

## **20091121 SEC: Lessons from the Financial Crisis for Financial Reporting, Standard Setting and Rule Making (Speech by SEC Commissioner Kathleen L. Casey)**

### **U.S. Securities and Exchange Commission**

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Thank you so much, Ken, for that kind introduction. I am pleased to join you today at this important conference, focused on some of the most important issues in financial reporting facing issuers this reporting season, as well as developments that will continue to affect issuers in upcoming years.

Before I continue, I need to make the standard disclaimer that my remarks today represent my own views, and not necessarily those of the SEC or my fellow Commissioners.

While financial reporting issues can be daunting even in the most benign market and regulatory environments, it is fair to say that the recent financial crisis has posed nearly unprecedented challenges for us all. As regulators, we have been challenged to analyze, understand and develop timely and measured responses to market conditions as the crisis has unfolded. As issuers, you have been challenged to keep up with, and comply with, regulatory responses and evolving accounting standards arising out of the financial crisis, while at the same time contending with operational and liquidity issues that attended a deteriorating economy and a crisis of confidence in the financial markets.

Although we have begun to emerge from the financial crisis, there are many lessons yet to be learned from it. The key, of course, is to draw the right lessons. And this is no small feat. There remain marked differences in view with respect to what went wrong during the crisis, what problems need to be fixed and how to fix them. Indeed, as we meet today, Congress continues to deliberate fundamental changes to the regulation and operation of our financial system and markets. The stated objective of this reform is to promote greater market resilience and financial stability. Insofar as these reforms implicate the quality, integrity and transparency of financial reporting, the outcome of this debate will have potentially far-reaching implications for the jobs that you do.

This afternoon, then, I would like to focus on three of the key lessons that I think we can take away from the crisis, and that should both inform policy makers' efforts at reform and caution against legislative and regulatory responses that would undermine the efficient functioning of our markets:

- First, financial stability depends upon market confidence; and investor confidence, in turn, depends upon the transparency of financial statements.
- Second, financial reporting and accounting standard setting must remain focused on the needs of investors. While there are many other important stakeholders that rely on financial statement reporting, investors' interests must remain paramount.
- Third, financial reporting must remain relevant and informative to investors, and should not impose unnecessary or costly burdens that do not add to investor understanding.

### **Lesson 1: Accounting Standards Must Promote Transparency**

It cannot be gainsaid that financial stability requires market confidence, and investor confidence depends upon transparent financial statements.

The fundamental purpose of financial statements is to inform current and prospective investors about an issuer's performance and financial condition, enabling investors to make well-informed decisions. As a result, transparent financial statements are the cornerstone of efficient capital

markets. Conversely, if financial statements are opaque, investors are forced either to make poorly informed investment decisions or to keep their money on the sidelines, leading to stunted and inefficient markets.

Moreover, efficiency is essential for the stability of our financial markets. When, however, information in financial statements turns out to be less than transparent and capital markets become inefficient, there is the potential for instability.

### **Financial Reporting during the Financial Crisis**

During the financial crisis, our financial reporting standards — particularly those relating to "mark-to-market" accounting — came under tremendous pressure, with respect to both the transparency of financial statements under existing accounting standards and the clarity of related disclosures.

It has been said that, "Amid the pressure of great events, a general principle gives no help." So, too, we saw the principles underlying mark-to-market accounting tested during the financial crisis as issuers dealt with the considerable pressures caused by inactive markets and illiquid securities.

Recognizing the need for clear direction to the markets, in 2008 the Division of Corporation Finance issued guidance on fair value measurements and other disclosure issues that preparers should consider in preparing their periodic filings. In September 2008, the Office of Chief Accountant, in coordination with the staff of the FASB, jointly issued a release providing clarifications on the determination of fair value under FAS 157 that were proving to be particularly challenging during the prevailing environment. Shortly thereafter, the FASB finalized authoritative guidance relating to the application of fair value accounting in inactive markets. And in April 2009, the FASB further refined its guidance on fair value accounting by addressing the valuation of assets where there has been a significant decrease in the volume and level of market activity for the asset when compared with normal market activity, and by enhancing the disclosures regarding fair value accounting.

Beyond these immediate regulatory measures that the Commission took on its own initiative, Congress also directed the SEC to review and study the use and effects of fair value accounting standards. The Emergency Economic Stabilization Act included among its provisions a requirement that the SEC conduct a study of mark-to-market accounting, in consultation with the Secretary of the Treasury and the Board of Governors of the Federal Reserve System.

