January 16, 2008

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, NE; 10th Floor
Washington, DC 20549

Dear Chairman Cox:

I am writing to express my grave concerns regarding some of the key recommendations now emanating from the Advisory Committee on Improvements to Financial Reporting. Having read the committee’s draft decision memo of January 11 and listened to much of the webcast of last Friday’s meeting, I am convinced that these proposals, if implemented, would reverse much of the progress made since the Enron disaster in improving the rigor of audits, the accuracy of financial reporting, and the reliability and usefulness of financial reports. That all this is being done in the name of improved financial reporting adds a special note of Orwellian irony to the proceedings.

I have not yet had an opportunity to prepare detailed comments on the committee’s report. However, I wanted to take this opportunity – while the meeting is still fresh in my mind – to highlight some of the issues I view as being of special concern. The problems start with the underlying assumptions the committee brings to this project: that the threat of litigation and enforcement over financial statement errors leads to poorer quality financial reporting, that more principles-based regulation will result in higher quality reports, and that less is more when it comes to financial restatements.

The committee makes no attempt to back up these assumptions with hard data. In fact, our post-Enron experience provides compelling evidence that each of these assumptions is false. That experience has shown us, for example, that:

- the combined threat of tough enforcement actions and civil litigation have provided an essential check on managers who have a strong incentive to keep bad news off the books and auditors who have been all too willing to let them;
• A more principles-based approach to regulation threatens to undermine consistency and clarity, move key decisions about how principles are applied out of the public rule-making process, and lead to the sort of lax enforcement that has characterized the Financial Services Authority in the United Kingdom;

• Investors are less likely to sue when they have confidence that managers are making a good faith effort to correct errors quickly and provide complete and accurate information, which helps explain why the dramatic rise in restatements has been accompanied by a similarly dramatic drop in litigation; and

• Finally, as a recent survey by AARP makes clear, investors strongly support the post-Enron reforms now being criticized as leading to “defensive” accounting and want managers and auditors held accountable for getting the numbers right.

We’ve seen no contrary evidence indicating that investors want less information about financial statement errors. The mere fact that investors respond rationally to the information they receive through restatements, distinguishing between those errors that have serious implications going forward and those that are less serious, does not by itself provide that evidence.

What is perhaps most disturbing about the committee’s report is its total failure to acknowledge recent events, in which public companies large and small were found to be cooking the books and auditors were found to be, at best, asleep at the wheel and, at worst, in collusion with dishonest managers. Reading the report and hearing the webcast was like entering a time warp where Enron and WorldCom had never occurred, and our biggest policy challenge was to get out of the way of honest companies doing their level best to provide investors with the most complete and accurate information possible. It was particularly disturbing in this context to hear committee members, including a representative of a major accounting firm, touting the benefits of making the financial statement preparation and audit more “collaborative” between managers and auditors. Surely, if Enron taught us anything, it taught us the risks of a collaborative approach in this area – that auditors who see themselves as on the same team as management risk losing the ability to exercise and enforce independent judgment and that investors pay the price in the form of shoddy and misleading disclosures.

Recommendations in three areas seem particularly likely to undermine the quality of financial reporting. These are:

• The recommendation that all FASB standards be adopted with a two-year evaluation period in which companies would be given broad leeway in deciding how to implement those rules with little fear of challenge or regulatory repercussions and no need to restate when they get it wrong;

• Recommendations related to materiality and restatements, including one that seems to permit a return to “stealth” restatements, in which numbers are corrected
without adequate notice to investors of the error being corrected, and another that allows past financial statements containing material errors to go uncorrected; and

- the recommendation to create a “safe harbor” protecting companies and their auditors from regulatory action and litigation where they document the basis for their judgments and claim that those judgments, however erroneous, were made in good faith.

A more thorough review of the committee recommendations may turn up additional examples, but these are the ones that, upon initial review, we see as most problematic.

Creating a two-year evaluation period for new accounting rules encourages companies to test the edge of the envelope during that period to see how much they can get away with. Even where the company is ultimately required to come into alignment with proper practice, investors would get little or no information about the misinformation produced under the initial erroneous accounting and, if other of the committee’s recommendations are adopted, will have no recourse for decisions based on false information. Where “excessive” diversity of practice resulted, standard setters would be sent back to the drawing board to revise the standard. Given the broad discretion allowed for diverse interpretations, this seems likely to be a frequent occurrence, leading to a situation in which standards are in constant flux. Under a related recommendation, the SEC would be discouraged from publishing guidance based on their observations of incorrect implementation without first going through a full rule-making process. Taken together, these provisions would create a bureaucratic nightmare that seems custom designed to impede efficient regulatory action and quick correction of abusive accounting practices.

