



U.S. Securities and Exchange Commission

Speech by SEC Staff: Changing the Future

by

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Good morning. Thank you for the kind introduction. It is an honor to be a part of such an important event in these critical times.

Before I begin my remarks, I must remind you that my remarks are my own and do not necessarily reflect the views of the Commission, Commissioners, or other members of the Commission's staff.

When I agreed to join the SEC staff almost two and a half years ago, I expected one of the most challenging and rewarding experiences of my life. In spite of those expectations, I had no idea what I was in for.

For me — and I know for many of you — the past year has been a difficult one. As accountants, our honor has been questioned; our credibility challenged. Even though we may want to, we cannot change the past. But we can change the future. That is what I want to focus on today — the future.

To restore the honor and credibility of the accounting profession, all participants must focus on one thing — doing what is best for investors. If we keep that as our focus, investors will be better served by the profession; and consequently, the reputation of the accounting profession can be restored.

Making investors our priority is an enormous challenge. There may be times when some members of the profession might lose sight of the right priorities, especially when one's own personal interests are involved. However, regardless of your position within the profession — whether you serve as a preparer, an auditor, or a regulator — if you remain focused on what is best for investors, in the long run, you will always come out ahead.

During the next few minutes, I would like to address five key issues which will play a significant role in re-establishing the profession's identity.

- First, I would like to provide you with some personal observations on certain provisions of the Sarbanes-Oxley Act;
- Second, I plan to spend a few minutes discussing the new Public Company Accounting Oversight Board;
- Third, I will speak briefly on the issue of standard setting;
- Fourth, I want to reiterate our willingness and interest in working with registrants to resolve issues on a timely basis;
- Finally, I would like to talk about what we, as accountants, can do to change the future and better serve the interests of investors.

Sarbanes-Oxley Act

In the next 40 days or so, the Commission will be completing much of the regulatory reform required by the Sarbanes-Oxley Act, which I will refer to simply as the Act. When the rules become effective, the accounting profession will be subject to new rules on auditor independence and record retention. The roles of audit committees and the nature and type of disclosures companies provide will be changed. And, just as importantly, the level of personal responsibility that a member of the accounting profession must assume for his or her own actions will be taken to a new level.

The first general observation I would like to make about the Act is, admittedly, a statement of the obvious; and that is, the breadth of the Act. The Act requires significant reform in all aspects of our financial reporting and disclosure system. When all is said and done, the Commission will be required to complete at least 15 rulemaking projects, 7 studies and participate in the process of establishing an entirely new oversight system for auditors.

It is clear that life for both registrants and their auditors has been forever changed. But the accounting profession is not alone. Under the Act, the activities of investment bankers, analysts and even lawyers will now be more closely scrutinized.

The second general point I want to make is about the themes that underlie the Act. Last summer I was asked to speak to a group of senior government

officials on lessons learned from Enron and what modifications they should make to the operations of their respective offices, departments, and agencies in response to the Act.

I recall thinking at that time that speaking on this topic was an insurmountable task. But since I had been "volunteered" for this presentation I set out to find a way to make it work.

In preparing for that presentation, it became clear to me that the answer was in the underlying themes of the Act. Here's how I summarize those themes:

- Each person must accept responsibility for his or her own behavior;
- Being an accomplice to or ignoring a bad deed may be the same as doing the bad deed;
- Those who carry out bad deeds shall be punished; and
- Appearance counts.

Using those themes I was able to develop a short, but relevant talk for those officials, even though the talk had nothing to do with GAAP or the accounting profession as we know it. Since that experience, I think of those themes from time to time and I encourage you to do the same. I believe understanding and remembering those themes will help you maintain the focus that is necessary to carry out the charge of this profession — serving investors.

With that context in mind, I would like to make a few comments on some of our rule-making projects. I will be brief as many of the projects have been or will be described in more detail by other presenters during the conference.

Tuesday, November 19 was an important day for investors. That was the day that the Commission proposed new rules on auditor independence and record retention.

