

INSTITUTE OF MANAGEMENT ACCOUNTANTS

POSITION STATEMENT PROFESSIONAL JUDGMENT

February 4, 2008

The following is a position statement from Paul A. Sharman, ACMA, president and CEO, Institute of Management Accountants (“IMA[®]”), regarding the role that professional judgment plays in interpretation of and compliance with accounting standards, rules, and regulations in the interests of society as it strives to create jobs and wealth.

With a worldwide network of more than 60,000 professionals and representation in more than 100 countries, IMA is the world’s leading organization dedicated to enabling accounting and finance professionals to drive business performance inside organizations through networking, research, education, certification, and professional development.

During 2007, the Securities and Exchange Commission (“SEC”) formed and launched its Advisory Committee on Improvements to Financial Reporting (CIFiR) due to the increasing concerns in recent years expressed by constituents regarding complexity issues in financial reporting. This complexity may partially be responsible for the high level of material financial restatements, which impacts a firm’s cost of capital, as well as investor protections. CIFiR is supported by various Subcommittees – Substantive Complexity, Standard Setting, Audit Process and Compliance, and Delivering Financial Information. On December 6, 2007, IMA senior management participated in a panel that was conducted by the CIFiR’s Standard Setting Subcommittee. The Subcommittee invited IMA and other organizations to express their views on hypotheses that the Subcommittee proposed as potential solutions to complexity in financial reporting.

The following is one of the hypotheses and Paul Sharman’s response:

Hypothesis

Accounting standards should be written in a manner that reflects the premise that there is trust and confidence in efficient markets through the respect of professional judgment, rather than by attempting to prevent abuse.

IMA Position on Professional Judgment

The notion of professional judgment of issuer staff is critical to the 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 a compliance and audit foundation.

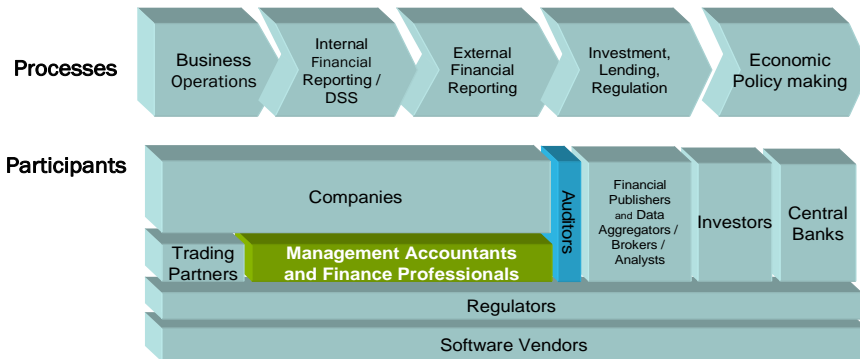
We first start with a literal understanding of what is meant by the words “professional” and “judgment,” along with components of the financial/information supply chain (see Exhibit A) in order to gain an appreciation for IMA’s overall position on professional judgment:

- a) Professional: Characterized by or confirming to the technical or ethical standards of a profession.
- b) Judgment: The process of forming an opinion or evaluation by discerning and comparing.
- c) Business reporting supply chain: The process of acquiring data from source systems, and processing, reporting, analyzing, and validating the operational and financial data.

In order to render appropriate professional judgment, an accounting professional has to have a sound foundation of technical skills sustained and enhanced with professional development and an appropriate professional certification. However, in practice, there is a heavy and disproportional reliance on external auditors to apply professional judgment to registrant’s financial reports. While external auditors play a valuable role in the financial/information 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 (e.g., accounting and financial managers, controllers, CFOs internal auditors, etc.), comprising more than 90% of the roughly 5 million finance function and accounting personnel in U.S. society, who need to have the sound technical foundation and ongoing professional development to render appropriate professional judgment.

The challenge faced by these professionals coming in to the workforce is that the accounting curriculum at colleges and universities are training these professionals to function in an external audit-centric environment of “checklists” instead of being trained to apply judgment as management accounting professionals through quality, risk, and performance management approaches.

The Financial / Information Supply Chain – Exhibit A



Our primary concern with the application of professional judgment is one of balance, not bias. In other words, the accounting education curricula, state licensing boards, and regulatory standards and guidance focus almost exclusively on the role of the external auditor. For registrants to issue “clean” financial statements to protect and preserve the wealth of investors, the finance function personnel who might be described as management accountants that work inside organizations to build quality finance and accounting systems and information to create sustainable value, must have the proper education, certification career specific experience, and professional development.

Management accountants perform a range of activities in enabling an organization to formulate and implement its strategy, drive business performance, and help to create stakeholder value. These activities start with demonstrated expertise in technical accounting, including transaction processing and financial reporting. In the financial/information supply chain, the management accountant plays a key role in designing, implementing, managing, and reporting financial information to all organization stakeholders both internal and external (this information includes financial statements, notes, management disclosure, and analysis.) In these roles, the management accountant is responsible for “building quality in” the financial reporting process so that the audit checklists at the tail end of the process result in zero defects or meet a predefined quality control benchmark. Designing, implementing, and managing financial reporting processes using management accounting disciplines (such as, continuous

process improvement, process management, risk management, performance measurement, and internal controls) are the best way to ensure high quality outputs. The management accountant can use this technical foundation as the basis for professional judgment, but as noted earlier, must have the skills, professional development, and appropriate certification to render these judgments.

In addition to the technical accounting foundation, management accountants leverage these skills to also drive business performance in more “forward-looking” activities, generally referred to as decision support and planning activities. This includes business cases, M&A support, new product introduction support, budgeting, strategic planning, forecasting, enterprise risk management, process quality techniques, and other value-adding disciplines -- knowledge of which is invaluable in forming early professional judgments about planning for compliance

In summary, IMA supports the initiatives of the CIFIIR and its Subcommittees as it relates to complexity in financial reporting. However, we are very concerned that an imbalance exists in accounting education, in the accounting community, and in the regulatory bodies which puts inordinately less attention on those in the best position to apply professional judgment to complex financial reporting issues -- the 90% or more of finance function staff who ultimately are accountable for ensuring the existence of high quality processes, procedures, systems, risk/performance management, and, of course, reporting to investors and regulatory agencies.

Professional judgment must be expected of people who are responsible for corporate performance and the reporting thereof in the financial information supply chain. In order to do so, we must recognize that it is the millions of finance function workers who actually do the work inside U.S. corporations that are responsible. In order to apply professional judgment, those people must be properly educated and certified and have a commitment to ongoing, pertinent, professional development, and ethical behavior. In other words they must actually be professionals.

ACCOUNTING CONTROL ASSESSMENT STANDARDS:
The Missing Piece in the Restatement Puzzle

A DISCUSSION PAPER PREPARED BY: Institute of Management Accountants
Finance GRC (Governance, Risk, and Compliance) Research Practice

February 2008



NOTE TO READERS: This paper reflects the views and opinions of the Institute of Management Accountants Finance GRC Research Practice. It was written to generate discussion and debate on the subject of accounting control assessment.

IMA gratefully acknowledges the contributions of Audit Analytics, Paisley, EDGAR Online and Navigant Consulting, who provided database and analytical support critical to completion of this discussion paper.

To provide input on this discussion paper, contact us at fgrcresearch@imanet.org.

To learn more about IMA's Finance GRC research practice, visit www.imanet.org/FGRC.

