

**Institute of Management Accountants**

**Comments on the Sufficiency of Scope on the  
Charter of the Advisory Committee on the Auditing Profession**

**United States Department of Treasury**

**February 4, 2008**

**Introduction**

The passage of the Sarbanes-Oxley Act of 2002 has redirected the financial community's attention to the quality of financial reports and disclosures issued by the public companies operating in the United States. IMA has and continues to be deeply interested in all such initiatives—regulatory and voluntary—that aim to enhance the relevance and reliability of financial statements provided to the capital markets for investment and credit decisions. In this brief note, we provide our overall reaction to the three issues as elaborated in the working discussion outline for consideration by the Committee.

Consistent with the Committee's charge, we agree that a "strong and a vibrant public company auditing profession" is one of the cornerstones of producing relevant and reliable financial reporting. However, examining only the sustainability of the auditing profession to the exclusion of larger financial statement preparer community's roles and responsibilities in this endeavor will only lead the Committee to half answers. To achieve the ultimate objective of making available to U.S. capital markets relevant and reliable financial statements, the Committee should not miss this opportunity to also actively consider in its deliberations what role the preparer community has, what responsibilities it must shoulder, and what accountabilities it must jointly share with the auditing industry.

The inherent assumption in the deliberations of the Committee appears to be that the capital markets are the most important piece of the economic engine of the US. We agree that the capital markets and investors interests are a vital piece of the market economy, but actually the most important piece is the companies that receive the funding. This is because they apply the funds to the building and running of strong corporations which are the core component of the economic engine of the US. It is the corporations which produce jobs and wealth, it is they that provide the return on investment, employ people, pay taxes, provide the goods and services and of course, provide employment opportunities and revenue for auditors. Effective and efficient corporation business performance should not be taken for granted in the deliberations of the advisory committee.

Unfortunately, in the United States, the public perception of what represents an “accountant” revolves too much around the practice of public accounting. Yet, the reality is that more than 90 percent of finance function professionals work within the issuer community that is “primarily” responsible to produce right, relevant, and reliable financial statements. Management accountants who are actually responsible and own the processes that yield effective internal controls to eventually produce right, relevant, and reliable financial statements are marginalized and overshadowed by excessive focus on public accountants and external auditors. When an auditor obtains a clean outcome, it is because the professional management accountants working inside these organizations have done their job right by “building quality in” the end-to-end financial reporting supply chain.

Undoubtedly, the task that this Committee has at hand—assessing the sustainability of the auditing profession—is considerable, if not monumental. And, any suggestions to broaden its scope would certainly be viewed with skepticism. However, when a Committee like this is formed, we are concerned that excessive focus on fine-tuning auditor’s “inspection” and “detection” role to produce right, relevant, and reliable financial statements will result in a missed opportunity to evaluate, facilitate, and re-direct management’s attention on “prevention” of errors and irregularities in their financial statements.

It is true that recent financial scandals, like Enron and WorldCom, have questioned the credibility of preparers and auditors alike. Corporate financial reporting has come to be viewed as a game where management works to “game” the numbers while avoiding detection by the auditor who, with all his might, is focused on inspecting and detecting aggressive accounting. However, in the aftermath of the Sarbanes-Oxley Act of 2002 and increased emphasis on its internal control over the financial reporting regime, significantly large numbers of managers and board members are taking corporate financial reporting much more seriously than before. For example, a 2005 survey of 300 business executives, conducted by Wirthlin Worldwide for Grant Thornton, reported that 70 percent of the public companies perceive inaccurate financial statements a critical or a very serious threat to their businesses. So, the tide is turning, and this Committee should also consider the preparer’s role and responsibility in producing right, relevant, and reliable financial statements. If the Committee were to consider quality financial reporting as a “partnership” between a preparer and its auditor, the nature and extent of its recommendation would be much different than if it considered a public auditor as the only “control” mechanism.

In addition to our above overall reaction, we make following specific observations on the sufficiency of scope on three broader areas mentioned in Paragraph B of the Committee’s charter.

