Testimony Concerning the Role of the Accounting Profession
in Preventing Another Financial Crisis
by
James L. Kroeker
Chief Accountant
U.S. Securities and Exchange Commission

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Chairman Reed, Ranking Member Crapo, 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 appreciate the opportunity to testify today on behalf of the Commission regarding the role of the accounting profession in preventing another financial crisis.

Importance of Reliable Financial Reporting

Financial reporting plays a critical role in establishing and maintaining 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. Reliable financial reporting becomes even more important in a financial crisis, when concerns about a company's fundamentals are most acute.

The federal securities laws mandate an independent audit according to specified standards by qualified professionals in order to provide assurance as to the faithfulness and integrity of the financial reporting presented. An audit by an independent public accountant is key to investor confidence and the functioning of our capital markets, and independent audits have long been recognized as important to credible and reliable financial reporting.

The Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board ("PCAOB") under the Commission's oversight to supplement the Commission's role in overseeing the audits of public companies. The PCAOB registers, inspects, sets standards for, and, where appropriate, disciplines auditors in its focused mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

This enhanced and independent oversight of the auditing profession is intended to provide tangible investor benefits through improvements to the quality of audits and thus financial reporting as a direct result. The Commission recently appointed three new board members: Lew Ferguson, Jay Hanson and its new Chairman, Jim Doty, who I am pleased to be joining on this panel today. They join Dan Goelzer, who recently served as Acting Chairman prior to Chairman Doty's appointment, and Steve Harris. We are appreciative of the work of the outgoing Board members who recently finished their terms, and we look forward to the newly constituted Board continuing the mission of protecting investors.

The Financial Crisis

The recent financial crisis resulted in the deepest economic recession since perhaps the Great Depression. What started with defaults on sub-prime loans quickly spread to illiquid markets for many types of financial instruments and ultimately affected many companies around the world.

As the financial crisis unfolded, regulators responded to financial reporting issues and auditing developments as they arose. For example, the SEC's Division of Corporation Finance published several "Dear CFO" letters from 2008 to 2010 to remind preparers of their responsibilities on a wide range of issues from fair value accounting to loss accruals and related disclosure. In 2008, the SEC staff and FASB staff jointly issued guidance on the application of fair value measurements. In addition, the PCAOB issued several staff audit practice alerts between 2007 and 2010 highlighting emerging economic circumstances of the financial crisis that affected how auditors conduct audits. Topics raised in the practice alerts included auditing fair value measurements, financial estimates, adequacy of disclosures, and ability to continue as a going concern. The PCAOB also issued a report that detailed observations of PCAOB inspectors across firms on audit risk areas affected by the financial crisis.

As our nation emerges from the financial crisis, we have both an opportunity and a responsibility to learn from it. This includes considering what lessons can be learned about the role of the independent auditor.

Role of the Auditor

A financial statement audit is designed to provide the auditor with reasonable assurance (which is a high level of assurance) that a company's financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles ("GAAP"). The work performed in an audit enables the audit firm to opine on the company's financial statements taken as a whole. In exercising this vital function, auditors play a key role with respect to one particular type of risk: the risk of material misstatement in financial statements reported to investors, or "financial reporting risk."

When we look specifically at the role of the auditor, it is critical to distinguish between financial reporting risk and other risks, such as business and operational risks, which may affect a company and impact investment decisions. While auditors must understand these risks to the extent that they impact financial reporting risk, the auditor's procedures and communications are not designed to specifically address risks other than financial reporting risk or to make judgments about the merits of a company's business strategies. An audit is not designed, nor can it or should it be designed, to take all risk out of investing. Audits are instead designed to attest to the accuracy of financial statements in accordance with established accounting standards to provide investors with reliable financial information they can use in making investment decisions.

