U.S. Securities and Exchange Commission

# Speech by SEC Staff: Remarks Before the 2005 AICPA National Conference on Current SEC & PCAOB Developments

***by***

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Good morning. It's a pleasure to be here this morning and to talk to you about how the complexity of our current system impacts full, fair, and accurate disclosure.

Full, fair, and accurate disclosure is the mantra that we live by in the Division of Corporation Finance. Has a company provided the information that an investor needs to make an informed business decision? In today's world, that is an increasingly difficult question.

Public companies are responsible for preparing periodic filings with information content that is relevant, complete and accurate. Of course, part of the information content is the financial statements which management is responsible for preparing and for ensuring their compliance with generally accepted accounting principles. Independent registered auditors play an important role in the financial reporting process when they audit the financial statements, but also when they discuss with management the accounting for new or complex transactions or accounting standards. The Commission and the PCAOB made clear in our May 15th guidance on internal control over financial reporting the importance of this communication in getting it right the first time and that neither the internal control process nor our independence rules preclude this type of dialogue. From recent conversations with participants in the reporting process, the dialogue has begun again and we expect it to continue.

It's no secret that the world of accounting and financial reporting has become increasingly complex. U.S. accounting standards have often been called the best standards in the world because of their comprehensive coverage, rigor, and basis in theoretical concepts. However, over the years, the concerns of various participants in the reporting process have created a constant demand for detailed rules, bright lines, and safe harbors in all areas of financial reporting. This demand for the answer to every question has resulted in a myriad of standards and interpretations that form the body of GAAP, a large, complex system that can be difficult to navigate and often to make sense of. There is no doubt that the FASB's project to codify into one database the body of GAAP that now exists will help tremendously. After all, having to look for the 180 plus places in GAAP that reference revenue recognition is a chore none of us need. The Commission and the FASB have also recognized the need for more principles-based, or objectives-oriented standards, however, it will take some time to recognize the benefits of this approach. The FASB, of course, has a lot on it's plate at the moment, not the least of which is the international convergence project - a necessary move to converging accounting standards worldwide.

Aside from the standard-setting solution, there are several things that preparers and auditors of financial statements can do in the meantime to ensure that financial statements and related disclosure are complete, accurate, and relevant for users. There are also areas to consider to reduce complexity. Here are some areas to consider for both:

First, we should learn to use technology better. The only way for a user to fully understand a company is to digest the available information - periodic reports, press releases, and the like. I'll talk in a minute about disclosure and how it can be improved. Once a user understands the company, they will typically want to compare the company to its competitors. That's where it gets tricky because none of the data is in an electronic format that allows for an easy comparison, not to mention that the numbers are often not comparable anyway because of different methodologies and classifications. Some heavy users of financial data have staff solely dedicated to the burdensome process of translating paper into data by manually entering the information in periodic filings into a model in order to make comparisons.

Many folks are working to try to find a solution to this. The Commission has been active in what I will call our tagged data initiative. Data tagging, through extensible Markup Languages - otherwise known as XBRL - is an Internet tool that the Commission has begun to actively investigate. At this point, we are not considering requiring XBRL, but we are gathering information and assessing its benefits to preparers, users, and regulators such as the Commission. XBRL uses what are called taxonomies to categorize data in a consistent manner that will facilitate comparisons across companies in an industry. I believe XBRL has the potential to create benefits and cost savings through easier access to and analysis of information, an obvious benefit for users, but which can also aid companies with both their internal and external financial reporting. Preparation and release of information should be easier and quicker for companies. Despite fears expressed by some, it will not result in companies' general ledgers being open to the public. The Commission has adopted amendments to our rules to establish a voluntary program to allow filers to report in XBRL. We encourage filers to participate in the program because your input will help form the basis for the future development of the program. Registrants can voluntarily furnish supplemental tagged information using the XBRL format in an exhibit to an EDGAR filing under the Exchange Act and the Investment Company Act. The front of the release lists the Commission staff that are involved in the program, so I encourage you to call them if you would like to volunteer.

