Testimony Concerning Accounting and Auditing Oversight: Pending Proposals and Emerging Issues Confronting Regulators, Standard Setters, and the Economy
by

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and Government Sponsored Enterprises
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Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee:

I am Jim Kroeker, Chief Accountant of the Securities and Exchange Commission. I serve as the principal advisor to the Commission on accounting and auditing matters. I thank you for the opportunity to appear before you today to testify on behalf of the Commission regarding current issues related to the accounting and auditing profession.

Importance of Reliable Financial Reporting

The reliability of financial reporting is critical to the confidence of the investing public. The objective of financial reporting is to provide information useful to providers of capital in their decision-making processes. Information provided to participants in our capital markets must be neutral, reliable, and portray economic results in an accurate and faithful manner. Just as important, participants must have confidence that this is in fact the case.

The U.S. system of financial reporting has long been considered a major asset of our capital markets. The prominence and reputation of the U.S. capital markets are directly linked to our system's ongoing commitment to high-quality, accurate financial reporting. This commitment provides investors with confidence, helping to minimize the cost of capital from uncertainty or suspicion as to an issuer's economic fundamentals and prospects.

As the agency empowered by the federal securities laws to be the investor's advocate, the Commission has the authority and responsibility to prescribe the methods to be followed in the preparation of issuer accounts and the form and content of financial statements filed with the Commission. The federal securities laws also mandate an independent audit of public company financial statements according to specified standards by qualified professionals in order to provide assurance as to the faithfulness and integrity of the information presented.

Two entities under the Commission's oversight have key roles in the financial reporting process. The first is the Financial Accounting Standards Board, or FASB, whose accounting and financial reporting standards the Commission has recognized as "generally accepted" for purposes of the federal securities laws. The second is the Public Company Accounting Oversight Board, or PCAOB, which is responsible for overseeing the audit of public companies that are subject to the securities laws. I am pleased to be on today's panel with Leslie Seidman, the Chair of the FASB, and Jim Doty, the Chair of the PCAOB. I also am pleased to be on this panel with Robert Attmore, Chairman of the Government Accounting Standards Board, or GASB.

Today, a confluence of factors—from the financial crisis to the decade-long effort to converge U.S. GAAP with International Financial Reporting Standards, or IFRS—has produced a significant volume of activity in the accounting and auditing areas. My office—the Office of the Chief Accountant, or OCA—works closely with the FASB and the PCAOB on these matters.

I would like to summarize for the subcommittee some of what I view to be the principal current issues.

Current Accounting Developments

The SEC continues to focus significant attention on two aspects of accounting. The first is the Commission's consideration of whether, and if so how, to incorporate IFRS into the financial reporting system for U.S. issuers. The second, and critically related to the first, is the ongoing efforts of the FASB and the International Accounting Standards Board, or IASB, in their efforts to converge U.S. GAAP and IFRS.

Global Accounting Standards

The Commission has previously stated its conceptual support for a single set of high-quality, globally-accepted accounting standards. This position advances the dual goals of improving financial reporting within the United States and reducing country-by-country disparity in financial reporting, which in turn facilitates cross-border capital formation and helps provide investors with the comparable and material information they need to make informed decisions about investment opportunities. Of course, having a single set of high-quality standards is not in itself enough to achieve these benefits. Investors must also have confidence in the standard-setting body and that the standards will be consistently applied and robustly enforced both within and across jurisdictions. And we recognize that there are many factors and challenges that need to be considered in pursuit of this objective.

The Commission has engaged in significant efforts to determine how to advance the goal of a single set of high-quality globally-accepted accounting standards, including through considering whether to incorporate IFRS into the U.S. financial reporting system. In February 2010, the Commission issued a statement in support of the FASB's and IASB's ongoing convergence efforts, and also directed the Staff to execute a Work Plan to evaluate issues relevant to a potential Commission consideration of incorporating IFRS for U.S. issuers.

The Work Plan includes the following areas for staff study:

- The sufficiency of the development and application of IFRS for the U.S. domestic reporting system, including enforceability and auditability of the standards, as well as comparability of IFRS reporting across jurisdictions;
- The independence of international accounting standard-setting for the benefit of investors;
- Investor understanding and education regarding IFRS;
- The U.S. regulatory environment that would be affected by a change in accounting standards;
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies; and
- Human capital readiness.

The Staff at this point has completed what I would consider the "field work" related to the Work Plan. In executing the Work Plan, we have sought input from U.S. investors, issuers, regulators, auditors, and other constituents; evaluated financial statements of foreign companies that assert compliance with IFRS; and researched the experiences of other jurisdictions that have incorporated IFRS into their financial reporting systems.

To inform the Commission and the public of our progress, the Staff has issued several reports and papers. The first report, published in October 2010, was a comprehensive status update on the Staff's Work Plan performance and planned next steps. This report also followed two public requests for comment, one specifically related to issues that may impact investors, such as their knowledge of and preparedness for IFRS, and one specifically related to issues that may impact public companies, such as compliance with contractual arrangements and regulatory requirements.