Focusing, then, on financial reporting risk, there is reason to consider the extent to which improper, fraudulent, or inadequate financial reporting relating to GAAP reported results or to disclosures outside of the audited financial statements played a role in the financial crisis. SEC enforcement teams continue to pursue cases stemming from actions that contributed to the financial crisis, following settled enforcement actions involving Countrywide Financial, American Home Mortgage, New Century, IndyMac Bancorp, and Citigroup.

When poorly performed audits contribute to or fail to detect financial reporting abuses, there are existing mechanisms for dealing with such misconduct, including SEC or PCAOB enforcement actions. For our part, we will continue to prosecute those who fail to comply with their obligations.

We are considering whether audits performed during the financial crisis complied with the current standards and rules. Particularly, given the lack of confidence expressed by some investors during the financial crisis, we and the PCAOB are actively working to determine how standards can be improved. Moreover, we are looking further to determine how the role of the auditor can be improved.

Improvements in Audits

Root Causes of Auditing Deficiencies

As I previously mentioned, the PCAOB issued a report detailing the observations of its inspectors on audit risk areas affected by the financial crisis. This report provided observations of financial reporting risk areas and related audit deficiencies across audit firms. While such reports represent a meaningful step to providing investors, auditors, audit committees, and others with information about audit quality, there is more work to be done to identify and address the underlying causes of the deficiencies.

One such area relates to identifying the root causes of auditing deficiencies. The PCAOB's inspection program has played an important role in improving audit quality at inspected firms. At the end of each firm inspection, the PCAOB issues a report that details audit deficiencies noted during the inspection. We continue to work with the PCAOB to support their efforts to identify and consider the root causes of recurring audit deficiencies. Being able to identify these causes has the potential to improve implementation and maintenance of appropriate quality controls, as well as to identify areas where auditing standards need to be improved.

Auditing Standards

The PCAOB has implemented processes, including the establishment of its Standing Advisory Group as contemplated by the Sarbanes-Oxley Act, where the Board performs regular outreach to investors, preparers, and auditors to seek input on a variety of topics, including its standard-setting activities. That outreach has been considered by the Board in adopting its recently-issued standards, including eight standards that deal with the auditor's assessment and response to risks of material misstatement. The new risk assessment standards also emphasize considerations of fraud throughout the audit and the importance of auditing disclosures.

Auditor's Reporting Model

The project relating to the auditor's reporting model is a particularly important initiative of the PCAOB's standard-setting agenda. Some investors have raised questions about the sufficiency of information they receive from auditors, including whether investors could benefit from additional early warnings from auditors. The PCAOB's project, which also has been taken up by other standard setters around the world, is to look at the content of the auditor's report. The goal of this project is to understand whether there is information investors are not getting from auditors today that would be useful in making investment decisions. A related question is who should be the appropriate party to provide that information to investors. That is, is this information the auditor should be providing, or is this information from management or the audit committee that needs to be addressed? Other questions include the form and manner in which investors receive such information.

Auditing Considerations around the Globe

International Inspections

The ability of the PCAOB to inspect foreign registered firms that audit issuers in the U.S. capital markets is a significant aspect of an effective auditor oversight regime. Section 981 of the Dodd-Frank Act allows the PCAOB to share information with its foreign counterparts. As a result of that statutory change, coupled with the hard work by the PCAOB and its counterpart in the United Kingdom, the PCAOB has been able to reach an agreement to resume inspections there. In light of the importance of inspections, we have been working with the PCAOB in their ongoing efforts to reach similar agreements with additional regulatory bodies in those locations where inspections are not currently being performed.

Other Standard Setters and Regulators

Interest in the role of auditors in the financial reporting system is not limited to U.S. regulators and standard setters. For example, the European Commission and the U.K.'s Financial Reporting Council also have projects underway to consider, for example, audit policy matters and the role of auditors and audit committees. Some of the ideas being explored are ideas that have been previously incorporated into the U.S. capital markets. For example, as a result of the Sarbanes-Oxley Act, the United States already has provisions for audit partner rotation and for listed companies to have an independent audit committee appoint the independent auditor. Nonetheless, these international undertakings have sparked interesting dialogue and debate, and it is important that we explore all reasonable ideas to improve audit quality for the sake of investor protection and the financial system as a whole.

