

I would like to challenge the IASB, FASB and other national standard setters to operate with speed without sacrificing high quality – to be both efficient and effective on behalf of investors. The Boards can do this by identifying the most critical issues and developing a set of standards that addresses these issues promptly. The European Commission, in their response to the Commission's Concept Release, stated that a number of topics need to be addressed by all standard setters, including: (1) the application of the principle of substance over form; (2) accounting for leases; (3) accounting for intellectual property assets; (4) performance measurement; (5) stock based compensation; (6) accounting for transactions between entities under common control and (7) accounting for joint ventures. The European Commission's list contains some of the accounting topics that I believe

warrant serious consideration for the initial agenda, including: business combinations, new basis, joint ventures, intangible assets, financial instruments and fair value accounting, pensions and post retirement benefits, leasing, revenue and liability recognition, restructurings and acquisition provisions, and accounting for a company's stock and other equity instruments. This is an agenda that will demonstrate the IASB's willingness to be a leader, not a follower in promulgating greater transparency for investors.

High quality investor information encompasses a wide range of criteria, many of which are described today in the FASB's Concept Statements and IASC's Framework. Those criteria set important benchmarks for the FASB and IASB to meet in developing new standards. These criteria also establish standards that preparers and auditors should use, including internationally. These include using the IASB and FASB criteria as a guide for discussions between Boards of Directors, audit committees, auditors, and management when determining which accounting policies should be followed and what disclosures to make. Such discussions are now required by U.S. auditing standards and I believe will contribute to meaningful improvement in the system of financial reporting.

Adding to these criteria for high quality, I would also hope that accounting standards developed by the IASB, FASB and other national standard setters would always include the following:

- A clear articulation and discussion of the basic principles and model the standards setter is trying to establish. This will allow preparers, auditors, and regulators to properly interpret and implement the standard.
- Implementation guidance to facilitate consistent implementation and enforcement of the standard.
- A discussion of how the standard improves the quality of financial reporting by satisfying the criteria set forth for high quality information.

Auditing Standards

Now, let's shift gears to the role of the independent auditor that investors rely on to ensure the numbers in the financial statements and footnote disclosures all comply in full with the applicable accounting standards. In the past, during my remarks at this conference I have spent considerable time focusing on accounting and auditing standards. But this year we have an increased focus on the role of the auditor in the capital markets. In several of the comment letters we received on the Commission's Concept Release, several commentators noted that an impediment to removing the reconciliation requirement was the lack of quality audits internationally that would ensure the IASC standards are properly implemented and enforced.

Currently, all auditors of SEC registrants are required to comply with U.S. auditing standards in their entirety. This includes auditors domiciled in foreign countries. We have and will continue to take enforcement actions where the requirements of U.S. standards have not been met.

Regardless of which standard setter promulgates them, accounting standards will have lasting value only if companies follow them. Turmoil in international markets is often symptomatic of accounting standards that lack transparency, are not widely complied with, and are poorly enforced. For example, during the Asian crisis we saw losses excluded from financial statements by avoiding consolidation of controlled subsidiaries and affiliates, a lack of accounting and disclosure of transfer pricing arrangements, capitalization of research and development costs that had absolutely no future economic benefit, and a lack of disclosure of cross collateralization and financing guarantees. A recent report in the "Economist" noted continuing concerns with the quality of the financial reporting *and* audits in South Korea. In addition, recent studies by the former Secretary General of the IASC have set forth numerous additional instances of noncompliance with international accounting standards. All of this has occurred while companies and their investors received "clean" opinions stating the financial statements are prepared in accordance with the appropriate generally accepted accounting principles when this was just not the case.

Auditing standards are a critical component to ensuring that financial statements are prepared in compliance with accounting standards. Yet quite frankly, International Standards on Auditing or ISAs are where the IASC accounting standards were at a number of years back. The auditing profession is behind on this issue and needs to run hard to catch up. There is a body of ISAs published and used in a number of countries around the world, but major improvements are needed to update and amplify the current body of standards. The International Auditing Practices Committee (IAPC) has projects underway to address some of these needs. I expect that additional efforts will take place in the future. I also expect that both the SEC and International Organization of Securities Commissions (IOSCO) will be monitoring work on international auditing standards in the future. IOSCO's Working Party No. 1 has established a subcommittee that is carefully evaluating the existing standards with the hope that areas for improvement can be identified, similar to what was accomplished with the very successful IASC core standards project.