ACCOUNTING CONTROL ASSESSMENT STANDARDS:

The Missing Piece in the Restatement Puzzle

TABLE OF CONTENTS

- I. Executive Summary
- II. Introduction
- III. Reducing Material Errors in Financial Statements: An Overarching Objective of SOX
- IV. Section 404 Creates Need for Generally Accepted Control Assessment Standards
- V. SEC Cast by Congress as the Accounting Control Standards Setter
- VI. The PCAOB's de facto Role as Accounting Control Standards Setter
- VII. Accounting Control Standards Report Card: December 2007
- VIII. Problems with the Current Approach to GACAS
- IX. The Way Forward: Some Options to Consider

Attachment 1. Audit Analytics Restatement Analysis, 2001-2006

Attachment 2. SOX 404 Restatement Analysis: Sample of 25

Attachment 3. Preliminary Hypotheses: Why Companies Produce Materially Wrong Financial Statements

I. EXECUTIVE SUMMARY

Financial restatements continue to be a major concern and focus of the Securities and Exchange Commission (SEC), U.S. Department of Treasury, U.S. Congress and others because they impact investor protections, a firm's cost of capital and ability to preserve/grow shareholder wealth, and U.S. global competitiveness. This paper, prepared by the Institute of Management Accountant's Finance GRC (Governance, Risk, and Compliance) Research Practice, draws on over three years of research, Congressional testimony, and thought-leader pieces. While we support the overarching mission of the various blue-ribbon committees focused on the financial restatement problem, we suggest that there is a "missing piece" to fully addressing the root causes of the financial restatement problem in the United States: a lack of effective Generally Accepted Control Assessment Standards (GACAS).

Supported by our prior research and a recent assessment of 25 large Accelerated Filers, we hypothesize that this lack of effective control standards with an explicit objective of reducing "error rates" may be a more significant root cause of material financial restatements than the complexity of accounting standards and regulations. Error rates are defined in this discussion paper as cases where management and their external auditors attest that they have an effective system of internal controls over financial reporting but subsequently issue a material financial restatement that can be related back to a breakdown in internal controls.

While this paper is primarily intended to provoke discussion, debate, and, most importantly, more comprehensive and global research to tackle and solve this critical problem, we also offer several options and solutions to consider (see Section IX and Attachment 3 to this paper), these options and possible solutions include assigning accountability to develop GACAS capable of identifying and reducing the incidence of material errors in financial statements over the long term (a possible option includes establishing and funding a new organization for such purposes), requiring disclosure of the

root cause(s) of control reporting failures, requiring analysis of audit opinion errors, enacting appropriate safe harbors for issuers and auditors to enable such disclosures, greater understanding and emphasis on technology (such as XBRL) to detect and prevent material errors, and implementing globally accepted risk frameworks using principles from the quality management discipline (which we continue to believe are more optimal than the current SEC management guidance and AS5).

Finally, we offer candid hypotheses as to why companies "get it wrong" and produce materially wrong financial statements at a rate in excess of one in every 10 Accelerated Filers (financial restatements as a percentage of total filers) in 2006. These hypotheses include a lack of fact-based, statistical information on the root causes of materially incorrect management- and auditor-certified financial statements; reluctance to tackle the tough, "indelicate" risks head-on (possibly due to the lack of robust risk frameworks and the "unforgiving" U.S. regulatory regime); too much money and time spent on low-risk areas; lack of emphasis on technology; and absence of an effective not-for-profit entity focused on reducing the frequency of material financial restatements.

II. INTRODUCTION

Consider the following:

- A February 2007 trend alert from Glass, Lewis & Co., a leading investor analyst firm, reported:

"The median one-year return of companies that disclosed material weaknesses last year was minus 4%, or 18 percentage points lower than the Russell 3000. In the last three years, the stocks of companies that filed restatements or disclosed material weaknesses underperformed just about every major U.S. stock index."

"2,931 U.S. companies, about 23%, filed at least one restatement during the last four years; 683 companies restated two or more times."

- In March 2007, the U.S. Government Accountability Office (GAO) issued an update to its July 2006 restatement study, reporting:

“The market capitalization of companies announcing restatements between July 2002 and September 2005 decreased over \$36 billion when adjusted for market movements.”

- A January 2007 research study paper written by Cristi A. Gleason, University of Iowa, Nicole Thorne Jenkins, Washington University in St. Louis, and W. Bruce Johnson, University of Iowa, titled “The Contagion Effects of Accounting Restatements,” concluded:

“Accounting restatements in our sample are accompanied by a reliably negative mean three-day announcement period abnormal return of -19.8%.”

Much has been reported about the negative impacts and related costs of financial restatements. In this paper, we suggest there is persuasive evidence that companies who are able to reliably assess and report the true effectiveness of their accounting controls are better positioned to produce reliable accounting disclosures to preserve and grow shareholder value. Unfortunately for those companies forced to issue restatements to correct material errors and/or irregularities, we believe that the opposite is also true: Companies that are unable to reliably assess and report on the effectiveness of their accounting controls will have difficulty producing reliable accounting disclosures to preserve and grow shareholder value. That is why we refer to this issue as the missing piece in the restatement puzzle.

To increase the visibility of the link between the representations made by senior management and external auditors on accounting control effectiveness and restatements, this discussion paper analyzes cases where a company was forced to issue a restatement to correct material accounting disclosure errors after its management and external auditors both concluded that its accounting controls were “effective.” The total number of

cases where management and external auditors of U.S.-listed public companies “got it wrong” in their original filing has been growing each year for the past six years statistics have been tracked. There are some signs, at least for Accelerated Filers, that the rate of post-SOX restatements (as a percentage of total filers) may have peaked, but concerns remain that the total number of restatements is still too high.

Based on research and analysis conducted by the Institute of Management Accountants (IMA®) Finance Governance, Risk, and Compliance (Finance GRC) Research Practice over the past three years, we believe that the current standards and guidance that define how management and auditors should approach the task of assessing and reporting on accounting control effectiveness are a key element of the restatement problem.

IMA continues to be very concerned that the current de facto accounting control standards setter for public companies listed in the United States is the Public Company Accounting Oversight Board (PCAOB), an entity created by the Sarbanes-Oxley Act of 2002 (SOX) to set standards for external auditors. We do not believe Congress intended that the PCAOB set accounting control assessment standards for all U.S.-listed public companies. We believe that major technical deficiencies in the PCAOB’s accounting control assessment standard, Auditing Standard No. 2 (AS2), “An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,” have not been fully addressed in its replacement (Auditing Standard No. 5 (AS5), “An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements”) and are at the root of a significant percentage of the accounting restatements that have occurred.

The external auditor community launched an initiative in January 2007 to fund and establish the Center for Audit Quality to address concerns with the current high rates of audit opinion failure. In the absence of an integrated focus on accountability for

ACCOUNTING CONTROL ASSESSMENT STANDARDS:

reducing the rate of errors, and with our continued concerns regarding the suboptimal nature of the SEC guidance for management and the PCAOB's AS5, we believe similar steps should be taken by the financial statement preparer community to form a properly funded and staffed organization responsible for defining more reliable Generally Accepted Control Assessment Standards (GACAS). While we applaud the serious efforts underway to adopt global financial reporting standards and reduce unnecessary accounting standards complexity, we believe that improving the overall quality of financial reporting requires a "triple play" approach that includes:

1. Development of less complex and more readily understood accounting standards,
2. Accounting control assessment standards capable of producing reliable conclusions on the true state of control effectiveness, and
3. Changes to the methods and tools used by external auditors to form their audit opinions on the fairness and reliability of financial statements prepared by management.

