

SEC Advisory Committee on
Improvements to Financial Reporting:

Panel Discussion on Professional Judgment
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Chairman Pozen and members of the CIFIIR, good afternoon, or should I say, good evening. Thank you for the invitation to be here today. As most of you know, I spent 4 ½ years at the Securities and Exchange Commission as Deputy Chief and Acting Chief Accountant. During that time, I wrestled with a lot of difficult issues, many of which your Committee has been wrestling with over the past 9 months or so. But none of the issues that I addressed while at the SEC was as troubling to me as trying to find a way to infuse more professional judgment into financial reporting that I perceived to be there.

Everybody agrees, that financial reporting is much more useful when the financial statements reflect the expertise and judgment of the parties involved in their preparation applied in an attempt to reflect the business in the most meaningful way. In my current role advising companies, attorneys, and others in regards to financial reporting matters, I constantly deal with issues that necessitate knowledge and experience, but also the application of good judgment, in order to achieve a transparent reporting result. But in the difficult litigation and regulatory environment that has enveloped the accounting profession most of this decade, many accountants associate applying judgment with playing Russian roulette, and would rather follow rules, formal or informal, instead.

I have met preparers of financial statements that have made a deliberate decision not to “go out on a limb” by using judgment, because of the fear of being second-guessed. Similarly, I have encountered auditors who are uncomfortable with accounting treatments that differ from the ones they perceive as “safe”, even if

the alternative interpretations seem to result in better accounting. And I have encountered regulators that believed that only one interpretation of a set of facts was acceptable, even where I could see several.

While this kind of thinking can lead to more consistency in certain areas of accounting, it places burdens on the financial reporting system. A significant amount of detail has been added to the accounting literature in recent years precisely because preparers and auditors were uncomfortable using certain methodologies without official acknowledgement of their acceptability. In addition, unofficial rules and bright lines are applied in situations where the official literature has none, in an effort to standardize interpretations and relieve individuals of the need (or the ability) to choose amongst various possible interpretations.

As a profession, I believe that sometimes we aren't sure anymore what it means to apply professional judgment. It isn't unusual for accountants to proceed as if their job is to comply with the written literature; no more and no less. Knowledge and expertise is applied only in so far as considering whether the literature specifically allows or specifically prohibits something. Other times, the term "professional judgment" is wielded as a weapon, as it is suggested that, absent a specific prohibition, a practitioner's conclusion that a treatment is acceptable is by default a reasonable application of judgment. But this kind of compliance-only mindset helps to foster accounting-motivated transactions and an ever-increasing need for interpretive guidance.

Against this backdrop, I find the Advisory Committee's proposal intriguing, because it suggests to accountants the things they ought to be considering when applying professional judgment.

How Will It Work?

The progress report suggests that the framework will improve practice by giving preparers and auditors greater confidence that their judgments will be respected. This would, in theory, enable the use of more principles-based standards, in addition to improving accounting judgments themselves. It appears that the CFIIR

believes that the framework would enable more use of judgment because of some combination of the following:

- The framework will improve the quality of accounting judgments by reminding preparers and auditors of steps they should take in dealing with interpretive issues, thus increasing the frequency with which these steps are undertaken, resulting in more knowledgeable conclusions.
- Regulators are already willing to accept, at least in some cases, reasonable judgments, but preparers and auditors do not believe this is the case. The endorsement of the framework by the SEC and PCAOB will give preparers and auditors something tangible to point to in order to feel comfortable applying judgment.
- Endorsement of a framework like the one in the proposal will cause regulators to be more accepting of good professional judgments than they currently are.

The SEC staff already tries to accept good faith judgments and will continue to try to do so whether the framework is officially endorsed or not. I believe that the implementation of the framework would only infrequently result in the SEC reviewers accepting a conclusion that they would have rejected without the framework. That might lead to a view that adoption of the framework is unnecessary. However, it also suggests that adoption of the framework will not impede the SEC's work. And it is clear to me that preparers and auditors fear being second-guessed, and that fear is affecting their actions in unhealthy ways. If adopting the framework would ease the concerns by putting the SEC formally on record with respect to the use of judgment, it would seem to be a beneficial thing to do.

