Consumer Federation of America

April 14, 2008

Ms. Nancy Morris M. Morris
Federal Advisory Committee Management Officer
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. 265-24
Advisory Committee on Improvements to Financial Reporting

Dear Ms. Morris:

I am writing to follow up on my oral testimony before the Advisory Committee on Improvements to Financial Reporting (CIFiR) Thursday, March 13 in San Francisco. At that time, I expressed CFA's strong opposition to: 1) the Committee's proposal to revise the guidance on materiality in order to make it easier to dismiss large errors as immaterial and 2) the Committee's proposal to revise the guidance on when errors have to be restated to permit past material errors to avoid restatement in certain circumstances and to allow past immaterial errors that accumulate until they become material to be corrected in the current financial statements without requiring a restatement of the financial statements in which the errors occurred. My purpose in writing is to reiterate our opposition to these proposals and to expand on the reasons for that opposition in light of the discussion during last month's meeting. Before moving to those issues, however, I would like to briefly address the issue of the proposed professional judgment framework.

1. **CFA opposes the Committee proposal to offer some form of legal protection to professional judgments made according to the recommended judgment framework.**

While CFA believes it is appropriate to improve procedures for making professional judgments, we oppose any proposal to provide protection from either litigation or enforcement actions to faulty professional judgments that are made according to that framework. Chairman Robert Pozen suggested during the San Francisco meeting that our concerns were unwarranted, as the Committee has not proposed a "safe harbor" for professional judgments. However, the clearly stated intent of the Committee is that reliance on its proposed professional judgment framework would result in some greater deference on the part of regulators and others for judgments made according to that framework. That, and not the legal form of any such policy, is the basis for our opposition.

We base our assessment of Committee intent on statements made by the Chairman, the Subcommittee Chairman, and other members of the Committee during the January 11 open meeting at which the Committee approved these recommendations. Chairman Pozen, for example, stated the following in opening the discussion of the professional judgment framework:

> "The Committee basically said … we would be okay if this was a policy statement or a safe harbor. We are not sure, as a legal matter, whether the Commission could just issue a safe harbor in this respect, and we are not going to try to make that decision."

Instead, he said, the Committee would "concentrate on substance" and "leave it to the legal beagles whether there can be a safe harbor or not." Later, in response to a question from SEC Chief Accountant Conrad Hewitt, Chairman Pozen offered this further clarification: "We are asking the Commission to issue a policy statement. Whether it is a safe harbor or not we leave to ... the legal issues and political issues … but we want a statement that would be able to be relied on … the exact form, the exact legal status, we're not trying to get hung up on."

Similarly, Subcommittee Chairman Michael Cook made it clear that, in his view also, the professional judgment framework is designed to provide some form of greater legal protection for judgments made according to that framework.

> "What we're really saying here is, if we could have a safe harbor, if that could be drafted as a safe harbor … if that were the acceptable outcome and doable, terrific, and we'd be all in favor of that."

If that's not achievable, he added, alternatives might include a position statement from the SEC "and perhaps that leading at some point to a safe harbor." The point, he said, is "to provide the environment and the protection we are seeking to achieve … We've got to change this environment of fear of being second-guessed." In explaining how that might work, Cook specifically suggested that one goal of the Committee is to provide a "framework for regulators and others to look to in overseeing and challenging judgments. That's one of the intended outcomes of this … is a respect for judgments that have been made in an appropriate way and in an appropriate framework."

Another Committee member, James Quigley, argued that the recommendations on professional judgment framework were perhaps the most important in the whole report. "I think it has to be sanctioned by the regulator, and I think it has to be respected by the regulator," he said. "I would strongly argue for a safe harbor," he added, noting that a "safe harbor from enforcement" could "build up case law" that would "help for the litigation environment." In fact, he added, "I think we might be wasting our time with this report if we can't have something like this."

In light of these comments, and the lack of any comparable discussion opposing new legal protections for professional judgments, it seems highly disingenuous for the Committee to now suggest that it is not recommending some form of safe harbor. Just to make our position absolutely clear, however, we oppose a safe harbor that protects professional judgments made according to the framework regardless of what form it takes, whether that is an actual legal safe harbor that protects judgments from enforcement action and litigation, an SEC policy statement that is designed to give greater legal protection to professional judgments made according to the framework, or any SEC policy, formal or informal, of refraining from taking enforcement actions against faulty professional judgments made according to the framework.