Based on 2006 statistics from Audit Analytics, an independent advisory and intelligence firm that specializes in monitoring public company control, accounting, and auditing disclosures and trends, the frequency of wrong control effectiveness opinions attached to original filings that were later restated was more than 10% of all Accelerated Filers (see Attachment 1 for more details). Success in significantly reducing the frequency of wrong internal control effectiveness opinions will result in a dramatic reduction of restatements and the massive costs that accompany them. In turn, this improvement will help to address the erosion of shareholder wealth and confidence caused by the high frequency of accounting restatements.

To provide a platform for discussion, debate, and further research, IMA presented four specific suggestions to the SEC Advisory Committee on

Improvements to Financial Reporting—Standard Setting Subcommittee on December 6, 2007:

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 for both management and their external auditors.
2. Endorse the conclusion by Subcommittee III (Audit Process and Compliance) "that the current disclosure surrounding a restatement is not adequate" and expand SEC rules to specifically require that Issuers include why the company's risk and control assessment processes failed or, if they didn't, explain to readers why the "effective" control opinion was correct in spite of the need to restate.
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 lessons from its systematic study of control and disclosure failures while still retaining the confidentiality of issuers and their auditors.
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.

This discussion paper provides more specifics on an area that we believe is not currently receiving the attention it deserves in order to protect and preserve the wealth of investors in a global marketplace—the link between restatements and incorrect control effectiveness opinions. The work of a number of blue ribbon committees, including the SEC and U.S. Department of Treasury initiatives,

to develop recommendations on how to improve accounting standards and financial reporting is vitally important and necessary. In the absence of addressing the shortcomings that we believe exist in the current approach to developing accounting control assessment standards, however, the core problem of an unacceptably high rate of unreliable financial reporting will persist. Our hope is that broad distribution of this discussion paper will spark further discussion, debate, and research on the need for more effective accounting control assessment standards to improve the overall quality of financial reporting over the longer term.

III. REDUCING MATERIAL ERRORS IN FINANCIAL STATEMENTS: AN OVER-ARCHING OBJECTIVE OF SOX

Following a “perfect storm” of seriously flawed accounting disclosures, including Enron, WorldCom, and others, The Sarbanes-Oxley Act of 2002 (SOX) was enacted “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.” This statement of legislative intent could have been worded more bluntly and technically as “to protect investors by reducing the frequency of material errors in financial disclosures issued by SEC registrants.” When reduced to its core intent, the primary mission of the SOX regulatory regime is to reduce the frequency of material errors in audited financial statements relied on by stakeholders. Five years later, a key question needs to be asked:

Has the SOX regulatory regime reduced the frequency of material errors in financial disclosures?

In February 2007, Audit Analytics published, “2006 Financial Restatements: A Six Year Comparison.” One of the most profound trends highlighted in this report is that 512 U.S. Accelerated Filers (companies with market capitalization in excess of \$75 million) issued restatements in 2006 to correct one or more material errors in their original accounting filings with the SEC. With a total reported registrant population of 3,861 Accelerated Filers, that rep-

resents an error rate of 13.3%. Stated simply, the rate of material errors being corrected in original filings by Accelerated Filers in 2006 was more than one in every eight. Attachment 1 provides details on all restatements identified by Audit Analytics from 2001 through 2006. Audit Analytics has promised an update to its report in February 2008. It is important to recognize that there are some signs that the restatement rate for 2007 will be lower than that experienced in 2006, but it still remains high as a percentage of total filers.

Accelerated Filers have now been through three to four full rounds of what has been widely reported as hugely expensive assessment work by management and external auditors to determine whether or not their financial reporting controls are “effective.” According to the SOX Section 404 regulations from both the SEC and the PCAOB, the definition of what constitutes “effective” is directly linked to the ability of the existing accounting controls to produce materially fault-free financial statements.

The high rate of restatements by U.S.-listed companies to correct material errors in original filings has been widely reported in the press, studied by the Government Accountability Office (GAO), and rigorously analyzed and commented on by Glass, Lewis & Co. and others. The high rate of accounting errors and restatements also is the subject of a number of high-profile committees, including the SEC Committee on Improvements to Financial Reporting and initiatives launched and funded by the U.S. Department of Treasury.

To date, what has not been widely reported on and analyzed adequately is that the CEOs, CFOs, and external auditors of the majority of Accelerated Filers that issued restatements in 2006 had publicly stated in their original SEC accounting filings that the controls in place over financial reporting were “effective”—i.e., that they were capable of detecting and preventing material errors. History has shown that, despite incurring high costs and expending significant effort, the management and external auditors of a rapidly growing number of public companies

ACCOUNTING CONTROL ASSESSMENT STANDARDS:

were incorrect in their original conclusions on accounting control effectiveness. See Attachment 2 for illustrative examples of large, high-profile companies that were forced to issue a material restatement after their management and external auditors had concluded originally that their internal controls over financial reporting were effective.

IV. SOX SECTION 404 CREATES THE NEED FOR GENERALLY ACCEPTED CONTROL ASSESSMENT STANDARDS

In June 2003, the SEC issued Release No. 33-8238, “Final Rule: Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports” (Final Rule). Several important facts were not explicitly referenced or acknowledged by the SEC at the time.

A RADICAL CHANGE

The most fundamental requirement in the Final Rule, the formal management opinions in public filings on the “effectiveness” of internal control over financial accounting (where “effective” is defined in the regulations to be zero material errors), was not recognized or acknowledged at the time for what it really was—a radical and onerous change from the status quo that went far beyond public company reporting requirements anywhere in the world. (NOTE: The Basel II reforms in the banking sector, on the other hand, were expected and acknowledged by the Basel II committees and national regulators to be a radical and onerous change that would require a decade to implement.) Although no statistics are available, market feedback suggests that few public companies were producing financial statement drafts for review by their auditors with zero material errors at the time SOX was enacted. If this number was known at the time—or even today, in the case of smaller, Non-accelerated Filers—we believe it would reinforce the point that the SEC was—and still is—asking for a radical, massive, and rapid improvement in financial statement quality that may be impractical and/or prohibitively costly to implement

in its current form relative to the investor benefits, particularly in smaller public companies. Many companies at the time SOX was enacted relied heavily on their external auditors to identify and correct accounting errors in draft statements, as many Non-accelerated Filers still do today.

COSTS

There was little disclosed about how much and what kind of work had actually been completed to test the SEC’s claim in the Final Rule that SOX control effectiveness reporting could be implemented at a total cost of \$1.24 billion, or \$91,000 per company. This underestimation of financial cost is only one element of the technical challenges ahead.

PRACTICALITY

There was no support cited for the SEC’s assumption that “reasonably consistent qualitative and quantitative measurement of a company’s internal control” was possible and practical with existing accounting control assessment methods and tools. At the time, no professional body in the world had established standards to develop formal binary (effective/ineffective) representations on internal control effectiveness.

CONTROL ASSESSMENT GUIDANCE

The Final Rule required, for the first time ever, formal disclosures from management related to the effectiveness of internal control over financial reporting. Specifically, Section II(B)(3) of the Final Rule called for:

- “A statement of management’s responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company’s internal control over financial reporting;
- Management’s assessment of the effectiveness of the company’s internal control over financial

reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. The assessment must include disclosure of any 'material weaknesses' in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting; and

- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.”