In late December, the SEC delivered the mandated report. While recommending against the suspension of fair value accounting standards, the report offered several important recommendations, such as developing additional guidance for determining the fair value of investments when markets are inactive and market prices are thus not readily available. The report also recommended enhancing existing disclosure and presentation requirements related to the effect of fair value in financial statements.

Among its key findings, the report noted that investors generally believe that fair value accounting increases financial reporting transparency and facilitates better investment decision making. The report also observed that fair value accounting did not appear to play a meaningful role in the U.S. bank failures that began to occur in 2008. Rather, the report indicated that these early failures appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. Although the report did not examine the much greater number of bank failures that occurred in 2009, I have no reason to think that the conclusion would be different.

Further, the report identified existing accounting standards for recording impairments as one of the most significant areas needing improvement. The report recommended that accounting standard setters consider, among other things, evaluating alternative reporting standards that would have the potential to provide investors with both current fair value information, on one hand, and transparent information regarding the cash flows that management expects to receive by holding investments to maturity, on the other.

Finally, the report highlighted a number of important recommendations of the SEC's Advisory Committee on Improvements to Financial Reporting ("CIFIR"). For example, the report pointed out that the use of judgment in accounting and auditing has increased due to the focus on more objectives-based standards (such as FAS 157) and recommended that the SEC and the PCAOB consider a CIFIR recommendation to adopt a policy statement related to the application of judgment in accounting and auditing.

I believe that the fair value report has been, and will continue to be, a useful source of information and guidance not only for the Commission, but also for policymakers in Congress and independent standard setters as they continue to consider these important issues.

## **Lesson 2: Investor Needs Must Be Preeminent**

The second key lesson is the importance of remaining focused on investor needs in financial reporting and accounting standard setting. In keeping with this precept, accounting standard setters should strive to promote transparency for investors above all. While the interests and preferences of other stakeholders are clearly important considerations in the standard setting process, where those interests conflict with the needs of investors, investors' interests must prevail.

In many instances, the interests of investors and the interests of other users of financial statements, particularly prudential regulators, are aligned. A primary example is loan loss provisioning. In March, the Financial Stability Board's Working Group on Provisioning, which I co-chaired with Comptroller of the Currency John Dugan, issued a report "assessing the contribution of loan loss provisioning practices to procyclicality and whether changes in existing loan loss provisioning accounting standards could reduce procyclicality . . . while still meeting the needs of investors for transparency."

By way of background, the theory that provisioning practices may contribute to procyclicality is as follows:

U.S. economic data suggest that, during an economic downturn, provisions increase as a percentage of loan volume;

Increased provisions lower accounting measures of profits and retained earnings. These measures typically serve as the starting point for determining regulatory measures of capital adequacy, and certainly affect the market's appraisal of the soundness of an institution;

An institution's remedial steps to address these issues might include reducing lending;

On a macro-level, reduced lending would negatively affect the economy;

Conversely, in periods of economic growth, provisioning practices may have the procyclical effect of "stoking" the economy.

It is possible that, by recognizing loan losses earlier in the credit cycle, procyclicality may be reduced. For instance, in the recent financial crisis, large provisions were recognized at the same time that operating revenues for financial firms were declining, resulting in a more dramatic incremental decrease in the determination of profit or loss for a financial institution. This decrease had the effect of decreasing firms' regulatory capital, at a time when the environment for raising additional capital was very difficult. The Working Group's report contained several recommendations aimed at improving the information provided to investors, including a recommendation that standard setters "reconsider the incurred loss model by analyzing alternative approaches for recognizing and measuring loan losses that incorporate a broader range of available credit information." This recommendation and other recommendations in the report, if implemented, would not only serve to increase transparency for investors, but would also serve the regulatory purpose of potentially reducing procyclicality.

Although the interests of investors and the interests of other users of financial statements are often aligned, they may not be aligned in all instances. When they do not align, it would be a mistake to promote accounting standards that would make financial statements less transparent for investors. An example of such a disconnect occurred in the early 1980s, when accounting policies relating to "supervisory goodwill" were put in place to achieve the regulatory purpose of incentivizing healthier thrifts to acquire thrifts that had failed largely as a result of a spike in interest rates that led to a rapid reduction in the value of their holdings of single-family fixed-rate mortgages. The creation of supervisory goodwill allowed the acquiring thrifts to increase their reported profits and regulatory capital even though the supervisory goodwill had little economic significance. When these accounting policies were later rapidly phased out after Congress passed FIRREA in 1989, which mandated the adoption of GAAP to replace Regulatory Accounting Principles, a significant number of institutions were revealed to be significantly undercapitalized, and many of these institutions

subsequently failed in the early 1990s.

