

# REGULATORY REFORMATION

THERE'S A SENSE OF AN URGENT NEED FOR CHANGE ON ACCOUNT OF THE FINANCIAL CRISIS – ESPECIALLY AT THE HEART OF THE WORLD'S CAPITAL MARKETS, WRITES **FRANCINE MCKENNA**

**F**or two days in June, the Mayflower Hotel in Washington DC heaved with compliance executives and accounting professionals, paying careful attention to a regulator-heavy line-up of speakers and standard-setters at *Compliance Week's* annual conference.

This time, amid the global recession, the regulatory set and their partners in law enforcement heralded far greater scrutiny of financial institutions – both locally and across national jurisdictions. But this year also marked efforts to shift the wider financial world to re-orientate their various reforms with investor needs in mind.

In the UK, this swing has begun, with the recent appointment of Stephen Haddrill, outgoing director general of the Association of British Insurers, to the role of accounting regulator.

In the US, delegates probably didn't need reminding, but Securities and Exchange commissioner Luis Aguilar did just that: 'Investors around the country are feeling the pain of this economic crisis – in their retirement nest eggs, their college savings plans and in their brokerage accounts ... The staggering amount of taxpayer funds that have been mobilised to try to manage this crisis are being paid to prop up companies who made serious mistakes.'

Aguilar and Richard Ketchum, chairman of the Financial Industry Regulatory Authority (FINRA), both proposed a renewed stress on investor-oriented regulation versus prior 'de-regulatory' regimes.

## REGULATORY INTEGRATION

'If an integrated capital markets regulator is created, it must be done in a way that puts investors first,' Aguilar said. And he even made news when he expressed strong support for combining the SEC with the Commodities Futures Trading Commission (CFTC), a controversial proposal in a long list of ideas for regulatory reform. But no sooner had the media reported it than it was shot down. US congressional leaders and the CFTC head made contrary statements almost immediately. Treasury secretary Timothy Geithner told congressional leaders that evening that he wouldn't push for a merger. House Financial Services Committee chairman Barney Frank



Luis A. Aguilar

was quoted as saying a merger isn't possible because of pushback from 'entrenched interests'. And the Obama administration later said that there was no 'one-regulator plan'. For now... Aguilar and Ketchum are also proponents of a 'systemic risk' regulator.

'The stovepipe regulations that exist in this country and ... in every other country simply had not evolved to deal with the risk or work with the difficulties with transparency,' Ketchum said.

Unfortunately, every time there's a discussion about adding or subtracting, combining or eliminating, realigning or reinventing financial sector regulators – the SEC, Public Company Accounting Oversight Board, Federal Deposit Insurance Corporation (FDIC), CFTC, or FINRA – turf battles start up anew to muffle the dialogue.

I think that Aguilar's candid comments regarding the SEC's funding are equally important to the regulatory infrastructure debate. 'Currently,' he said, 'the SEC does not have the ability to self-fund, and this has harmed the agency's ability to perform its mission in terms of long-range planning, developing necessary technology, and maintaining appropriate staffing levels.'

The SEC was harshly criticised by Congress during hearings on the financial crisis and the Madoff scandal. How can the SEC improve, do more, or clear the current backlog of cases, if there's insufficient budget and too few competent staff? Although Aguilar defended the SEC, he also unfavourably compared its capacity to the FDIC. The FDIC is significantly larger but monitors fewer institutions. The SEC, in Aguilar's opinion, needs more resources.

The SEC, for example, doesn't generally hire entry-level professionals. US regulators could take advantage of the Obama administration's emphasis on public service rather than perpetuating the idea that government service comes with a huge opportunity cost. We have accepted lobbying, conflicts and a 'revolving door' back into private firms as inevitable after a few years of public 'martyrdom'. We need top graduates of elite schools, as well as good graduates of good schools, and mid-career markets experts in particular, to dedicate themselves to public service such as one sees in the UK and France. It's both idealistically and practically desirable.

### THINK YOU KNOW THE SEC?

Scott Taub, formerly a senior official at the regulator and an Arthur Andersen alumnus, was also on the conference agenda. Taub is a managing director of Chicago-based Financial Reporting Advisors. His advice is highly valued by troubled companies, such as those threatened with SEC investigations and forced accounting restatements.

His talk, *The top 10 things you think you know about the SEC, and why you're wrong*, was a laundry list of misconceptions companies have about the SEC. He gave practical advice for developing cooperative, non-confrontational relationships with the regulator. Taub's mantra can be summarised in three words: discuss, document and disclose.

For example, some executives think that the SEC makes or changes generally accepted accounting principles (GAAP) via speeches. Taub says that they ought to discuss their fact pattern with the SEC and reference actual GAAP, not what they think someone said in a speech. He further cautioned that when a comment

letter says 'Please revise', the conversation isn't over yet. Taub says that companies should provide more information, and appeal to senior staff, if necessary.

'Materiality' is another concept that often causes debate and confusion. Big numbers are not always material and small amounts sometimes matter, says Taub. The SEC's Staff Accounting Bulletin 99 (SAB) issued in 1999 was intended to clarify materiality criteria, but companies need to go beyond applying formulas and look at investor perception.

### IFRS

The US conversion to International Financial Reporting Standards was one of the most passionately discussed topics at the conference. I asked speakers from Microsoft and Eli Lilly about the level of effort and cost for their combined Extensible Business Reporting Language (XBRL) and IFRS initiatives, given the necessity for coordination. Both answered that this issue had not yet been addressed, but they expect significant time and money to be spent.

Taub emphasised that SEC staff have always supported principles-based accounting, having neither time nor the inclination to create new rules. Companies, attorneys and external auditors more often seek a rules-based approach. SEC staff, per Taub, will accept professional judgment when it's consistent with principles. However, uniform application of standards across companies is likely to be impossible under IFRS. SEC staff accept 'inconsistency' provided there are disclosures.

So what changes has Taub seen since last year? His 2008 presentation focused on restatements. Now, the hot issue is disclosure: 'After resolving a difficult accounting issue, I always ask "What disclosures are you planning to make?" Too often I still hear "Oh, only a sentence or two." That's the wrong answer. Disclosure is an opportunity to communicate with investors, not a risk.'

Can US professionals sincerely adapt to IFRS given the famously litigious US environment? I asked Taub specifically about the impact of IFRS on litigation against companies and their accounting firms after restatements. He doesn't think the change to IFRS will matter much. It's companies' attitudes about disclosure and transparency that will help them avoid lawsuits. But it's going to take a while for auditors, investors and attorneys to trust their own and others' judgment rather than expecting bright lines.

When the conference ended, participants took in a short breath before returning home to full dockets. The issues remain, in most cases, unresolved and outcomes are still uncertain. XBRL and IFRS conversion mandates are on a slower timetable, but both are inevitable. Companies shudder at the time and money required to do them well.

Regulatory reform is a global issue, but the ongoing debate in the US is loud, raucous and, at times, contentious. At this stage it's still unclear as to whether we will get a framework that merely avoids another crisis or whether leaders will develop an approach that improves responsiveness to all stakeholders.

What is clear is that a stronger enforcement of fraud, malfeasance and anti-bribery provisions now require an en garde attitude on the part of every market participant.

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