Remarks before the U.S. Department of Labor's ERISA Advisory Council

by

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Introduction

It is my pleasure to be with you this morning. My name is Paul Beswick. I am a Deputy Chief Accountant in the Office of the Chief Accountant at the Securities and Exchange Commission. I am pleased to appear before the ERISA Advisory Council to discuss the current financial reporting and auditing model for employee benefit plans in SEC filings and the oversight regime for independent public accountants that appear and practice before the Commission. I must preface my remarks with a disclaimer – my comments this morning are my own; they do not necessarily reflect the views of the Commission, the individual members of the Commission, or its staff.

There have been dramatic changes in financial reporting, auditing standards and the accounting profession since ERISA became law 36 years ago. I commend the Advisory Council for its interest in addressing what actions the Secretary of Labor might take with respect to the current audit and financial reporting model for employee benefit plans covered by ERISA in order to enhance participant and beneficiary protection.

As you know, some, but not all, employee benefit plans are subject to reporting obligations with both the Department of Labor and the Securities and Exchange Commission. A plan that is required to file annual reports with the SEC generally does so on Form 11-K. Plans can also satisfy those reporting requirements by including annual plan financial statements in the employer's annual report on Form 10-K in lieu of filing a separate Form 11-K. Over the last twelve months, approximately 2,000 employee benefit plan annual reports were filed with the SEC. I understand that approximately 80,000 employee benefit plans include audited financial statements in the information filed annually with the DOL on Form 5500. Those numbers give a sense of the portion of employee benefit plans subject to ERISA that are also subject to the SEC's registration and reporting requirements.

This morning I would like to share my perspectives on two areas of SEC regulation that may inform your study of the DOL's audit and financial reporting model.

The topics I will cover are:

- Financial reporting requirements of employee benefit plans, and
- The auditing regulatory environment.

Reporting Requirements

If an employee benefit plan allows employees to invest their plan contributions in employer company securities, the SEC requires the plan to register the offer and sale of plan interests under the Securities Act and comply with Exchange Act reporting obligations. The Commission's rules and regulations are designed to promote sound investment decision-making by requiring robust disclosure of financial information. A core element of the Commission's rules and regulations is the requirement that plans file annual financial statements prepared in conformity with U.S. generally accepted accounting principles. U.S. GAAP prescribes financial reporting, which is premised on providing information useful to investors, creditors, and others in making capital allocation decisions. U.S. GAAP addresses how financial statements are to be presented, including how plan investments and liabilities should be recognized, measured, and reported. The Commission furthers this objective through rules and regulations requiring specific disclosure and the timely filing of information.

The Commission requires that the Form 11-K include an audit report prepared by an independent accountant registered with the Public Company Accounting Oversight Board. The audit report filed with the SEC must be unqualified as to scope and opinion.

In contrast, I understand that a plan administrator may be permitted by ERISA and the Department of Labor to file an audit report with a qualified opinion based on a scope limitation. The permitted scope limitation covers audit procedures relating to plan investment information, but only if the plan investment information is otherwise certified by a bank or similar regulated institution. An audit report qualified in scope is not acceptable in filings with the SEC.

Complete and accurate plan investment information is vital for an understanding of the plan's financial statements and serves as the basis for a variety of purposes ranging from regulatory funding requirements to the plan administrator's management of the plan. Inaccurate or misleading investment information could result in failure to comply with regulatory requirements, poor decision making by the administrator, reputational risk to the sponsoring company and, most importantly, result in obligations to plan participants not being fully satisfied.

A limited scope audit provides less assurance than a full scope audit. In a limited scope audit the plan administrator instructs the auditor to limit the scope of testing on investment information prepared and certified by a qualified trustee or custodian. The auditor has no responsibility to test the accuracy or completeness of the investment information certified by the plan's trustee or custodian, but rather, perform procedures, including, determining that this information is included in the financial statements in accordance with GAAP and are in compliance with DOL rules and regulations. Also, the auditor is not required to perform audit procedures over plan investment information certified by the plan's trustee or custodian related to the valuation of the plan's investments. While no audit provides absolute assurance, a full scope audit increases the likelihood of the auditor detecting misstatements in plan investments. In a full scope audit, the independent auditor obtains an understanding of the processes and internal controls related to investments, performs test and other procedures, and thereby forms a sound basis for a professional opinion on all aspects of the financial statements, including the completeness and accuracy of investment information.

