Speech

Remarks before the 2018 Baruch College Financial Reporting Conference: "Working Together to Advance Financial Reporting"

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New York, NY

May 3, 2018

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Introduction

Thank you for the kind introduction. I'm grateful for the opportunity to visit the striking "vertical campus" of Baruch College in New York City and to speak at this financial reporting conference for the third time.

Before I continue, let me remind you that the views expressed today are my own and not necessarily those of the Commission or of my colleagues upon the staff of the Commission.

Let me also express my gratitude to my colleagues in OCA for continuing to provide thoughtful advice to the Commission regarding accounting and auditing matters and acknowledge in particular the assistance of Robert Sledge in preparing me to make today's remarks.

The work you do as investors, audit committee members, auditors, preparers, standard setters, and academics is critical to advancing the quality of financial reporting. Financial reporting helps underpin the efficient functioning of our capital markets and economy. Our capital markets depend on companies supplying high quality financial information that enables investors, lenders, and other providers of capital to make better-informed decisions. Individual and institutional investors must be able to trust publicly-available financial information, and that trust is reinforced by independent auditors conducting interim reviews and issuing annual audit reports.

The economy is dynamic and often unpredictable. Financial reporting, however, should be consistently relevant and faithfully represent the results of operations and the economics of transactions. Financial reporting should also be comparable, verifiable, timely, and understandable by investors and others. I thank you for your commitment to achieving these goals of general purpose financial reporting.

Today, I would like to share my perspective on the objective of financial reporting and its importance to our markets. I will then briefly comment on new accounting standards, non-GAAP measures, and other developments. I will close by discussing the role of audit firm governance and culture.

Maintaining the Objective of Financial Reporting

General purpose financial reporting is a core element of the disclosure of business and financial information to shareholders. Its objective is "to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity."[1] While other parties, such as regulators and members of the public other than investors, lenders, and other creditors, also may find general purpose financial reports useful, those reports are not primarily directed toward these other parties.

Special purpose financial reports, by contrast, are prepared using a special purpose framework to address particular needs of specific users who intend to use it. They have more limited purposes and uses.

I make the distinction between general and special purpose objectives to emphasize the value of keeping and maintaining general purpose financial reporting free from other objectives. When formulating standards for general purpose financial reporting, the FASB (and the IASB[2]) do not seek to influence the outcome of investor capital allocation decisions or actions taken by management; rather, the boards design standards that provide better information to inform those decisions and actions. The alternative, whereby standards are designed to privilege certain objectives, economic activities, financial products, or market participants, could diminish confidence in the accuracy or quality of reported information, which could thereby impair capital formation, and in turn negatively impact economic activity. Again, by keeping general and special purpose financial reporting objectives clearly distinct, without merging the two, each are able to serve best their respective purposes.

And so, I encourage you to support the standard setting bodies that maintain *general* purpose financial reporting frameworks—distinct from special purpose ones. The process advances with your broad participation, robust feedback, timely implementation, and quality application of the standards.

New Accounting Standards, Non-GAAP, and Other Developments

High-quality accounting standards for general purpose financial statements must continuously evolve, just as our markets and investor behavior evolve over time. Against this backdrop, standard setting is not, and cannot, become focused on maintaining the status quo in the face of evolving needs. Even this year, several changes in accounting standards are effective that will result in better financial reporting to investors.

Revenue recognition in 2018; leases in 2019; and credit losses in 2020

For example, calendar year end public companies are now reporting their revenue from contracts with customers under the new revenue recognition standards issued by both the FASB and IASB.[3] The reporting includes a substantial step forward for corporate reporting, including additional disclosures, and for greater consistency between the information reported and the underlying economics of contracts with customers. Across companies this has been a substantial, though manageable effort, which is a testament to the level of coordinated planning for the implementation, including from the FASB, AICPA, and other industry groups.

Stakeholders must also continue their focus on successful implementation of the new leases standards for next year, and implementation of the new credit losses standard after that. I am confident this period of accounting change will leave our financial reporting system stronger.

Accounting for the effects of income tax reform

Companies, auditors and others have also responded swiftly to the significant changes brought about by the passage of income tax reform in December. The SEC staff released guidance[4] on reporting the effects of income tax reform on the day the bill was signed by the President. The FASB and its staff also provided guidance.[5]

The SEC staff guidance clarified that the staff would not object to a company, when accounting for the effects of the tax reform, utilizing a measurement period that ends when an entity has obtained, prepared, and analyzed the information necessary in order to complete the accounting, which is not to exceed 12-months. The staff expects companies to act in good faith to complete the accounting, and as they do so, investors should receive insight through the disclosures described in SAB 118 about the status of a company's accounting for the effects of income tax reform during the measurement period.