The second area is education. I believe there are a lot of accountants who may not be technically competent in some areas and education is not as high a priority as it should be. I doubt I would get disagreement from anyone in this room on that point - there is never enough time in the day, nevermind having to carve time out for training. There are areas that some of us never see in our day to day work, and when we do, the easiest and quickest thing to do is to search out the expert in our office or in our audit firm for the answer. I'm not sure we can continue to do that in as many areas as we might have in the past. For example, there are relatively few experts on FASB Statement 133 on derivatives and hedging, yet the use of derivatives has become increasingly common. When the standard first came out, everyone did lots of training - the firms had training classes for their staff, as did we at the SEC, and they provided seminars for their clients. After the training, some saw quite a bit of derivative activity in their work with financial institutions. Others saw mainly interest rate swaps on company debt or the occasional hedge of a forecasted transaction. So, of course, those that worked with the standard more frequently retained the most knowledge of the standard. Those that didn't, and those new to the profession, have very little knowledge of the requirements of the standard despite its frequent application by registrants. We need to remember that training isn't just something that enables us to maintain our cpa licenses. It is an important part of our jobs as accountants, to stay current and to refresh ourselves on the existing literature.

The third area is reducing complexity. Preparers should think about whether their accounting needs to be as complex as it is. In certain standards the FASB establishes one clear accounting application, but in many cases because of insistence from the preparer community, allows other methods to be used at the option of the preparer. Registrants should look for opportunities to improve financial reporting now, rather than waiting for changes in standards. Those opportunities could include such radical suggestions as:

- Choosing the direct method of cash flow,
- Choosing not to aggregate segments,
- Presenting the income statement by function and nature, and
- Adopting more rigorous other-than-temporary impairment policies.

As another example, let's go back to Statement 133. The FASB's clear preference in this standard, leaving aside cash flow hedging, is for derivative instruments to be fair valued with changes running through the P&L. However, they allowed the use of fair value hedging, which hangs up the changes in fair value of the derivative on the balance sheet. This, of course, added many, many paragraphs of requirements and guidance to the standard, increasing its complexity. Therefore, a simple thing that preparers can do to decrease the complexity of their accounting is to forego the use of the exceptions and alternative treatments in GAAP.

We examined the area of complexity in our 2003 study on the use of objectives oriented standards. In our off-balance sheet study, the staff also provided views on several broad goals that we believe are key to increasing the transparency and raising the quality of financial reporting. They include:

- Eliminate (or at least reduce) accounting-motivated structured transactions; the transparency and degree to which accounting and disclosure standards achieve their goals can be greatly diminished by the use of structuring, even when that structuring appears to comply with the standard (example - leasing),
- Continue implementation of objectives-oriented approach to standard setting, as the results of the current study have only served to reinforce the previous conclusion of the importance of taking an objectives-oriented approach to standard setting,
- Improve the consistency and relevance of disclosures, and
- Improve communication focus in financial reporting.

The study also made several recommendations for changes to accounting and reporting standards; the recommendations speak directly to the issue of transparency. They are:

- Revisit standards on accounting for leases,
- Revisit standards on accounting for defined-benefit retirement arrangements,
- Continue to work on consolidation policy,
- Continue to explore the feasibility of reporting all financial instruments at fair value, and
- Develop a disclosure framework.

The last recommendation relates to disclosure in the financial statement footnotes. The FASB's conceptual framework does not contain much guidance related to the notes to the financial statements. As a result, disclosure guidance tends to vary from standard to standard. The staff believes that more useful and consistent disclosure requirements for the notes to the financial statements could be achieved if a disclosure framework were developed that set forth the objectives to be used in these disclosures.

