

Statement

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to Financial Reporting – Standard Setting Subcommittee

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Chairman Sidwell, Subcommittee Members Beresford, Evans, Quigley and Observers Herz and Olson: I am Paul Sharman, President and CEO of the Institute of Management Accountants. Thank you for the invitation to share our thoughts on the important topic of how standard setting can help improve the quality of financial information.

With me this morning is Allan Cohen, Vice President at Time Warner, Inc. and a member of our Financial Reporting Committee whose October 3<sup>rd</sup> letter I know you all have. Also with us is Jeff Thomson, IMA VP of Research.

Of the 160 members of IFAC, IMA ranks among the top 10 in number of members. IMA represents all management accountants and finance function staff who work inside organizations. As you may know, IMA is an educational not-for-profit organization, which sponsors the Certified Management Accountant or CMA certification, the most appropriate certification for professional accountants who work inside organizations.

IMA has been involved with standard setting since 1973 when the process became independent of the founding organization. IMA was a founding member of XBRL US and continues to be a member. IMA is an active member

of the COSO board and is actively involved with research into SOX 404 implementation. IMA has and continues to be deeply interested in financial accounting. Indeed, our Financial Reporting Committee is the most broadly representative group of “accountancy” in the United States. It includes preparers, the external audit community and educators.

It is very clear that the public perception of what represents an “accountant” in the U.S. revolves around public accounting and auditing. Yet the reality is that of the 5 million people involved, more than 90 percent of finance function workers in this country work inside organizations, of whatever nature, where they do business accounting work. It is they who are responsible for ensuring that effective, efficient, and “in control” processes, systems, and procedures are in place. It is they who actually are responsible for ensuring that management processes yield successful internal controls and the associated relevant, reliable, understandable and useful financial reporting. When an auditor obtains a clean outcome, it is because the financial professionals inside the organization have done their job right.

This is better recognized in other parts of the world than it is in the U.S. In Britain the Financial Reporting Council states about their approach to regulation, and I

quote: “We do not regard regulation as an end in itself. We believe in wealth creation. We believe that our role in promoting confidence in corporate reporting and governance, as a part of a regulatory framework that promotes enterprise, investment and employment, can make the creation of wealth more likely.”

Our big concern is that the US emphasis in its standards and regulations is on inspection and compliance, rather than facilitating practical implementation of principles using a “build quality in” mentality. The United States absolutely has complexity and lack of practical implementation in its finance and accounting standards and regulations. It seems that regulators and standard setters have no interest in checking that such standards and regulations can actually be implemented, witness the inability of the SEC to adequately assess the cost-benefit of its SOX 404 management assessment guidance.

In our opinion, the quality of financial information as measured by the number of restatements is impacted by two primary drivers. The first driver is the accounting standards themselves that prescribe how the accounting should be done, and the second driver is the underlying system of controls that ensures that the accounting is done right. We will first focus on the accounting standards in the context of the preliminary hypotheses,

and then turn to the need for internal control standards as part of “Other Areas” for this subcommittee’s consideration.

IMA fully supports the subcommittee’s efforts to determine the impact that complexity in accounting standards and standard-setting processes have on the quality of financial information, and ways to deal with it. IMA’s Financial Reporting Committee (FRC) has filed a comment letter dated October 3 that provides specific suggestions on the first driver, including the equivalent of an “accounting court” where companies and auditors can seek to resolve disputes they have with the SEC over interpretations of complex accounting rules.

With respect to the hypothesis on Governance (Hypothesis 1), we have previously stated our concerns regarding the audit and public accounting focus of our regulatory bodies and therefore applaud any serious efforts to reconstitute these bodies to be more representative of the entire business supply chain.

With respect to the hypotheses on Agenda and Standard Setting Processes (Hypotheses 2 – 12), we generally applaud efforts to expand supply chain representation in regulatory agenda setting and prioritization while being cognizant of time to market needs. We should note that

with respect to hypothesis 8 (field testing and visits), our FRC supports field testing and visits to reduce the amount of subsequent interpretations of pronouncements. Developing cost-benefit analysis as part of the field tests is equally important to ensure overall market benefit, something frankly that has not been adequately done for SOX 404. We also support fatal flaws reviews (Hypothesis 9), but suggest those experienced in the Quality Assurance arena (e.g., six sigma) be specifically targeted for input. Our greatest potential concern is with hypothesis 10 – formal post-adoption effectiveness reviews of new standards within 2-3 years of implementation. It occurs to us that this long of a time lag would leave a lot of room for the opportunity or need for multiple interpretations of standards, which increases complexity.