These proposals are particularly important because many have asserted that the accounting profession no longer acts in a manner that puts investors' interests first. Whether that assertion is true really does not matter anymore. The perception is so strong in the minds of many that it is affecting business activities, investment decisions, and the markets.

As the events of the past year have shown, perceptions affect beliefs, and what a person believes affects his or her actions. When investors perceive that accountants are not serving the public interest, they lose trust and confidence in the securities markets, and they take their money out of those markets.

What matters now is that we move to restore confidence in the work done by members of the accounting profession so that the public believes accountants

are focused on the public's interest rather than their own.

The Commission's auditor independence proposal, if adopted in its current form, will result in more rigorous rules for auditors. Some may be tempted to resist the proposed change. Others may view these proposal only in terms of their effect on short-term financial interests.

I encourage you not to do that. Instead, I ask you to focus on the long term benefit to the profession and work with us to implement Congress' intent. In fact, I hope you will actively participate in the comment process.

I hope you will write comment letters that describe how you would address any problems you believe might exist in this rule proposal, and not simply point out what you believe the problems to be. We don't believe that we have all of the answers and we expect to learn much from insightful, well-reasoned comment letters.

Now, let's talk specifics.

In the proposal, the Commission has described a model, based on three basic principles, to determine when non-audit services would impair the auditor's independence. Those principles are that an auditor should not audit his or her own work, act as management, or be an advocate for his or her audit clients. If you think about it, it's hard to argue with those basic principles.

Consistent with the model, auditors generally would no longer be able to serve as internal auditors, install information systems or provide actuarial services for their audit clients. This will be a big change for some firms.

That said the proposal contemplates that audit firms would be able to continue providing most traditional tax services. I think we all acknowledge that the Sarbanes-Oxley Act did not ban all tax services.

In the proposing release, the Commission has attempted to describe when non-audit services impair an auditor's independence by applying the model to various types of non-audit services. We hope that the model will result in more effective, consistent, and comparable implementation of the independence provisions of the Act. If we can improve the proposal, please let us know how.

It also is important to note that a company's audit committee would be required to approve all services. Failure to obtain such approval would cause the auditor's independence to be impaired even when providing potentially allowable audit and non-audit services.

The idea of mandatory firm rotation has become a hot issue in the last year because of the fresh look it would bring to the financial statements. In response, others cite the risks that auditors encounter in the first year or two of a new audit engagement, which they base on studies suggesting that the

greatest risk of audit failure is in the first year or two of an audit relationship. As directed by the Act, the GAO is currently studying the issue of mandatory audit firm rotation.

Consistent with the Act, our current proposal does not call for firm rotation. It does, however, call for more extensive partner rotation. Under the proposal, all partners providing significant audit services on a continuing basis will be required to rotate every five years and be subject to a five-year time out. The goal is to provide the fresh look afforded when auditors rotate, without losing the knowledge gained in prior audits.

To achieve that goal, it will be important for firms to stagger the rotation of their partners on engagements with multiple partners. Additionally, it is important that firms properly staff all engagements to ensure that the engagement team is appropriately qualified and knowledgeable about the client and industry conditions.

The goal is to strike the appropriate balance between loss of continuity and the need to have a "fresh set of eyes" involved in the audit. Achieving this goal is critical. Indeed, many other related but equally critical issues need to be considered if we are to implement the proposed partner rotation requirements. For example:

- Will these partner rotation requirements affect an audit firm's ability to have competent personnel assigned to the engagement?
- What will be the impact of this proposal on smaller audit firms? and
- How will the proposal impact foreign audit firms?

These are just a few of the questions that we ask in the proposing release and areas that we need to better understand. Creative thinking as to how we achieve that fresh look is welcome.

In addition to these questions, we are particularly interested in your comments about the costs and benefits related to the proposed rotation requirement, and for that matter the cost benefit effects of all our proposals. This is information that is always difficult to get. We also are interested in learning what the potential implications of these proposals would be on competition for and quality of audit services.