The fourth area is applying judgment. Everyone involved in the financial reporting process needs to allow for the use of reasonable judgment in the preparation of GAAP financial statements. The application of many of today's accounting standards involves the use of estimates and assumptions that may change over time. There are many who believe that fair value is a more relevant measure than historical cost and the FASB seems to be increasingly moving in that direction. The result will be more estimates and assumptions and greater use of financial models. Since management is responsible for the financial statements, they need to ensure that they have a solid foundation upon which to base the estimates and assumptions they use. Management also needs to describe for the user how they arrived at the estimate or assumption, what events may occur that could force changes in the estimate or assumption, and what their history is with the accuracy of prior estimates or assumptions. Sounds just like the critical accounting estimate financial reporting release, rule proposal, and discussion in the 2003 MD&A interpretive release - don't forget to consider that guidance for those estimates and assumptions that have a material effect on results of operations. Auditors need to ensure that they follow professional standards in this area, that they engage experts if they do not have the relevant expertise, and that they challenge management where evidence necessitates. Regulators and users also need to be mindful of hindsight and second-guessing, but rather should expect registrants to have a reasonable basis for the estimate or assumption.

And the final area is reducing disclosure overload. Preparers, auditors, advisors, standard-setters and regulators need to remember that users may be suffering from disclosure overload. Many of the filings made with us have grown in volume over the years. Of course, some of this may be due to the variation in business ventures undertaken by a particular filer and the need to describe its various and increasing activities. And the complexity of the business environment and of business transactions has also increased the level of disclosure. Aside from the necessity to explain a companies' business activities, management also needs to provide financial statements and discuss results of operations, cash flow, liquidity and financial condition in MD&A.

There are several ways that preparers can reduce the volume of filings, and we pointed out some of those in the 2003 MD&A interpretive release. They are things such as - Prioritize disclosure for investors. Introduce MD&A with those important issues that keep the CEO up at night. Eliminate the boilerplate in MD&A - rather than just disclosing the calculated changes in various line items, actually discuss the analysis of the underlying reasons for the changes, such as volume and price changes. Discuss the real drivers of changes in results of operations as management sees them. Communicate in plain English. Eliminate redundant or non-value added disclosure. Disclose whatever will help investors understand what happened. Determine where disclosure best fits and don't repeat it without necessity. For example, certain disclosure is required by GAAP in the audited financial statements for a restructuring. Don't repeat the very same disclosure in MD&A. Rather, MD&A is the place to discuss:

- the reasons for the restructuring - is the company consolidating or eliminating operations?,
- what the effect will be on the registrant's operations - are any facilities being closed? are any products being discontinued?,

- the impact the restructuring has had, and is expected to have, on results of operations, financial condition, liquidity and cash flow - are there significant uncertainties that will be resolved in the future in the form of further charges? will there be significant cash outflow related to the plan?, and
- any other relevant forward-looking information.

Remember, reporting is a communication exercise, not a compliance exercise. Of course, I also recognize the role that the Division plays in disclosure and how our activities can affect the way that companies approach their disclosure obligations. We approach our review of disclosure in filings from the standpoint of the user and often request additional or revised disclosure in certain areas. If a registrant believes our disclosure requests would result in disclosure that is not material, or worse, is redundant of other disclosure in the filing, I hope they will engage in dialogue with the staff to ensue that the user is getting the information that they need and is not being inundated with elevator music.

Note that I haven't mentioned internal control over financial reporting. That is not to say that internal control isn't a vital part of ensuring that financial statements and related disclosures are complete and accurate, because it definitely is. We are continuing to focus on implementation issues for companies, large and small, domestic and international. We recognize that this is not an easy area either and have provided staff FAQs and a Commission statement on implementation. Because there is a separate session at this conference devoted to internal control over financial reporting, I haven't gone into this area in any detail. But I urge preparers who are responsible for management's assessment and the auditors who are responsible for the attestation to use their experience and judgment to design an assessment and audit process that fits the needs of the company. Don't let the goal of the production of reliable financial statements be overshadowed by the process.

So, the five items I've discussed are the simplest things I can think of to ensure that financial statements and related disclosure are complete, accurate, and relevant for users: learn to use technology better, don't forget education, reduce complexity, use judgment, and reduce disclosure overload. I encourage all of you, despite the challenges you face, to consider these and other ways you can further the goal of full, fair and accurate disclosure for users of financial reporting.

*http://www.sec.gov/news/speech/spch120505cas.htm*

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