Based on the wording in the Final Rule—and in the absence of other evidence at the time—it appears that the SEC staff believed that the Internal Control-Integrated Framework produced in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) could be used to achieve these results. Section II(B)(3)(a) of the Final Rule states:

“The COSO Framework satisfies our criteria and may be used as an evaluation framework for purposes of management's annual internal control evaluation and disclosure requirements....

“Specifically, a suitable framework must: be free from bias; permit reasonably consistent qualitative and quantitative measurements of a company's internal control; be sufficiently complete so that those of relevant factors that would alter a conclusion about the effectiveness of a company's internal control are not omitted; and be relevant to an evaluation of internal control over financial reporting.”

Although there has been ample focus on the cost ramifications of SOX, we believe that not nearly

enough attention has been paid to the SEC's underestimation of the deficiencies in existing guidance and the technical hurdles that must be overcome to develop control assessment standards and guidance capable of producing reliable and repeatable opinions on the “effectiveness” of accounting controls. More than four years after the SEC issued the Final Rule, companies and their auditors are still finding that arriving at reliable accounting control effectiveness opinions is challenging (where “effective” is defined as zero material accounting defects in the financial statements). This is evidenced by the high rate of financial restatements associated with “effective” internal controls representations from both management and external auditors.

The SEC has indicated its belief that SOX Sections 103(a)(2)(A)(iii) and 404 require binary (effective/ineffective) representations of control effectiveness. Although this is fundamentally a legal interpretation issue, our interpretations of these sections is that other representations of control effectiveness are also reasonable. The public is not being served properly when a formal and public representation process produces an error rate of about 10% on average (percentage of total filers) from both management and external auditors.

It is important to note that the SEC determined that it has the authority to reject the everyday meaning of the words in SOX Sections 302(a)(4)(C) and (D) that call for management to evaluate their internal accounting controls quarterly and to make public representations on internal control in each quarterly report on the state of control effectiveness. Given the latitude the Commission indicates it has to interpret these sections of SOX, it seems reasonable to us that the Commission has similar latitude to interpret Sections 103 and 404 in a sensible, practical manner.

V. SEC CAST BY CONGRESS AS THE ACCOUNTING CONTROL STANDARDS SETTER

When The Sarbanes-Oxley Act was unanimously passed into law in 2002, it is likely that few members of Congress, if any, recognized the full significance of Section 404(a):

“The Commission shall prescribe rules requiring each annual report...contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.”

This short paragraph calls for something never before attempted in any country in the world—formal declaration by the CEO and CFO of a company that its existing controls are, or are not, capable of producing reliable financial statements free of material accounting disclosure defects. More importantly, in the absence of any existing authoritative guidance, Congress cast the SEC as the first authoritative body charged with establishing Generally Accepted Control Assessment Standards (GACAS). In the area of accounting control assessment, GACAS are equivalent to Generally Accepted Accounting Principles (GAAP) found in the area of accounting standards. A quote from the Financial Accounting Standards Board (FASB) website (<http://72.3.243.42/facts/index.shtml>) that speaks to how primary standards should be established is particularly relevant:

“The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission’s policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.”

Because SOX Section 404(b) required external auditors to provide an independent opinion on whether a company’s accounting controls are effective, it also

required that the PCAOB prescribe audit methods that would enable an external auditor to form an opinion on whether the accounting controls in place are capable of producing financial statements with zero material defects. It is important to note that for calendar year 2006, Audit Analytics reported over 1,000 instances where auditor-certified financial statements were eventually shown to contain one or more errors and/or irregularities large enough to necessitate a restatement of the accounts.

(NOTE: We believe that a small percentage of reported restatements may not have had “material” control weaknesses as currently defined. Additional research will be required to isolate the cases where a company had to reissue its financial statements for reasons not linked to the effectiveness of accounting controls.)

In 2006, IMA published a SOX research study titled “COSO 1992 Control Framework and Management Reporting on Internal Control over Financial Reporting: Survey and Analysis of Implementation Practices.” The survey responses within the study suggest that very few companies had a clear idea of how to arrive at fully supported binary opinions on accounting control (effective/not effective) using the available guidance at the time SOX 404 was being implemented. Given the magnitude of the task and tight timeframe demanded by the original regulations, the vast majority of companies turned to consultants and external auditors for advice and assistance. Unfortunately, the restatement statistics suggest that many of these highly paid advisors also were not prepared to deal with the new control assessment effectiveness standard. In effect, this standard demanded that management identify for the auditors every situation where there was more than a remote possibility of one or more material errors in the draft accounts.

VI. THE PCAOB'S DE FACTO ROLE AS ACCOUNTING CONTROL STANDARDS SETTER

Shortly after the SEC issued the Final Rule for Section 404, the PCAOB issued an exposure draft for Auditing Standard No. 2 (AS2), "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements." Without specific accounting control assessment guidance from the SEC, and given the limited implementation guidance in COSO's Internal Control-Integrated Framework regarding how to tackle a binary control effectiveness opinion, the PCAOB had no choice but take on the role of defining generally accepted control assessment and reporting principles. On March 9, 2004, the PCAOB issued AS2 in its final form. It contained very granular guidance on how the PCAOB envisioned an assessment of accounting control should be approached by auditors. Both auditors and the management of U.S.-listed Accelerated Filers adopted the final version of AS2, comprising 185 pages of fairly prescriptive assessment guidance, as the "best available" authoritative control assessment guidance. By default, AS2 became the world's first authoritative set of guidance on forming binary opinions on internal control effectiveness, with "effective" defined as zero material defects in draft financial statements prepared by management for auditor review.

As a result of criticisms related both to the level of costs being incurred by Accelerated Filers as well as the lack of guidance written specifically for management, the SEC issued new "risk and principles-based" control assessment guidance in the spring of 2007. Shortly after, the PCAOB issued the 102-page Auditing Standard No. 5 (AS5), "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements," to replace AS2.

The rules in AS5 still stipulate that external auditors must independently decide if they think a company's accounting controls are "effective"—in an environment where the public accounting firms are extremely concerned about the risk of litigation

if history proves the financial statements they certified as fairly presented are, in fact, materially wrong. Because auditors are still the final judge of what constitutes "effective" accounting control, we remain very concerned that AS5 will prove to be the de facto authoritative guidance for company management on how to assess and report on accounting control effectiveness. While we would be pleased to be proven wrong for the sake of global investors, it was an IMA research study in 2005-2006 that first identified AS2 (which was intended at its inception to provide "optimal" guidance to auditors) as the de facto controls assessment standard for management.

VII. ACCOUNTING CONTROL STANDARDS REPORT CARD: DECEMBER 2007

The 2007 calendar year marked the fourth year that management and auditors of most large U.S. public companies were required to assess and report on the "effectiveness" of their accounting controls—using assessment standards issued by the PCAOB as their primary roadmap. After three full rounds of Section 404 control effectiveness reporting by Accelerated Filers, and with thousands of Non-accelerated Filers scheduled to start reporting on control effectiveness starting at year-end 2007, what conclusions can be drawn about the performance of the PCAOB as the accounting control assessment standards setter?

Auditing Standard No. 5, the guidance developed to replace the much-maligned AS2, will be used by both management and auditors to guide their year-end 2007 control assessment and reporting work. When assessing how helpful AS2 was during the first three reporting rounds, the PCAOB stated:

"Costs have been greater than expected and, at times, the related effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting."

