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Speech by SEC Staff: Remarks before the Leventhal School of Accounting: SEC and Financial Reporting Institute

by

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Good Morning. It is certainly an honor to participate in this conference with its reputation as one of the premier financial accounting and reporting events on the West Coast and I want to extend my thanks for the invitation. While this is my first time attending or participating in this prestigious event, interestingly enough, my last trip to the L.A. area was also prompted by my desire to attend a world class event hosted by the University of Southern California. I traveled to the West Coast with great expectations for a successful day and on the date of the event awaited anxiously for the activities to begin. However, shortly after the beginning of the festivities I came to the realization that the event I had chosen to attend was going to be a great disappointment for me (along with thousands of other Nebraska fans who made the trip to the coliseum). Indeed, as has been the case for many over the last few years the Trojans went out to easily defeat my alma mater. However, after looking at the line-up in today's schedule of events, I'm certain that, unlike that day last fall, today's event will not be a disappointment.

As I'm sure many of you can attest, it is a challenging time to be a member of the accounting profession, I personally believe it is also an extremely exciting time. As a profession we face a host of exciting opportunities, and through these opportunities we have the potential to define the direction and the future of financial accounting and reporting for years to come. I'm confident that during the course of today we will hear about and discuss a

number of projects, ideas and initiatives focused on ways to improve upon our existing financial reporting framework. I'll spend just a few minutes highlighting some of the initiatives that we have been focused in the Office of the Chief Accountant; you'll hear more detail in the next panel addressing current developments at the SEC. With the balance of my time I will focus on a few areas where I think we can make immediate and meaningful progress in addressing the challenges we face on a daily basis.

However, before I go any further I must say that one of the things I have picked up on very quickly in my new role is that I need to remind you that the views I express here today are my own and do not necessarily reflect the views of the Commission, the Commissioners, or other members of the Commission staff.

AS No. 5 and Management Guidance and International Activity

Let me begin by highlighting just a few projects that will have a significant impact on financial accounting and reporting. I'll just highlight the initiatives and Joe Ucuzoglu will discuss these projects in more detail in the next panel.

First, let me highlight the guidance to be issued to assist management in its requirement to assess internal controls. The Commission's proposed interpretive guidance to management for Section 404 of the Sarbanes-Oxley Act is founded on a couple of key principles. The first, management should evaluate whether it has implemented controls to prevent a material misstatement. Second, management's evaluation should be based on their assessment of risk. These principles, the foundation of the Commission's guidance to management, should provide a framework for companies (both large and small) to make an assessment in an efficient and effective manner. At a Commission meeting last week, the Commission unanimously approved the new guidance. This guidance provides management with a clear framework, outside of the auditing guidance, enabling them to focus on what matters to investors in financial reporting.

Moving on to the PCAOB's proposed new auditing standard (AS No. 5). This proposed auditing standard should, if approved by the Commission, also result in meaningful improvement to the financial reporting process. While AS No. 2 has unquestionably provided much needed and significant improvements, it also did so by adding tremendous costs. As stated by SEC Chairman Christopher Cox, "Congress never intended that the 404 process should become inflexible, burdensome, and wasteful". By focusing the direction of audits on areas of risk and by encouraging a more integrated approach, this new standard has the potential to provide significant benefits to investors. Focusing on risk will not only result in a more efficient process but will, as a result of that greater focus on risk, result in a more effective process as well (resulting in a greater focus on those controls that really matter). Jointly, the new management guidance and auditing standard have the potential to strike the right balance, maintaining and building upon the benefits already realized under Section 404 while eliminating unnecessary or inefficient uses of resources.

The third major initiative that I want to briefly highlight is in the area of international financial reporting standards. Just a few short weeks ago the Commission issued a press release announcing the intention to issue a Proposing Release requesting comments on rule changes that would permit the use of IFRS (international accounting standards), as issued by the IASB, in financial reports filed with the SEC by foreign private issuers. In addition, the Commission expects to issue a Concept Release addressing whether U.S. issuers should be provided the same option as their foreign counterparts. That is, the Concept Release will address the issue of whether U.S. issuers should be permitted the option of moving away from U.S. GAAP and applying IFRS. While the idea of allowing the use of international accounting standards is a new one, the impacts on investors, preparers, auditors and others could be significant. The opening up of the U.S. capital markets to IFRS has the potential to shape the future of financial reporting and I encourage each of you to take the opportunity to provide input to the releases. I look forward to reading what I am certain will be many thought provoking and insightful responses.