In the second paper, published in May 2011, the Staff sought public input on a possible method of incorporation of IFRS. This possible method previously had not been described in as much detail as other potential approaches. It contemplated establishing an endorsement protocol whereby the FASB would incorporate existing IFRSs into U.S. GAAP over an extended transition period, while also incorporating any new or newly-amended IFRSs into U.S. GAAP. The paper also described and sought feedback on potential benefits and risks that may be associated with such an approach. The staff received over 100 thoughtful and productive comment letters in response to this paper.

The third and fourth staff papers were released in November 2011, and both relate to the Staff's work in considering the sufficiency of development and consistency of application of IFRS. The first of these papers provided a summary of the status of the FASB-IASB convergence projects and an analysis of the Staff's comparison of the written text of U.S. GAAP to that of IFRS. In comparing the two sets of standards, the paper noted many similarities in the overarching principles, but also noted examples of differences, including many differences in the detailed text. The second of these November papers analyzed recent annual financial statements of approximately 180 companies (including both SEC registrants and companies that are not SEC registrants) that assert that their financial statements are prepared in accordance with IFRS. This paper notes two general themes: first, across topical areas, the transparency and clarity of the financial statements reviewed could be enhanced through improved disclosures; and second, diversity in the application of IFRS presented challenges to the comparability of financial statements across countries and industries.

We anticipate publishing a final staff report in the upcoming months that will summarize our findings and observations for each of the areas of the Work Plan.

Convergence

Another critical component in evaluating whether to incorporate IFRS into the U.S. financial reporting system is the outcome of the FASB-IASB joint convergence projects. The Commission in its 2010 statement expressed support for the Boards' efforts and noted the importance of completing such convergence projects according to the Boards' then-current work plan as part of the Commission's consideration of incorporating IFRS. The convergence efforts also demonstrate that the United States is committed to considering changes to our accounting standards in conjunction with the IASB in areas where both Boards have acknowledged that both sets of standards are in need of improvement.

The FASB and the IASB have worked together since 2002 to improve and converge U.S. GAAP and IFRS. In 2006, the FASB and IASB developed a joint project plan (commonly referred to as the Memorandum of Understanding) that identified those standards perceived to be most in need of improvement. The Boards set out to develop new comprehensive standards to address those topical areas. By June 2010, the Boards had achieved some successes, but many challenges remained, and stakeholders were expressing concerns that the rapid pace of standard setting made it difficult for them to provide meaningful, high-quality comments on draft standards. The Boards therefore reprioritized their agenda and modified their joint standard-setting timetable. The Boards made further adjustments in November 2010 and April 2011, again in response to stakeholder concerns.

Despite rigorous efforts by the Boards, including monthly joint meetings, the timetable for completing the priority projects has been gradually extended, from June 2011, to the end of 2011, and now into 2012 to allow for sufficient time to complete deliberations on certain projects and to allow for re-exposure of draft standards for public comment on other projects.

The Board's current priority convergence projects include the accounting requirements in three areas: financial instruments, revenue recognition, and leases.

Financial Reporting Series

In recent years, we have seen repeatedly how important it is that financial regulations and accounting and auditing standards keep up with changes in the business environment. To assist in the early identification of risks related to, as well as areas for potential improvements in, the reliability and usefulness of financial information provided to investors, OCA launched the Financial Reporting Series on November 8, 2011.

The Series is intended to be an ongoing series of roundtables designed to provide a thorough and balanced examination of emerging issues in financial reporting. The roundtables will include a cross-section of capital markets participants, including investors, preparers, auditors, and others, to discuss their individual views. The FASB and the PCAOB also will participate as observers.

The topic of the inaugural roundtable was measurement uncertainty in financial reporting. Measurement uncertainty exists when values are computed based on judgments about unknown future events. The concept of measurement uncertainty touches on many issues important to investors, preparers, and auditors alike.

Current Auditing Developments

Let me now turn to auditor and PCAOB oversight. In 2011, the Commission appointed three new board members to the PCAOB, including Chairman Doty. Last month, the Commission appointed a fourth new board member, Jeanette Franzel, to replace the last founding PCAOB board member, Dan Goelzer, whose second term had ended.

Audit Quality

This coming July will mark the tenth anniversary of the Sarbanes-Oxley Act of 2002. With the financial crisis looming large in our memories, we also must not forget the crisis of confidence in the audit profession caused by the accounting scandals of just over a decade ago. The Act created the PCAOB, strengthened the role of audit committees, and focused management and auditors on the importance of internal controls. Now there are important issues being debated about what the auditor should audit, how the auditor should communicate its results to investors, and whether the auditor is sufficiently independent and objective.

In this environment, both we and the PCAOB are continuing to devote substantial attention to these issues. The PCAOB's inspection program continues to identify audit deficiencies of varying nature and severity. While the presence of an audit deficiency does not necessarily mean that the related financial reporting contains material undetected errors, it may increase the risk of material misstatement in that reporting. The PCAOB has undertaken efforts to identify and analyze further the underlying causes of audit deficiencies in developing its inspection reports.