The IAPC, in the role of a standard setter of international auditing standards, must work vigorously towards the creation of a set of high quality auditing standards that can be accepted globally – standards that will outline what is required for completion of a high quality audit. The recommendations in the report from the Panel on Audit Effectiveness (also known as the O'Malley report) are an important starting point for the IAPC in planning its work and set an appropriate benchmark from which to measure IAPC achievements. As noted in the O'Malley report, international auditing standards should be "comprehensive and sufficiently specific and rigorous so that they serve as appropriate benchmarks to judge the work of auditors."

Black Lettering

In that vein, the Preface to the codified ISAs contains language that discusses the use of the so-called "black lettering." In that Preface, black lettering is described as being synonymous with "basic principles and essential procedures."

After reading the Preface to the ISAs, one is left with the conclusion that black lettering delineates essential and basic procedures that an auditor must perform in the completion of an audit in accordance with ISAs. The connotation is that the procedures that are not "black lettered" are not essential and, therefore, may be optional or of a lesser importance than their "black lettered" counterparts. Given the nature of some of those procedures, the IAPC should reconsider the procedures it believes are essential and basic. For example, did you know that the following procedures are not "black-lettered?"

- Having the auditor attempt to obtain sufficient appropriate audit evidence to remove substantial doubt as to a material financial assertion.
- Having the work of assistants reviewed by personnel of at least equal competence.
- Having the auditor consider the professional competence and independence of the predecessor auditor when reviewing a predecessor auditor's work papers for purposes of obtaining sufficient competent audit evidence regarding opening balances.

I believe these procedures, as well as many other procedures within ISAs, are basic and essential in the execution of a high quality audit. They cannot be optional in auditing standards that are written to protect investors and used in the U.S. capital markets. High quality audits that promote investor confidence that financial information has been prepared in compliance with high quality accounting standards facilitate the success of capital markets.

Quality Controls

As a follow-on to that thought, auditing standards that produce a high quality audit have to be supplemented by strong and effective quality controls, as well as a profession-wide quality assurance mechanism. As I said earlier, 2001 is a year of great opportunity. The international auditing profession is in the midst of restructuring some of its organizational components. Shoring up investor confidence through the enhancement of the public's trust in the international auditing profession can lead to high quality investor information. The O'Malley report includes several recommendations on this front. Some of the recommendations from the O'Malley report are as follows:

- Creation of a global oversight body to monitor and report on the activities of individual country self-regulatory organizations. The

charter of the oversight body should establish clearly that its primary goal is to serve the public interest.

- The global oversight body should be consulted on the membership appointments and agenda of the IAPC. It should ensure that the IAPC's standards are comprehensive and sufficiently specific and rigorous.
- There should be external reviews of the quality controls of auditing firms over their accounting and auditing practices.
- There should be a comprehensive annual report to the public by the global oversight body on its activities, including the results of its monitoring of the quality assurance functions for the auditing profession, on a country-by-country basis. The global oversight body's goal should be to bring "transparency" to how the global auditing profession functions and serves the interest of investors.
- Auditing firms should implement uniform audit methodologies throughout the world.
- Auditing firms should subject all audit practice units to periodic inspection procedures covering all audits, not just foreign registrants of affiliates of SEC registrants.

Public Oversight

Perhaps the most crucial recommendation from the O'Malley report is the establishment of a self-regulatory structure for the international auditing profession. The first step in creating such a structure is the formation of an International Public Oversight Board (IPOB). The IPOB should have but one goal: serving the public interest of investors. It must have the broad mandate to actively oversee and publicly report on international standard setting, self-governance, and disciplinary activities of the profession.

In order to create a public interest IPOB, the initial selection of the members of the IPOB must be done in an open public manner. It cannot be a body that is hand picked by the profession or the largest firms within the profession. The selection process must be one that is done in the sunshine and results in a charter and initial representatives that focus on the public interest as their most important mission. Needless to say, the IPOB members must be public interest representatives without ties to the accounting profession.

I understand the current process entails the profession drafting the charter for the new IPOB, selecting candidates for the IPOB that will be submitted to a review board for comment and then selecting the final board members. Such a process, dominated by the profession, falls dramatically short of being credible and will perhaps cause irreparable harm to the initial IPOB.