### **Standard Setting Process**

Thus, the goal of standard setting must be to develop high-quality and unbiased accounting standards that promote transparency and that are, in turn, viewed as credible by our markets. If, however, the standard setting process is subject to undue commercial or political pressure, market participants may lose confidence in the financial information reported by firms. But while accounting standard setters must be independent, they must also be held accountable. The standard setting process is a delicate balancing act that highlights the importance of the Commission's oversight function. The Commission strives to ensure that this process is not compromised by inappropriate pressure and, at the same time, that the process produces high quality standards that elicit information meeting the needs of investors and other users.

The standard setting process is designed to ensure that standard setters hear and consider differing points of view on difficult accounting issues expressed by a wide array of stakeholders. In the context of fair value, for instance, the standard setting process has been informed and improved by the public debate among prudential regulators, investors, issuers, academics, and other policymakers and market participants in support of, or opposing, mark-to-market accounting.

When politicians and others fail to make principled arguments, however, and instead threaten or otherwise bring undue pressure to bear on standard setters in an effort to achieve political or other ends — such as to gain advantage for companies domiciled in certain jurisdictions — we subjugate the interests of investors to these ends and risk sacrificing transparency in financial reporting. Even perceived lapses in standard setters' due process can be damaging and serve to undermine efforts to achieve high-quality accounting standards.

### **IFRS Roadmap and Convergence**

As I have already noted, the objective of financial reporting is to provide decision-useful information to investors to enable them to make judgments across a wide variety of investment opportunities. In our global markets, however, investment opportunities are not limited to U.S. companies. As a result, accounting standards that provide investors with highly comparable, decision-useful information about businesses without regard to their domicile will facilitate well-informed capital allocation decisions among investment opportunities across the globe, leading to continued improvements in the efficiency of the global capital markets.

For many years, the Commission has supported and led efforts to develop a single set of high quality accounting standards to support this need of investors for information on companies worldwide. As you know, consistent with the Commission's 2005 roadmap, in 2007 the Commission eliminated the requirement that foreign private issuers that file in IFRS, as issued by the International Accounting Standards Board (or IASB), reconcile their financial statements to U.S. GAAP. The question now before the Commission is the extent to which the use of IFRS should be permitted or mandated for U.S. issuers.

This goal of providing investors with comparable information about businesses worldwide is the animating principle behind the Roadmap for the Potential Use of Financial Statements Prepared in Accordance with IFRS by U.S. Issuers, which the Commission published in November 2008 (the "Roadmap"). Our consideration of the Roadmap, and the dialogue on global accounting standards, is ongoing. We received over 200 comment letters on the Roadmap from a wide array of stakeholders, and your thoughtful comments are extremely helpful.

As the number of U.S. investors with holdings of securities of non-U.S. companies continues to increase, the Commission and the FASB would be remiss and would fail the needs of investors if we did not continue to support the development of a single set of high quality global accounting standards. The desirability of convergence on certain key accounting standards — particularly those related to financial instruments and other areas relevant to the credit crisis — has been highlighted in a number of forums, including the March 2009 communiqué of the G-20 finance ministers, the Department of Treasury's June 2009 Regulatory Reform report and the July 2009 Report of the Financial Crisis Advisory Group. The Commission strongly supports the continued convergence efforts of FASB and IASB. The existing convergence targets of these two standard setters pursuant to their 2006 MoU, as updated in September 2008, set the goal of completing several major joint projects by 2011. And less than two weeks ago, the FASB and IASB issued a joint statement reaffirming their commitment to achieving convergence of IFRS and U.S. GAAP, and announcing

plans to intensify their efforts to complete the major joint projects described in the MoU.

Going forward, it is crucial that the United States continue to play a leadership role in the support and development of a single set of high quality global accounting standards. It is also my hope and expectation that the Commission will soon articulate the next steps to be taken with respect to the use of IFRS by U.S. issuers — further signaling our commitment to this important goal.

