U.S. Securities and Exchange Commission

Speech by SEC Commissioner: Remarks Before the ABA Committee on Federal Regulation of Securities

by

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Good afternoon, it is always an honor and privilege to speak before such a distinguished audience. Before I begin my prepared remarks, I am obligated to give you the usual disclaimer that Commission members must make when speaking publicly; which is that the views I express here today are my own and do not necessarily reflect those of the Commission, other Commissioners, or the Commission's staff.

When Mr. Keller first invited me to speak today, he noted that I spoke to this Committee early in my tenure at the Commission. He thought that it would be fitting for me to provide you with some insight into the important issues facing the Commission today from the vantage point of my six years as Commissioner. So in preparing to speak here today, I thought that I would look back and see what sage advice I gave you in 1996.

And to my surprise the title of my speech back in 1996 was "Contemporary Thoughts on Disclosure." My first thought was "Wow;" the title of my speech is as applicable today as it was in 1996. I thought to myself, "I must be a visionary." Of course my second thought was a little scarier. "Oh no! What did I say in 1996 about Disclosure? " Did I praise the contribution that independent analysts make to our disclosure system? Did I say nice things about accountants? Thankfully, and to my relief, all the speech did was discuss what the Commission had already done: Plain English, Task Force on Simplification, and Commissioner Wallman's report on Company Registration. No mention of analysts or accountants anywhere.

So for the record: while it is true that I do have a few friends who are accountants, I never let them advise me on non-audit services; I rotate seeing them on a monthly basis; and I always ask them to disclose their critical assumptions and estimates, especially when dividing up the dinner check.

But seriously, Mr. Keller's suggestion was a good one. It got me thinking about all the Commission has accomplished during my years as a Commissioner. As many of you know, in these years the Commission has been quite aggressive in its rulemaking. The Commission has addressed issues regarding market structure, decimalization, the Internet, Plain English, Audit Committees, Integration, Regulation FD, and Accountants' independence, to name just a few. And while I won't make predictions on what future Commission rulemaking holds, I think with Chairman Pitt at the helm it's safe to say: "You ain't seen nothing yet!"

In reflecting on the Commission's past actions and the benefits that they provided to investors, it has been in the area of accounting where I believe the Commission has made its most significant contributions to furthering the goal of investor protection and enhancing efficient capital formation.

Audited financial statements provide the foundation for our securities markets. Audited financial statements allow investors to make decisions on whether to buy, hold, or sell a particular security. If the numbers in the audited financial statements can't be trusted to provide relevant and reliable financial information about the company, investors might as well head to Vegas. Because it will be by chance that their investments will be profitable. Unfortunately, based on some of the Enforcement cases that I have reviewed, I have come to believe that some shareholders would have received better odds in Vegas.

What I am telling you, however, is not new. After all, it was in 1933 that the U.S. first officially recognized that the integrity of a public company's financial statements was paramount to the health of our capital markets. As noted in the U.S. House of Representatives Report that accompanied the enactment of the Securities Act of 1933, Congress then sought, among other things, to provide for the disclosure of "distribution of profits, watered values and hidden interests." Congress sought to achieve such disclosure, in part, by requiring that an *independent* public accountant certify the financial statements of companies raising capital in our public markets.

During the adoption of the Securities Act, Congress considered whether the government should be in the business of auditing public companies. It determined, I believe correctly, that the accounting profession was best able to handle the task of auditing and certifying a company's financial statements. And thus, accountants became gatekeepers to our capital markets. It has been, in part, due to the significant efforts of the accounting profession that the Commission has not only been able to protect investors but also watch over the creation of the most liquid and efficient capital markets the world has ever seen.

So for those out there who would have us throw away GAAP and dismantle the U.S. accounting profession let me make this public service announcement: The U.S. capital markets are second to none! There is more transparency, comparability, and frequency of disclosure here than in any other system in the world!

Now that is not to say that we can't make improvements in our system. But we must be careful that we do not harm our capital markets in our rush to address its problems. These problems did not happen overnight, nor should we expect to solve them overnight. While it is true that we have seen some significant accounting failures recently including: Sunbeam, Waste Management, Cendant, Microstrategy and Enron, there have been relatively few when you realize that there are over 16,000 public companies filing audited financial statements annually. But even a few is too many.

As I have stated before, there are lessons that I believe we have already learned from these failures. Here are four issues that I believe we must continue to address in the hope that through this effort we can enhance our system without jeopardizing its existing successes.

