



## U.S. Securities and Exchange Commission

### Speech by SEC Staff: Advancing Investors' Interests

*Remarks by*

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#### Introduction

Jim and Amy, thank you for the kind introduction. I am pleased to be back at this podium.

Some of you may be old enough to remember that I spoke at this conference 3 times in the early 1980s. Twice I spoke as a Professional Accounting Fellow in the Chief Accountant's Office and another time as a member of a panel discussing a rule-making proposal I helped draft as a member of the staff. That proposal, which would have required disclosure of interim segment information, was considered "revolutionary" at the time. Ultimately, it crashed and burned, unfortunately, around the time of the conference. Now, of course, similar requirements are embedded in FASB Statement 131, issued in 1997.

I guess you could sum it up this way. Basically, every 20 years, I speak at this conference, and then 15 years later the profession adopts my proposals! I guess the point of my story is, if you're not planning to be practicing accounting in 15 years, this is probably a good time to go return phone calls!

Given my past experience, I never expected to speak at this conference again, let alone as Chief Accountant-and I am sure that none of you expected it either. It is a great honor and privilege and it is an excellent opportunity both to embrace the strength of the SEC as an agency and to help lead it through a period of innovative change as it strives to advance investors' interests.

Before I move on, let me 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's staff. That disclaimer applies to all members of the staff who are speaking at this conference.

I have now been on the job for a couple of months and that time has provided me the opportunity to check and refine the perceptions and observations I developed during the last 17 years since leaving the SEC. One thing that has remained constant is the opportunity to work closely with incredibly talented people on the staff who are dedicated to protecting investors.

I began my career as a professional accountant 32 years ago this month. And while I spent almost all of that time with one firm, there were two hiatuses that were enormously instructive. In addition to my 2 years as a PAF, I spent two years as a corporate controller of a public company. I have worked with countless professionals — on various "sides of the desk" — and I have deep respect for your efforts to produce credible financial reporting. I know that it is in your interest to do so for a variety of reasons, just as I know that the outcome is in the public's interest.

## **Mission**

Let me start by discussing how I intend to carry out the mission of the Office of the Chief Accountant.

There is no question that the unique power of the SEC enables it to have a profound influence on accounting and financial disclosure. I am firmly convinced that proactive use of that power can lead to great things. However, we must be judicious in its use.

I believe that the Office of the Chief Accountant should work with the leaders of the accounting profession-as they coordinate the profession's activities and give it direction. The SEC has a unique position out on the front line by virtue of its legislative authority, regulatory review and enforcement activities.

And, I believe that the intelligence gained from those activities should be very valuable to domestic and international standard setters, including their implementation groups like the EITF, as they set their agendas.

Through its oversight role, the SEC has the ability to interact with the various standard setters, which may be especially important if they start heading in

divergent directions. This coordination is particularly important as we work towards global convergence of accounting standards.

I also recognize that the SEC must be careful how it weighs in, to provide guidance in a respectful manner and to not dictate the way at every turn or the outcome. To do otherwise undermines the significant contributions of all involved. Now that you have a sense of my *modus operandi*, let's talk more about my plans.

### **Three-point Plan to Advance the Interests of Investors**

I want to discuss with you a three-point plan for the SEC, the corporate community, the accounting profession, and private sector standard-setting bodies to work together to advance, not just protect, the interests of investors.