Given the varied nature and complexity of investment vehicles available in today's markets, I understand that the Council is seeking views on adopting a so-called "split model" audit, whereby the bank certification would be limited to certain types of investments (presumably those posing lower misstatement risk). Other types of investments (presumably those with higher misstatement risks) would be subject to audit procedures. I understand that a potential benefit from this approach would be an increase in the likelihood that a misstatement would be detected, especially for those investments where the valuation is more subjective in nature while trying to limit the incremental audit costs. However, in my view the expected cost saving of such an approach would not be significant because the level of audit effort expended on testing investments that are actively traded in the market place is significantly less than the effort for those hard to value assets. Additionally, defining "hard to value" in a manner that could be applied on a consistent basis will most likely pose significant challenges. Finally, depending on the mix of investments, an auditor may conclude that they have to issue a qualified opinion regardless; particularly depending on the materiality of those easy to value investments.

The Commission does not permit a plan administrator to avoid a full scope audit, regardless of whether or not the plan administrator has obtained a certification on the completeness and accuracy of plan investments. The full scope audit provides additional assurance on the accuracy and fairness of the completeness of the plan's investments and a level of assurance which investors rightly expect from financial statements filed with the Commission. I believe this approach is consistent with the Commission's mandate for investor protection, particularly when the credibility of financial information is so critical to investor confidence.

Another area you may consider examining is the frequency of periodic reporting by employee benefit plans. The Commission's rules and regulations require current reporting when certain specific events occur that may be important to an investor. This obligation is intended to make investors aware of events that may materially impact a registrant. While the SEC does not impose interim or current reporting requirements on the employee benefit plans it regulates, plan participants nonetheless have access to the periodic (including current and interim) reports provided by the issuer of publicly-traded securities held by the employee benefit plan.

Let me illustrate three examples of Commission requirements to report on a current basis events involving auditors.

The first example is a change in auditors. If an accountant resigns an audit engagement, is dismissed, or declines or is refused reappointment, the registrant must report details of the incident to the Commission on Form 8-K within four business days after the event. When a replacement auditor is engaged, that appointment must be reported separately, also within four business days after the event.

Another example is circumstances which compel an accountant to advise an audit client that a previously issued audit report can no longer be relied upon. The registrant must notify the Commission on Form 8-K regarding the details of that advisement and provide the accountant with a copy of the notification on the same day it is reported to the Commission. In addition, the registrant is required to request a letter from the accountant addressed to the Commission, stating whether the accountant agrees with the statements contained in the registrant's notification and if not, why not. The registrant must then submit the letter to the Commission by way of amendment to its Form 8-K, within two business days after receipt of the letter.

The third example involves reporting responsibilities under federal securities law that reach beyond publicly-traded companies. Many broker-dealers (whether or not they are public companies) are required to engage an independent accountant to audit their financial statements annually. Under current rules, if a broker-dealer auditor discovers a material inadequacy in the accounting system or internal control procedures for safe-guarding securities, the auditor must call the matter to the attention of the chief financial officer. The broker-dealer then has the responsibility to inform the Commission of the auditor's report within 24 hours. The broker-dealer must provide the auditor with a copy of the notice to the Commission within the same 24-hour period. If the accountant does not receive the notice timely, the accountant must so advise the Commission within 24 hours. If the accountant disagrees with the statements contained in the broker-dealer's notice, the accountant must so advise the Commission. If the relationship between the broker-dealer and the auditor is severed for any reason, the broker-dealer has reporting obligations to the Commission similar to what is required of registrants under the same circumstances.

Auditing Regulatory Environment

I'd now like to turn to my second topic regarding the SEC's regulatory environment with respect to auditors. Most public accountants practicing before the Commission today are required to be registered with the Public Company Accounting Oversight Board. In the interest of time, I will defer to the testimony of Michael Stevenson, Deputy General Counsel of the PCAOB, who will discuss the PCAOB's separate and complementary oversight responsibilities of auditors registered with the Board.

The federal securities laws confer a unique role to the auditing profession in the financial reporting process; a role different from any other member of the financial community. The profession's core responsibility is to provide enhanced credibility to the financial statements prepared by management. Confidence in the reliability of audited financial statements depends upon the public perception of the outside auditor as a competent and independent professional. It is for this reason that we impose strict standards of conduct on auditors who practice before the Commission. Failure to comply with professional standards and the Commission's rules and other guidance can result in severe sanctions.