Investors want issuers and auditors to take very seriously their responsibility to get the numbers right. Sending the message that sound process excuses bad results is not the way to achieve that. Regardless of the occasional caveats provided by Committee members indicating the policy would not limit regulators' ability to "ask questions" or "challenge" bad judgments, we believe the overwhelming message from the Committee is quite the opposite. In short, unless the professional judgment framework is completely divorced from any suggestion that reliance on the framework protects issuers and auditors from being second-guessed, we will continue to oppose it on the grounds that it is not in investors' best interests.

2. CFA opposes the Committee's proposed revisions to guidance on materiality.

The Committee indicated during the San Francisco meeting that its intent in proposing to revise the guidance on materiality is to clarify that SAB 99 is "a two-way street." Specifically, the Committee indicated that clarification is needed to send the message that, just as quantitatively small errors may be judged to be material based on qualitative factors, quantitatively large errors may be judged to be immaterial based on qualitative factors. In explaining this recommendation, Committee members reiterated their view that issuers and auditors today are being "too conservative" in their judgments on materiality and, as a result, are issuing restatements that investors "don't care about." Ignoring the irony of proposing to revise policy in this area based on their second-guessing of issuers' and auditors' professional judgments about materiality, the Committee says its goal is to reduce these "unnecessary" restatements. We oppose this recommendation on the grounds that it is unneeded and poses risks to investors that far exceed any potential benefits.

A. The Committee has failed to make the case that investors do not care about many current restatements.

The Committee appears to base its judgment that investors don't care about restatements on the lack of significant market reaction to some restatement announcements. At least, it has offered no other explanation that we are aware of for its judgment. This is a highly questionable measure of investor preference that cannot reliably be used to justify the Committee's recommendations. SAB 99 rejected market impact as "too blunt an instrument" to be relied on in determining whether a particular error is

material. The Committee itself points out several short-comings in this analysis in its January interim report, albeit hidden away in the footnotes. Specifically, footnote 54 of the interim report states:

> "Examples of the limitations in using market reaction as a proxy for materiality include (1) the difficulty of measuring market reaction because of the length of time between when the market becomes aware of a potential restatement and the ultimate resolution of the matter, (2) the impact on the market price of factors other than the restatement, and (3) the disclosure at the time of the restatement of other information, such as an earnings release, that may have an offsetting positive market reaction."

To these we would add several more, including research that indicates the method of announcing a restatement has a significant impact on the degree of market reaction, regardless of the severity of the restatement[1] and the notion that accounting information often lags more timely but less verifiable information and thus tends to provide feedback on the market's reaction to the earlier information rather than trigger that reaction.

Taken together, these factors argue strongly against basing judgments about materiality, and whether investors care about a restatement, on the lack of a "statistically significant market reaction" to restatement announcements. Moreover, this assumption about investor preferences conflicts with recent survey research. For example, a survey of investors released last year by AARP[2] found that the vast majority (79 percent) believe auditing and financial reporting standards should be much (30 percent) or somewhat (49 percent) stronger, compared with only 3 percent who felt such standards should be either much or somewhat looser. While this survey did not directly test investors' attitudes toward restatements, it does suggest that investors would be highly skeptical of policies that would have the effect of loosening materiality standards and/or restatement requirements.

B. The Committee has failed to show that the benefits of reducing restatements it deems to be "unnecessary" outweigh the potential risks.

CFA believes investors receive significant benefits from the "conservative" approach to materiality judgments that the Committee seems so intent on eliminating. These benefits include greater trust in the reliability of financial reports and the integrity of the markets. Ironically, increased investor confidence that companies are getting information about errors out quickly may make investors less likely to "over-react" to restatements. In short, this increased confidence may contribute to the lack of market reaction that the Committee attributes to "unnecessary" restatements. It would be ironic indeed if a Committee appointed to improve financial reporting adopted changes that

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[1] Swanson, E., Tse, S., Wynalda, R. "Stealth Disclosure of Accounting Irregularities: Is Silence Golden?" Aug. 21, 2007.