Equity investments and non-GAAP

Companies are also planning how they will communicate with investors regarding changes in accounting requirements for stock held in other companies.[6] Starting this year, companies will recognize in net income changes in the fair value of the stock from one period to the next.[7] Investors will see the effects of management's decision to not only acquire or sell the stock, but also to hold it during the period. The reporting under the new standard reflects the economic realities of changing market values, and this standardized approach can facilitate comparisons across companies by investors and other users of the financial statements.

The FASB standard-setting work is designed to yield measures of items such as net income that are relevant and useful to users by providing a standardized scorecard of a company's operations. This information can be supplemented with additional disclosures or non-GAAP information to provide additional information to investors. However, to be absolutely clear, non-GAAP reporting may supplement but is not a substitute for GAAP reporting.

Non-GAAP

Financial statements based on GAAP are intended to provide a complete and standardized view of historical operating performance. Management may also assess performance through non-GAAP financial measures. Non-GAAP financial measures disclosed together with the SEC's required reconciliation to the most directly comparable GAAP financial measure and the related disclosures[8] can provide investors with useful information regarding how management monitors performance and can facilitate analysis.

With non-GAAP and other disclosures, our rules require that companies must have disclosure controls and procedures, which typically would include appropriate governance practices regarding the measures and policies and controls that prevent error, manipulation, or mischief with the

numbers, including a policy that addresses how any changes in the non-GAAP measure will be reported and how corrections of errors will be evaluated.

A company's audit committee can play an important role in understanding whether—and how and why—management uses any supplemental scorecards in understanding and tracking results and how that supplemental information may be used in addition to GAAP financial statements in the company's public reporting. In a moment, I will discuss audit firm governance and culture, but I want to pause on this topic and provide a specific example of governance and culture in financial reporting and, in particular, audit committee involvement in the review and presentation of non-GAAP measures. Audit committees that clearly understand non-GAAP measures presented to the public—and who take the time and effort in their financial reporting oversight role to review with management the preparation, presentation, and integrity of those metrics—are an indicator of a strong compliance and reporting culture. Audit committees can review the metrics to understand how management evaluates performance, whether the metrics are consistently prepared and presented from period to period, and the related disclosure policies. Audit committees that are not engaging in these processes should consider doing so. A demonstration of strong interest in these issues can have a positive effect on the quality of disclosure.

Market and other risk disclosures

Another area where both audit committees and management can have a positive effect on the quality of disclosure is in the area of market risk information. There has been a recent rise in the general level of market interest rates. I have no view on the future direction or volatility of the markets. Yet, it is worthwhile to emphasize the importance of management's attention and financial reporting oversight of the disclosures companies make to investors about material risks in this area. For example, some businesses' balance sheets, results of operations, and cash flows are particularly sensitive to changes in economic and market conditions such as changes in the liquidity in the markets, the level and volatility of market prices and rates, including for debt and equity investments, market indices, or business and other sentiments that affect the markets. I encourage those involved in the disclosure preparation and oversight process to be attentive to disclosures regarding changes in market risks.[9]

Auditor independence

Auditors play a vital role in the capital markets, in part, because of their impartial and objective judgment about companies' financial reporting. The integrity and credibility of their judgment is critical, and is reinforced by auditors' independence from company management. Just as auditors need continually to monitor and assess their maintenance of this independence from their audit clients, we, as regulators, need to monitor and assess our auditor independence rules. Just yesterday, on May 2, the Commission proposed for public comment a rulemaking to address certain substantial practical challenges to compliance related to one part of our auditor independence rules, known as the "Loan Provision."[10] In particular, yesterday's proposed amendments seek to more accurately identify those lending relationships with equity owners of audit clients that could feasibly impair, or appear to impair, the auditor's objectivity and impartiality. I encourage you to read the proposal and provide us with your input as part of this rulemaking.

Role of Audit Firm Governance and Culture

While the quality of a company's financial reporting processes are foundational to reporting information to investors, so too is the quality of an auditor's interim reviews and annual audits.