**Issue 1: Human Capital and Its Impact on Audit Quality**

Any discussion of the myriad of issues related to accounting human capital is incomplete unless preparer and auditor requirements are concurrently examined and debated. It is important to remember that the ultimate goal is to enhance the quality of financial reporting. From that vantage point, audit quality is a means to that end and not an end in itself. Auditing adds value only if it contributes to the quality of the financial statements that are relied upon by the capital market for making sound investment and credit decisions. Thus, we urge the Committee to consider human capital issues within this broader context.

Undoubtedly, since the passage of the Securities Act of 1933, that first mandated independent audit of an issuer's financial statements, business transactions have become increasingly complex and related accounting rules more granular, arcane, and difficult to apply. Over the years, as the accounting body of knowledge and auditing standards/guidance has grown exponentially, the accounting community has become convinced that significant improvements are needed in the skill-set of the individuals entering the field of accounting and auditing. Yet, the accounting curriculum in our business schools and the preparatory course work for various professional certification exams has remained relatively static. This has resulted in significant gaps in the core skills that are needed of an accountant to produce right, relevant, and reliable financial statements and then opine on their fairness such that underlying economics of the business transactions are captured and communicated to the capital markets for sound investment and credit decisions. For example, even five years after the passage of the Sarbanes-Oxley Act of 2002, assessing risk and internal controls over financial reporting is given at best minimal coverage in current educational and certification programs.

A key question to consider is how many of the accounting graduates and certified professionals who work directly with producing or auditing financial statements understand the notion of risk-based assessments to allocate scarce organizational resources in a balanced manner to the "preventative" and "detective" aspects of producing right, relevant, and reliable financial statements? Although the American Institute of Certified Public Accountants (AICPA) overwhelmingly approved a 150-hour requirement for those wishing to enter the auditing profession, ironically 20 years later this requirement is yet to be fully implemented in all U.S. jurisdictions granting a CPA license. Further, even today, some of the auditing organizations do not support systematic and methodical university-level education in accounting to truly train future auditors in an increased body of accounting and auditing knowledge. Instead, they suggest that "experiential learning [and] required (perhaps accredited) firm training" could suffice (see James Turley testimony of December 3, 2007 before this Committee.)

Additionally, what further compounds the problem is that U.S. educational institutions focus a large part of their accounting curriculum to help students pass the “auditor-centric” certified public accountant exam without sufficient emphasis on training these rising accounting professionals in the skills that are needed to produce materially fault free financial statements. What drives this “tunnel-vision” is the fact that due to heavy turnover, the public accounting profession hires a significantly larger proportion of graduating accounting seniors than non-auditing firms. In the short-run, these students support the “high contribution margin” model of the auditing industry. However, after a few years when the senior accountants and managers move to preparer-organizations, they find themselves ill-equipped to properly execute the process of producing materially faulty free financial statements. This is because they are frankly not technically prepared or competent in identifying and assessing the ‘real’ risks facing their organizations that materially impact the quality of financial reporting.

The hurdle of inappropriately heavy emphasis that the accounting community places on the “assurance track” in accounting education is significant. Until we alter the “mental model” of accounting education and training from only “assurance” to “management ownership” of right, relevant and reliable financial statements, we will not see a meaningful decrease in the number of errors in publicly issued financial statements. Additionally, inside the preparer community, there must be appropriate training, professional development, and certification to ensure that technical competence is applied across the entire end-to-end financial reporting supply chain.

**Issue 2: The Auditing Firm and the Audit: Organization, Financial Resources, and Communication**

The Securities Act of 1933, in which the United States Congress mandated independently audited financial statements from all public companies, bestowed upon the auditors a professional and a social obligation to install trust, faith, and confidence in the U.S. capital markets. From the “eyes” of a common investor, this is the value add of the audit and assurance activity. Consequently, auditing came to be viewed as a “profession” which meant that “auditors are not for sale” (see Damon Silvers testimony of December 3, 2007 before this Committee). As recent scandals would suggest, unfortunately, in the eyes of the same common investor, auditing has now regressed from being a “profession” to an “industry.” The reality, unfortunately, is that “industries” do focus on their profitability, legal liability protection, cost-efficiencies, etc. to protect and grow value for their stockholders (i.e., partners and employees) relative to emphasis on advancing the profession for the good of economic development and societal gain.

