Statement

Paul A. Sharman, ACMA

President and CEO

Institute of Management Accountants (IMA)

Before the SEC Advisory Committee on Improvements to Financial Reporting – Standard Setting Subcommittee

December 6, 2007
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 my thoughts on the important topic of how standard setting can help improve the quality of financial information.

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.

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.

Today, we want to share some thoughts on the second driver, specifically, the role of standard setting in the area of internal accounting control and its impact on the quality of financial information. 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.