



## U.S. Securities and Exchange Commission

### **Speech by SEC Staff: Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments**

*by*

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Good morning. As many of you know, I have been serving as Deputy Chief or Acting Chief Accountant at SEC for a little over four years. During that time, I have given dozens of speeches and presentations, some of which have been preserved for posterity and your reading pleasure on the SEC's web site. Also on the web site is the press release from a couple of weeks ago announcing that I will soon leave the SEC. So this will almost certainly be my last speech as Deputy Chief Accountant - my last chance to remind you that, as a matter of policy, the SEC does not accept responsibility for what I say, and that my words are therefore my own, and don't necessarily reflect the views of the Commission.

While I thought about just talking about all that's happened in the last four years, in the end, I decided I'd talk to you about the thing that has frustrated me most in the four years that I've been here at the SEC - the difficulty that I have observed with regards to applying professional judgment in financial reporting.

I've spoken often about the importance of applying judgment, and some of the responses have really surprised me. Some have responded by telling me, on little question cards like the ones you have in front of you, that they refuse to apply judgment because doing so will put them at risk of being second-guessed. Others have stated that expecting people to apply judgment in today's environment is a fantasy. These kinds of reactions concern me,

because, as I noted, I'm getting ready to leave the SEC, and I won't find my next job, whatever it is, much fun if I wind up in a situation where I have to base all decisions on specific rules, and it will be even less fun if I wind up feeling, as these reactions seem to portend, that I cannot function in the absence of detailed rules. So for those who do feel that way, let me say that I am sorry for any part that the SEC or its staff have played in generating these feelings. And I know some of you believe the SEC and its staff have played a huge part, because you've told me, again on those little question cards.

So, let me try, for one last time as Deputy Chief Accountant, to respond to these concerns. Perhaps stating the obvious, I don't believe that following the rules that do exist is inconsistent with applying professional judgment. In fact, it is an application of professional judgment, just a different type than is required when the standards are more reliant on principles and subjective analyses. As noted in the SEC staff's 2003 report on objectives-oriented accounting standards, "One consequence of continuing to move to an objectives-oriented regime is that preparers and auditors would be called upon to exercise professional judgment in a different way than is currently required." It then goes on to note that "...professional judgment also is needed to apply rules-based standards. However, in applying rules-based standards, professional judgment is needed to determine where within the numerous scope exceptions and conflicting guidance the company's transaction falls. Indeed, in many respects, the exercise of judgment in an objectives-oriented regime is merely different than under a rules-based regime."

Perhaps this may shine a light on part of the problem. We have a system of reporting standards and requirements now that includes many bright-line hard-and-fast rules, and also many places that explicitly require the consideration of subjective factors. Perhaps practitioners, regulators, and others sometimes have trouble remembering just which kind of professional judgment is required in a given situation. Sometimes I hear complaints about rules that exist, like the ones delineating who gets to use the short-cut method, while other times I am asked to make rules that don't, like a specific measure for materiality. Perhaps these situations really arise because the accountant is having difficulty in applying whichever type of judgment is required in a given situation, and therefore is asking for changes that would allow the application the other type of professional judgment. I just bring this up as a different way of thinking about the use of judgment and the whole rules vs. principles debate.

As I've already insinuated, the SEC staff does believe that bright-lines in the standards ought to be respected - not necessarily because we like them, but because it is appropriate to apply the standards that exist, as opposed to the ones we might wish existed. Ignoring the output of the standard-setting process on a case-by-case basis with no public input or deliberation seems at best inappropriate. So we will ask you to capitalize the lease even if you just barely went over the 90% threshold. And we won't accept application of short-cut accounting when you've met all but one of the criteria necessary to be scoped into that method. On the other hand, we won't ask you to

capitalize a lease that has minimum lease payments equal to 89% of the fair value of the leased asset, even though it would seem to be better accounting, and we won't object to the application of the short-cut method if you do meet all the criteria, even if some ineffectiveness is ignored. But to suggest that this means the SEC doesn't really respect judgments is taking it too far. As I noted above, these situations just call for a different kind of professional judgment.

However, while bright lines exist in many areas, there are plenty of places where the accounting literature calls for the consideration of subjective factors. But we're not always ready for that, apparently. Last year there was a lot of concern over an EITF consensus related to evaluating whether impairments of financial assets were other than temporary. The consensus had no bright lines in it and called for the application of judgment and evaluation of the available information. Nonetheless, after the consensus was issued, discussion centered on a "tainting" notion in which a company that sold a security at a loss without previously recording an impairment would be deemed incapable of forming an intent to hold other impaired securities until recovery. The consensus didn't say anything like this; the SEC staff indicated that such a tainting notion was inappropriate. Eventually, the consensus was withdrawn because it was obvious that a bright line was going to be applied even though the standard didn't have one.

When the literature says to use a best estimate, or to consider available information, or to assess the likelihood of something occurring, those are all cues to evaluate the information and use judgment, and we must all be comfortable with that. And perhaps most importantly, when a transaction arises for which the literature is unclear, which is bound to happen time and time again, the application of good professional judgment is needed to determine an appropriate accounting model.

