PCAOB Inaugural Meeting of the Investor Advisory Group

Brandon Becker
Executive Vice President and Chief Legal Officer, TIAA-CREF

I am pleased to have the opportunity to serve on the PCAOB's (Board) inaugural Investor Advisory Group (Group). The establishment of this Group will enhance the ability of the Board to fulfill its mission, "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies."[1] As one of the world's largest private pension funds, TIAA-CREF always has pursued a strong commitment to transparency and accountability on behalf of our 3.7 million participants and maintains a robust corporate governance program. TIAA-CREF has supported and advocated for initiatives designed to provide shareholders meaningful rights, including on subjects such as executive compensation structure (we are proud to be one of the U.S. first companies to adopt voluntarily and implement an advisory vote on executive compensation policies) and the right to the annual ratification of a company's auditor. Institutional investors in public companies depend on management to communicate with us through financial reports and other public documents. The quality of reported information is effectively the life blood of financial markets. The purpose of financial statements should be to represent transparently the true condition of the reporting entity. Without these trusted statements investors are unable to effectively judge risk and allocate capital appropriately.[2] In the wake of the financial crisis, the Board can bring more confidence to these financial statements by examining auditor independence and expertise, more effective risk assessment and meaningful financial statements, as well as our preparedness for an international accounting regime.

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[1] 15 USC 7211, Title I – Public Accounting and Oversight Board, Section 101, Establishment; Administrative Provisions

[2] Responsible Investing & Corporate Governance, Lessons Learned for Shareholders from the Crises of the Last Decade, TIAA-CREF, January 2010

The constant news reports and revelations on the demise of firms once considered titans on Wall Street, leads me to the conclusion that there needs to be a comprehensive examination of the recent financial crisis to identify problems and rectify them. The results of a thorough evaluation would be of value to investors and help to focus the Board's work ahead[3]. For example, auditors need greater ability to execute the risk assessment of a company based on company specific factors as opposed to a one size fits all standard. Did auditors overlook indications of fraud or excessive risk? Would the establishment of a Fraud Center aid in transparency? There is a need to evaluate auditor independence and what the Board can do moving forward to ensure increased independence within the community. The Board should consider revisiting independence rules to take into account developments in the market place. Could increased transparency of audit firms lead to enhanced assessment of risk, better quality of audits and more accurate financial statements? Were communications between the audit committees and the auditing firms sufficient? The Board's March release for comment of amendments to the interim standards related to Communications with Audit Committees will facilitate further discussion on this subject. It is vital for our ability as investors to be able to make judgments and forecasts regarding future cash flows, that disclosures provide a complete and accurate picture of a company.

Last December, the Commission's Final Rule on Proxy Disclosure Enhancement acknowledged the tie between certain executive compensation structures and the promotion of

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[3] In advocating for a Capital Markets Safety Board during a hearing before the House of Representatives, Professor Andrew Lo discussed the value of investigations and examinations after a crisis, "each failure is viewed as a valuable lesson, to be studied and reviewed until all the wisdom has been gleaned from it." Written Testimony of Andrew W. Lo, Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008, Prepared for the U.S. House of Representatives Committee on Oversight and Government Reform November 13, 2008 Hearing on Hedge Funds.

behavior contradictory to prudent risk prevention.[4] I believe that complex executive compensation structures are a symptom of the lack of confidence in the accuracy of financial statements, specifically, how we are measuring the quality of earnings. One of most controversial provisions of FASB 157 was the establishment of a fair value hierarchy, which measures the inputs used in the valuation of assets and liabilities within three broad categories. Within this framework, the highest priority is afforded to quoted market prices in active markets (Level 1) and the lowest priority to unobservable inputs (Level 3). I believe the Board should consider how it can implement a similar hierarchy for firms to measure the quality of earnings of securities dealers and financial services firms, particularly those engaged in widespread use of derivatives or record unrealized gains and losses due to trading and capital markets activities.

Under an appropriately designed quality of earnings hierarchy users of financial statements would be able to determine to what extent earnings derived via capital markets activities represent the specific conclusion of a financial instrument's earnings cycle. Such a framework would be relevant for issuers whose primary activities involve capital markets transactions and generally account for their activities using fair value accounting and related valuation techniques and methodologies, and would bring an enhanced transparency and accountability to financial statements.

Currently, users of financial statements are unable to easily gauge to what extent capital markets activities are based on realized gains and losses (representing the completion of a specific instrument's earnings cycle) as opposed to unrealized gains and losses which employ estimates or complex modeling. This also goes to the heart of properly assessing risk. As seen over the last few years, the abundance and diverse complexity of products which capital markets

[4] http://www.sec.gov/news/press/2009/2009-268.htm

companies produce, may lead to certain products quickly becoming liquidity constrained due to changes in market sentiment and confidence in underlying pricing models and valuation techniques. Unrealized gains and losses are often recognized based on complex and estimation derived valuation models before the earnings cycle is complete as a reporting entity still retains the risk of an underlying asset or liability whose value was estimated in a current period and such valuation is appropriately recorded as a component of the company's fundamental financial position and operations. However, as estimates are adjusted and valuation techniques refined, the securities and derivative positions that produce such unrealized gains and losses may cause earnings volatility, which may impact a company's management and decision making activities in a number of ways which may include the following:

Compensation - Historically, compensation has been dispensed as a percentage of profits or trading derived earnings for capital markets participating entities. Nevertheless, without any specific criteria for "quality of earnings," compensation may be awarded to individuals who are dealing in products where the earnings cycle has not been finalized. For instance, trading gains may be earned by the disposal of a security interest at a value greater than the original cost basis and thus a trading gain is recognized. Similarly, trading gains also may be derived from the increased fair value of derivative contract sold where the company has a future obligation to perform, such as a written swap or option contract. In either case, operating or trading revenue was created. The inherent "quality of earnings" in either case may be different because the writing of the derivative contract implies a further obligation owed by a derivative writer and thus the earnings cycle is not yet complete. From a compensation perspective, boards and their compensation committees should have the ability to look at individual trading arrangements which derive the trading revenue, and compensate individuals based on a measurable quality of earnings standard for such revenues which distinguishes those trading revenues which also may create a future obligation for the company.