[2] AARP, "Sarbanes-Oxley: A Survey of Investor Opinions," 2007. Data collected by Knowledge networks. Report prepared by Jeffrey Love, Ph.D.

undermined investor confidence in the reliability of financial reporting, but that is exactly the direction in which we see this Committee headed with its recommendations on materiality and restatements.

We also believe a conservative approach to materiality and restatements may help to prevent earnings management which, if allowed to go unchecked, could evolve into fraud. As I noted during the discussion at the San Francisco meeting, our thinking in this area is based on research currently underway at the Wharton business school that looks at the connection between accounting fraud and manager over-confidence.[3] That research, by Wharton accounting Professor Catherine M. Schrand and doctoral student Sarah L. C. Zechman, reportedly looks at a certain type of fraud that appears to start, not with an intent to defraud, but with a desire on the part of managers to keep bad news under wraps and off the books for a quarter or two until the manager can get things turned around. According to this theory of "accidental fraud," the manager in question may be tempted to engage in some gray area accounting or minor earnings management with the expectation that it is only a temporary necessity. Where the manager runs into to trouble is if they fail to turn things around as expected, leaving them with a choice between correcting their previous errors or engaging in even more aggressive accounting to hide both the worsening situation at the company and their previous earnings management.

In our view, a system based on a conservative approach to materiality is more likely to prevent the original gray area accounting or minor earnings management. And, if it fails to stop the deception at the outset, it is far more likely to prevent the more egregious accounting adopted later if management's overly optimistic predictions of a quick turn-around fail to materialize. In contrast, a system that shrugs off small errors, or even quantitatively large errors, as immaterial is more likely to allow this sort of "accidental fraud" to evolve unchecked. Moreover, it seems to us that this risk is greatly exacerbated in a system that does not require restatement of previous financial statements for small errors that accumulate over time, particularly if those small errors just happen to make the difference between recording a profit or a loss or making analysts' earnings estimates.

The Committee argues that its proposals will benefit investors by reducing costs associated with restatements. However, it offers no evidence about the costs associated with the small restatements it claims to be focused on, the number of restatements where quantitatively large errors are likely to be viewed as immaterial, or the countervailing risks associated with its proposals. We frankly question whether the "unnecessary" restatements the Committee claims to be focused on eliminating are the same ones that impose the significant costs and information delays that the Committee cites in justifying its recommendations. Certainly, the Committee has offered no evidence to support this view. Moreover, it offers only a weak rationale for its view that investors don't care about many current restatements. Because we believe the Committee has failed to make its case that many restatements today are "unnecessary" or that investors would benefit from their elimination, and because, on the contrary, we believe investors benefit from the conservative approach to materiality and would be exposed to undue risks if issuers and

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[3] "Are Overconfident Executives More Inclined to Commit Fraud?" Published: March 05, 2008 in Knowledge@Wharton, http://knowledge.wharton.upenn.edu/article.cfm?articleid=1907.

auditors were encouraged to dismiss large errors as immaterial, we oppose the Committee's recommendations for new guidance on materiality.

C. The Committee should acknowledge widespread investor opposition and withdraw its proposal calling for new guidance on materiality.

CFA does not stand alone in challenging the Committee recommendation on materiality. Our skepticism is shared by a number of investors and investor advocates. Elizabeth Mooney, an analyst with The Capital Group Companies, expressed similar concerns in her testimony before the San Francisco meeting. Mooney, who surveyed other analysts at the company, said for example that they:

> "… emphatically oppose having anyone other than investors determine whether quantitatively significant errors provide relevant information to investors; that is, whether such errors are capable of making a difference in user decisions. Quantitatively large errors should not be deemed immaterial by the company and auditors."

The Investors Technical Advisory Committee to the Financial Accounting Standards Board was equally adamant in its opposition, expressed in a December 13 letter to Subcommittee Chairman Cook. The ITAC letter stated that "the current guidance provided by the courts, Securities and Exchange Commission (SEC) and American Institute of Certified Public Accountants Auditing Standards Board regarding assessment of materiality is appropriate." It adds that, "A material transaction from a quantitative perspective should typically not be determined to be immaterial from a qualitative perspective, unless such a calculation should produce a numerically non-meaningful result (such as when the comparison is to an insignificant amount of earnings)." Similar reservations have been expressed by the AFL-CIO.