But this is an area in which I see the "I've applied professional judgment, don't object" argument used in a way that is certainly contrary to the way I think of professional judgment. Some continue to try to take advantage of situations in which the literature doesn't specifically have anything that speaks to their transaction by twisting the facts to allow an analogy to the accounting they see as preferable. And some structure transactions specifically to take advantage of the possibility of making these twisted analogies. I have complained about transaction structuring often during my term at the SEC, and there have been some improvements, but it still happens, and not infrequently. Hiding behind "professional judgment" to justify attempts to do something that is intended to hide, mislead, deceive or confuse is an insult to professionals who value integrity and transparency and to the users who will rely on the information provided.

I would be remiss if I didn't mention one other manifestation of the fears that are out there about applying judgment. This relates to the desire to look for an answer that can be deemed the "safest". I continually see attempts to find a "default" accounting that can be considered a "safe" starting place in a difficult analysis, even when the issue doesn't lend itself to such a methodology. For example, I have heard that some read FIN 48 to suggest

that a detailed analysis and documentation is required to support even the most obvious tax position, such as a deduction for depreciation or charitable contributions, and that, in the absence of such detailed documentation, it would be improper under the FIN for the company to record the benefit of such a deduction. This is just wrong. FIN 48 doesn't require a significant amount of documentation and analysis to support obvious tax positions - it is written for those positions for which there is uncertainty. And FIN 48 also doesn't have a default provision that suggests that no position may be recognized until sufficient documentation is prepared. In fact, I find FIN 48 to be blissfully principles-based - record the benefit if it is more likely than not that it would be deemed an appropriate position -- yet it is being read by some to include rules that simply aren't there. And if this race to the "safe" answer of either not recording the tax benefit or creating significant work to support obvious positions continues, we will end up with either bad financial reporting or useless work being done. We don't need to make things harder than they are.

I'd like to address more directly the assertion that the SEC staff's actions raise the fear of being second-guessed to the point where people just don't want to leave open that possibility. First, let me say that we're human at the SEC. Just as you in the audience may be uncomfortable in situations in which rules don't exist, we can be uncomfortable in those situations as well. And we may respond by looking for consistent interpretation of principles in situations in which it turns out it isn't reasonable to do so. For that, I apologize. But if you feel that is happening - if you think we're asking you to adhere to a rule that doesn't exist, or that we're not respecting your knowledge and understanding of the transactions you've entered into, let us know. We are relatively intelligent, popular mythology notwithstanding, and I think we do a good job of second-guessing ourselves when appropriate.

Next, I should point out that we see many instances in which companies apply the best of their efforts to support misleading accounting for structured transactions or to justify accounting that didn't receive a thoughtful analysis before a filing was made. Needless to say, we are skeptical of the analyses put forward in these instances, because the judgments weren't made in a neutral environment. Rather, they are arguments meant to support an answer that either was always intended in the first place, or one that is being backfilled, as it were, because it has already been reported to the public. And sometimes, we may have trouble figuring out if a specific issue we're dealing with falls into one of these "less than objective" categories. Again, if we've judged your situation too harshly, I apologize. But please, let us know if you think that's happening.

Finally, let me note that we aren't "out to get" anybody. I've heard it said that if you want a particular accounting treatment to be approved by the SEC, your best bet is to suggest the opposite. Boy, I really hope that isn't true. We care about getting to transparent reporting, not conjuring up errors that don't exist to pad statistics that we don't even keep.

"OK", you may be saying, "exactly how does knowing all of that help me deal with my issue?". Fair question, so I'll give you a couple of suggestions. First,

spend some time thinking about significant issues before you file your financial statements. We wind up agreeing with a registrant's accounting a much higher percentage of the time when it turns out the registrant identified the issue, thought about the accounting, and documented its considerations at the time the transaction occurred. Second, if you believe the SEC staff isn't giving due consideration to your analysis, ask for the involvement of senior reviewers, or the front office in the Division of Corporation Finance, or even for the views of the Office of the Chief Accountant. This is not an uncommon thing, and, contrary to popular belief, we don't blacklist companies as trouble-makers for doing this. Although I I'd be lying if I suggested that I know how every accountant at the SEC thinks, I can say that we have a very highly-qualified staff, and I am confident that we are comfortable operating in a principles-based environment. We obviously shouldn't be objecting to well-founded, reasonable judgments that are made within the context of the existing accounting literature, and we have neither the desire nor the incentive to do so.

Finally, let me close by thanking you for your attention as I've delivered these remarks, and for your counsel, your advice, and your efforts these past four years that I've been at the SEC. You in the audience and your colleagues in the financial reporting community are a large part of the reason that my job has both fun and rewarding. Thank you again, and I look forward to responding to questions at the end of the day.

*<http://www.sec.gov/news/speech/2006/spch121106sat.htm>*