Immediate Steps to Improve Financial Reporting

As the SEC's Chief Accountant, Conrad Hewitt, has expressed on a number of occasions, addressing complexity in financial reporting is one of the top priorities of our office for the foreseeable future. Complexity in our current financial reporting system has been the topic of significant discussion and interest, at conferences such as these, in the media, and certainly in Norwalk CT and in Washington D.C. Many rightly question whether the U.S. financial reporting system (the premier system in the world, in my opinion) could be improved by a concerted and aggressive effort to address the issue of complexity and transparency in accounting. Many also rightly question whether, if not addressed, the current level of complexity in our system has the ability to undermine our competitive advantage in financial reporting. As I stated before, the issue of complexity in financial reporting will be a high priority for our office over the next year (it's an area I am concerned deeply about and one of the reasons that I took the job). Our office has been working closely with the FASB and the PCAOB to address the issue, and one of the potential ideas is to form a committee to study the causes of complexity, to consider the transparency of current financial reporting and evaluate the need for changes. The idea would be for the committee to study the issues and make concrete recommendations as to how we can continue to improve upon the best system of financial reporting in the world. It is an idea that FASB Chairmen Bob Herz has been speaking about for a while now and I think the time is right to get something going in this area. I am hopeful that we will see some meaningful activity on this front in the near future.

I think taking a step back to study ways to reduce complexity and improve transparency is a much need effort. However, I do not believe that we need to wait for the recommendations of some committee to make strides to address complexity as we strive to improve upon our financial reporting system. I believe that there are meaningful steps each of us can take,

almost on a daily basis, as we go about fulfilling our respective roles in the financial reporting network. With the balance of my time here this morning, I'll offer just a few suggestions or observations that I have in this regard.

Focusing on the objective of existing standards

There appears to be a growing sense that U.S. accounting standards are "rule-based" and that standards established internationally are more "principles" based. In my opinion, there is too much guidance (maybe that leads to the conclusion that there are too many rules) when it comes to telling us how to apply U.S. standards. However, it is certainly not clear to me that there is any common agreement on what exactly a principles-based standard setting regime should look like. Further, it is even less clear to me that U.S. standards are inherently less principles-based than those established in London. In fact, I would contend that the vast majority of U.S. standards were established with a principle or objective in sight. Undoubtedly, exceptions, bright-lines, application guidance and interpretations (what may be viewed by some to be "rules") can have the effect (at least from time to time) of blurring our vision on the principles. What is clear to me is that the volume of guidance in the U.S. is certainly more expansive than the volume of guidance related to other accounting standards systems.

Given that the vast majority of U.S. standards are written with an objective (s) in mind, it is in this area that I believe we can all benefit by focusing on the existing standards and their underlying objective. When faced with a question related to how to account for a given activity, take a step back, if there isn't an existing rule don't ask for one, rather see if the question can be addressed within the existing framework of the literature.

While I am not at all suggesting that we ignore the words in existing authoritative accounting literature, I believe that we can make meaningful improvements in our process by stepping back and focusing on the objectives or principles (the P in GAAP) when considering how to account for a transaction. I believe that in the long run we will find more simplicity in looking to the objective of a standard rather than seeking for a rule. Taking a broader step back and considering the underlying economics of a transaction and how to most accurately portray a transaction is a useful exercise, which leads me to my second point.

Exercising professional judgment

Exercising judgment is a necessary and valuable component of our financial reporting framework. Many have made this point in the past, and while I certainly do not want to sound like a broken record, I believe it is an area where we can all afford to focus some additional attention (regulators, standard setters, preparers, auditors and even users of financial information). I believe that we can take important steps forward by resisting the temptation to provide (as standard-setters and regulators) and to ask for (as preparers, auditors and regulators) guidance to address the myriad of

potential financial accounting difficulties we see on a daily basis. Rather than seeking detailed guidance we should first seek to address the given difficulty by looking to the objective(s) of a standard and applying professional judgment.

