U.S. Securities and Exchange Commission

Speech by SEC Staff:
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by

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Good morning. Thank you very much. It is my great pleasure and honor to be here. As many of you know the USC Leventhal School of Accounting is near and dear to me, and the success of the annual SEC and Financial Reporting Institute Conference is a testament to the school's dedication to promoting public dialogue among regulators, standard-setters, academics, investors, registrants and auditors. Running a conference such as this one requires a lot of hard work and dedication - so let me take this opportunity to personally thank at least some of the people responsible for bringing us here today including Dean Gupta, Dean Beatty, Professor Holder and Ms McClendon.

But, before I continue I do need to make the usual SEC disclaimer. Most of you are already familiar with it, but for those of you who aren't, the remarks I make today are my own and do not necessarily represent the views of the Commission or others of its staff.

Let me begin by acknowledging that 2004 was a difficult year-end close for virtually everyone involved in financial reporting. This was in part a result of the many important reforms that took hold this past year. I sincerely appreciate the significant efforts expended by so many - and especially those of you here today - to improve the quality of financial reporting, and I want to take this opportunity to thank you for your efforts and for your continued interest in improving the quality of information provided to investors. Many have contributed much, sacrificing family and personal time. That includes regulators and standard-setters in the US and abroad, but I would especially like to recognize the efforts of corporate America and the dedicated support of so many boards of directors, audit committees, and internal and external auditors. Given all the change that was implemented and considering that the

environment was generally averse to risk, this was indeed a difficult undertaking and I recognize that it took extraordinary efforts. But I also believe much progress has been made and you should be proud of your efforts. You are essential to the success of our capital markets. What you do every day does matter.

Perhaps one of the most significant activities last year was implementation of Section 404 of the Sarbanes-Oxley Act, which requires public reporting on internal controls over financial reporting. This past year - for the first time - our larger registrants and their external auditors reported on the effectiveness of controls. This was a massive and - I believe - generally beneficial exercise. I also recognize that the first time through was difficult and costly but I am a firm believer in the objective of Section 404: we all want good controls because they make it easier to ensure that preparers get the numbers right - numbers that impact investor decisions and confidence.

I've been around long enough to know that major change does cause stress. And I also know that improvements can be made to almost any process, but especially when they are as new and as significant as reporting on control effectiveness. In April the Commission held a public roundtable to review first year implementation of Section 404 and to consider changes. Our Commissioners sat side-by-side with the PCAOB Board members and listened intently for a full day - consisting of six panels - to what was communicated about successes and shortcomings. We also set-up a website to receive comments from the public on their experiences. The feedback we received was extremely beneficial and informed the subsequent staff and Commission guidance that we issued last month as well as the guidance issued by the PCAOB Board and staff. All of that guidance was issued shortly after the roundtable because your planning for 2005 was imminent.

No issue - not even accounting for stock options - has created as much emotion - both for and against - as the broad-based implementation of the Section 404 requirements. In some respects I suspect 404 has become a short-hand code to express the feelings of those who were affected not only by that section of the Act, but by the many other recent changes resulting from the financial frauds and excesses of the late 1990s. People provide me with their views on 404 not just at meetings and conferences such as this one but at dinners, on the street, in the elevator, on the plane, train, in cabs and even at my own dinner table when I sit down with family and friends. Don't take this the wrong way. I'm not complaining. I do sincerely appreciate and need that feedback.

I believe the 404 guidance that we issued last month was an appropriate and balanced response but if additional guidance is necessary, we will consider providing it. As I said earlier, I recognize that preparers, audit committees, external auditors and others spent countless hours working through the new requirements. Their hard work is commendable and appreciated. But this was the first effort: it wasn't perfect and I believe significant improvement to the process is possible. We need to strike the right balance.

I'm very hopeful that both preparers and auditors will feel confident in exercising good judgment in making revisions to their processes in 2005. Yesterday, at Chairman Donaldson's press conference, he said we are looking for a commonsense approach. It is your effort and judgment that in the end will most affect the success and cost of the controls work.

