

The SEC Rules

Five years after Sarbanes-Oxley, the SEC is flexing its regulatory muscle as never before.

Kate O'Sullivan, CFO Magazine
August 01, 2007

This is the second of a three-part series examining the state of accounting five years after passage of the Sarbanes-Oxley Act.

If Enron made accounting sexy and the Sarbanes-Oxley Act made it lucrative, the current power struggle over rule-setting makes it both compelling and consequential. Accounting may ultimately come down to numbers, as math does, but the rules that govern how those numbers are added, subtracted, and classified are hardly fixed. The standards by which assets, liabilities, debt, taxes, and the other components of corporate finance are reported are subject to constant revision. Indeed, one could argue that accounting is every bit as dynamic as the economy that it describes.

The same was not supposed to hold true for the entities that make the rules, however. As former Federal Reserve chairman Paul A. Volcker noted several years ago, "competent professional standard-setters" play a vital role in guaranteeing that accounting rules possess "consistency, coherence, and credibility."

Volcker made those remarks at a time when Congress was weighing in on the debate over whether and how companies should expense stock options. That was (and remains) a significant issue, but today the battle has shifted. Rather than coalescing around a single point of contention, the struggle for control now extends across the entire accounting landscape. The debate is hardly academic. Accounting determines both Corporate America's reality and its perception on the part of investors, competitors, and other stakeholders. Whether, for that reason, it should be regarded as a public-policy issue or insulated from public-policy debate is at the heart of the contest.

The key players in this battle are the Securities and Exchange Commission, which has largely focused on enforcing the rules; the Financial Accounting Standards Board (FASB), a panel of accounting experts that has written much of the existing accounting rulebook; the Public Company Accounting Oversight Board (PCAOB), a regulator created to oversee audit firms; the American Institute of Certified Public Accountants (AICPA), a professional organization with membership that includes sole practitioners as well as CPAs in industry; the public accounting firms; and the business lobby.

The catalyst, of course, is the Sarbanes-Oxley Act of 2002. Not only did it mandate the creation of the PCAOB, but in an effort to create greater accountability in financial reporting it sought to more clearly define the roles of all accounting rule-makers.

Five years later, the SEC has emerged as the clear winner in that reshuffling. While the commission has always had nominal jurisdiction over FASB, and was granted clear jurisdiction over the PCAOB under the terms of Sarbox, only recently has it begun to exercise its sway over both. Under the energetic leadership of Christopher Cox, who was appointed in June 2005 by President Bush, the SEC is letting the accounting world know that it is calling the shots.

This creates plenty of uncertainty for businesses on at least two counts. First, the SEC is led by political appointees, raising the specter of a boom-and-bust cycle for business-friendliness. (Not that it's terribly predictable: despite his GOP roots, Cox has not appeared to bow to corporate wishes as much as many had anticipated.) Second, the SEC's push for a single set of global, principles-based accounting standards may achieve its stated aim of benefiting both businesses and investors by ushering in a clearer and simpler financial-reporting regime — but not without mandating an overhaul of current practices that will make the changes wrought by Sarbox seem trivial.

Setting the Standards

For a taste of the new, more assertive SEC, one need look no further than to its relationship with the PCAOB. When asked about the PCAOB's independence at a hearing of the House Financial Services Committee in June, Cox characterized the relationship as "collegial." At the same time, he noted that the SEC has both budget and operational oversight of the board. "We don't want to breathe down their necks. We want to let them do their jobs and supervise it," said Cox. "We do not want to micromanage them."

Steven Scholes, a former SEC attorney who is now a partner at McDermott Will & Emery, says the relationship between the two agencies is a work in progress. "The PCAOB is so new that it's still trying to figure out its role," he says.

But other observers are more stark in their assessment. The board operates as "a wholly-owned subsidiary of the SEC," according to Jack Ciesielski, publisher of the newsletter *The Analyst's Accounting Observer*. Since the board's creation in 2002, he says, "the SEC has pretty much set the agenda."

That certainly seemed to be the case when the PCAOB attempted to rewrite Auditing Standard No. 2, which directs auditors' implementation of Sarbanes-Oxley Section 404. The commission became heavily involved in order to ensure that the PCAOB's new standard, Auditing Standard No. 5, was in sync with the SEC's own newly issued guidance to public companies. "The recent revision of AS5 gives an indication of how closely the SEC is working with the PCAOB," says John Archambault, managing partner of professional standards at Grant Thornton.

Independence in Principle

The relationship between the SEC and FASB is more complicated and perhaps more indicative of the SEC's expanding reach. Enconced in an office building in Norwalk, Connecticut, FASB has set accounting standards since 1973, in a think-tank environment largely free from the interference of the SEC — or anyone else, for that matter. With paid, full-time members hailing from industry and academia, the board's mission is to create accounting rules independent of private interests.