Why do I make that distinction? As you all know, we at the SEC are sworn to protect investors. And doing so can include a wide variety of actions. I believe that by taking a proactive, inclusive approach we can do better than that — we can actually make investors better off by providing them with higher quality and more timely information. To do that means that we at the SEC adopt Chairman Pitt's philosophy that government is a service industry. It means that you all have roles to play, as well. And, with that said, here are the three points:

- First, working together to get it right the first time. Our capital markets are much more efficient if the financial statements you prepare, or audit, reflect appropriate accounting policies and contain appropriate disclosures. Getting it right after a restatement resulting from a staff review or enforcement action by the Commission will still be possible, but it's far less desirable.
- Second, working together to improve the effectiveness of the standard setting processes. To maximize the effectiveness of standard setting, we must work together to ensure that the appropriate parties are working on the right things and doing so in a timely manner. By working better together, we can make our world class system of standard setting and the application of those standards more responsive to the information needs of investors.
- Third, working together to modernize financial reporting and disclosure. I envision this part of the plan as a series of incredibly fun things we can do together to shape financial reporting and disclosure for the future. This effort will include looking at the types of information disclosed and the nature and timing of how disclosure occurs. This also will include the knotty issue of international accounting. More modern financial reporting should equate to more transparency to investors and more efficient capital markets.

### **Point 1—Working Together to Get it Right the First Time**

Now, to point 1—working together to get it right the first time. Over the years, one of the things that has truly distinguished the SEC as an agency has been the willingness and ability of its staff to provide interpretative guidance. We want to enhance that process!

In the area of accounting, the method of interpretation that first comes to mind is the pre-clearance process. Many of you are aware of and have utilized the pre-clearance process—in which you discuss an anticipated event, a planned transaction or other accounting matter with the staff. You ask us to concur with—and hope that we will respond that we do not object to—your proposed accounting.

Pre-clearing accounting issues is not a new idea. The staff originally asked registrants to pre-clear novel or unusual accounting issues in footnote 4 of SAB 57. Ironically, that footnote appears in a staff accounting bulletin of which I was a principal author. I believed in it then and I continue to believe in it today!

Of course, other vehicles for obtaining guidance are available, such as the EITF, but that takes time since it only meets every other month and registrants and their auditors must deal in "real-time."

### Our Part

We understand that registrants have to deal with issues on a real-time basis in order to issue their financial statements on a timely basis and to get deals done. Auditors also must deal with issues on a real-time basis to complete their reviews and audits. And we understand that talking to the staff takes time. So here is what we are going to do to enhance our ability to work with you.

First of all, we are revising our process for dealing with registrants. The PAFs will describe the changes in more detail later. However, I will pull a little rank and share a few highlights.

- We will have early involvement of one of my deputies or me.
- We will get back to you promptly—let you know who is on the issue—and ask "top of the mind" questions from reading your submission.
- We will tell you whether we think resolution of your issue could be expedited through a face-to-face meeting.

I don't know what has happened over the years, but I have been back for 2 months and only recently have I had a couple of requests to meet face to face with a registrant on an accounting issue that arose in the review and comment or pre-clearance process. I hope it's not something I said! Seriously, I want you all to know we welcome the opportunity to meet and discuss issues freely.

The process of writing back and forth can be important to "getting all of the facts," but it has diminishing returns. A face-to-face meeting can accelerate the understanding and resolution of your accounting issues.

When you come in, we may not always agree with you. But I promise two things:

- One, we understand that GAAP is subject to interpretation and that legitimate differences of opinion can exist. We will not insist on our personal preferences provided investors are adequately protected by your approach and it has a legitimate basis under GAAP.
- Two, while you won't always like what we say, we hope you will conclude that we listened to you with respect and that your views were fairly considered.

### **The Pre-clearance Process Is Not Utopia**

Despite my enthusiasm for the pre-clearance process, I realize it is not utopia. As I mentioned earlier, you must work in real time. You need an answer and we must protect investors. Furthermore, as the recent report by the GAO on our procedures for dealing with registrant matters points out, our pre-clearance conclusions often are not publicized.

So, we are going to try something new—something that I have advocated to my predecessors for at least the last 10 years. And that is that after we address issues that reasonably would apply to more than a minimal number of other registrants, we will refer them to the EITF for their consideration.

We will make those decisions based on our judgment, which also will be informed by the frequency of similar questions and consideration of the overall environment (for example, accounting for troubled debt restructurings in today's economy).

