

Statement

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Financial Reporting – Audit Process and Compliance
Subcommittee

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Chairman Cook, Subcommittee Members Nusbaum, Jonas and Griggs and Observers Smith and Goelzer: I am Paul Sharman, President and CEO of the Institute of Management Accountants. Thank you for the invitation to share my high level thoughts and those of my two preparer colleagues on the important topic of audit process and compliance as it relates to improving the quality of financial information.

Generally, we understand the scope of this subcommittee to be financial restatements, use of professional judgment (and the potential need for a framework or additional guidance), and, preparer interactions with audit firms and regulators (e.g., SEC Office of Chief Accountant, PCAOB). I will touch very briefly on the first two items, and my two colleagues (Allan Cohen from Time Warner and Janie Copeland from Caterpillar) will touch on these items with particular emphasis on preparer interactions including roadblocks, issues and ideas for improvement.

Financial Restatements: First I will touch briefly on the topic of financial restatements and briefly summarize some of our input to the CIFR standards sub-committee on December 6. 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.

Based on our assessment, 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. 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 Assessment Standards” (GACAS) do not exist in a comprehensive, integrated and easy to apply manner.
2. Partially as a result of this fragmentation, there is no single private-sector organization focused and accountable for tracking, analyzing and reducing errors detected in the financial statements and internal control assessment opinions.

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. Implement actions to support the conclusion by this subcommittee (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.
2. Consider focusing the accountability for error rate identification and reduction in a single, properly chartered and funded organization (e.g., a complementary preparer-led version of the Center for Audit Quality that would address quality issues across the entire financial reporting supply chain).
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.

We are attaching for each member of this subcommittee a copy of a discussion paper we have prepared that summarizes in greater detail our thoughts and research relating to root causes of material financial restatements (Attachment 1).

Professional Judgment: We are also attaching for each member of this subcommittee a copy of a position statement on the topic of professional judgment (Attachment 2), which resulted from our meeting with the CIFR standards setting sub-committee on December 6. In short, akin to our views on financial restatements, we respectfully suggest that all CIFR subcommittees consider a broader view of the financial reporting supply chain in order to improve its overall quality, integrity and transparency for investors.

In practice, there is a heavy and disproportional reliance on external auditors to apply professional judgment to registrant's financial reports. While external auditors clearly play a valuable role in the financial reporting supply chain, they are ultimately responsible for checking the work (at the end of the supply chain) of the internal finance staff that is ultimately responsible for building quality in. It is these internal finance function staff (financial managers, internal auditors, etc., comprising more than 90% of all finance function and accounting personnel) who need to have the sound technical foundation, certification and on-going

professional development to render appropriate professional judgment and implementation of quality principles to improve audit quality.

I have with me today two colleagues, Allan Cohen from Time Warner and Janie Copeland from Caterpillar, for their comments from a preparer perspective. Allan is also a member of IMA's Financial Reporting Committee (FRC), a technical committee which includes preparers from some of the largest companies in the world, valuation experts, academics and others. You may recall that the FRC filed a comment letter on January 4 which elaborated on a proposal to create an "accounting council" to address the diminished use of professional judgment caused, in part, by fears of second-guessing on the part of regulators and others. The FRC believes that creation of this organization is complementary to a "safe harbor" provision which the FRC discussed in its October 3, 2007 letter.

Thank you for your time and attention.

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Attachment 1 – IMA Discussion Paper on Root Causes of Financial Restatements

Attachment 2 – IMA Position Statement on Professional Judgment