### **Commission Actions Relating to Disclosure**

In addition to the Commission's recent efforts relating to the quality, clarity and transparency of accounting standards and related disclosures, this past summer, the Commission proposed new rules affecting the Compensation Discussion and Analysis section of issuers' proxy statements. These rules would require issuers to include a discussion and analysis in the CD&A about how the company rewards and incentivizes its employees to the extent that their compensation policies and practices create risks to the company. The proposed rules relate to compensation policies and practices for employees generally — not merely those relating to the named executive officers — if risks arising from those policies or practices may have a material impact on the company.

It is important to understand this proposal in the context in which it was offered. One of the myriad factors that have been cited as possible contributors to the financial crisis was the failure by some large financial institutions to appreciate the risk-taking incentives created by certain compensation policies and structures, and to manage these risks effectively across the firm as a whole.

Although commentators, the Commission and other policymakers do not contend that compensation policies of all public companies raise these same concerns or contributed meaningfully to the financial crisis, the Commission recognized that, at individual firms, it is possible that compensation policies and practices, and their relationship to a firm's risk management function, can be significant to investors in those firms. Once again, your comments relating to the proposed new CD&A requirements have been thoughtful and helpful, and will help to shape any final rules that we ultimately adopt.

#### **Lesson 3: Financial Reporting Must Remain Relevant**

Nevertheless, it is important that the Commission not forget that the goal of our disclosure rules must always be to provide investors with material information to facilitate their capital allocation decisions. We cannot allow our disclosure rules to become a means of advancing political or social agendas, which leads me to the third lesson: financial reporting must remain relevant and informative to investors, and should not impose unnecessary or costly burdens that do not add to investor understanding.

For example, there has recently been some discussion of the Commission's disclosure requirements relating to "climate change," including the possibility that the Commission will issue interpretive guidance in this area. My governing principle in determining whether to support any such guidance, as with my analysis of any other rules or guidance, will be that it must be driven by investor needs and designed to elicit decision-useful information for investors, rather than advancing an agenda unrelated to investor protection.

Financial statements and disclosures are, by their nature, long, dense, and potentially overwhelming. Our challenge in adopting new disclosure requirements is to make the new disclosure useful and informative. If we are not successful in making this disclosure relevant to investors — for instance, if disclosure becomes unwieldy, confusing, or boilerplate (as is too often the case) — we will have only succeeded in making an already long and cumbersome document even denser, rather than better.

### **Financial Reporting Innovations**

One way that the Commission can make disclosure and financial information more useful, and thus relevant, to investors is to make it more accessible. Innovations in financial reporting, such as the use of interactive data, are helping the Commission to make important strides towards this end.

In January, the Commission adopted rules requiring that issuers provide their financial statements to the Commission and on their corporate Web sites in interactive data format using XBRL. From our receipt of the first mandatory filing using XBRL in July 2009 through the end of October 2009, 448 companies had filed reports in XBRL under the new rule, including 32 smaller companies that were not yet required to file using XBRL.

The second phase of the rule, which will go into effect in July 2010, will require that approximately 1,500 more companies file using XBRL. In addition, the first group of filers will, for the first time, be required to file detailed data from financial statement footnotes in XBRL.

These rules show great promise and I continue to be encouraged by our good progress. Nevertheless, the Commission must remain vigilant and responsive in ensuring that any requirements that we impose on issuers accomplish their objectives.

### **Conclusion**

In conclusion, as we emerge from a period of tremendous turmoil and instability in our capital markets, it is more important now than ever that our laws, regulations and accounting standards promote transparent financial statements and decision-useful disclosure for the benefit of investors, in order to facilitate well-informed investment decisions. All stakeholders have a part to play in achieving this goal, from policy makers, including the Commission, the other executive agencies, the accounting standard setting boards, and Congress, to commentators, who help to inform policy debates and ensure that policies are based on a rigorous evaluation of their merits, to you and your auditing firms, who have the ultimate responsibility of preparing and reviewing the financial reports and disclosure on which investors — and the global capital markets — depend. So long as we maintain a common understanding that investors must always be our primary focus, I believe our markets can emerge from the recent tumultuous period stronger and better positioned to achieve the objectives of long-term stability and growth.

I would like to again thank the FEI for inviting me to speak to you today, and I wish you all a safe trip home and a wonderful Thanksgiving.

**NovaRes Team**