> **1. Congress should consider, as it is now doing, prohibiting accounting firms from providing non-audit related services to audit clients. The Commission, however, should have the authority to define non-audit related services.**

The Commission is foremost a disclosure agency. Banning a profession from entering and engaging in a legal business enterprise, I believe, is a decision better left to Congress and the President. As you all know the Commission struggled with this issue, and while I tentatively believe a ban on such services is desirable it seems to me better left to Congress and the President to take such drastic action. Now while I believe Congress should enact a ban I believe the Commission should have the authority to define non-audit related services. In this regard, I would continue to permit accounting firms to provide tax services to their audit clients. In all the accounting frauds that I have reviewed, I cannot recall one that implicated the tax advice or tax services provided by accountants to client companies. Tax accruals do not appear to be the cause of restatements. Additionally, I believe that the IRS and the criminal sanctions that it can bring against accountants and companies serves as a nice backstop against accounting fraud in this area. On the other hand, the one thing I would not permit is for an outside auditor to provide its clients' with internal audit services.

A contrary view on this issue, articulated by Chairman Pitt and others, is that, in the words of Chairman Pitt, "we should give the rules already adopted a chance to work, we should also prohibit engagement auditors from receiving compensation for cross-selling non-audit services to engagement clients, and... we should think through the expansion of such separation carefully, lest we actually reduce the quality of audits, rather than enhance them."

2. We should continue to try to answer the question of whether option compensation should be expensed, as well as the question of are we sure that such options are, or can be, properly valued.

Currently companies have the choice whether to expense non-incentive based option compensation or to provide footnote disclosure in the audited financial statements. This choice, I believe, makes the operating income and earnings numbers less comparable between companies. The question of the proper accounting treatment for option compensation is a difficult, "hot button" issue. Yesterday's editions of the *New York Times* carried reports of Chairman Pitt's remarks at Northwestern Law School on Wednesday in which he opined that the issue is not so much whether options are expensed or not, but rather ensuring that the interests of management are aligned with those of shareholders. The issue then becomes whether shareholders get to vote on the issuance of options after first approved by a committee of independent directors, and, even then, only if appropriate disclosure has been made in a proxy statement.

Those same editions of the *Times* include a column entitled "Leave Options Alone" in which the authors, John Doerr and Frederick W. Smith, argue that expensing options would result in them being counted twice in earnings per share: "first, because present rules already require companies to report earnings on a diluted basis-counting the potential decrease in ownership of existing shareholders due to the granting and exercise of options and second, as a charge against reported earnings." The result, in the authors' view, would be a greater distortion of the true picture of a company's finances.[1] In today's issue of the *Economist* an article titled "An Expense by any other Name" concludes:

> There are no good arguments for continuing to pretend that options cost nothing. The rules should at last reflect reality.

And finally, people on all sides of this issue recognize the difficulty of accurately calculating the expense of options for a given company.

My tentative views: The lack of expensing option compensation can be problematic because companies can reduce their labor expenses and thus their cost of goods sold by paying more in option compensations than cash. If a particular company does not expense its option compensation then its operating income and earnings numbers will be greater compared to similar companies that either paid more in cash compensation or chose to expense option compensation. As recent newspaper articles have discussed, option compensation has exploded. The effect on earnings can be dramatic. For example, according to the *Wall Street Journal*, operating income at Oracle would have been reduced by $933 million dollars had the company expensed its option compensation.

Our capital markets appear to be highly efficient in reflecting in a company's stock price the information contained in earnings figures. If earnings are less than expected a company's stock price may get pounded; if more than expected it may be rewarded *by going* to new heights. While our markets may also be efficient in reflecting information found in the footnotes to audited financial statements, (where information as to what the options expenses would have been had the issuer chosen to expense them is set forth) I believe they are less efficient reflecting such information than when reflecting information contained in the body of companies' operating income and earnings statements. This could effect the allocation of resources, with more capital being invested in companies that on the surface appear to be high growth earnings companies because their labor costs are not fully reflected in their financial numbers.

Now I know some may disagree with me and argue that the market is equally efficient for footnote disclosure as earnings figures disclosure. Even if they are right, however, there is still a problem with not expensing option compensation. Footnote disclosure only occurs on an annual basis. Accordingly, investors and analysts are not able to accurately adjust the quarterly earnings figures because the information regarding the value of quarterly or semiannual option grants is not available.