With respect to Accounting Interpretations (Hypotheses 13 – 19), we strongly agree with the need to control and reduce the number of sources of authoritative guidance and interpretations. Flattening the GAAP hierarchy to 2 levels makes sense so long as shorter and simpler accounting standards are the outcome (hypothesis 13). Having a single private sector standard setter for GAAP makes perfect sense (hypothesis 14); one that we argue also makes sense for *internal controls* standards (see Other Areas for Consideration below)

Finally, with respect to Design of Standards (Hypotheses 20 – 21), we strongly support the premise of moving from a “gotcha” mentality in the U.S. to one that respects and allows for professional judgment in interpreting complex accounting standards. IMA’s FRC has provided specific thoughts in this area in its 10/3/07 Comment Letter as alluded to earlier (e.g., “Accounting Court” safe harbor concept). Writing standards clearly and concisely (part of hypothesis 21) is a clear enabler to reducing complexity – the question is, does the current composition of skill sets in the regulatory bodies allow them to “speak the language of the preparer”??

The notion of professional judgment of issuer staff is critical to implementation of principle based standards. Presently, there is a huge lack of adequately educated and certified finance function “professionals” who work inside corporations. This needs to be addressed by regulator and institutional encouragement of the deployment of professional certification for those workers, but premised on something other than one based on a compliance and audit foundation.

We now wish to turn our attention to “Other Areas” for this subcommittee to consider in the broader context of

the objective at hand – improving the quality of financial information.

The second driver we mentioned at the outset impacting the quality of financial information and the number of restatements is the role of standard setting in the area of internal accounting control. We are concerned that this important driver has not received the attention it deserves.

In a high proportion of financial restatements, management and their external auditors had concluded in the original filings that the system of internal controls was “effective”. With only a few exceptions, a restatement is indicative of internal control opinion error. Key questions that need to be asked are:

1. Why were these control effectiveness opinions wrong in the first place?
2. Are existing internal control assessment standards and guidance, or lack thereof, contributing to the high incidence of incorrect control effectiveness opinions and restatements?
3. What can this subcommittee do to address these problems?

In addressing these three questions, we offer some preliminary observations for your consideration.

1. There is currently a lack of focus, both by issuers and their external auditors, on the need to systematically record, track and analyze errors detected in the financial statements and internal controls assessment opinions.
2. The current internal control assessment standard-setting system is highly fragmented in the U.S. (e.g., PCAOB, SEC, COSO, AICPA, IIA, ACFE, ISACA and others). “Generally Accepted Control Principles” (GACP) do not exist in a comprehensive, integrated and easy to apply manner.
3. This situation is further exacerbated by the litigious environment in the U.S. that some would argue rationally precludes a systematic analysis of the root causes of internal control failure and financial restatements.

To address these observations and reduce the internal control effectiveness opinion error rate, we recommend that this subcommittee consider the following:

1. Consistent with the FASB model of accounting standards setting, we suggest that an independent and adequately funded private sector organization be charged with the creation of internal control assessment standards (“GACP”) for both management and their external auditors.
2. Endorse the conclusion by Subcommittee III (Audit Process and Compliance) on page 6 of the November 2, 2007 minutes that “the current disclosure surrounding a restatement is not adequate” and expand to specifically include why the issuer’s risk and control assessment processes failed.
3. Have the PCAOB require that all audit firms associated with wrong control effectiveness opinions linked to restatements regularly and systematically study and document the root causes of such incorrect opinions. The PCAOB inspectors should assess the adequacy of this process as part of a firm’s quality control during its periodic inspections. We further suggest that the PCAOB synthesize key learnings of its systematic study of control and disclosure failures while retaining the confidentiality of issuers.
4. Put appropriate safe harbors in place to protect issuers and their external auditors to encourage

candid and thorough analysis of the root cause of disclosure failures as discussed above.

In closing, we endorse and fully support the critical work of this subcommittee and the other subcommittees comprising the SEC Advisory Committee on Improvements to Financial Reporting. In particular, we support this subcommittee's efforts to determine the impact that complexity in accounting standards and standard-setting processes have on the quality of financial information. We do believe, however, that investors will be optimally served by also studying another important driver of financial restatements – the internal controls system designed to produce materially fault free financial disclosures. The need for “Generally Accepted Controls Principles” is indeed the missing link.

Thank you for your time and attention.