The Committee has repeatedly stated that decisions about materiality and restatements should be based on the needs of reasonable investors. We respectfully suggest that the same is true for policy in this area. Given widespread preference among investors and investor advocates for retaining the current guidance on materiality, we urge the Committee to withdraw this proposal.

3. CFA opposes the Committee's proposed revisions to guidance on when errors have to be restated.

Based on the same questionable assumption that investors are indifferent to many of the restatements occurring today, the Committee has proposed to revise the guidance regarding when errors have to be restated. Arguing that decisions about whether to restate should be driven by the needs of "current" investors, the Committee has proposed not requiring restatements for past material errors in some circumstances. It has also proposed allowing past non-material errors that accumulate over time until they become material to be corrected in the current financial statements without requiring a restatement of the past

financial statements where the errors originally occurred. We oppose both these recommendations.

The Committee has tried to soften the impact of these recommendations by noting that errors would still have to be corrected, simply not subject to a formal restatement. It is difficult to assess how such an approach would work, as the Committee has provided few details. Indeed, the discussion at the San Francisco meeting seemed to suggest that the Committee itself is unclear on exactly how this might work. This is far too important a feature of the proposal to be left as vague as it is in the current proposal. Frankly, we fail to see how an alternative approach to correcting errors could provide the same degree of notice to investors, comparability, and verifiability as a restatement, and still result in lower costs. Unless there is a cost savings, however, the Committee's recommendation is not justified even on its own terms.

Ultimately, we share the view expressed by the ITAC in its letter to Subcommittee Chairman Cook: "When a material error is corrected, it is important investors be provided corrected financial statements that present all periods in a consistent and comparable manner. Investors should not be required to 'adjust' prior period financial statements to make them comparable." We think this will only occur if financial statements have to be restated so that all periods are reported using the same accounting. In our view, allowing errors that occurred in previous periods to be corrected in the current financial statements fails to provide the consistency and comparability of treatment we seek. Instead, it threatens to make both past and current financial statements incorrect while leaving financial statements for different periods subject to different accounting treatments. This hardly seems consistent with the Committee's charge to improve financial reporting.

We also oppose allowing past material errors to go uncorrected, on the assumption that they are not relevant to "current" investors. If the term current investors includes potential investors – and we believe it must – we disagree with the underlying assumption that these investors do not have a strong interest in seeing all periods reported accurately and on comparable terms. We believe many current investors share this interest, as it is much more difficult to track trends if these corrections are not made. Again, Ms. Mooney indicated in her testimony before the Committee that this view is shared by the analysts at her firm. While there may be some point at which errors occurred at so remote a period in the past, and are so irrelevant to current finances, that they would be irrelevant to current investors, but we doubt such cases account for a significant enough portion of restatements today that it merits changing the policy to accommodate them. Certainly, we would not see the recent restatements related to stock options spring-loading in this light, since the errors in those cases were associated with a violation of fiduciary duty that is likely to be extremely relevant to current investors.

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The Committee has failed to make its case that investors do not care about many current restatements, a basic assumption that underpins its recommendations in this area. More importantly, the Committee appears to have given little if any consideration to how

its recommendations might contribute to a resurgence of the lax accounting practices that so recently damaged our markets. Unfortunately, the Committee appears to have been swept up in the deregulatory fervor of those who argue that over-regulation and excessive litigation are hurting the global competitiveness of U.S. markets. Ironically, these recommendations are being debated at a time when events are demonstrating, once again, that it is lax regulation and loose accounting that deals the most devastating damage to our markets, to investors, and to the economy as a whole. Because we believe these recommendations would seriously undermine the quality of accounting and auditing for U.S. public companies, we strongly oppose their adoption. Because we believe the Committee should follow its own stated intent of ensuring that decisions about restatements are based on the interests of investors, we urge the Committee to withdraw these proposals and to focus instead on those Committee recommendations that would truly result in improvements to financial reporting.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

cc: The Honorable Christopher Cox, Chairman, Securities and Exchange Commission
The Honorable Paul Atkins, Commissioner, Securities and Exchange Commission
The Honorable Kathy Casey, Commissioner, Securities and Exchange Commission
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 Cmte
The Honorable Paul Kanjorski, Chairman, House Capital Markets Subcommittee
The Honorable Deborah Pryce, Ranking Member, House Capital Markets Subcmte