While I might like to see this problem fixed tomorrow I realize that is not possible. The FASB has many more important priorities that must be addressed before it can reexamine accounting for option compensation. For example, accounting for special purpose entities and revenue recognition issues must be FASB priorities. Moreover, the International Accounting Standards Board is currently examining this issue. It very well may be prudent to see what they come up with it before FASB or the Commission address this issue. This does not mean that accounting for option compensation should be a ten year project, but as I noted earlier we did not get here overnight nor should anyone expect us to resolve this issue overnight. I believe it is much more important to make sure the valuation of options is accurate. For example if, as some have argued, the current method of valuation overvalues these options we may be in no better place than our current situation of generally not expensing option compensation. Expensing overvalued options would result in the earnings numbers appearing to be lower than they actual are. This situation would be no better and perhaps worse than where we are today. While, again, I have a tentative view on this issue, I am not prejudging it. I intend to keep an open mind and will await comments and views from the public.

> **3. The Commission should consider issuing a rule proposal that would require companies to disclose whether their audit committees received advice from independent counsel and/or independent accounting experts. And if such advice was not sought and provided, why the committees thought that it was not needed?**

Over the years, the Commission has and is likely to continue to expect audit committees to play a greater role in the oversight of public companies. I believe in today's business environment many issues arise that audit committee members must past judgment on that could have significant consequences to a company and its shareholders. While I personally believe that audit committees should have independent legal counsel and accounting expertise, I also believe that mandating changes in corporate governance should be left to the states, SROs, such as NYSE and NASDAQ, and shareholders. The Commission, however, has the obligation to ensure that shareholders have the information needed to evaluate the corporate governance of their companies. Accordingly, I think that this disclosure of the activities and choices of audit committees will allow shareholders to better evaluate their audit committee reports and recommendations.

4. The Division of Corporation Finance should consider conducting a full review of all S&P 500 companies each and every year.

First, before anyone in the audience has a heart attack let me tell you that I believe that I am in the minority at the Commission with regard to this suggestion. Moreover, the Division of Corporation Finance would clearly need additional resources before undertaking such an objective. Currently Alan Beller and Chairman Pitt are examining the Division's selective review procedures and are planning to possibly institute risk management techniques that could address my concerns in a more cost effective manner than annually reviewing all S&P 500 companies. My recommendation, however, is based upon the past six years and without a background in risk management it is difficult for me at this time to evaluate all possible alternatives.

So let me tell you why I think reviewing S&P 500 companies it is important and why I do not believe it will slow down the offering process, which I am sure most of you are rightly concerned about.

First, investors have over $10 trillion dollars invested in the S&P 500. This number does not even reflect the dollar value of other financial instruments whose value is derived from changes in the S&P 500 index. Additionally, the S&P 500 index is often used as a benchmark to judge the performance of investment mangers and mutual funds. Finally, these companies have the ability to go to market, whether offering debt or equity, at a moment's notice. Since it is not always possible for the underwriters to conduct extensive due diligence immediately prior to a shelf takedown, I believe additional review is warranted.

Now, while I realize that staff review will not eliminate frauds or even prevent major restatements by these companies, it can help obtain additional disclosure for investors as well as help ensure that companies' disclosures are clear and understandable to the ordinary investor. I suspect there are many in this room who were critics of our plain English initiative. Today, however, prospectuses, on average, are clearer and more understandable than they were five years ago. This has been largely due to the staff review process.

Lastly, let me address your concerns regarding timing of such review. In the earlier 1990s, during the S&L and banking crisis, then Chairman Breeden ordered the staff to conduct full reviews of bank filings within 15 days of those filings being made with the Commission. If we could do it for the banks in the early 90s, I believe our vaunted staff can do it for the S&P 500 in this new millennium. Second, by conducting reviews annually the staff will become more familiar with those companies and thus might develop the ability to review such filings on shorter time frames. For example, our accountants will have already reviewed two of the three years of audited numbers contained in a company's annual report. Thus, I believe letters containing 100 or more comments would become a thing of the past, something I am sure you all can appreciate. This should enable your clients to become more comfortable going to market even while their disclosure is still under staff review.

Well those are my pearls of wisdom this year. But just in case your Committee Chair invites me back again five years from now, as a Commissioner *emeritus*, to review this sage advice, let me clarify one thing: I always reserve the right to get smarter. And if the help of the ABA has provided me over past five years continues, I am sure that I will.

Thank you and have great day.

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[1] See also the thoughts of Walter P. Schuetze, former Chief Accountant of the SEC, former Chief Accountant of the SEC's Division of Enforcement, and charter member of the Financial Accounting Standards Board, on this issue in his 25 March 2002 letter to Senator Charles E. Schumer (D.NY), "Accounting for Stock Options Issued to Employees." In that letter Mr. Schuetze explains that "for technical accounting reasons," he would not charge expense for stock options issued to employees.

http://www.sec.gov/news/speech/spch550.htm