Risk Measurement/Value at Risk - As risk management techniques have evolved, many issuers that actively participate within (and those that monitor and regulate) the capital markets rightfully have placed an increased emphasis on risk/stress testing and value at risk techniques to determine the overall risk characteristics of an entity's portfolio. Nevertheless, it is quite challenging to evaluate liquidity and or other correlated market risks within the context of a quantitative risk management model based on assumptions such as a normal distribution of market results and that current fair value is appropriately representative of an asset's actual value due to the inherent information limits of the capital markets. Future obligations related to an instrument may not be contemplated in a current earnings model and must rely on more sophisticated risk management techniques or a definitive model for the measurement of the quality of earnings. The PCAOB should consider recommending guidance on the inclusion of more forward-looking risk measurement models within the purview of an audit firm's attestation process with a focus on the assessment of whether the assumptions and inputs used in such models are of an appropriate nature.

Capital Adequacy of Financial Institutions - Capital adequacy considerations employed by capital markets regulators assume that current GAAP equity is the most relevant benchmark in measuring an entity's capital where such capital is derived using valuation techniques from throughout the "quality of earnings" spectrum. Nevertheless, without a consistent framework for the measurement of such quality of earnings, it is increasingly difficult to determine the relative soundness of entity's earnings and related capital position without a more objective ability to measure an entity's quality of earnings.

While we understand there would be many implementation challenges and judgment employed when measuring quality of earnings for individual capital markets firms, we believe the transparency afforded by developing such a framework to implement these measurements will benefit internal and external users of financial statements by creating more measurable ways to allow companies to demonstrate how their capital markets earnings operate within the context of the earnings cycle. In addition to investors having more relevant information, such a concept will allow board members and other governance bodies to more readily consider and reward behaviors in line with an institution's fundamental risk tolerances as the nature and sophistication of financial products has prolonged the duration of the earnings cycle. Nonetheless, implementation would have to be handled carefully and provide appropriate industry context as similar earnings cycle concerns may exist for companies that offer guarantees, warranties or other "post purchase" obligations, even outside of the capital markets.

The financial crisis also has led to the discussion of the level of expertise within the accounting and audit community. Were auditors sufficiently knowledgeable about the issuer and its environment and did they have the specialized skills necessary to conduct audits effectively? This is not a new area of focus. In October of 2008, the Treasury Department's Advisory Committee on the Auditing Profession referenced this very issue and stated "the increasing complexity of business transactions and financial reporting as among the most significant challenges facing the profession as well as financial statement issuers and investors." [5] It is apparent that in the lead up and during the financial crisis, the use of innovative, complicated financial products were not fully appreciated. An in depth understanding of these instruments and the environment of the issuer were required for accountants and auditors to be able to effectively assess risk. As the recently published PCAOB Strategic Plan notes, the financial crisis has resulted in a "need for auditors to have comprehensive understanding of their audit clients' businesses and transactions, as well as economic conditions in order to be able to access the potential impact of liquidity and other risks associated with the crisis."[6] Though more than half of the Board staff is devoted to the inspection process, it is critically important for investors to trust that those inspectors retain the training and expertise necessary to provide effective oversight of audit firms. Further, does the Board need to revisit the inspection process and the review of expertise within firms? The Board should discuss whether it has a role in building and measuring specialized skills within the accounting and audit community and if so, how it should fulfill that role.

As we continue to move closer to global financial accounting reporting standards, the Board appropriately has begun to consider the possible impact on these standards. As the Commission's Work Plan staff examines our readiness and ability to fully embrace International Financial Reporting Standards (IFRS), there will be much work ahead for the audit community here in the United States to develop its expertise. A more principles-based accounting system, will result in more discretion, making the need for the Board to ensure the independence of auditing firms for investors all the more critical. The Board will need to adjust to meet the

[5] U.S. Department of Treasury, Advisory Committee on the Auditing Profession, Final Report, October 6, 2008
[6] Public Company Accounting Oversight Board, Strategic Plan: 2009 – 2013, November 30, 2009

demands of a transition and the convergence of audit standards with the IASB. The investor community must be able to maintain a high level of confidence in the Board's inspections and audit firms under an international regime. This is especially true in the area of assessing risk. There is no doubt U.S. companies will confront many changes in their systems and controls making the need for robust risk assessment in audits all the more crucial for the investor community. The Board should examine the inspection process to adapt to these new circumstances. What kind of additional guidance will there be for auditors in a more principles-based IFRS system? Will the level of expertise be there to identify risk and fraud effectively? How does the Board ensure that transparency isn't hindered in an international regime? While the Board has created both a training program on IFRS Fundamentals and established a Working Group, a clearly articulated plan for managing these issues would be of value for investors. I also would note that the momentum toward global standards also provides the Board with an opportunity for addressing audits of multi-national issuers and their inspections process, increased access for inspections of non-U.S. accounting firms and cooperation with its current overseas counterparts.

Investors, owners of the capital of public companies, deserve to have appropriate information to evaluate the effectiveness with which their capital is being managed. Managers of these public companies are accountable to investors, and investors have a unique ability to identify problems within the financial system. As this Group commences its work, I hope we will use the lessons of the recent financial crisis and the impending changes in the accounting community, as an opportunity to identify more effective ways to bring confidence to an issuer's financial statements for investors.