Of course, there are pros and cons to this approach. Let me share a couple of hypothetical outcomes:

- Example one. We agree with you but the EITF, after it has devoted more time and resources, does not. Okay, we have thick skin and will typically accept the EITF's answer. We aren't pushovers, but when one deals with emerging issues on a real time basis there is a risk that with more resources, deliberation and time, one might reach a different conclusion.
- Example two. We don't agree with you. Let's say that you have a good case—good facts and analysis of GAAP—but we are concerned that it would be a precedent that might be subject to a decline in the quality of financial reporting through inappropriate analogy in the future. Well, the EITF's process is terrific at creating fences, qualifications, and the

like and, once they do, we would accept the EITF's answer assuming, as we expect, that it would adequately protect investors.

I strongly believe that it can work. And I believe the November 2001 EITF meeting gave a flavor, or preview, of how it will work.

For example, as discussed in that meeting, we asked that the EITF address the effect on consolidation accounting of surrendering voting rights. Recently, we have had to answer several questions in this area and are hopeful that the EITF can build a model that results in consistent, high quality, transparent financial reporting.

In another example, the FASB staff decided to make a staff announcement on a derivatives question that we had dealt with on a specific registrant basis. Our analysis revealed a diversity in practice. We talked the matter over with the FASB staff and they decided to make a staff announcement that we think will resolve the inconsistency.

### **Registrants' and Auditors' Responsibilities**

Now let me talk about the responsibilities of registrants and auditors when working together with the SEC staff to get it right the first time.

As has been said before, we encourage registrants to pre-clear with us novel and unusual accounting questions. When you do so, please follow our protocol and send us a clear and comprehensive submission. The submission should explain the business purpose of the transaction, accounting alternatives considered, and the reasons for your proposed accounting treatment.

If you elect to pre-clear an issue with us, you should discuss it with your auditors, including their national office technical experts, before coming in to see us. We will want their insight prior to giving you an answer. Often times, their technical experts can provide you with an appropriate answer.

Do your best to think of the related questions we inevitably must consider and provide us with your thoughts on those issues as well. For example, we recently received an industry paper arguing that the intangibles fundamental to their business should be afforded an indefinite life that results in no amortization under new FASB Statement 142.

It was an excellent paper. It thoroughly explained the facts, including the historical impact of the governmental and regulatory environment in which the industry operates. In other words, it was compelling! Well, almost.

It did not tell us anything about how impairment would be evaluated. Since objective impairment testing is fundamental to an appropriate application of Statements 141 and 142, we must consider those issues as well. And while we can deal with that situation by asking questions, it slows things down.



We have updated our protocol to include this idea of addressing the follow-on questions, and we are going to ask you to include your proposed disclosure as part of your submission.

As I mentioned before, once a particular practice is accepted, many view it as a precedent, so transparent disclosure is essential to ensure inappropriate analogies do not get started. And, even more important, quality disclosure is key for investors.

In addition, when you submit your issue to the staff, we would like you to tell us about your audit committee's views about your proposed accounting treatment.

## **Point 2—Working to Improve the Effectiveness of Standard Setting**

The second of my three points is working to improve the effectiveness of standard-setting. As I stated at the outset, the SEC staff is on the front line of financial reporting by virtue of our day-to-day activities. From that vantage point, we will sometimes see issues that look to us like they require a broader resolution in the form of new or revised standards. Chief Accountants at the SEC have made formal recommendations to the FASB on such issues in the past, such as Mike Sutton with the accounting for business combinations, and Clarence Sampson with measuring financial instruments at fair value. And, in a speech last summer, my predecessor urged the Board to produce guidance for consolidation of special purpose entities.

Some find it controversial when this is done formally, because the SEC is sometimes seen as "dictating FASB's agenda." But such involvement with agendas of standard-setters is an important part of our job, and I intend to work hard to keep open lines of communication with the standard-setters.