In addition, endorsement of a judgment framework like the one proposed could conceivably close some of the gaps between what preparers and regulators believe is reasonable. So perhaps there is reason to believe that the implementation of this proposal could increase the amount of judgment that is used in considering reporting issues. Following that train of thought, more transparent financial reporting would enable investors to better understand the

financial position, results of operation, and future prospects of public companies, leading to lower cost of capital, and increased valuations for public companies as well.

The question is whether it will indeed do any or all of these things, and, importantly, whether the potential costs of the framework outweigh the potential benefits.

Benefits and Costs

The progress report makes clear that following the framework would not insulate an accounting judgment from being deemed an error, as it states “...the mere completion of the process outlined in the framework in making a judgment would not prevent an auditor and/or regulator from asking appropriate questions about the judgment *or asking companies to correct unreasonable judgments.*” This seems correct, as it is of course possible to follow a good faith process like the one outlined in the framework, and still make a mistake that leads to an accounting error.

The progress report does contemplate, I believe, that a company that followed the framework would not be deemed to have committed a securities law violation even if its accounting were ultimately found to be in error. This also makes sense. The SEC’s enforcement staff shouldn’t be spending time and resources going after people that tried to do it right, used reasonable diligence, and simply made a mistake.

On the other hand, as the progress report notes, there is a risk that a “best practice” framework like the one proposed would get treated like a rule. In that situation, the framework could become a burden to preparers who already thought they were doing a good job in applying judgment. Worse, it could lead to a situation where any judgment that didn’t incorporate all twelve of the suggested points is presumed to be inadequate and result in inappropriate accounting. To be clear, there is nothing in the recommendation that suggests that this should happen, but I have seen similar things happen before, and I believe the concerns about the potential for it to happen here are reasonable.

Some have raised a different concern -- that the framework could be used by companies intent on deception to escape the consequences of their actions. I have no doubt that, if a framework like this one existed, there would be attempts to use it inappropriately. This is always the case with new rules and regulations, and we've all seen it many times. The question is whether the risk that the framework would be abused is so high that we shouldn't put it in place in the first place.

In my experience, it is generally better to allow policymakers to set the rules they believe are best, and leave handling the abusers to the enforcement function. The framework as proposed includes some protections against false claims. For example, the framework indicates that the evaluation of the issue should be made contemporaneously, not after the fact, and that documentation and disclosure is key. Although not explicitly stated, it seems clear to me that those who seek to avail themselves of loopholes or bright lines in GAAP through an accounting-motivated structured transaction would not be entitled to the framework's benefits either. Adding more anti-abuse cautions to the framework might further help in this regard as well. While nothing will prevent all unscrupulous actors from lying in an attempt to gain the benefits of the framework, it does seem that an investigation could identify and expose those lies for what they are.

Further, I'd like to suggest that concerns about the framework becoming a de facto rule and about the framework potentially inappropriately giving protection to those intent on deception should both be reduced if the framework is adopted as a working policy, rather than a legal safe harbor. By using the framework as an SEC working policy, the judgments about who deserves the benefits of the framework and about the effects of not complying with all of its points would be made, in general, by SEC staff who have expertise in financial reporting matters, rather than by judges and juries, who may not.

Adding it All Up

CiFIR should be commended for trying to address this issue. If I had to vote now, I'd be inclined to give the framework a try as an SEC working policy, because I'm

not satisfied with where things are now, and this proposal represents an attempt at improvement. But it'll only work if the various participants in the financial reporting process believe it will work. For example, if preparers think the whole problem is the SEC staff, and that this proposal won't change their actions, the framework will not be useful. And the framework can't achieve its goals until and unless investors believe that will encourage better, and not worse, financial reporting.

Because the success of this proposal depends on how those affected view it, I'll be very interested to see the public comments. If preparers, auditors, and investors don't believe that the adoption of the framework will be an improvement, then perhaps we need to go back to the drawing board. I'm a proponent of trying to do something to help foster more use of good professional judgment, but pushing a solution that the relevant parties don't have confidence in is not likely to produce positive results.