PCAOB Standard-Setting Projects

Another important component of audit quality is auditor independence and objectivity, and there are considerations being debated both here and abroad in this area. In August 2011, the PCAOB issued a concept release soliciting comment on new standards for auditor independence and audit firm rotation.

Mandatory firm rotation has been explored in the past. For example, the subject of firm rotation was debated in the development of the Sarbanes-Oxley Act. The eventual Act required audit partner rotation and requested a study of possible firm rotation by the U.S. Government Accountability Office. In its report, the GAO expressed the belief that mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality considering the additional financial costs and the loss of institutional knowledge of a public company's previous auditor of record. The GAO also stated that several years' experience with implementation of the Sarbanes-Oxley Act's reforms would be necessary in order to adequately evaluate whether further enhancements or revisions, including mandatory audit firm rotation, may be needed.

The PCAOB's comment period on the concept release closed in December of last year. Many important issues that require careful consideration were raised in the more than 600 comment letters received by the Board. The PCAOB also last week held two days of public meetings on the concept release. My staff will work with the PCAOB as it continues its deliberation on auditor independence, objectivity, and professional skepticism.

Other jurisdictions are currently considering mandatory firm rotation along with other auditing reforms. The European Commission, for example, has released a proposal for audit market reform that includes mandatory firm rotation and encouragement of joint audits. In addition to reinforcing auditor independence and professional skepticism, the stated objectives of the proposal include promoting competition among audit providers.

Another project the PCAOB has undertaken is the consideration of the usefulness or relevance of the audit report to investors. In this vein, the PCAOB is actively considering whether there should be changes to the information the auditor provides in the audit report to investors. This is another topic that is also being considered in other jurisdictions as well as our own. Questions being explored include: (1) what, if any, additional information about the audit or the related financial reporting should be included in the audit report; (2) should the scope of the audit be expanded; and (3) should there be additional disclosure regarding participants in the audit, such as the engagement partner and other audit firms that have performed work in the audit? The PCAOB issued a concept release and a proposal last year on these ideas, and my staff will continue to work with the PCAOB as it moves forward with these projects.

In the meantime, the PCAOB is undertaking a significant amount of very important work to update existing audit and quality control standards to reflect the lessons it has learned from nearly a decade of audit firm inspections. Many of the PCAOB's standards are still "interim" standards that the Board adopted in 2003. There is increasing focus on the need for significant progress on updating the interim standards that directly address audit performance, which may have a direct positive impact on audit quality. The PCAOB's standard-setting agenda includes a number of active projects related to some of the interim audit performance standards, including auditing fair value measurements, the use of specialists by auditors, the use of the work of other audit firms, and firm quality control standards. In addition, last month the PCAOB issued for public comment a proposed auditing standard on related party transactions. Finally, the PCAOB recently received a number of comments on its re-exposed standard related to auditor communications with audit committees, which it intends to finalize later this year and submit to the Commission for approval.

Dodd-Frank Considerations

I'd like to address briefly two other areas related to auditing, both related to the Dodd-Frank Wall Street Reform and Consumer Protection Act. These are the expanded PCAOB authority over audits of brokers and dealers, and the audit requirement over an issuer's internal control over financial reporting.

First, the Dodd-Frank Act granted the PCAOB explicit oversight authority over audits of brokers and dealers registered with the Commission. Last June, the Commission proposed amendments to the financial reporting requirements for brokers and dealers. Among other things, the proposed amendments are intended to facilitate the ability of the PCAOB to implement its oversight of auditors of broker-dealers, and to eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually registered as, investment advisors. Last July, the PCAOB proposed new auditing and attestation standards that would apply to the audits of broker-dealers. Both sets of proposals are still under consideration.

Second, Section 989G of the Dodd-Frank Act amended Section 404 of the Sarbanes-Oxley Act to provide that smaller companies (specifically those that are not "accelerated filers" or "large accelerated filers" under Commission rules) are exempt from the requirement in Section 404(b) that an independent auditor attest to, and report on, the issuer's assessment of its internal control over financial reporting. The Dodd-Frank Act also mandated a study with respect to Section 404(b) requirements for issuers with a market capitalization between $75 and $250 million. That study was delivered to Congress in April 2011. It recommended maintaining the existing investor protections of Section 404(b) for this category of issuers and encouraging activities that have the potential to improve further both the effectiveness and the efficiency of the evaluation of internal controls. One of these activities is the plan by the Committee of Sponsoring Organizations, or COSO, to review and update its internal control framework, which is the most common framework used by management and the auditor alike in performing assessments of internal control over financial reporting. COSO exposed a draft of its updated framework for public comment; the comment period closes on March 31.

Conclusion

In sum, there is a substantial amount of activity in the accounting and auditing space. We will continue to work closely with the FASB and the PCAOB on these matters, guided by the Commission's mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. Thank you, and I would be pleased to address any questions.