Periodically, the SEC and FASB have been at odds. For example, in 1994, the board was considering requiring the expensing of stock options. Congress leaned on the SEC, which in turn pressured FASB to drop the issue. The board required disclosure of the cost of options only in the footnotes to financial statements. (In 2005, FASB — with the support of the SEC — required expensing, despite a clamoring Congress.)

But with the passage of Sarbox, the board's funding structure changed. Instead of receiving contributions from the accounting firms and the AICPA, FASB is now funded by mandatory fees collected from public companies. The law also mandates that the SEC approve FASB's budget.

In a 2003 conversation with *CFO* magazine, former FASB chairman Dennis Beresford identified a possible problem with this arrangement: while the change freed the board from the potential influence of the accounting industry, "it's not clear that [FASB] has more independence from the political process," he said. "In fact, it may have less [independence] from Congress and other people in Washington. The SEC could give it a hard time with its budget."

In fact, it has. Last spring, the SEC refused to approve FASB's budget until the Financial Accounting Foundation, FASB's parent organization, agreed to let the agency review board nominees, propose its own candidates, and interview candidates during the selection process. The SEC claims that Sarbox requires it to certify the board every year, and former chairman Harvey Pitt says both he and his predecessor, Arthur Levitt, provided input on candidates. But the commission only occasionally suggested board members or raised objections to those whom FASB chose. Under the new agreement, the SEC "goes a great deal further in its involvement in the selection process," says Edward Trott, a retiring board member.

Former FASB chairman Edmund Jenkins is also worried about the change. "I am very concerned that this new protocol provides the basis for Congress — which has the responsibility to oversee the SEC — to get more directly involved with FASB. I think it's a step in the wrong direction," he told *CFO* in March.

"It is eminently clear that the SEC is insisting on a seat at the table during the process through which FASB members are nominated," says Scholes, the former SEC attorney. "What is not as clear is how the SEC will use that seat."

Better for Business

The appointment of Cox, a former Republican congressman, led the business community to hope the new regime would ease the regulatory headaches created by Sarbox and by the previous SEC chairman, William Donaldson.

To some degree that hope has been realized. Last December, for example, the SEC announced a change to its newly issued rules for disclosure of executive compensation. The new rules aimed to provide investors with an easy-to-read table that would show a single compensation number — fully loaded with the value of perquisites, salary, and bonus — for companies' five highest-paid executives each year. But just before Christmas, the SEC stated that instead of reporting all stock options granted an executive in a given year, companies need only disclose in the table the options vested in that year. (The total value of all grants must be detailed in a separate location.) While the commission said it had changed its rule simply to be consistent with the treatment of options under accounting rules, governance watchdogs were outraged. House Financial Services Committee chair Barney Frank called it a Christmas gift to the business community.

Then, in May, the SEC answered the chorus of calls for relief on Section 404 by releasing new guidance for managers on how to document and test their internal controls, together with the revised version of AS2. Both stressed a more risk-based, top-down approach aimed at reducing companies' cost of compliance.

So far, finance executives are pleased with the steps Cox has taken to clarify 404 compliance. "We're moving in the right direction," says Ted French, CFO of Textron. "I'm pleased that the SEC is saying, 'We did put some inefficiency into the system, but let's get back to looking at the big risks.' We seem to be moving back toward sanity." French says that, by following AS5 and the SEC's new guidance on 404, as well as its own improved audit planning process, Textron was able to reduce its internal-compliance workload by 21 percent and cut its audit cost by 12 percent.

"The guidance to take more of a risk-based approach is definitely the right direction," agrees Sharon Tetlow, CFO of Cell Genesys, a San Francisco-based biotech company.

But Cox cannot be accused of taking a doggedly pro-business stance on every issue, however. Apart from the change on options disclosure, the new executive-compensation rules, which require a full accounting of all compensation elements, certainly didn't win the commission any friends among highly paid senior executives. Furthermore, the SEC has declined to exempt small businesses from 404, despite heavy pressure from lobbying groups like the Chamber of Commerce.

What Will Congress Do?

What about Jenkins's concern that the SEC's increasing involvement with FASB opens the door to more direct interference by Congress? Thus far that hasn't happened. A June hearing of Frank's finance committee, dubbed "A Review of Investor Protection and Market Oversight," failed to generate the fireworks predicted by the press. Instead, members of Congress seemed eager to solicit the commissioners' views on the competitiveness of U.S. markets and a range of other financial topics. Cox fielded four hours' worth of questions capably and earnestly, and acquitted himself better than many committee members, some of whom appeared to be merely grandstanding for their small-business constituents rather than truly grasping the complex regulatory issues facing the commission.