ACCOUNTING CONTROL ASSESSMENT STANDARDS:

Based on our analysis of the differences between the original control assessment standards in AS2 and the modifications made in AS5, it is our view that the PCAOB's revision of AS2 was primarily focused on trying to address the high costs of compliance incurred in the short term, rather than attempting to fix the high rate of internal control effectiveness opinion errors exhibited by SEC Accelerated Filers, which impacts costs over the longer term.

We believe a key question needs to be asked at this point:

Ignoring the issue of cost, how good was the AS2 guidance for management and auditors regarding the reliable identification and reporting of control weaknesses that could result in one or more material accounting errors?

ASSESSING AS2

To assess how useful AS2 was to managers and auditors, we think it makes sense to look at the number of times a company's management and external auditors concluded that controls over financial reporting were effective (i.e., capable of producing financial statements free of material accounting disclosure errors) but later issued a material financial accounting restatement. We believe that the best available source of data is the financial restatement statistics tracked by Audit Analytics (as discussed in Section II, "Reducing Material Errors in Financial Statements"). Also helpful was the February 27, 2007, Yellow Card Trend Alert produced by Glass, Lewis & Co., titled "The Errors of Their Ways." In this report, Glass, Lewis & Co. concludes:

"Companies take note: If you restated, you must have had material weaknesses. We still have a hard time figuring out how so many companies that restated also could have reasonably concluded that their internal controls are effective and that they have no material weaknesses—or that no material weaknesses even existed at the time of the errors."

To better understand how the frequency of Accelerated Filer restatements relates to SOX 404 control effectiveness opinions made by CEOs, CFOs, and external auditors, we selected 25 high-profile companies from the total population of Accelerated Filers restatements listed in the Audit Analytics database (see Attachment 2 for a list of the companies). Our assessment and analysis included the following steps:

1. We obtained the company's SEC filings made in the original financial statement filing period.
2. We extracted the control effectiveness opinion reported by the company's CEO and CFO in that filing period to determine if they had reported that the company's accounting controls were "effective" or, if an area of control was identified as ineffective, that it did not relate to the area being restated.
3. We obtained the control effectiveness opinion reported by the company's external auditor in the original filing period.
4. We examined the statements and explanations provided by management when the company issued restated accounts and identified the nature of the error(s) in the original accounts filed.
5. We determined whether management retracted their original opinion that accounting controls in the original filing period were effective.

The companies examined represent a very small segment of Accelerated Filer restatements, and a much more comprehensive research study needs to be mandated and properly funded. Yet we believe the following broad hypotheses and preliminary conclusions are reasonable:

- High Error Rate of CEO/CFO Conclusions. A high rate of senior management of Accelerated Filers reached inaccurate conclusions on the effectiveness of their company's controls despite the commitment of significant human and financial

resources in implementing SOX Section 404 requirements.

- **High Error Rate of External Auditor Opinions.** Auditors of the same companies also concluded that accounting controls were “effective” (i.e., capable of preventing material errors in the financial statements). In addition to their reports on control effectiveness, the auditors also certified that the original financial statements were fairly presented. An important underlying premise of the Sarbanes-Oxley Act is that auditors should be better equipped to provide reliable opinions on the financial statements if they have better information on the reliability of the internal control systems that support the financial statements. To date, at least on the surface, restatement trend statistics appear to contradict this assumption since the frequency of total restatements in absolute terms has increased in the post-SOX era. (Note: This may also indicate that the number of companies that were concealing material errors and irregularities discovered in audited financial statements prior to SOX was even higher. It is also important to note that there are some signs that restatement frequency in the Accelerated Filer community may have peaked).
- **High Error Frequencies Despite High Spending Undermines Investor Confidence.** Just as confidence in credit agencies has been severely shaken by the inaccurate conclusions they reached on many of the subprime mortgage investment vehicles, an error rate in the opinions of control effectiveness from CEOs, CFOs, and highly paid external auditors that is in the range of 10% should be viewed as a major problem—particularly given the monies currently being spent to form these control opinions.

VIII. PROBLEMS WITH THE CURRENT APPROACH TO GACAS

IMA has publicly voiced its concerns to the SEC and PCAOB regarding the approach used to define and implement accounting control assessment standards over the past three years. This includes the December 6, 2007, comments that IMA CEO Paul Sharman and VP of Research Jeff Thomson presented to the SEC Advisory Committee on Improvements to Financial Reporting—Standards Setting Subcommittee. IMA has gone on record as stating that correcting the significant problems with SOX 404 assessment guidance should be seen as a critically important priority directly linked to improving the quality of financial reporting and, ultimately, U.S. global competitiveness.

Our efforts to better understand why so many CEOs, CFOs, and external auditors are reaching incorrect opinions are still at an early stage. The following observations are offered to generate more discussion, debate, and comprehensive research on what we believe needs to be corrected in the current control assessment standards. (See Attachment 3 for additional detailed commentary on why we believe so many U.S.-listed companies are restating their financial statements.)

INADEQUATE FOCUS ON SYSTEMATIC ERROR REDUCTION

We believe there is a lack of emphasis in the existing SEC and PCAOB control assessment standards on the critical need to systematically record, track, and analyze errors (including errors detected in financial accounting systems during the year, in financial statements drafts produced by management for auditor review, in financial statements filed with the SEC, and in internal controls effectiveness assessment opinions made by CEOs, CFOs, and external auditors).

We believe that the global body of knowledge in business quality assessment and control can provide valuable insights into this area, particularly the methods and tools available to reduce product “rework” by using “cause of failure” analysis.

ACCOUNTING CONTROL ASSESSMENT STANDARDS:

Restatements in the accounting world are analogous to a product that requires warranty repairs or replacement after being sold to a customer.

INADEQUATE FOCUS ON IDENTIFYING THE “REAL” RISKS

The work done by Audit Analytics and Glass Lewis, as well as our own research and analysis, suggests that more needs to be done to require that management identifies and documents the most significant risks that cause materially wrong auditor-certified statements. In addition, more needs to be done to specifically identify and document the controls in place to mitigate these risks. These truly significant risks include reward systems for senior management and management in subsidiaries that create incentives to circumvent controls and manipulate earnings, the inability of management and auditors to cope with complex and sometimes confusing accounting standards, inadequate recognition of which accounts and notes are relied on most by key stakeholders that use the statements (e.g., debt covenants, ratios tracked by analysts, and others), and the lack of tools to help management and auditors identify and correct the most common accounting errors made by other companies in their industry sector. Company management and external auditors have indicated to us that they feel they are “politically” precluded from candidly documenting the “really big” risks that result in materially wrong financial statements, presumably because of the sensitivity of the issue and the litigious and “unforgiving” regulatory environment in the U.S.

SUBOPTIMAL GACAS STANDARD SETTING

The current system of setting internal accounting control assessment standards is highly fragmented, with involvement from groups such as the PCAOB, SEC, COSO, American Institute of Certified Public Accountants (AICPA), Institute of Internal Auditors (IIA), Association of Certified Fraud Examiners (ACFE), Information Systems Audit and Control Association (ISACA), International Organization for Standardization (ISO), and joint initiatives, as well as Big Four guidance papers and others. While serious efforts have been made recently to “har-

monize” global financial reporting standards (i.e., the SEC, FASB, International Accounting Standards Board), there is no corresponding effort underway relating to one of the prime drivers of high-quality financial disclosures—global accounting controls assessment standards. Generally Accepted Control Assessment Standards (GACAS) do not exist in a comprehensive, integrated, and easy to apply manner that produces reliable management and auditor conclusions on accounting control effectiveness. The data clearly indicates that the implementation of the control assessment guidance in AS2 has produced high rates of wrong conclusions on control effectiveness, and, although we see AS5 as an improvement, we are very concerned that control effectiveness error rates will remain high. The rate of control effectiveness errors made by Non-accelerated Filers in their first year of SOX 404(a) filings will be particularly relevant since they will have the benefit of AS5 and the new SEC guidance for management.