Another area of potential change relates to disclosures of fees paid to a company's audit firm. Different and more detailed disclosures would be required under the proposed disclosure of fees paid to auditors. The aim is to make the disclosures more transparent, line them up more directly with the Act and the rules, and provide comparable information.

The Commission also proposed to prohibit members of an audit engagement team from being directly compensated for selling non-audit services to their audit clients. The point is to remove any incentives for behavior that might

jeopardize an auditor's independence. Again, it is important that investors perceive the auditors as independent.

These are just a few of the highlights. When it was all said and done, the Commission attempted to take both the letter and the spirit of the Act and add the necessary definition and precision to most effectively implement it. I encourage you to look closely at the proposal for more details.

Next, let me turn to the topic of internal controls. One section of the Act requires rule-making by the Commission to require the inclusion in annual filings of an internal control report that states the responsibilities of management for establishing and maintaining adequate internal controls, as well as an assessment by management of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. Furthermore, the Act calls for an independent accounting firm to attest to management's report on internal controls.

In response to the Act, the Commission has proposed rules calling for a company's annual report to include a report by management that contains:

- A statement of management's responsibility for establishing and maintaining adequate internal controls and procedures for financial reporting,
- An evaluation, as of the most recent year-end, of the effectiveness of a company's internal controls and procedures for financial reporting; and
- A statement that the independent accounting firm has attested to, and reported on, management's evaluation of the company's internal controls and procedures for financial reporting.

The Act also states that the attestation and reporting of the independent auditor must be made in accordance with standards for attestation engagements "issued or adopted" by the new Oversight Board. Once operational, the impact of these requirements will be profound.

Auditors will be required to understand, test and report on the internal control structure over financial reporting. The point is that while it requires additional work for the auditors, it also provides a tremendous opportunity for auditors to gain a greater understanding of their client's internal controls. I believe this may be one of the most important provisions of the Act as it relates to improving the quality of audits.

It is safe to say that the days of documenting that a system of internal controls is effective and then auditing around the internal controls are over. Auditors will need to understand the systems and report on the deficiencies; and companies and their management will be held accountable for the deficiencies in the systems.

In addition to the Commission's proposal on auditor independence and

internal controls, the Commission proposed more stringent record retention requirements for auditors. These proposed rules specify the information which would be required to be retained by auditors for a five year period subsequent to the completion of the engagement. This again is to improve the accountability of auditors.

Another area where registrants have shown a particular interest is in the newly required officer certifications. The basic idea in requiring management to certify the company's results is to cause management to be more diligent the next time the company makes a filing.

I am sure that you have already witnessed changes in behavior among some CEOs and CFOs with respect to financial reporting practices. It is important that CEOs and CFOs understand what they are certifying to.

They are certifying as to the fairness and completeness of the information in their filing as well as to their controls over financial reporting. Their certifications are not limited to stating that the financial statements comply with GAAP. Their certifications are much broader. They are certifying that, to the best of their knowledge, the filing provides a fair presentation of the company's financial position and results of operations and does not omit any material fact necessary for investors to understand the company's financial results.

Public Company Accounting Oversight Board

Now, let's turn to the topic of the new Public Company Accounting Oversight Board, which I will refer to as the Oversight Board. One of the outcomes of the Act was an end to self-regulation for the accounting profession. The new Board will be responsible for all aspects of oversight of auditors.

The Board's powers and responsibilities will include registering firms and conducting inspections and disciplinary actions of auditors on matters of audit quality, ethics and independence. And the Board will be responsible for standard setting in those areas as well.

From a practical standpoint, this means no more POB nor TOS, and no more PEEC, peer review, QCIC nor ASB as they operate. While they may continue in some advisory capacity, their authority over audits of public companies has been withdrawn, and their power has been lost. The Act is based on the premise that the profession failed to adequately regulate itself in a manner that instilled the public with a sense of trust and confidence.

Some of you might see the new Board as a threat to the future of the accounting profession. However, I see it as our ally.