From my perspective the most important result of the 404 work is that management, investors and others have focused so intently on what's important to investors - reliable financial reporting and the need for good internal controls to accomplish that. Now, as the process matures and becomes baked into the overall financial reporting efforts, we all need to guard against the risk that tests for effectiveness don't evolve into a check-the-box exercise. Such an approach could negate the many benefits to investors of Section 404. And, as management and auditors gain additional and deeper experience, I expect that the process will continue to evolve and become increasingly more effective, better focused and cost efficient. Judgments required by management and auditors will be easier to make as the experience base grows. Since the process of reporting on controls is still in its early stage, I suspect that further fine-tuning by all participants may be necessary again next year and if guidance is required by us, we will consider appropriate action. We will also push hard for solutions for smaller businesses. One size does not fit all.

In a few minutes one of my deputies, Scott Taub, will describe other key priorities that we established for the Office of the Chief Accountant at the beginning of fiscal year 2005 and our progress to-date. I'm proud of the efforts of my staff, the way that they work with others at the Commission, at the PCAOB and at the FASB and what we have been able to accomplish as a team.

While in the near future I intend to dedicate an entire speech to one of our key priorities - reducing the complexity that has crept into our financial reporting processes over the years - I want to at least briefly highlight my concerns this morning. But, to put your minds at ease, I also want you to know that I consider this to be a longer-term effort. And I'm delighted that it is also a priority shared by Bob Herz and others at the FASB.

We are now very close to completing the last significant report required of the OCA staff by the Sarbanes-Oxley Act, the so-called "off-balance sheet report." We plan to issue that report, addressed to Congress and to the President, later this month. Our work on that report, combined with my prior experiences, confirms for me the need to reduce complexity while at the same time improve both the transparency and usefulness of financial reporting for investors. The report also directly addresses a number of long contentious issues, both on and off-balance sheet, where our current accounting models are sometimes complex and where improvements appear necessary. In addition it describes structured transactions and identifies steps companies can take now to improve the transparency of reporting.

Much of what I describe as complexity is the direct result of (1) a desire to

reduce volatility in the income statement, (2) the development of numerous exceptions to basic principles or (3) the application of detailed rules. When I talk about reducing complexity, I am not talking about dumbing down accounting or implying that accounting or auditing will be simple. In any event, you will soon be able to review our off-balance sheet report and draw your own conclusions. I won't go into any further detail here so stay tuned. Changes - even to reduce complexity - are not simple, and they will take time and of course must be subject to appropriate due process. Further, I recognize that every significant change in accounting will, for many companies, require systems changes and testing to ensure that internal controls are effective before the change in accounting can be made. It's clear that the FASB has a very difficult job ahead.

I wanted to tee this up with you today because its success will ultimately be dependent on obtaining your help and support as well as that of other investors, preparers and auditors. If we are to achieve real progress in reducing complexity - and its related cost - it will require a willingness to implement change. That's not to say that we couldn't at the moment use a cooling-off period to digest all the recent changes. I do see a value in a quiet period, but I believe it's also important that we begin now to set the stage so that needed improvement can be accomplished in a planned and orderly fashion.

Reducing complexity in financial reporting will require the same type of discipline that we have seen businesses adhere to when implementing other quality improvement initiatives. And, just as we've seen specific companies and entire industries ranging from health care to automotive to airline to technology simplify their processes, I believe that a similar commitment will be necessary if we are to significantly improve financial reporting for investors. Standard-setters will need to consider reducing the number of exceptions permitted to basic accounting principles, especially as we move closer to objectives-based accounting. With movement in that direction, both preparers and auditors will be called upon to exercise increased professional judgment.

Finally let me say a few words about my staff and the many good people who work at the Commission. They are a terrific group of intelligent and highly technically skilled individuals working toward the same basic goal - representing the interests of investors. You will hear from some of them today. They don't work the long hours for the money or the perks. They come to the office everyday because they know that they are making a difference and contributing to our great nation. That in itself is very gratifying.

Thank you.

http://www.sec.gov/news/speech/spch060205dtn.htm

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