But Congress is the wild card in accounting oversight, and legislators haven't been shy about promoting their own causes to the SEC. For example, at the June hearing, Frank pushed for a date on a proposal to allow shareholders to nominate directors on corporate proxy ballots, a pet project of his. Also in June, a group of House members sent a letter to the SEC asking it to look at the accounting treatment of subprime mortgages. "There are the dominos for you," says Ciesielski of *The Analyst's Accounting Observer*, referring to the letter about mortgage accounting. "Barney Frank will nudge the SEC, which will nudge FASB." Despite the mutual respect demonstrated at the hearing, it is unclear how Cox will respond should Congress attempt to further its own agenda.

Politically motivated tweaking of accounting standards is cause for concern. Changing accounting rules to suit the prevailing wind in Washington could result in gross inconsistencies — a formula for abuse and economic disruption at worst, and a whole lot of work for finance folks at best.

Convergence Changes Everything

The SEC's most significant move to date — to accelerate the push for a single set of worldwide, principles-based accounting standards — signals a dramatic shift that could, in the end, either increase the SEC's influence or divert power away from any U.S. entity and toward the international business community. At the very least it will require systemic changes that far surpass anything mandated by Sarbox.

The issue of international convergence has simmered on accounting regulators' back burner for years, and FASB and the International Accounting Standards Board (IASB) have been working steadily toward a unified system since 2002. But Cox has clearly made convergence a top priority.

In June, the SEC voted to propose allowing foreign companies listed in the United States to file under international financial reporting standards, or IFRS, a more principles-based system created by the IASB, rather than U.S. generally accepted accounting principles (GAAP). The decision is now out for comment.

Going one step further, SEC chief accountant Conrad Hewitt announced just a week later that the commission would release a concept draft to test the idea of allowing domestic companies to do the same.

Also in June, the SEC established the Advisory Committee on Improvements to Financial Reporting, to be led by Robert Pozen, chairman of MFS Investment Management. The group is charged with studying the complexity of the existing U.S. system and making recommendations on how to make financial statements more user-friendly. The committee is explicitly tasked with evaluating the impact of "the growing use of international accounting standards."

The SEC is not alone in embracing the idea of a global standard. "There is a growing consensus around the need to have international standards," says Robert Kueppers, deputy CEO of Deloitte & Touche USA. "It's striking how quickly that consensus has formed, as very senior people in the Administration, from the SEC to the Department of the Treasury, are focusing on the issue." While FASB and the IASB have been working methodically to converge standards, "I think the policymakers have made it more of a priority, and they're saying we can accelerate it," says Kueppers.

Finance executives seem to agree. A *CFO* survey last year found that 47 percent of finance executives supported a shift to principles-based accounting, while just 10 percent opposed such a move.

If the United States moves to IFRS, the SEC could extend its reach far beyond the PCAOB and FASB to the international arena. As more foreign issuers would presumably list in the United States thanks to the change, the SEC's compliance umbrella would cover that many more companies, establishing the commission as the preeminent global financial regulator. In fact, Cox appeared to be paving the way for a greater international SEC presence during a European tour last spring in which he discussed cooperation and information-sharing with European securities regulators.

As for FASB, chairman Robert Herz has acknowledged that the organization could change as it moves toward international convergence. Indeed, says David Sherman, an accounting professor at Northeastern University and a onetime candidate for a seat on FASB, "when people talked about hiring me at FASB, they didn't seem to assume that it was going to exist forever."

But even if the United States does move toward IFRS, the board needn't rush to pack up its Connecticut headquarters. "Down the road I think we will see more and more acceptance of international accounting standards," says Archambault, the Grant Thornton partner. "But I can't even give you a guess on the number of years before we would have a single set of worldwide standards." Herz has noted that despite the adoption of IFRS by many countries, many national accounting regulators still exist to oversee implementation of the standards.

One possible future for FASB: a friendly merger of equals with the IASB. The international accounting regulator will unquestionably play a greater role in the future of U.S. accounting if IFRS take hold, and the board has worked extremely closely and amicably with FASB on convergence thus far. A blended standards board could eventually serve as the sole author and interpreter of the new rules.

Five years after the passage of Sarbanes-Oxley, the SEC has asserted its dominance over the other accounting regulators and has played a leading role in moving the challenging concept of global convergence to the top of each agency's agenda. By pushing for a principles-based approach, it has also raised questions about the very nature of corporate accounting in the United States, and added its considerable weight to a process that may literally redefine the system. Five years from now, companies could find themselves playing by a profoundly different set of rules — or perhaps without any rules at all.