We do not believe that any single organization currently in the areas of internal controls and financial reporting is financially or organizationally prepared to be accountable for (1) defining global control assessment standards and (2) reducing the current high rate of control effectiveness opinion errors. Additionally, while the SEC initiative to provide simpler, shorter guidance to smaller public companies for assessing and reporting on internal control effectiveness is well intentioned, we believe it paints a misleading picture of the challenges that thousands of Non-accelerated Filers will face this year when they must comply with SOX 404(a) for the first time.

U.S. LEGAL SYSTEM PRESENTS MAJOR CHALLENGES

We believe that the high rate of restatements and accounting control effectiveness opinion errors is exacerbated and caused, at least in part, by the litigious U.S. legal system—a system that some people believe rationally precludes a systematic analysis of the root causes of material errors in audited financial statements because of the fear of litigation. Without the use of systematic and documented error analysis, significant progress in improving the

reliability of financial disclosures will be difficult, if not impossible, to achieve. This aspect of the problem warrants specific study, particularly in regard to restating companies disclosing why both the financial disclosures and their control effectiveness opinions were proven to be materially wrong.

ABSENCE OF FACT-BASED RESEARCH

As far as we are aware, there has never been a published study that examines the root causes of materially wrong management- and auditor-certified financial statements. Improving the reliability of financial reporting will be significantly impeded until more is done in this regard. We recognize that legal issues will need to be addressed to make progress in this area.

IX. THE WAY FORWARD: SOME OPTIONS TO CONSIDER

This paper raises a number of issues related to the inadequacy of current processes and structures in place to develop accounting control standards and the link to the high rate of accounting restatements. To foster more comprehensive research, discussion, and debate on this subject we propose some ideas to consider.

INTEGRATED FOCUS AND ACCOUNTABILITY TO SET GACAS USING FACT-BASED RESEARCH

Consistent with the external audit community's January 2007 initiative to establish the Center for Audit Quality to study the problem of unreliable audit opinions, we suggest that the preparer community take steps to establish an independent and adequately funded organization charged with the primary responsibility of creating more reliable Generally Accepted Control Assessment Standards (GACAS). This entity would be focused on error root causes and improvement initiatives more comprehensively in the end-to-end financial reporting supply chain. Given current initiatives underway to transition from U.S. GAAP to international accounting standards, we believe that the most appropriate body to define GACAS would be a new body linked to the organization that will define international financial reporting standards (IFRS). We make this recommendation because:

1. We do not believe any single organization believes that its primary objective and accountability is to track and reduce errors as we have defined them, and
2. SEC management guidance and AS5 remain suboptimal, with no changes anticipated at least until an economic analysis is completed, which will take some time.

COSO has made a number of major and important contributions to the field of internal control over the past 20 years and could be a core element of the new private-sector organization we envision. It is important to note, however, that COSO is in the midst of formulating its strategy and may remain a volunteer committee of five sponsoring organizations with limited human and financial resources.

REQUIRE DISCLOSURE OF THE CAUSE OF CONTROL EFFECTIVENESS REPORTING FAILURES

We recommend that the SEC accept and endorse a particularly important preliminary recommendation made by the SEC Advisory Committee on Improvements to Financial Reporting Subcommittee III: Audit Process and Compliance. In the committee minutes from November 2, 2007, the Subcommittee concluded "that the current disclosure surrounding a restatement is not adequate" (p. 6). We recommend the SEC should take steps to expand current reporting requirements so that companies are required to include an explanation as to why its risk and control assessment processes failed. Alternatively, if the company does not believe the failure was due to control failure, it would be required to explain to investors why its original "effective" rating was correct in spite of the need for restatement. To reduce the risk of obfuscation regarding the true root cause of the material errors and/or irregularities in filings, SEC registrants should have to identify what they believe was the root cause of the undetected disclosure error from a menu of specific root cause options provided by the SEC.

ACCOUNTING CONTROL ASSESSMENT STANDARDS:

REQUIRE ANALYSIS OF AUDIT OPINION ERRORS

We recommend that the PCAOB require all external audit firms associated with wrong control effectiveness opinions linked to financial restatements to systematically study and document the root causes of their incorrect audit opinions. This analysis should rely heavily on globally recognized quality assurance and improvement methods. The PCAOB inspectors should assess the adequacy of the “cause of failure” analysis systems during its periodic inspections. To provide broader value, we also recommend that the PCAOB synthesize and publicly report the key lessons learned from this initiative—while retaining the confidentiality of the data. We believe that careful and systematic analysis of the causes of failure is absolutely essential to improving the quality of financial disclosures. Legal safeguards may need to be put in place to encourage audit firms to develop formal audit opinion error analysis and reduction systems.

ENACT SAFE HARBORS FOR ISSUERS AND AUDITORS

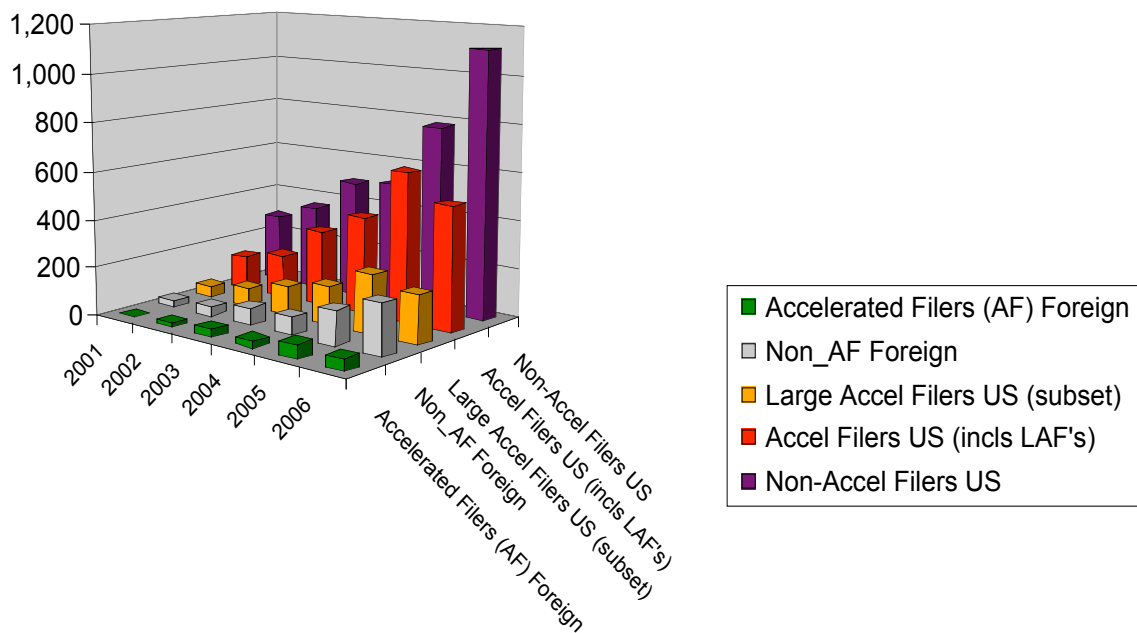
To encourage thorough analysis of the root causes of accounting disclosure errors and irregularities, we suggest that Congress put appropriate safe harbors in place to protect issuers and their external auditors. The medical profession has developed effective approaches designed to foster learning and improvement from mistakes. If deemed practical, they should be implemented. A ground-breaking report from the Institute of Medicine, titled “To Err is Human: Building a Safer Health System,” provides a foundation that could be used to reduce the current error rate in accounting disclosures. The opening paragraph of the Preface to this report illustrates the relevance:

“The title of this report encapsulates its purpose. Human beings, in all lines of work, make errors. Errors can be prevented by designing systems that make it hard for people to do the wrong thing and easy for people to do the right thing.”