Let me give you an example. With over 50% of SEC enforcement cases being related to revenue recognition, there is a clear need for broad-based principles. The FASB is considering adding such a project to its agenda and, as Ed Jenkins knows I encourage it to do so.

Once standard setters have added projects to their agendas, they incur an obligation to get the job done in a quality, timely and operational manner.

Standard-setting is a very difficult business. Standard-setters must consider the interests of and input from many constituencies as they strive to ensure companies provide investors with transparent, neutral information about their performance. That is why groups like the FASB and IASB operate in an open forum subject to a full comment process.

I think standard-setters should keep one word in mind as they develop standards—balance. This includes avoiding complexity while providing sufficient implementation guidance to ensure comparability among companies and ensuring that relevant information is reliable. We all play a part in this

effort and need to realize that for the product as a whole to be its best we will not always get our favorite rule or exception.

And lastly, in this Internet age, speed to completion is a key attribute for standard-setters.

Another issue facing standard-setters is the need for convergence of domestic and international accounting standards. Converging accounting standards is critical to a continued, efficient expansion of our global capital markets. Standard-setters should be cognizant of the effects on international accounting as they carry out their activities in the future, and I hope that convergence becomes a more near-term objective. Time does not permit a full discussion of my views on international accounting today, but it will be a major focus for the Chief Accountant's Office.

With the continuing pressure to increase the efficiency of our global markets, there is plenty of work ahead for the standard setters and I look forward to working with them.

### **No Rule-Making By Speeches**

The first time I spoke with Chairman Pitt about my coming to the SEC we compared notes about our priorities. As you might expect by virtue of the fact that I am here today, we found much in common. And near the top of both lists was a commitment to address concerns that there has been *rule making by speeches!*

As I mentioned earlier, the GAO recently reviewed the operations of the Office of the Chief Accountant in dealing with registrant matters. One of the criticisms was the communication of our views through speeches. A suggestion that arose as part of that report was that our speeches be codified if we were going to expect registrants to follow them.

Our accounting literature is now so voluminous that it literally fills rooms. Can you imagine adding 250 or so speech topics to this volume? Suffice it to say, we have considered the suggestion and decided that it is not realistic.

With that said, I recognize that a speech posted to the website offers a quick and effective means of communication about how the staff concluded on a particular fact pattern, which can be helpful for many of you to know. However, such speeches can cause confusion as well.

First, the speeches are hard to keep track of—even in today's Internet age. Second, many of the speeches are old and out of date and an effective means for updating them does not exist. Most deal with specific questions that sometimes are analogized to inappropriately. And sometimes they can bump up against ingrained practice and raise questions about an adequate notice and comment process. Too much emphasis on these speeches can undermine GAAP and our private sector standard-setting activities.



So, we are doing something different this year and the PAFs will fill you in on the details, including telling you what we are doing with the old speeches that have been on our website. We'll stick to rulemaking by rulemaking

And, to go back to the subject of the volume of accounting literature, I think that the FASB's consideration of a project on codification and simplification of GAAP affords an excellent opportunity to balance operationality and conceptuality.

### **Point 3—Modernizing Financial Reporting and Disclosure**

Now let's turn to point 3-working together to modernize financial reporting and disclosure.

Our existing system of financial reporting and disclosure was developed back in the 1930s and is showing its age. During the last 70 years, technology has advanced to a point where computers and the Internet are a part of our everyday lives. But relatively few changes have been made to the Commission's rules regarding what financial information is disseminated and how it is communicated. As a result, it seems like no better time exists than now to consider modernizing the system. So, we will take a fresh look, one that is no-holds barred in terms of being open to new ideas. Let me give you a flavor for some of the issues:

- Whether investors would be better served, in this era of instant communications, by supplementing our existing periodic disclosure with a new concept of current disclosure.
- Whether investors would be better served if public companies were encouraged to disclose trend information more broadly.
- Whether investors would be better served if disclosures were simplified so that financial statements were more easily understood.
- Whether investors would be better served if our accounting model were updated to include disclosure about, or accounting for, intangibles.