While again I am not suggesting that we ignore the existing accounting guidance, I am suggesting that in places where bright-lines, exceptions and rules do not exist we all need to resist the temptation to ask for them. It seems fairly clear to me that if we keep asking for more and more interpretative work, scope clarifications, and the like then it should come as no surprise when we find that our standards become overly burdened and detailed. On the other hand, if we are going to get to a place where as a profession the volume of bright-lines and other interpretative guidance is reduced, the temptation to structure accounting motivated transactions that are not consistent with the objective of transparent reporting needs to be resisted. It will be difficult to move to a less complex world if, when faced with an accounting alternative that appears to be in conflict with the objective of a given standard the response from accounting professionals is to ask "show me where it says that I can not do this?". This sounds like a call for a rule and in the past that has often been the response.

Likewise we must understand that accepting judgment will mean accepting some level of diversity in practice. This has to be the case as there will certainly be times when reasonable people acting in good faith will not reach identical conclusions in practice. Accounting, at least in my opinion as practiced today, is not a series of immutable truths. There certainly will occur, from time to time, situations where the reasonable application of judgment will result in more than one acceptable accounting or financial reporting conclusion. If you don't believe this just listen to the discussion that goes on at a FASB board meeting when they are in the process of debating an accounting issue. There are clearly issues where even the top minds at the FASB find room for reasonable disagreement and I can assure you that the same thing happens in our office from time to time.

Some may believe that any significant application of judgment in accounting and the potential for diversity in views will lead to significant non-comparability from one company to the next. As already discussed, it's important to keep in mind that it is likely impossible and in my view certainly not desirable to eliminate professional judgment from accounting, and I don't believe we should try to do so. Instead, if we are to move forward with focusing more on objectives, we need to re-focus accounting professionals to spend their time applying judgment in the right areas -- the principles or objectives, rather than specific rules. Of course this may require some training to refocus accounting professionals. However, if professional judgment of preparers and auditors is exercised in the interest of investors, principles-based standards have the potential to increase the transparency and comparability of financial reporting. In a regime that is overly proscriptive or "rules-based" where the focus is on compliance with a set of rules or where the rules detract from the objective the potential to create a smokescreen in which one might try and hide inferior financial reporting is introduced. Such a system also has the ability to foster an environment

where structuring the terms of transactions to achieve an accounting objective without consideration of the true economics becomes acceptable. I believe that investors are better served (through increased transparency) and complexity is reduced when the role of accounting professionals is one of focusing on faithful reporting of business. Professional judgment is critical to this process.

In this regard, disclosure of transactions in which significant judgment is required seems like an extremely useful tool for management to describe the economics of a transaction, the business purpose and the judgments involved in reaching an accounting conclusion which brings me to my third and final point.

The role of transparent disclosure

As I just discussed, in applying judgment there will inevitably be times when there are multiple reasonable conclusions. Rather than asking for a rule to address each and every one of those situations, I would be much more comfortable seeking to deal with the issue by asking companies to explain in plain English the conclusion reached, how the accounting principle(s) was applied and the significant judgment(s) made.

In fact, I believe that complexity in accounting can be reduced when companies approach financial statement disclosure from the standpoint of thinking about disclosures as an opportunity to communicate clearly with investors, rather than approach disclosure from the view point of the minimum requirement of a given standard. Approaching disclosure from this perspective appears to me to be a step that entities can take that will go a long way to helping users understand the significant judgments made by management.

I believe it is important for the financial reporting community to continue to embrace the opportunities that we face and I am excited about the direction we appear to be moving toward. However, many of the initiatives that we are talking about as a profession will not have an impact overnight. I outlined just three small areas (I'm certain that there are many others) that I believe can have an impact on each of us as we strive to improve upon our financial reporting system. Thank you again for the opportunity to participate in the program today.

<http://www.sec.gov/news/speech/2007/spch053107jlk.htm>