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September 20, 2007

Ms. Nancy M. Morris
Federal Advisory Committee Management Officer
Securities and Exchange Commission
100 F Street, NE
Washington DC 20549 -1090
USA

Dear Ms. Morris:

File No. 265-24: Discussion Paper for Consideration by the SEC Advisory Committee on Improvements in Financial Reporting

The Canadian Public Accountability Board (CPAB) is the oversight body for firms that audit Canadian public companies. To be accepted by Canadian securities regulatory authorities, auditors' reports on public companies must be signed by a firm in good standing with CPAB.

CPAB is pleased to respond to the above request for comments.

Our comments focus on the references in the Discussion Paper to "professional judgment" – or in some cases simply to the "judgment" – to be exercised by professionals in preparing or auditing financial statements. We note that one of the six areas of enquiry identified in the Advisory Committee's charter (Pages 7 and 8) states:

> *Other environmental factors that drive unnecessary complexity, including the possibility of being second-guessed, the structuring of transactions to achieve an accounting result, and whether there is a hesitance by professionals to exercise* <u>*professional judgment*</u> *in the absence of detailed rules (emphasis added).*

This point is repeated in the lead-in to the preliminary topics to be considered by the Audit Process and Compliance subcommittee, on Page 20 of the Discussion Paper. Further, a paragraph entitled "Use of Judgment" (Pages 21 and 22) is offered for consideration by this subcommittee:

Any move toward reducing complexity and increasing transparency should consider the role of preparer and auditor judgment as it relates to the reduction of prescriptive application guidance. For example, one approach to consider could be whether to expand the use of accounting and auditing standards that allow for more judgment in application. The subcommittee should also consider the role of disclosure in such an environment. For example, some have suggested that more latitude should be provided in standards, with the caveat that more disclosure is provided about the alternative(s) that were considered and why the selected alternative was applied. This subcommittee may wish to consider whether an increase in the use of judgment (elimination of bright lines and detailed application guidance) would result in increased usefulness of financial reports, including the potential impact on comparability. Furthermore, the subcommittee may wish to consider whether an increase in judgment on the part of preparers and auditors is impacted by not knowing or understanding how these groups will be judged by the SEC, the PCAOB or other (emphases added).

CPAB recommendations

CPAB makes the following recommendations to the Advisory Committee for consideration in preparing its report:

1. That the Committee defines or describes "professional judgment", and avoids using "judgment". – **Differences between judgment and professional judgment**
2. That the Committee stresses that preparers or auditors of financial statements cannot avoid making professional judgments, regardless of the type of standards being applied. – **Professional judgment will be needed with all types of standards**
3. That the Committee assesses whether the second-guessing of professional judgments made by professionals would be more easily defended if the professional judgements are carefully documented, including documentation of consultation. – **Defence against being second-guessed**

Our comments below are provided in support of these recommendations. They address the differences between judgment and professional judgment, the need for the exercise of professional judgment with all types of standards, and the avoidance of being second-guessed.

1. Differences between judgment and professional judgment

The Discussion Paper does not define "judgment" or "professional judgment", or describe the differences between them. Also, we are not aware of any other SEC publication, or any final pronouncement by a standard-setting body, that does so.

However, a recent exposure draft by the International Auditing and Assurance Standards Board, *ISA 200, Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing,* issued in April 2007, describes professional judgment in auditing as :

a) the application of relevant knowledge and experience,

b) within the context provided by auditing, accounting and ethical standards,
c) in reaching decisions appropriate in the circumstances of the audit engagement, and
d) a personal quality, meaning that judgments may differ between experienced auditors (but training and experience are intended to promote consistency of judgment). (Paragraph A24)

As a result of these characteristics, the exercise of professional judgment in any particular case may – according to the exposure draft - be regarded as reasonable if other experienced auditors can agree that this is the case. (Paragraph A25)

Interestingly, the exposure draft description does not refer to the need for due care, integrity or objectivity in making a professional judgment, all of which were components of the definition developed in the comprehensive study by Michael Gibbins and Alister Mason, *Professional Judgment in Financial Reporting*, published by the Canadian Institute of Chartered Accountants in 1988.