In order to practice before the Commission as an auditor, an independent accountant must be in good standing and entitled to practice public accounting under the laws of the state where the accountant maintains a residence or principal office. Consequently, at a foundational level the Commission relies on the application and licensing processes of the various state boards of accountancy to screen accountants seeking to practice before the Commission. However, this reliance does not ensure a uniform level of skill and professional experience among individuals appearing before the Commission. It is in part for that reason the Commission imposes its own rigorous standards on practicing accountants with respect to independence, the content of audit certifications, and auditor reporting of key events to the Commission.

In addition to the professional standards imposed on accountants with respect to certifying financial statements to shareholders, the federal securities laws and the Commission's rules require accountants, under certain circumstances, to report information directly to the Commission. The Private Securities Litigation Reform Act of 1995 added Section 10A to the Exchange Act. Under that section, an auditor is required, among other things, to perform procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts. If, while conducting an audit of a registrant's financial statements, the auditor becomes aware of information indicating that an illegal act has occurred or may have occurred, the auditor is required to determine whether it is likely that such act occurred and, if so, its possible effect on the financial statements. The auditor is required to inform the registrant's management of any likely illegal act as soon as practicable. The auditor must also be assured that the board of directors is adequately informed of any detected illegal act, unless the illegal act is clearly inconsequential.

If the auditor determines that:

(1) the illegal act materially affects the financial statements,
(2) management has failed to take timely and appropriate remedial action, and
(3) the failure to take remedial action is reasonably expected to warrant a departure from a standard audit report or to warrant the auditor's resignation,

then, the auditor is required to report those determinations directly to the audit committee or board of directors. The board, in turn, has one business day to notify the Commission of such report. If the auditor does not receive a copy of the board's notice within that same one-day period, the auditor is required to furnish the Commission with a copy of the report not later than the following business day. Resignation from the engagement does not absolve the auditor from reporting to the Commission.

With respect to the performance of the auditor, the Commission possesses broad authority under the federal securities laws and its own rules to enforce compliance with professional standards and to protect the integrity of the Commission's processes as well as the federal securities laws.

Regarding the need to protect the integrity of the Commission's processes, the Commission first asserted its authority to regulate professional practitioners as early as 1935 by adopting the predecessor regulation to what is known today as "Rule 102(e)." Rule 102(e), which was later codified in 2002, permits, among other things, the censure, suspension or disbarment of accountants and any other persons appearing or practicing before the Commission.

Rule 102(e) is not, of course, the only way to address accountants who engage in misconduct. The Commission has authority that is available to address and deter misconduct that is not encompassed by Rule 102(e), including the full weight of the Commission's ability to seek, among other things, injunctions, cease and desist orders, disgorgement of fees or profits and penalties.

The Commission exercises its discretion in tailoring remedies under Rule 102(e) to fit the accountant's misconduct. Thus, for example, if during the course of an audit of a public company, the auditor intentionally fails to exercise professional skepticism with respect to what are later found to be material misrepresentations by management concerning the issuer's financial statements, the auditor can be suspended, temporarily or permanently, from practice before the Commission. This remedy represents the simplest and most direct means of protecting the integrity of the Commission's reporting processes – removing the offender from the process. In other circumstances, the Commission might censure the firm and require it to undertake measures designed to provide reasonable assurance that the firm will in the future comply with professional standards and Commission rules requiring independence from audit clients. Such undertakings might include ethics or other training for professional staff, an internal investigation of the circumstances surrounding the misconduct, or implementation of quality control procedures designed to prevent future violations. Such sanctions exemplify the remedial dimensions of Rule 102(e).

If the action involves a suspension from practice, the accountant must apply for reinstatement to appear and practice before the Commission. We view the reinstatement process as a critical component to the Rule 102(e) program, as it provides the Commission with the opportunity to review all the individual's remedial conduct in the event that he or she wishes to again practice or appear before the Commission.

But Commission action may not spell the end of the wayward accountant's troubles. As a matter of policy, a public accountant sanctioned under Rule 102(e) is routinely referred to the state board of accountancy that issued the offender's license for possible further disciplinary proceedings. Revocation of a state license to practice bars the accountant from all audit engagements, not just audits of public companies.

As I suggested earlier, it is not uncommon in Rule 102(e) proceedings involving improper professional conduct by accountants for the violations to be chargeable not only to individual auditors, but also to the accounting firm with which such individuals are associated. The Commission considers carefully whether an action against the firm is appropriate given the nature of the improper professional conduct of its staff.

Closing

In closing, I thank you for your time today and I would be happy to address any questions you may have.