Our view of the various issues raised in this section is that this Committee should not become a vehicle to make a case for the “auditing industry” to obtain “safe harbors” and “legal protections” primarily for profit motives. We believe this Committee should support protections for the auditing industry only so long as they are adequately balanced with clearly defined and enforced accountabilities in areas such as fraud detection, opinion error-rate reduction, etc., that would “push” the auditing “industry” back to its public interest role of being a “profession” for societal benefit.

To fulfill its public interest role and reclaim the status of being a “profession,” the auditing industry should rebalance its excessive current focus on issuer management as its sole “customer” and redirect more attention to the audit committee and capital providers as its key customers. This rebalancing would highlight for the industry that it should focus on enhancing the quality of audit opinions. This rebalancing would mean that auditors will need to work harder to improve their internal processes and quality control mechanisms with a goal of producing “fault-free” audit opinions that would measurably reduce the incidence of financial restatements. The auditor will also need to focus on developing a “transparent” infrastructure within its organization that would systematically and methodically, while preserving client confidentiality, analyze the root causes of “repair entries” and “errors” detected in the financial statements asserted to be fair and reliable by the issuer managements at the beginning of the audit. The Public Company Accounting Oversight Board (PCAOB) should inspect the robustness of this process to ensure that audit firm methodologies and processes are appropriately adjusted in a cost-effective way to achieve tolerable error rates in publicly issued financial statements.

More discussion of these ideas can be found in the February 2008 just released IMA discussion paper titled “Accounting Control Assessments: The Missing Piece in the Restatement Puzzle.”

On balance, we also realize that it would be absolutely unreasonable to expect auditors to be held accountable for their public interest obligations without considering their current business model and resultant financial implications. To that end, we support that the Committee should do everything possible to remove any barriers in licensing, mobility, training, etc., that unnecessarily add operating costs to the auditing industry.

**Issue 3: Auditing Profession Structure: Competition, Concentration, Independence, and Other Professional Standards**

The current structure of the auditing industry, including fragmented certification and training requirements across various U.S. jurisdictions, certainly does not encourage efficiency nor consistent application of technical standards and guidance. Currently, there are three major standard setting bodies -- International Auditing and Assurance Standards Board (IAASB), Public Company Accounting Oversight Board (PCAOB), and American Institute of Certified Public Accountants (AICPA) -- who set audit standards. We believe that over the long-term this model is not sustainable and adds an additional layer of unnecessary complexity and inefficiency for the “auditing industry.” We encourage this Committee to consider developing, much like co-Chairman Nicolaisen’s international financial reporting roadmap, a road-map that would start the debate of guiding the practice of auditing through a globally accepted set of high-quality auditing and independence standards.

**Summary**

Overall, we applaud Secretary Paulson for creating this Committee to debate critical issues impacting the auditing profession. It is important that the Committee uses this opportunity to take a balanced and critical look at the end-to-end financial reporting supply chain including preparers and auditors in producing right, relevant, and reliable financial statements for making sound investment and credit decisions. We are optimistic that the recommendations generated with this view in mind will not only ensure the sustainability of a strong and vibrant public company auditing profession in the United States, but will also enhance investor trust, faith, and confidence in our capital markets to enhance U.S. global competitiveness. Corporations and their management accountants help to facilitate business performance and economic development critical to a robust economy and position in the global capital markets.

We will keenly follow the Committee’s deliberations and findings. Should the Committee ask we will also be happy to provide our input on these deliberations and recommendations.

Thank you for asking IMA to provide comments on the sufficiency of scope of the Committee’s charter.