Auditing is about confidence and trust in the transparency, accuracy, and reliability of financial information. Trust is earned through words and actions as the profession consistently delivers audit quality and value to audit committees and the investing public. Trust can be nurtured or broken—it is neither static nor assumed.

The audit profession continues to evolve and audit quality has improved over time.[11] Audit committees and their key partner, the PCAOB, rightfully expect this evolution. Yet, to meet the realities of growth, multidisciplinary scope, and a need for greater consistency of quality audit work in all parts of the world,[12] the audit profession must continue to focus, and in some respects do more, to maintain and nurture trust.

One lesson regulators and leaders in the profession have learned is the key role of audit firm governance in maintaining an effective firm-wide (enterprise) risk management system,[13] which serves as a framework to anticipate and mitigate the risk of break downs and failures. It is not a new concept for audit firms, although the maturity and emphasis have increased over time.[14] Also, frameworks are just that—guidance that is flexible, scalable and proportionate to the objectives and structure of the organization. To be clear, risk management frameworks may overlap with, but are not a substitute for, the standards for quality control for a CPA firm's accounting and audit practice as well as governance and reporting practices more generally. Even with robust risk management systems and a strong commitment to quality control standards, certain risks will materialize and mitigation and remediation become essential. In those circumstances, governance and reporting are especially critical.

Another lesson regulators and leaders in the profession have learned is the importance of independent, diverse thinking on corporate boards, and particularly, audit committees,[15] brought by independent directors as an element of strong corporate governance. In addition to bringing valuable external perspective to board deliberations, these directors take on roles and responsibilities with substance and credibility because the directors are independent. Examples include resolving disputes between management and the external auditor as well as oversight of complex and sensitive investigations. Also, independent directors are often in the best position to deliver candid, sometimes tough, but critically important messages to management and other board members without fear of retribution. The strengthening of corporate audit committees with independent

members is one of the most prominent, recent enhancements to the corporate governance scheme.[16] These enhancements in corporate governance practices over time have also been used by private companies.[17]

Good governance is not an isolated concept. It is intertwined with tone and culture—the understanding of ethical values, risks, and desired behaviors.[18] This means that audit quality and value can be more difficult for firm leaders to integrate into regular processes unless the firm as a whole—top to bottom and across service lines and geographies—views the mandate for audit quality and value as key to its success. Poorly diagnosed or designed culture initiatives do not tend to be long-lasting in addressing underlying behavioral norms. The maturity of culture, as I have experienced it, tends to follow along the following spectrum:

- Indifferent culture – "Requirements do not matter or apply to us."
- Reactive culture – "We respond and address requirements when others tell us to."
- Guiding culture – "We need employees to follow the requirements we set for them."
- Pervasive culture – "All of our people are involved in our requirements and aware of their connection to our and others' expectations."

These points on the spectrum illustrate that culture is a human issue and changing it requires both human solutions and structural changes, which in unison adjust behaviors effectively over time.

With these lessons in mind, the leaders of the largest, most complex firms, have appointed, or are taking steps to appoint, independent directors or independent advisory council members with meaningful governance responsibilities; they understand that the benefits of outside perspectives can translate to audit firm governance as well. Regardless of the design, the purpose should be the same: to foster audit quality and safeguard against noncompliance threats and the resulting costs to the reputation of the firm, its network, and the audit profession generally.

In doing so, leaders have a view toward meeting both U.S. and global expectations. Audit firms in the U.S. are subject to local ownership, licensing, registration, and other regulatory requirements. Yet, leaders within these audit firms are also appropriately challenging themselves to think across a network of firms to deliver to investors and the public consistency in quality around the globe, drawing on globally common tools and world-wide quality monitoring, among other examples. Accordingly, it is important to consider risk management at both a U.S. firm-wide *and* global network-wide level.

These governance and culture considerations can be insightful to audit committees in overseeing the external audit relationship at the companies they serve. The largest audit firms voluntarily provide audit quality reports to communicate how the firm performs individual audits, how they run the business, and how they think about the role and relevance of the audit profession. In this context, I believe it is important to communicate meaningful information about the design of an audit firm's governance and culture, including the design of the firm's board, its membership, the particular responsibilities assigned to the members, why a member of a board or advisory council or other structure is determined to be "independent" of the firm, and related information that would inform an audit committee's consideration of the audit firm's commitment to factors that impact audit quality. Note that many of the factors I just cited, including independence and reporting structure, are just the qualities we expect from issuers.