We believe that many of the recommendations for reducing the frequency and magnitude of errors in the medical profession proposed in “To Err is Human” have direct applicability to the current problem of literally thousands of materially wrong financial statements being issued each year to investors and other key stakeholders around the world. What makes this report even more relevant and valuable is that it recognizes that the solutions implemented must take in to account the nature of the U.S. legal system, which actively discourages embracing the age-old adage, “We must learn from our mistakes.”

ATTACHMENT 1: AUDIT ANALYTICS RESTATEMENT ANALYSIS, 2001-2006

All Restatements



	Number of Restatements						2006 Registrant Population	2006 Percentage
	2001	2002	2003	2004	2005	2006		
Accelerated Filers (AF), Foreign	2	15	33	29	58	46	465	9.9%
Non-AF, Foreign	26	38	73	75	143	210	2113	9.9%
Large AF (subset)	46	77	120	154	242	196	1963	10.0%
AF, U.S. (includes Large AFs)	138	177	314	404	620	512	3861	13.3%
Non-AF, U.S.	286	355	491	510	778	1108	11986	9.2%

ACCOUNTING CONTROL ASSESSMENT STANDARDS:

ATTACHMENT 2. SOX 404 RESTATEMENT ANALYSIS: SAMPLE OF 25

Company	Restatement Year Examined	Managemnet's Original Control Option	Auditor's Original Control Opinion	Restatement Issue(s)
Altera Corp	2005	Effective	Effective	Stock Option Accounting
Apple Inc.	2005	Effective	Effective	Stock Option Accounting
Aon	2005	Effective	Effective	Stock Option Accounting Cumulative Impact
First Data Corp	2005	Effective	Effective	Derivative Accounting
Fifth Third Bancorp	2006	Effective	Effective	Cash Flow Misclassification
General Mills	2006	Effective	Effective	Goodwill Valuation
General Motors	2004	Effective	Effective	Cash Flow Misclassification
Juniper Networks	2004, '05	Effective	Effective	Stock Option Accounting
Marvell Technology Group Ltd	2005, '06	Effective	Effective	Stock Option Accounting
NVIDIA Corp	2004, '05, '06	Effective	Effective	Stock Option Accounting
Shire plc	2005	Effective	Effective	Accounting Treatment R&D
SLM Corporation	2004, '05	Effective	Effective	Cash Flow Misclassification
Thor Industries Inc.	2006	Effective	Effective	Fraudulent accounting in a subsidiary
Time Warner Inc.	2004, '05	Effective	Effective	Revenue and Expense recognition
United Health Group	2005	Effective	Effective	Stock Option Accounting
Verisign Inc.	2005	Effective	Effective	Stock Option Accounting
XL Capital Ltd.	2004, '05	Effective	Effective	Foreign Exchange Accounting Company and its auditors do not believe the restatement constitutes a material control weakness
CA Inc	2005	Ineffective	Ineffective	Weakness not detected in original filing reliabilities, payables, reserves
Corning Inc	2005	Effective	Effective	Asset valuation, equity investments
Dell	2004, '05, '06	Effective	Effective	Reserve and accrual liabilities
Federated Department Stores	2006	Effective	Effective	Cash misclassification error
Ford Motor Company	2005	Effective	Effective	Interest rate derivative accounting
General Electric	2004, 2005	Effective	Effective	Hedged paper transactions/FASB133
Monster Worldwide Inc.	2005	Effective	Effective	Stock option accounting

ATTACHMENT 3. PRELIMINARY HYPOTHESES: WHY COMPANIES PRODUCE MATERIALLY WRONG FINANCIAL DISCLOSURES

We reviewed a wide range of data during the course of developing this discussion paper, including the GAO 2002-2007 Financial Restatement reports, restatement analysis prepared by Glass, Lewis & Co., restatement analysis and trend data prepared by Audit Analytics, proceedings of the SEC Advisory Committee on Improvements to Financial Reporting, papers and articles published by academics, professional association guidance, and other sources. Before more robust conclusions (vs. hypotheses) can be advanced, more detailed information is needed on every company that has been forced to issue a restatement to correct material errors and irregularities. “Best possible” information for this research would include details on the approach used by the restating company and its external auditors to assess and report on accounting control effectiveness. Additional helpful information would include the specific approach used by the company’s auditors to audit the particular area(s) in which the major errors and/or irregularities occurred. We recognize that this data may never be available without appropriate safe harbors.

While we do not have the benefit of a large, comprehensive pool of reliable statistical information, we believe that a number of hypotheses and observations on the root causes of restatements can be advanced and warrant additional exposure, discussion, debate, and properly mandated and adequately funded research.

HYPOTHESIS #1: WE DON’T HAVE ENOUGH INFORMATION, WHICH RESULTS IN SUBOPTIMAL SOLUTIONS

There is an absence of fact-based statistical information on the root causes of materially wrong management- and auditor-certified financial statements. We believe this has resulted in expensive, “broad-brush” regulatory solutions that cast a wide net but are not directly focused on the root causes of materially wrong financial statements.

Academics tell us that the lack of data is largely due to the absence of publicly available information needed to complete this type of research. Lawyers suggest that it will be difficult to get cooperation from management or external auditors in obtaining the necessary data because the area is seen as a litigation minefield. It is a dangerous area for researchers because of the lack of reliable, relevant data and the risk of slander or libel. It is dangerous to the companies and senior executives in cases where the data could be linked to claims of negligence and/or fraud. Other possible reasons include a lack of legislative/regulatory mandate to gather the information, a lack of funding and resources at the SEC and PCAOB to gather and systematically analyze the root cause of restatements, and a lack of willingness on the part of accounting and auditing professional associations to launch research and investigations that could open their members to scrutiny and legal risk.

Despite these significant hurdles, a key stakeholder must not be overlooked—the investors who put their faith in the U.S. regulatory system to protect them from fraud and preserve and grow their investments. If the legal implications and negative repercussions caused by higher transparency of the root causes of material errors in public accounting disclosures outweigh the benefits of getting at the root causes of the inordinately high rate of financial restatements, investors need to be told candidly that they should not expect significant improvements in the quality and reliability of financial disclosures.