### **Example of Such an Initiative**

Let me give you an example of how an initiative for modernizing financial reporting and disclosure might work.

Seven or eight years ago, the SEC worked with Ray Groves to flesh out ideas he had to simplify financial statement disclosures and MD&A so that reasonably informed investors would find them time-efficient to use. Mr. Groves found that the volume of disclosure in MD&A had increased exponentially, and in the complex world in which we live, that has continued to be the case.

Working together with the SEC staff led to a proposal for abbreviated financial information, which would consist of "condensed financial statements" and abbreviated footnotes, and would be sent to shareholders with annual meeting proxy statements. Full disclosure would be maintained in Form 10-K. This proposal was not unlike the FEI and Deloitte & Touche initiatives in the early to mid-1980's that advocated a summary annual report.

Unfortunately, there was not much support for this initiative. (I know the feeling). Some in the business community saw it as being only additive, and others did not like it as they saw it as somehow jeopardizing GAAP, or depriving ordinary investors of the full product. Legal advisors were concerned that the approach might lead to more liability.

But now, with new technologies, investors might be able to start with summarized financial statements and footnotes and, if they want, hyperlink to the more detailed underlying information. The power of technology and the Internet has proven to enable assimilation of as much or as little information on a topic as the user wants.

Analysts still would get all the details they get today, but companies would be responsible for doing their own simplification, which would be available to all investors simultaneously.

### **Next Steps**

This project is in its infancy and a lot of hard work lies ahead. The next step for the staff likely would be to put together, for consideration by the Commission, a thought leadership piece to sort out the issues and gather public input, which likely would be in the form of a concept release. Naturally, part of that process would include getting our arms around what has been done (for example, the efforts by the FASB and AICPA to explore a new business reporting model) and the various projects currently underway, such as IASB's project on reporting financial performance. These efforts of the private sector standard setters, the profession, and the SEC will need to be coordinated.

I do not know how this project will ultimately turn out. But I do know that we will not throw out the current system, and we will be very sensitive to costs and benefits. We think there is much to be gained from harnessing better use of technology in terms of both delivery and design. And by doing so, investors win!

### **New Special Advisor**

Now, as with many new ideas, this may be simpler to envision than to implement, and forming the project details, getting input, conceptualizing, and getting more input will be a prodigious task.

To help us move forward with this massive and crucial undertaking, I am pleased to announce that Robert Bayless has agreed to join the Office of the

Chief Accountant as my Special Advisor to work on these tasks.

You all know Robert as a tireless, brilliant and eloquent member of the SEC staff for many years. Robert and I both look forward to working with you on this initiative.

You will be hearing much more about these ideas in upcoming months, and hopefully by the time of this conference next year, the staff will be up here with others, talking about concrete steps in our initiative to modernize financial reporting and disclosure.

### **Accounting and Auditing—and Regulating—in a Tough Economy**

Now it's time to turn to the here and now. No speech by the Chief Accountant of the SEC at this time of year, in a year such as this one, would be complete without some comments about the issues raised by the economy. The year 2001 has been a terrible one for our economy. We've just learned from the experts in such matters that our country has been in a recession since March. And, of course, the economic consequences of the terrible atrocities of September 11th have been particularly severe for certain industries. When the topic is negative news, it's especially important to apply the myriad of applicable accounting and disclosure requirements, including MD&A, that others from the SEC staff will be reminding you about over the next two days.

Tough economic conditions also exacerbate the challenges faced by auditors. The need for due professional care and skepticism are never higher. And it has been a long time since our last recession, so many of you have not recently thought through these types of issues. Or perhaps when this last occurred some of you were in positions in your firm where more senior people had the responsibilities to make tough calls on issues such as going concern modifications of your reports. If so, now it's your turn!