In sum, I believe it is critical that the auditing profession continually look in the mirror and assess its conscience—is it earning the public's confidence and trust in audits?[19] Taking a fresh look at governance and culture as part of firm-wide risk management is one way U.S. firms can take steps to meet the high standards expected of accountants.

Conclusion

Market and regulatory forces are reshaping the accounting profession. Economic pressure, higher expectations, evolving capital market needs, and technological innovation are evident in virtually all parts of the accounting profession. While these forces are individually familiar to many, their confluence is leading to changes within and across firms.

The importance of our long-standing, public-private sector financial reporting arrangement cannot be overstated in its positive impact to the Commission and PCAOB's ability to carry out their legislative mandates.[20] Financial reporting is not strong in spite of the participation of accountants and others. It is strong *because* of their participation.

Yet, if we are to continue to have the best financial reporting system, the commitment from accountants to high-quality financial reporting must continue. Standard-setters and regulators need to have, and hear from, individuals with diverse perspectives and experiences. The financial information reaching the public must continue to be credible and decision-useful, and we should all collectively work towards that end.

I want to thank you again for the opportunity to share my views, and I look forward to your questions.

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[1] *See* Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting*, paragraph OB2 (September 2010) and International Accounting Standards Board ("IASB") *Conceptual Framework for Financial Reporting*, paragraph 1.2 (March 2018).

[2] The standards issued by the IASB are significant to our capital markets. IFRS are used by companies that sell securities in the U.S. representing trillions of dollars in equity market capitalization based on the SEC staff's analysis of filings and market information. In addition, many U.S. companies, particularly those with global operations, also continue to have an ongoing interest in the quality of IFRS.

[3] Accounting Standards Codification ("ASC") Topic 606, *Revenue from Contracts with Customers* and International Financial Reporting Standards ("IFRS") 15, *Revenue from Contracts with Customers*.

[4] *See* SEC Staff Accounting Bulletin ("SAB") No. 118 (December 2018), available at https://www.sec.gov/interps/account/staff-accounting-bulletin-118.htm and SEC Division of Investment Management Information Update, "Applicability of Staff Accounting Bulletin No. 118 to Investment Companies Impacted by the Tax Cuts and Jobs Act," (December 2018), available at https://www.sec.gov/divisions/investment/imannouncements/im-info-2017-07.pdf.

[5] *See* FASB Media Advisory, "FASB Issues Four Staff Q&A Documents on Implementation Issues Related to the Tax Cuts and Jobs Act," (January 22, 2018), available at http://www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176169885422&pagename=FASB%2FFASBContent_C%2FNewsPage and FASB News Release, "FASB Improves Income Tax Accounting Related to the Tax Cuts and Jobs Act," (February 14, 2018), available at http://www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176170037380&pagename=FASB%2FFASBContent_C%2FNewsPage .

[6] *See* FASB Accounting Standards Update ("ASU") No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. The guidance in this ASU is not limited to investments in the stock of corporations, but also includes other equity securities and other forms of ownership in entities, such as partnerships, unincorporated joint ventures, and limited liability companies. However, this change does not apply to holdings that are large enough to convey control or significant influence, or to a few other types of instruments as discussed in the guidance.

[7] See ASC paragraph 321-10-35-1. However, in accordance with ASC paragraph 321-10-35-2 an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

[8] *See* Item 10(e)(1) of Regulation S-K and SEC Division of Corporation Finance Compliance and Disclosure Interpretations for Non-GAAP Financial Measures, available at https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[9] *See*, e.g., Item 305 of Regulation S-K, which requires quantitative and qualitative disclosure about market risk. 17 CFR 229.305.

[10] *See Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Release No. 33-10491 (May 2, 2018), available at https://www.sec.gov/rules/proposed/2018/33-10491.pdf.

[11] *See* Jeanette M. Franzel, Board Member, PCAOB, *The PCAOB's Role in Improving Audit Quality*, The CPA Journal (August 2017), available at https://www.cpajournal.com/2017/08/21/pcaobs-role-improving-audit-quality/ .

[12] *See* International Forum of Independent Audit Regulators, *Survey of Inspection Findings – 2017* (March 8, 2018) available at https://www.ifiar.org/activities/annual-inspection-findings-survey/index.php?wpdmdl=7970&ind=XDEJIUVfHwUTu2UZahT2C6iwyPjorgVMdkvQckkCICYvnlRf0BjUtGVTNLq_5eTqWagorxcU3q4O2982om6-FMt_MtYq3WTy_gUWhAOys02onhXK8tA9Zl2YX5L8akLM4-ggjtpfY-_nQ9N9P8lqNQ&#zoom=100 .

