

August 29, 2007

Mr. Robert Pozen  
Chairman of the SEC Advisory Committee on  
Improvements to Financial Reporting  
Chairman of MFS Investment Management  
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**Three Recommendations to Reduce Restatements**

Dear Mr. Pozen,

I have read with great interest about the SEC Advisory Committee on Improvements to Financial Reporting which you are leading. Congratulations on your appointment to lead this important committee.

I am writing to share with you three recommendations that I sincerely believe can dramatically reduce the number of restatements of public company financial results. My recommendations are summarized in the attachment to this letter. The suggestions are relatively simple and can be implemented at minimal cost. I think the benefits will be significant. I hope you find these recommendations useful.

Sincerely,



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## Three Recommendations to Reduce Restatements

For the sake of discussion, accounting errors which give rise to restatements can be divided into three categories:

<u>Category</u>	<u>Description</u>
A	Transactions processed accurately and consistent with the Company's intent -- but the Company's methodology is not in accordance with generally accepted accounting principles ("GAAP").
B	The Company had the correct GAAP but it made an honest mistake.
C	The Company had the correct GAAP but someone in management overrode the correct GAAP to achieve an incorrect result.

The recommendations described herein will collectively have a positive impact on all three categories of restatements described above.

### **Background**

In its current state, audits are a bit like Easter egg hunts – only instead of Easter eggs, the auditors are looking for accounting errors. The audit firm's hunt for errors is complicated by the fact that the hunting is being done by a lot of young people just out of college who are far from becoming experts in auditing and accounting. Many of these auditors have not passed the CPA exam until their second or third year with a public accounting firm. The truly knowledgeable people about auditing and accounting (the partners) account for a very small fraction of the total time on an audit (usually only 5% to 8% of the total hours). The large audit firm business model limits the partner's involvement to a high level – generally removed from where the errors are hidden.

In addition to the hunt for errors described above, the audit firm requires its client to sign a representation letter addressed to the audit firm. The scope and nature of the representation letter is prescribed by existing auditing standards. Among many things, the company is required to represent to the audit firm that it has prepared the financial statements in accordance with generally accepted accounting principles. In many cases, however, this is a hollow representation. The realities are:

- The less sophisticated companies do not have the requisite knowledge in-house about GAAP to be able to genuinely represent that their financial statements are prepared in accordance with GAAP. These companies are instead relying heavily on the external auditor to be sure they are following GAAP.
- The larger more sophisticated companies may have varying levels of in-house knowledge about GAAP. However, these companies also tend to have greater complexity and geographic dispersion which often strain the company's limited GAAP technical resources.
- There is no requirement that the Chief Accounting Officer who signs the company's 10-K be a CPA. While many public company Chief Accounting Officers may have passed the CPA exam and at one time held an active CPA

license, most have let their CPA licenses expire because they failed to comply with the continuing education requirements. In many instances, it may be ten years or more since the former CPA, now Chief Accounting Officer, was current with the continuing education requirements for the CPA license. Given the complexity of accounting and the pace of new pronouncements, the absence of adequate continuing education can render someone technically obsolete in a relatively short period of time.

If the client's representation to the auditor is hollow, wouldn't we all be better off if the auditor at least understood what its client thinks is GAAP? Unfortunately, it is not practicable to require each company to compile a complex document detailing all of its accounting transactions and the technical citations supporting the Company's application of GAAP. However, there is a simple and suitable alternative that will facilitate the identification of any non-GAAP practices – and thereby reduce the number of restatements.

### **Recommendation # 1**

Require each public company to prepare a document that summarizes how it accounts for transactions which are material, either individually or in the aggregate. The Company need not recite the applicable technical guidance or provide a technical analysis. Rather, I am suggesting that each company simply identify the transactions it processes -- and then identify how those transactions are accounted for. This should be a relatively simple document for any company to compile.

To clarify, I am not talking about a document which simply mimics the summary of significant accounting policies found in footnote 1 to the audited financial statements. I am talking about a document which provides the following information for each significant transaction or group of similar transactions processed by a company:

- A description of the transaction or group of similar transactions.
- A description of the relevant accounting entries (with particular attention to the timing of revenue and expense recognition and the recording of assets and liabilities).
- If the accounting entries involve some type of calculation or estimate, the mechanics of that calculation should be described (to enable the reader to ascertain if the mechanics yield a GAAP result).

### **Why Would This Help?**

The beauty of a company prepared document which articulates the company's accounting practices is that it brings the Category A errors out into the open – where they can be identified and dealt with in a timely manner by the engagement partner – before these errors become restatement material.

There is another benefit. Every large audit firm has a concurring review partner assigned to each public company audit. The concurring review partner performs a quality control

review, looking at the financial statement draft and the significant issues identified during the audit. The concurring review partners tend to be the partners who are the most technically proficient in GAAP. Unfortunately though, the concurring review partner is even more removed from the details of the audit than the audit engagement partner. Additionally, the concurring review partner's time on the audit is even less than the audit engagement partner. If each audit client prepares a summary of the company's accounting methodology for significant transactions, the concurring review partner can perform a valuable function by also reviewing that document to assure that the Company's accounting conventions match up with GAAP.

After all, shouldn't the company and its auditor be 100% in synch as to the types of transactions the company is processing and how they are being accounted for? Why should anything this simple be left to chance and obscured from the view of the audit team members most skilled to identify these types of issues?

### **Recommendation # 2**

Require that the Chief Accounting Officer for public companies with a market capitalization above a specified threshold be CPA's with an up-to-date license evidencing that the holder is current with the state board's continuing education requirements. This recommendation should help to reduce both Category A and Category B errors.

### **Recommendation # 3**

In connection with the CPA licensing requirement described above, require mandatory ethics training for Chief Accounting Officers which specifically emphasizes the adverse consequences to Chief Accounting Officers of fraudulent financial reporting. The training should dwell on real instances where people have jeopardized and destroyed their careers by giving in to pressure to do the wrong thing. I am reminded of the technique often used in traffic school. If dangerous drivers are required to watch footage of horrific traffic accidents, memories of those accidents may help the dangerous driver make better choices over the long run. This recommendation should help to reduce category C errors.

### **One Final Thought**

One thing we all find frustrating is the company executive who says 1) he didn't know what the financial reporting rules were and 2) he didn't know that what he was doing was wrong. My recommendation # 1 should sharply reduce the number of times we hear that excuse. Recommendation # 1 will get the issues out in the open. If something goes wrong going forward, it will either be because the company was not forthright enough about its transactions and its accounting – or the auditor failed to perform its duty. I am hopeful that my recommendation will result in greater accountability by all and less finger pointing by those who failed to perform their duties.