In the name of reducing the number of “unnecessary” restatements, the committee has made several proposals on materiality and related issues that would decrease the information that investors get about errors. On the one hand, the recommendations appear to make it possible for companies to correct errors found close to the next reporting period on the next financial statement without having to restate the current erroneous reports. It doesn’t take a genius to figure out that companies will try to get as many restatements as possible handled in this way. At the same time, the recommendations would allow companies that find material errors affecting a number of years to correct only the current financial statements. This would eliminate comparability of financial reports from year to year, decreasing the quality of information provided to investors. It would also make it easier for companies to obscure the full impact of multi-year errors.

Finally, several committee members suggested that all their work would be in vain if the SEC failed to adopt a safe harbor protecting companies and auditors whose professional judgments prove faulty. It was suggested that this safe harbor should preclude both litigation and regulatory actions where the judgment was made in good faith and had a reasonable basis, and where the reasoning behind that judgment was
contemporaneously documented. The safe harbor is needed, according to the committee, in order to make auditors and managers comfortable exercising professional judgment. This might seem reasonable to someone entirely ignorant of recent accounting scandals. To understand its likely impact, however, one need only consider how enthusiastically such a safe harbor would have been embraced by Enron’s managers and auditors to protect the “professional judgments” they made, all backed by reams of documentation, of course.

Moreover, in touting this approach, the committee has failed to offer a single example of litigation or enforcement actions that unfairly punished reasonable judgments made in good faith. On the contrary, the soaring litigation settlements often cited by advocates of new limits on litigation were awarded in cases where none but the perpetrators would claim good faith. We have no doubt, however, that were this approach adopted, the next generation of Fastows would be shameless in claiming this safe harbor as a shield. That would make the job of regulators all the more difficult and the chances of remuneration for defrauded investors even more remote.

In short, because of its failure to confront the reality of widespread corporate wrong-doing, the committee has produced recommendations that, if implemented, would make it easier for ill-intentioned managers to fudge the numbers, harder for investors to tell when they had done so, and less likely that managers and auditors would be held accountable for wrong-doing. That seems like a heavy price to pay, even if the committee could produce on its promise to reduce complexity. In fact, however, a number of the committee’s recommendations are at cross-purposes, threatening to increase dramatically the very lack of consistency in application of accounting rules that committee members cite as one of the chief causes of avoidable complexity.

The committee does offer one recommendation – for greater investor participation in the standard-setting process – with which we wholeheartedly agree. As the draft decision memo notes: “Only if user/investor perspectives are properly considered will the outcome of the financial reporting process meet the needs of those for which it is primarily intended to serve.” The same logic, of course, applies to SEC advisory committees. Unfortunately, this committee provides yet another example of the biased and unbalanced recommendations that result when investors are given only token representation. Among other things, robust representation for investors on the committee might have forced the committee to justify its proposals with facts rather than rhetoric and could have served as a check on proposals, such as those listed above, that attempt to turn back the clock to the pre-Enron era of loose accounting and lax enforcement. It is particularly disheartening that investors have been given so minor a role in the discussion of issues that are of vital importance to their financial well-being and where, as the committee itself acknowledges, their concerns should be paramount.

I urge you, therefore, as you consider whether or how to move forward on the committee’s recommendations, to recognize that these are ideologically driven recommendations that do not in any way represent a fair presentation of investor interests or viewpoints. And, as I have in the past, I once again urge that you take steps to ensure
that any advisory committees appointed by the agency in the future include full and balanced representation for investors.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

cc: The Honorable Paul Atkins, SEC Commissioner
    The Honorable Kathleen Casey, SEC Commissioner
    The Honorable Annette Nazareth, SEC Commissioner
    The Honorable Christopher Dodd, Chairman, Senate Banking Committee
    The Honorable Richard Shelby, Ranking Member, Senate Banking Committee
    The Honorable Jack Reed, Chairman, Senate Securities Subcommittee
    The Honorable Wayne Allard, Ranking Member, Senate Securities Subcommittee
    The Honorable Barney Frank, Chairman, House Financial Services Committee
    The Honorable Spencer Bachus, Ranking Member, House Financial Services Committee
    The Honorable Paul Kanjorski, Chairman, House Capital Markets Subcommittee
    The Honorable Deborah Pryce, Ranking Member, House Capital Markets Subcommittee