Accounting

Because the role of the auditor is so directly tied to the accounting standards themselves, the recent financial crisis also provides us with the opportunity to examine whether accounting standards could be improved. I am pleased also to be here today with the FASB Chairman, Leslie Seidman. The financial crisis highlighted the type of information that investors, regulators, and other users of financial reports need to see reported on a company's financial statements. My office requested in January 2008 that the FASB improve financial reporting for many financings, securitizations, and other transactions that previously had not been consolidated on the balance sheet. This request was consistent with the leadership shown by this Subcommittee and Chairman Reed in the 2008 hearing on Transparency in Accounting and Proposed Changes to Accounting for Off-Balance Sheet Entities. The existing standards were in need of improvement regarding what companies should be reporting as their own assets and liabilities, and we believed immediate action was needed. The President's Working Group on Financial Markets made similar recommendations in March 2008.

In response, the FASB completed a major standard-setting initiative for the accounting of financial asset transfers and consolidation. These requirements became effective for reporting 2010 results. A critical component of these reforms was to eliminate the previous exemption for so-called "qualifying special purpose entities." This structure was used for many securitizations. This so-called "scope exception" had grown beyond its original purpose, and the FASB determined to place all securitization structures and other structured entities under a single accounting model.

The new model addresses concerns that accounting and consolidation determinations were too often based on complex mathematical calculations rather than a more qualitative, objectives-based analysis. This was consistent with a Commission staff study in response to the Sarbanes-Oxley Act on appropriate models for accounting. In addition, recognizing that it is not possible to predict each type of structure that could be created to circumvent or otherwise avoid the new consolidation guidance, the FASB included a general protective measure that non-substantive terms, transactions, and arrangements are to be disregarded when applying the consolidation criteria.

The new standards also require a number of new disclosures that are designed to provide better information about a company's exposure to risks, regardless of whether that asset or liability is recorded on the balance sheet. Among other disclosure requirements, companies are required to disclose the significant judgments and assumptions made in forming their consolidation determinations.

These new standards should enhance financial reporting transparency. However, Commission staff will continue to monitor their effectiveness. This includes not only guarding against attempts to circumvent the new model, but also relaying to the FASB, based on our experience with the resulting reporting, further refinements that may be needed.

Continuing Improvements to Accounting Standards

The FASB and the International Accounting Standards Board ("IASB") are working on joint projects to improve financial reporting and eliminate unnecessary differences between U.S. GAAP and International Financial Reporting Standards ("IFRS") in a number of key areas. The FASB has made significant progress towards completion of a project to improve and simplify accounting for financial assets and related impairments. As the FASB and IASB move forward, there are two fundamental issues that have been raised as a result of the crisis: (1) was there in fact compliance with existing accounting and disclosure requirements; and (2) what improvements could be made to what is required to be reported in an issuer's financial statements to assure that they reflect an entity's financial condition. The result of the FASB's and IASB's work also is extremely important to the Commission's own consideration of whether to incorporate IFRS into the financial reporting system for U.S. issuers.

The Commission staff will continue to review companies' accounting and reporting practices to determine if companies are complying with existing requirements and to determine whether changes to those requirements are warranted. As Chairman Schapiro testified last year before the full Committee, we will take appropriate action where we find that companies are improperly reporting their financial condition. We also will continue to consider whether existing disclosure requirements are adequate to provide full and transparent disclosure.

Conclusion

One of the most significant lessons from the recent financial crises was the same one that led to the philosophy of this country's commitment to securities regulation over 75 years ago. That is, when pressures are highest, and investor confidence has the greatest potential to be shaken by uncertainty, the importance of transparent, objectively audited financial reporting to investors, and an independent and objective system to establish standards for such reporting, are necessary and critical components to both short term and long term success. Working with the FASB and the PCAOB, we will diligently continue to look for ways to improve the financial reporting system.