It is true that we will be held more accountable for our actions — but for the lion's share of us who are out there trying to do the right thing — we will be fine. In fact, we will be better off because the profession as a whole will be better off. And the others, who are not putting investors first — well, expect

the Board to do everything in its power to weed them out.

The Board is in a start-up phase at the moment. They must do some of the mundane things like find offices, get copy machines, phone lines, and e-mail addresses — and of course, hire its staff.

However, its first formal meeting is just days away — in early January. And, it is already beginning to wrestle with some of the bigger issues such as structure, registrations and firm inspections.

Inspections is one of the first issues the Oversight Board will face — especially as it relates to the upcoming peer review season that is just in the planning stage. As you may know, the Board is required to inspect the largest firms annually and other firms every three years. That will take a significant amount of resources and planning to effectively carry out the legislative mandate in this area.

Another matter is what happens to GAAS. Ultimately, that is a question for the new Oversight Board and the SEC. In the meantime, let me make one point clear. Auditors have been and continue to be required to follow GAAS when performing audits of companies registered in the United States. That fundamental requirement is not going to change without action by both the Board and the Commission.

I would like to make one last point regarding the Oversight Board before I move on. The SEC staff will be closely overseeing it. In fact, any rules proposed by the Board will be required to be approved by the Commission. This is much different than how standard setting has been done in the past. And, I assure you, we fully intend to carry out our oversight responsibilities.

Standard Setting

Now I would like to make a few comments on standard setting. When the Enron story first broke, one of the first to be blamed was the standard setters, in particular, the FASB. Certainly, the current state of SPE and financial instrument accounting is an issue for everyone.

However, as more accounting scandals surfaced, auditors and management became the prime targets for blame. More and more people focused on the fact that these people were not following the rules. In some cases, we were not dealing with complex structures. Rather, the questions were relatively simple, for example, whether costs should be capitalized or expensed. I wonder what would have happened and how the current climate might be different if they would have followed GAAP.

During the past year, the standard setters have been quietly moving along and have had a pretty successful year. For example, the FASB provided new guidance on things like guarantees and restructurings and impairments. And the Board tells us that guidance on SPEs is just around the corner.

And problems, such as those related to the accounting for energy contracts, have been addressed. A major project on revenue recognition was added to the Board's agenda. Finally, the FASB has announced its intentions to work with the IASB to achieve greater convergence of accounting standards worldwide.

The Auditing Standards Board has been at work too. The ASB decided to prohibit auditors from issuing SAS 50 letters on hypothetical transactions. Those letters were often the backbone to pitch transactions that were financially engineered to skirt the rules and improve the look of the books. That action by the ASB was another great day for investors!

The ASB also recently issued more guidance aimed at improving the detection of fraud. However, some have asserted that the standard does not go far enough in closing the expectation gap. Again, appearance counts and the actions and efforts put forward should be responsive both to studies such as the O'Malley Panel, and to the needs of investors.

Standard setters have many challenges ahead. One relates to the perceived quality of earnings. A key element of that concern can be attributed to how we measure earnings and net assets.

Unfortunately, we still have a mixed attribute model that can be arbitrated and not much has been done yet about providing measurement guidance, especially related to providing valuation guidance when estimating fair value. The good news is that the FASB is considering working more diligently in this area.

Because of concerns about the quality of earnings, investors have been placing more emphasis on cash flow information. Unfortunately, it did not take the financial engineers long to catch on. The Commission is watching closely — for example, it brought an enforcement action against a company that called cash inflows from debt an operating activity simply because they issued the debt in the form of a derivative instrument.

I am happy to say that a lot of good has come from these problems. Registrants and auditors are more aware of problems created by manipulations of the cash flow statement, and standard setters have made and are continuing to make strides to improve cash flow reporting.

I believe that an important aspect that needs to be completed in order to resolve the measurement issues and to improve cash flow presentation is the performance-reporting project. That project is being worked on simultaneously by the IASB and the FASB.