The operation of the IPOB and its structure will be crucial to its viability, and

to its acceptance by the investing and regulatory community as the guardian of investors' interests. In my view, there are seven key elements that must be present if the IPOB is to be successful on a long-term basis. First, the funding for the IPOB must be "with no strings attached" to ensure independence, in fact and in appearance. Second, the IPOB must oversee relevant activities of the International Federation of Accountants (IFAC), including its standard setting committees, and the IPOB must have the power to approve the chairs of those committees. Third, if it is to be effective, the IPOB also must have an oversight role with regard to the enforcement of the IFAC standards set by those committees. Fourth, the IPOB must be subject to an independent review by representatives of the public interest. Fifth, the IPOB must have the power to initiate special reviews of the accountancy profession, as deemed necessary by the IPOB. Sixth, the IPOB must prepare, at a minimum, annual reports to the public on its activities and progress of the profession in achieving its goals and acceptance. And seventh, the IPOB must be able to establish its own charter that sets forth a mission of serving investors, of proactive oversight, and the establishment of quality audits.

Auditor Independence

While high quality auditing standards are an important component of a reporting infrastructure, auditor independence is paramount. Both preparers of financial statements and auditors have important roles in the evaluation of the independence of auditors and protecting investors. Independence rules that are written for the protection of the investor, and fully complied with, will provide investors greater confidence and trust in the integrity and objectivity of the audits on which they rely.

In November 2000, the SEC issued new rules regarding auditor independence. During the rulemaking process, we received thoughtful and constructive input from a broad spectrum of interested parties. That input, which included about 3,000 comment letters and written and oral testimony during four days of public hearings (about 35 hours of testimony from over 100 witnesses) helped us to better understand the sincere and strongly-held views on all sides, and to shape final rules.

The application of the Commission's general rule on independence is based on four underlying principles, which are consistent with the factors described in the O'Malley report. In considering that general rule, the Commission looks in the first instance to whether a relationship or the provision of a service:

- Creates a mutual or conflicting interest between the accountant and the audit client;
- Places the accountant in the position of auditing his or her own work;
- Results in the accountant acting as management or an employee of the audit client; or
- Places the accountant in a position of being an advocate for the audit

client.

Bright Lines

Application of the general rule will be easier in some respects and more difficult in others. However, clear lines have been drawn in areas where independence will be impaired. The staff, as always, is more than willing to meet and discuss issues that are not otherwise defined or clear. Too often we find that there has been an independence violation and are then asked to waive the requirements of the rules, or that the firm be given a period to "cure" the problem in the future. With adequate quality controls, including ongoing training, monitoring, and a substantive disciplinary mechanism, the staff expects that the rules will be complied with. If the rules are violated, unless covered by an inadvertent violation exception built into the rule, an auditor and his or her firm's independence will be deemed to be impaired. The rules are clear and the staff does not intend to grant no action relief where clear lines have been drawn.

I would like to take a few minutes to further discuss a few specific provisions in the final rule that may be of particular interest to those of you in the audience. These areas include bookkeeping, legal services, contingent fees, and fairness opinions. I would urge those of you who are preparers to also keep a mindful watch on these issues and remind you that the registrant has the responsibility to get an independent audit. A lack of vigilance can result in an auditor not complying with the rules, which in turn will require the retention of a different accounting firm in order to receive the requisite opinion of an independent auditor. In addition, auditors will also need your cooperation in some instances to ensure you do not have foreign affiliates or subsidiaries that engage your auditor for prohibited services.

It is important to note that the SEC does not accept compliance with foreign independence rules in lieu of or as a substitute for the SEC's independence rules and regulations. However, two and a half years after the staff first expressed its concerns about auditors' independence on an international scale, the SEC staff continues to see troubling examples that suggest a lack of sufficient global quality controls. Four kinds of non-audit services are especially troubling to the Staff and will continue to be closely scrutinized.

Bookkeeping

Except for very limited situations (which are outlined in the rule), when the auditor performs bookkeeping services for an audit client, an auditor's independence will be deemed impaired. Providing bookkeeping services for an audit client impairs the auditor's independence because the auditor will be placed in the position of auditing the firm's work when auditing the client's financial statements. It is hard to maintain the requisite objectivity about one's or one's firm's own work. This is especially true where finding an error would raise questions about the adequacy of the bookkeeping services provided by the firm. In addition, keeping the books is a management function, the performance of which leads to an inappropriate mutuality of

interests. And no matter how high the quality of an audit, once an auditor has provided prohibited bookkeeping services, its independence *has* been impaired.