[13] *See, e.g.,* COSO *Enterprise Risk Management—Integrating with Strategy and Performance*, available at https://www.coso.org/Pages/ERM-Framework-Purchase.aspx. *See also* Institute of Internal Auditors, *The Three Lines of Defense in Effective Risk Management and Control* (January 2013), available at: https://na.theiia.org/standards-guidance/Public%20Documents/PP%20The%20Three%20Lines%20of%20Defense%20in%20Effective%20Risk%20Management%20and%20Control.pdf .

[14] For example, the PCAOB, as the primary audit regulator of registered public accounting firms, has long emphasized an element of firm-wide risk management systems—the need for appropriate tone at the top and strong quality controls in firms they supervise. *See, e.g.,* Remarks before the AICPA Conference on SEC and PCAOB Developments: "Update on PCAOB Efforts to Enhance Audit Quality," Jeanette M. Franzel, Board Member, PCAOB (December 5, 2017), available at https://pcaobus.org/News/Speech/Pages/Franzel-update-PCAOB-efforts-enhance-audit-quality-12-5-17.aspx .

[15] *See* Remarks before the University of Tennessee's C. Warren Neel Corporate Governance Center: "Advancing the Role and Effectiveness of Audit Committees," Wesley R. Bricker, Chief Accountant, U.S. Securities and Exchange Commission (March 24, 2017), available at https://www.sec.gov/news/speech/bricker-university-tennessee-032417.

[16] For example, a combination of the Sarbanes-Oxley Act provisions and exchange listing standards mandated by SEC rules require that publicly-listed companies maintain fully independent audit committees that are directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm and the audit.

This is not a new development. The initial reason for the establishment of the audit committee appears to have been a desire to strengthen the independence of auditors from management, as Commissioner Loomis noted in a speech in 1978, as he reached even further back in time to a Commission proposal in 1940. See Remarks before the Institute of Chartered Accountants in England and Wales: "Audit Committees—the American Experience," Phillip A. Loomis, Commissioner, U.S. Securities and Exchange Commission (November 3, 1978), available at https://www.sec.gov/news/speech/1978/110378loomis.pdf.

[17] *See, e.g.,* https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Risk/gx-ccg-on-boards-agenda-feb-2016.pdf ; https://www.pwc.com/us/en/industries/private-company-services/library/building-renewing-your-board.html ;

http://www.ey.com/us/en/issues/governance-and-reporting/audit-committee/boardmatters-quarterly--september-2013---private-company-board-service ; and https://boardleadership.kpmg.us/relevant-topics/private-companies.html .

[18] *See, e.g.,* Remarks before the 36th Annual SEC and Financial Reporting Institute Conference: "Advancing the Role of Credible Financial Reporting in the Capital Markets," Wesley R. Bricker, Chief Accountant, U.S. Securities and Exchange Commission (June 8, 2017) (urging "firms to maintain a system of quality control to recognize the organizational and individual pressures in today's audit environment and control them sufficiently") available at https://www.sec.gov/news/speech/bricker-remarks-financial-reporting-institute-conference-060817.

[19] Many of you may have heard the story of Colonel Arthur H. Carter—then managing partner of Haskins & Sells and president of the New York State Society of CPAs—when he testified in 1933 before the U.S. Senate Banking and Currency Committee during the formulation of the early federal Securities Laws. In response to questioning by Senator Barkley, Col. Carter noted that audit firms audit companies. Senator Barkley famously quipped, "Who audits you?" to which Col. Carter responded "Our conscience."

[20] In April of 1938, the Commission announced in Accounting Series Release No. 4 its decision to encourage the observance of generally accepted accounting principles. *See also* John R. Evans, *An Evaluation of SEC Accounting Policies and Regulations*, 7 Journal of Competitive Business and Capital Market Law 393-405 (1985), available at https://www.law.upenn.edu/journals/jil/articles/volume7/issue3/Evans7J.Comp.Bus.&Cap.MarketL.393%281985%29.pdf (noting that ASR No. 4 embodied the principle of making use of expertise within the private accounting profession for the development of principles and standards with limited government involvement and expense, but recognized as well the necessity of Commission supervision to assure appropriate standards for the protection of investors).