HYPOTHESIS #2: SOLVING ONLY THE COMPLEXITY ISSUE WILL NOT SOLVE THE RESTATEMENT PROBLEM

Reducing complexity in financial reporting is a valid goal, but we question whether it is statistically a major cause of accounting restatements. Although a number of SEC and Treasury Department initiatives currently underway focus on the issue of accounting complexity, there is no fact-based research that indicates that complexity by itself is a major cause of accounting restatements. If it is, this suggests that the accounting rules are

ACCOUNTING CONTROL ASSESSMENT STANDARDS:

too complex for both preparers and their external auditors to deal with given current approaches and tools. If this is one of the primary root causes of the current restatement problem, both management and auditors should formally document accounting complexity and/or rule uncertainty as a major risk when evaluating the control systems during their SOX 404 assessments. We are unaware of any company that has listed “the inability to deal with complexity” as a material weakness in its SOX 404 filings with the SEC.

HYPOTHESIS # 3: RELUCTANCE TO TACKLE THE TOUGH, “INDELICATE” RISKS HEAD-ON

Some companies, audit committees, and external auditors are reluctant to tackle the really tough risks head-on. We believe that one of the significant reasons that companies and their auditors issue materially wrong financial statements is because some of the major risks to reliable disclosures are seen as too sensitive, political, or economically dangerous to deal with in a direct, upfront manner. Issues “too hot to touch” include the technical competence of senior management or the audit team, management attempts to manage earnings that may “cross the line,” and the complexity of the corporate structure and/or sector is beyond the ability of a company’s personnel, systems, and controls to handle.

We believe that the human tendency to avoid the direct approach to tackling problems before harm is done has often been, and will continue to be, at the root of many major accounting failures. Not all audit committees are comfortable asking the company’s external audit partner about the frequency and size of accounting errors it detected during the audit of management’s draft statements and, even more importantly, whether key accounting personnel are up to the job of consistently preparing draft financial statements with zero material errors.

HYPOTHESIS #4: THE TECHNOLOGY TO DETECT AND PREVENT ERRORS IS NOT BEING USED AS EFFECTIVELY AS POSSIBLE

Only a small percentage of companies or their external audit firms are tapping into the full power of available technology to find and prevent material accounting errors and irregularities. Vendors such as Thomson Publishing, Wolters Kluwer, Audit Analytics, Compliance Week, and others are developing Internet-based reference tools that provide quick, easy access to details on the most common accounting errors being detected in restatements, the relevant accounting standards and guidance available related to those issues, the most common accounting control problems by industry sector, and more. Other technology vendors offer tools that can help identify accounting “repair entries” booked in the accounting system after an accounting period has passed to correct mistakes in prior period accounting disclosures. Additionally, they can identify “suspicious” trends that suggest additional work is necessary on specific accounts, particularly high risk period-end accounting adjustments, and have tools to mine the accounting records for fraud “red flags.” Unfortunately, we believe that only a small percentage of public companies are using these tools to full effectiveness.

Based on our inquiries, we have not identified any external audit firms that maintain five-year historical records of all errors and irregularities they have identified during their audits. This data would allow pattern analysis, helping with the identification of trends and patterns that would disclose systemic control weaknesses, including the frequency that management has not provided full and frank disclosure. As noted earlier, in order for full transparency and understanding of systemic root cause errors to be a reality, appropriate safe harbors for issuers and public audit firms need to be seriously considered.

As a founding member of XBRL-US, we also believe that the growing adoption of the eXtensible Business Reporting Language (XBRL) will afford the opportunity to better capture the frequency of GL account errors from multiple internal financial and operations

systems and provide direct linkage to relevant information capable of preventing material errors.

HYPOTHESIS # 5: NO SINGLE ORGANIZATION TODAY IS ACCOUNTABLE FOR REDUCING THE FREQUENCY OF MATERIAL ACCOUNTING ERRORS

There is currently no organization, association, or standards body specifically focused on or responsible for reducing the frequency of material errors and irregularities in financial statements. The National Commission on Fraudulent Financial Reporting (now known as COSO) was created over 20 years ago with the mandate “to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence,” yet the problem of fraudulent and unreliable financial reporting has increased significantly in frequency and severity. Based on the rate of accounting restatements identified by Audit Analytics through the end of 2006, the overall reliability of accounting information is still a major problem. While early indications suggest that 2007 may show small signs of improvement, error rates remain high enough to be a major concern.

As a founding member of COSO, IMA continues to believe that COSO has stood the test of time in terms of raising awareness in the area of internal controls. We are concerned, however, that COSO is not currently funded or chartered to take on the role of defining and maintaining global accounting control assessment standards with the specific goal of reducing control effectiveness opinion errors. As noted earlier, the charter of the new organization we envision should include specific and measurable goals to improve the quality and reliability of financial reporting (e.g., lower number of financial restatements) driven by more effective internal controls systems. Currently, no organization specifically and publicly acknowledges that the reduction of accounting errors and irregularities in public company accounting disclosures is one of its core responsibilities, and we believe that this lack of direct and specific accountability is part of the problem.

HYPOTHESIS #6: TOO MUCH MONEY AND TIME ARE BEING SPENT ON LOW-RISK AREAS

In the March 2007 update to its July 2006 report on financial restatements, the GAO reported:

“The number of SEC enforcement cases involving financial fraud and issuer reporting issues increased from 79 in fiscal year 1998 to 185 in fiscal year 2005—a more than 130% increase. Moreover, in fiscal year 2005, cases involving financial fraud and issuer reporting issues constituted the largest category of enforcement actions.”

In a 2007 Oversight Systems study, 81% of respondents indicated that a primary reason that frauds occur is the “pressure to do ‘whatever it takes’ to meet goals”; 72% cited “personal gain”; and 40% percent said that those committing fraud “do not consider their actions [to be] fraudulent.”

A February 26, 2007, comment letter to the SEC from Greg Jonas, managing director of Moody’s Investor Service, voiced the issue succinctly:

“The requirement to report on internal control resulted from one particular type of internal control breakdown: senior management of some major public companies overrode their control systems and issued misleading financial statements. History has shown that senior management cooking the books has been most costly of control failures. It has caused billions in investor losses, undermined confidence in reporting affecting the liquidity and cost of capital for many companies, and triggered significant new regulations and requirements, including reporting on controls. Other forms of fraudulent financial reporting, such as misleading reporting by lower-level employees, have not had the same impact. Neither has control failures resulting in honest errors in financial reporting requirements, regardless of whether they relate to insufficient accounting skills, complex reporting requirements, difficult estimates or judgments or systems failures.”

ACCOUNTING CONTROL ASSESSMENT STANDARDS:

The 2006 SOX research study by IMA indicated quite clearly that existing guidance, including COSO's 1992 Internal Control-Integrated Framework and the PCAOB's AS2, did not provide adequate guidance to address fraud-related risks and focus resources where they were needed most. Given the major role that fraud risk has played in accounting failures and restatements, and in spite of signs of some improvement in this area, we believe that application of the current control assessment standards continue to direct a majority of SOX 404 spending to areas that have rarely been the source of material errors and irregularities in financial statements. It would be illuminating to ask registrants how much of their current SOX 404 efforts are focused directly on analysis of major accounting fraud prevention controls and then express those totals as percentages of the total time and costs of SOX 404 assessment and testing.

A new initiative by the ACFE, AICPA, IIA, IMA, and other supporting organizations to develop new fraud prevention guidance related to accounting disclosures is a step in the right direction, but we believe that it is premature to conclude that the current guidance from the SEC, the PCAOB, or this consortium will correct the current substantial misallocation of management and external auditor focus on areas that have rarely been the cause of materially wrong financial statements.



10 Paragon Drive
Montvale, NJ 07645-1760

Phone: 800-638-4427
201-573-9000

Fax: 201-474-1600

E-mail: ima@imanet.org
www.imanet.org