Legal Services

Fundamentally, a conflict exists between the role of an independent auditor and that of an attorney. The auditor's charge is to examine objectively and report to the public, regardless of the impact on the client, while the attorney's fundamental duty is to advance the client's interest. I understand that outside the United States lawyers affiliated with accounting firms on occasion provide legal services to the firm's audit clients. The Commission's new rule does not address this practice where local law permits it and the services relate to matters that either are not material to the client's financial statements or are routine or ministerial. As clearly documented in the adopting release, legal services provided outside of the United States to registrants raise serious concerns under circumstances that don't meet at least those minimum criteria.

Contingent Fees and Commissions

The final rule defines a contingent fee as any fee established for the provision of any service or product pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service or product, including commissions and similar payments. For example, an auditor might undertake a study of certain types of a client's expenditures in order to identify greater amounts of qualifying expenses that would result in greater income tax credits. In such a case, the accounting firm's economic benefit will be greater if the tax credits are maximized. Because this interest is inconsistent with acting independently in assessing the accuracy of the impact on the income tax accounts and financial statements of those tax credits, those kinds of fee arrangements are prohibited under the final rule.

Fairness Opinions

Fairness opinions continue to be a concern of the staff. Situations where an accountant issues a fairness opinion or similar report in connection with a transaction involving an audit client have been and will continue to be questioned by the staff. While the new rule provides limited situations where fairness opinions may be permitted, the implied mutuality of interest severely limits the situations where such services may be provided by the auditor. The staff has agreed to an engagement whereby the auditor performs specified procedures as set forth in a letter to the Italian securities regulator, which is on our website at www.sec.gov.

The Role of IFAD

Another organization with the potential to play an important role in the

development of a global financial infrastructure is IFAD, the International Forum for Accountancy Development (IFAD). IFAD is composed of members and observers from several international bodies and financial institutions, the Big-Five global accounting firms, and other accounting firms. However, my skepticism about this organization was heightened when at a meeting the leadership presented a vision for country-by-country assessments and action plans with great fanfare and high hopes. But this plan lacked any significant actions to be taken by the firms themselves to upgrade the quality of their own auditing policies, procedures, and quality controls on a global basis. At the same time, IFAD asked for our support and in turn requested we not publicly criticize the organization. I ask, what reasonable business CEO would sign on to a nondescript business plan and agree not to criticize it.

Instead of relying exclusively on Country Action Plans, IFAD's members could be asking themselves: "What can we do today, while we work with countries, to improve their frameworks for auditing standards?" The answer seems clear: IFAD, with the experience and the resources of the Big Five and other international accounting firms, could begin now to make a significant difference in the quality of international audits and in international financial reporting. IFAD could promptly undertake major voluntary actions by the firms themselves to agree on best practices, and to sign their firm names only to audits conducted in accordance with high quality internationally acceptable standards and practices.

On February 23, 2000, I sent a letter to the leadership of IFAC and IFAD, expressing concern about IFAD's focus on regulatory reforms as a pre-condition to action by the accounting profession. I urged that IFAD, and in particular, the "major firm" members, take a leadership role by raising their own firms' minimum standards. And I noted that one of the first steps IFAD could take is to encourage accounting firms to require, on a worldwide basis, a uniformly high quality of financial reporting as a condition for association with a major firm name.

I am convinced that rapid and widespread improvement in international auditing could be achieved if the large multinational audit firms got together with IFAC and established a set of rigorous auditing standards. This can be done if they agree to set audit firm procedures and quality control policies to a standard of the highest common denominator. The role of the individual audit firms – and the actions of individual auditors – is critical. Everyone must step up to the challenge of reporting to investors on a global basis.

Closing

Let me close by saying that I believe that all participants in the global financial reporting infrastructure – including both the private sector and regulators – can work toward developing an effective infrastructure. Such an infrastructure is key to the development of high quality, transparent financial reporting, which ultimately protects investors and builds successful global financial markets. However, it cannot be a project towards incrementalism. Rather, as with any business, it must be a march toward being the best. A

march toward an effective system that serves investors well.

I invite all of you to contribute to that mission and goal of investor protection through high quality financial reporting. I want to thank Professor Günther Gebhardt and all of the others who have made this conference possible. I am hopeful that our discussions from today, and those made yesterday, will lead to that increased high quality, transparent financial reporting. Thank you.

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