

Keynote address by Donald T. Nicolaisen at the December 6, 2005  
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Before I begin, I would like to express my appreciation to The Institute for sponsorship of this important programme. While considerable progress has been made in recent years on both sides of the Atlantic in strengthening corporate governance, I believe we can continue to learn much from each others' experiences. Today's dialogue--which focuses on similarities and differences between US and UK practices--is a useful way to challenge each other and to identify best practices. Before our panel begins its discussion, I have been asked to speak briefly about developments in the US. Many of you know that last month I retired from my position as Chief Accountant of the US SEC. Since then, I have joined the board of a public company, participated in my first meeting at that board, and am beginning to shift my thinking from that of a regulator and auditor, to that of board member. Thus, this meeting has special significance to me! In the interest of stimulating our discussion, I intend to touch briefly on six topics:

- Vacuums
- Principles vs rules
- Convergence
- Measurement and reporting
- Complexity, and
- Materiality.

*First, vacuums.* We all know that they tend to be filled. Likewise actions cause reactions. And, major change follows a crisis. The SEC was created following the market crash of 1929, the resulting great depression and a severe lack of investor confidence. Likewise, the Sarbanes-Oxley Act responded to the excesses of the 1990s--cooked books, fraud, rule bending, audit failures and more. Investors lost billions and the plans and dreams of many were shattered. Changes were necessary to strengthen governance practices so as to permit investors to regain confidence in the integrity of our capital markets. Regulatory reforms introduced in response to a crisis are by their nature broad in scope and short on time for optimal implementation. Sarbanes-Oxley was no exception. The Act has impacted all participants in our capital markets, but especially those charged with governance and auditing responsibilities. The PCAOB was created and the audit profession is now a regulated business. Governance boards are required to assess their effectiveness. Controls are being tested. CEOs and CFOs are certifying results and much more. Regulatory reform is costly--witness Section 404 of the Sarbanes/Oxley Act which requires evaluation and public reporting on internal controls. The changes were sweeping, resource consuming, and the cost is being borne by all, not just those companies which

previously lacked controls or which had minimal corporate governance. As a result, I have concern that the intense and costly effort to comply with regulation could potentially stifle future innovation. And, if a check the box mentality should develop, it's not pleasant to consider what might happen, including the possibility of further regulation. We need to find the right balance in governance, and do in response to market demands, not government fiat.

*Principles vs rules.* For the record, I support principles. The SEC, which has quite a few rules of its own, is nonetheless essentially driven by a simple principle, that of protecting investors by maintaining market integrity. The most basic objective which underlies SEC practices is that all investors, whether large institutions or private individuals should have access to certain basic facts before making an investment. Armed with information, investors--not the government--can decide where to invest. Nonetheless, principles alone are short on guidance and some rules are necessary to answer basic questions. Questions such as; what information should be made available to shareholders...in what detail...when should disclosures be made...what form should financial statements and disclosures take...how are the rules enforced...by whom? Similarly, the exchanges have appropriately, post Sarbanes-Oxley, modified their rules of corporate governance to improve clarity...what does it mean to be an independent director...what information regarding insider activities must be disclosed...who qualifies as an audit committee expert...how often must a board assess its effectiveness?

*Convergence.* I've written and spoken often about converging accounting and auditing standards. While I support convergence, I recognize that cultural and historical differences may dictate that there be some differences and that is likely to be especially true of corporate governance practices. However, from an accounting perspective, I've never quite understood why an asset or a liability reported by a company in its host country should disappear when applying another country's GAAP. Accounting should track economics and differences in accounting for similar transactions should be consistent with those economics. Investors seek the highest returns in making investments across national borders. Their decisions are easier if accounting differences, of significance, are few. While one size may not fit all, there are clear advantages of cost, efficiency, and transparency in harmonizing accounting principles to the extent practical. Those advantages extend not just to investors, but also to those involved in corporate governance and auditing activities that involve cross-border transactions.

*Measurement and Reporting.* That which is measured and reported receives attention. For example, in the US, prior to enactment of Sarbanes-Oxley, companies were long been required to maintain an effective system of internal controls. Material weaknesses were to be fixed, but historically very few were identified. Along came Section 404 of the Sarbanes-Oxley Act with its requirement that controls be evaluated and tested for effectiveness by

management and in turn subjected to independent audit with material weaknesses disclosed to investors. In the initial reporting, after testing the assertion that controls are effective, more than 15% of public companies that did so indicated they had one or more material weakness. Many more companies corrected control weaknesses prior to the reporting deadline or the percentage with material weaknesses would have been even higher. That which is measured receives attention. As companies improve the effectiveness of their controls, there will be adjustments. Last year nearly 10% of public companies disclosed that their accounts had been restated. That measure will hopefully decline over time as a culture of strong controls over financial reporting becomes the norm. In all areas of life, improving quality requires measurement and testing. And, over time, better and more efficient ways of testing will undoubtedly evolve and a more acceptable cost-benefit relationship will develop. Regulators-- the SEC and the PCAOB--can play a role in ensuring that such balance is achieved.

*Complexity.* In the US, I believe our accounting standards and related SEC requirements have over the years grown overly complex. The volume of rules and interpretations necessary to accurately apply certain standards--derivatives, pensions, leasing, consolidation-- is daunting. Too many exceptions are permitted and principles have increasingly been overshadowed by detailed rules. The complexity in accounting contributes to a loss of transparency for investors, errors by preparers and auditors and restatements. And, the cost of maintaining adequate controls over financial reporting is adversely affected. New technologies--such as the use of XBRL or other data tagging tools--are beginning to gain momentum and offer some hope that similar transactions will be disclosed consistently between companies.

*Materiality.* I said earlier that what gets measured gets attention. Much has been written about how to assess materiality over the years, but in the current environment, preparers, auditors, investors, analysts and regulators all seem to be applying materiality at increasingly lower levels. The result has been more auditing, additional record keeping and higher costs. Some of that has been fully warranted but there are limitations to the degree of precision possible in timely reporting. I am concerned that some companies, after consultation with their auditors and working through their governance process, have not only disclosed out of period adjustments ( a practice that is commendable), but have actually restated prior results for what appear to be very small such amounts. This is perhaps a topic for another day, but I would encourage additional dialogue regarding the role that materiality expectations play in financial reporting.

Thank you for your interest. I look forward to the panel discussion.