While I am on the issue of international accounting, I am going to say just one thing: If you are a single product domestic manufacturer whose customers only reside in the U.S. — and you do not believe that international accounting matters to you — you should come to the session tomorrow on

international accounting.

During that session I will speak to the issue of principles and rules. While it is a very important issue, it is easily discussed in terms of international convergence, so I am going to bite my tongue for now.

With everything that is going on today in the world of standard-setting, I could go on for days. But at this point, I think it might be more productive for me to talk about what can be done as we work together to advance the interests of investors.

Working with OCA

At last year's conference you heard a lot about the protocol for submission of matters for pre-clearance by the staff. Let me first reiterate that we remain ready to work with you to resolve issues in a timely and professional manner.

The staff continues to receive a number of submissions and our goal has been and continues to strive to resolve the issues as promptly and professionally as possible. You may not, necessarily, like our answers; but my expectation is that you will feel as though your issues have been carefully considered and your viewpoints have been heard.

You can help the process by providing us with the information we need to resolve the question without the need for an extensive amount of follow-up. Let me again refer you to our website which provides the protocol for submission of issues for consideration by the staff.

You have my assurance that we will be responsive to your request, and work with you in a professional manner. Of course, our focus will remain on reaching the appropriate accounting and reporting answer — the answer that best serves the interests of investors.

Changing the Future

Let's talk about changing the future! I would like to begin with the accountants working for registrants. I want to reiterate that I am aware that most of you do a terrific job. But others need some help. So I am going to give you some ideas that you may wish to consider in the upcoming months. Even for those of you that do a good job, these ideas may be a good refresher.

As I mentioned earlier, the Act places a great deal of emphasis on personal responsibility. The changes mandated by the Act can be a catalyst to update your company's internal controls. As you go through that process, here are a few questions you may wish to consider:

- Do you require management throughout your organization to provide you with representation letters before you sign the one given to the

auditor?

- Do you ask for representations regarding the status and application of your reporting systems before signing the certification of your filing?
- Do you have a process for consultation on difficult accounting issues?
- What are your controls around the signing of significant contracts, creation of special purpose entities, and assessing the effects of side-agreements?
- During the last year, has your company entered into a transaction of any sort that you do not personally understand?
- Finally, did you perform a top to bottom review of your accounts during the last year?

While this is not everything one needs to do to prepare financial statements, it is certainly a good start.

Now auditors. This is an extremely challenging time for you. But it also is an opportunity for you to update your audit processes. And it provides an opportunity to examine your firm's independence and quality control policies to ensure that your firm is serving the needs of investors. In that light, here are some things you may wish to consider:

- What is the "tone at the top" of your firm? Is professionalism valued more than salesmanship?
- Are your firm's quality control policies communicated adequately?
- Does your firm have processes established for consulting on difficult accounting issues?
- How is that consultation process documented and how are disagreements between the engagement team and your technical experts resolved?
- How is audit partners' compensation determined?
- Do you teach younger staff about the importance of ethics and independence? And,
- Is professional skepticism alive and well at your firm?

Again, I could go on, but you get the idea.

Let me finish my remarks with a quick story. When I joined the Commission, I received a lot of congratulatory calls — and lots of advice. One call I have always remembered was from a retired audit partner of my former firm,

whom I will refer to as Joe. During the course of the conversation, Joe was reminiscing and he said "Jack, I had the greatest job in the world. All I had to do was just tell the truth."

That call could have come from any one of a number of you in the audience. The fact is, now is the time for all members of the profession to come together and do their part to help restore the honor and credibility of this profession. To all the Joes out there, whether you work for an audit firm or a registrant, now more than ever, it is time to stick to your belief and remember what is good for investors is good for you.

Be assured that all of us in the Office of the Chief Accountant are continuing to work diligently to serve investors' interests. We look forward to completing the rule-making efforts required by the Act, to working with the Board, and to working with the accounting profession. And we are going to do our part to rebuild investors' trust.

Thank you.

<http://www.sec.gov/news/speech/spch121202jmd.htm>