To help you get it right the first time, the Professional Issues Task Force of the AICPA's SEC Practice Section, the profession's self-regulatory body, recently issued Practice Alert 2001-2, "Audit Considerations in Times of Economic Uncertainty." I won't repeat what the Practice Alert says; I do urge each of you to read it, think about what it says, and apply it in each of your upcoming audits. And make sure your staff reads it, too.

Lastly, I want to comment on the Cautionary Advice release the SEC issued two days ago regarding the use of so-called "pro forma" financial information in earnings press releases. The tough economic times seem to have accelerated the trend toward companies releasing quarterly earnings on a basis other than GAAP. And, there were concerns that under certain circumstances pro forma information can mislead investors. So, the staff recommended, and the Commission agreed, that action should be taken before the next deluge of quarterly reporting.

The release makes several points:

- First, the antifraud provisions of the federal securities laws apply to a company issuing "pro forma" financial information. This is so even though quarterly earnings press releases are not required to be filed with the SEC.
- Second, departures from GAAP in these releases raise particular concerns if there isn't clear disclosure of the basis of the presentation.
- Third, statements about a company's results that are literally true may be misleading if they omit material information.
- Fourth, if done properly and with appropriate disclosure, pro forma financial information can serve useful purposes. The earnings press release guidelines jointly developed by the Financial Executives International and the National Investor Relations Institute specify a plain English disclosure of how the announced results deviate from GAAP, as well as the amounts of those deviations.

If the SEC staff finds instances where these types of disclosures would mislead investors, I am sure we will recommend appropriate enforcement action.

So, in a nutshell, be careful about making a non-GAAP presentation. If you decide to do so, get it right the first time! And if you don't get it right...well, I think you get the picture.

### **Confidence in our System of Financial Reporting**

Finally, no speech by the Chief Accountant this year should conclude without some remarks about the events of the last few weeks. The stunning collapse of a Fortune 10 company in such a short period of time gives pause to all of us who care about financial reporting-and about its customers-the investors. As has been widely publicized, the SEC is investigating the Enron matter. So, neither I nor any other staff member is allowed to comment on any of the specifics.

However, here is what I can say: Not only is the collapse of Enron in and of itself stunning, but it comes on top of several other widely publicized problems and restatements. One has to conclude that there is a threat to the confidence in our system of financial reporting and our capital markets. In the coming weeks and months, we will learn more about what really happened. But, improvements cannot wait until a full analysis of all of the facts is completed.

In that regard, I commend the 5 largest firms and the AICPA for their announcements on Tuesday describing their initiatives that are designed to improve financial disclosure and audit performance in the near term. In light of those actions, it is clear that the profession recognized the need to move forward in a positive way.

The profession is planning to provide guidance for this reporting season to enhance disclosures and improve auditing coupled with additional rule-making that would provide longer term solutions. This guidance would strive to build on the recommendations of the Panel on Audit Effectiveness. It would include guidance for company managements and audit committees on deterring fraud. We at the SEC stand ready to facilitate those efforts.

The fact that the 5 largest firms and the AICPA are working together to improve auditing is realistic and positive. I encourage the profession to think more expansively about what can be done in this area, just as they will be thinking about needed improvements in self-regulation.

In the meantime, here is something that I encourage preparers and auditors to think carefully about during this year's upcoming reporting season: Look carefully at your accounting policies and identify the top 3 or 4 or 5 that require significant judgment or involve complex estimation process to apply. Think hard about the sufficiency of the disclosures -not just about the policies themselves-but also about the explanatory information of the amounts included in the financial statements that is subject to those judgments and estimates. Ask yourself whether investors know enough about the impact of those judgments and estimates on the financial statements. Then challenge yourself to improve these disclosures in either the financial statements or in MD&A. Appropriate, transparent disclosure is the most effective way to mitigate the potential for negative surprises and to advance the interests of investors.

I would be happy to take questions.

*<http://www.sec.gov/news/speech/spch526.htm>*