In contrast to the characteristics of "professional judgment", anyone can make a "judgment" – they can express an opinion or make a decision which may not be based on knowledge or experience, may not be within the context of any standards, and may not lead to a decision that is appropriate in the circumstances. Also, it may not be made with due care, integrity or objectivity. In other words, there is nothing professional about such a judgment. For these reasons, the Advisory Committee should define or describe professional judgment in the report it produces, and should refrain from simply using "judgment" in relation to a decision to be made by a preparer or auditor of financial statements.

2. Professional judgment will be needed with all types of standards

This issue was thoroughly discussed in the SEC's *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System*, published in 2003. It clearly set out the varying types of professional judgment required under rules-based, principles-based and objectives-oriented standards.

That Study took particular care to rebut the commonly-held belief that a comprehensive set of rules-based standards can minimize or eliminate the need for professional judgment. It summarized the reasons for this belief being mistaken on Pages 15 and 16; the final reason is especially telling:

> *"Finally, it is simply impossible to fully eliminate professional judgment in the application of accounting standards. To pretend that standards can be written in such a manner results in both unnecessary cost and a misplaced regulatory focus. No set of ever more complicated rules can substitute for the essential ingredients to the reporting process of professional integrity and accountability. Furthermore, as noted earlier, because of the exceptions and internal conflicts inherent in a rules-based system of accounting standards, judgment is not eliminated at all. Rather, the judgment shifts to a determination of which part of the contradictory rules should be applied."*

The conclusions drawn by the SEC were supported by the FASB in its release *FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System* in July 2004. However, the FASB cautioned that a move towards more objective-oriented standards would require shifts in attitude, behaviour and expertise of preparers and auditors. It continued (Pages 6 and 7):

> *The Board believes that it may take several years or more for such attitudes and behavioural changes to take root. One reason for that belief is that preparers continue to request scope exceptions, scope exemptions, and treatment alternatives and to oppose changes that would eliminate existing scope exceptions and treatment alternatives. In addition, the Board's recent experience suggests that many preparers and auditors have become less willing to exercise professional judgment in areas involving accounting estimates, uncertainties, and inherent subjectivity. Instead, they have been requesting detailed rules and bright lines in an apparent effort to reduce the need for the exercise of judgment in inherently subjective areas. Increased accountability for the accuracy of financial information under the new requirements related to the Sarbanes-Oxley Act coupled with a fear of "second guessing" by enforcement agencies and the trial bar are frequently cited as reasons for this behaviour.*

We believe that it is important that the Advisory Committee remind preparers and auditors that professional judgments will not be eliminated, or even necessarily minimized, if different types of standards are developed.

3. Defence against being second-guessed

The first quote from the Discussion Paper (on the first page of this letter) refers to concerns that professionals may have about being second-guessed. Later in the Paper it is specifically pointed out that preparers and auditors don't want to be second-guessed "by regulators, litigants, etc. in situations where reasonable/good faith judgments were made" - Pages 8 and 9.

This issue was addressed in the SEC's 2003 Study of a principles-based accounting system, referred to under the previous heading. That Study noted that a strong enforcement mechanism would be needed for an objectives-oriented regime to function properly, and that preparers and auditors should be able to demonstrate that they have made "*reasonable, good-faith judgments*" and interpretations of the applicable accounting literature. Specifically, the Study stated that such judgments in an objectives-oriented regime could best be demonstrated by (Page 35):

- Maintaining contemporaneous documentation that shows:
  - How the transaction or event was evaluated, including the determination of the substance of the transaction or event;
  - What body of accounting literature was applied to the transaction or event and, importantly, other alternatives that were considered, including the reasons for rejecting those alternatives;
  - The basis for concluding that the body of literature applied was appropriate; and
  - The auditor has communicated and discussed the matter with the company's audit committee.
- Clear and transparent disclosures in the financial statements or filings about the significant transactions and events and how those transactions were accounted for.

Interestingly, this advice does not refer to the desirability of consultation with other experienced professionals (and documenting that consultation), when making a professional judgment on a difficult issue. Perhaps discussion with the audit committee was considered to be sufficient, but it would seldom happen that the needed expertise to deal with a number of complex accounting issues would be represented on one committee – even a committee that has more than one "audit committee financial expert", as defined in the SEC release *Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*.

A particular aspect of alleged second-guessing was indicated in a recent informal survey of PCAOB inspection findings. A random sample was taken and reviewed of 20% of the PCAOB draft inspection reports issued from inception to August 31, 2007. The public accounting firms inspected are entitled to respond to the reports, and the reviewer focused on those responses.

The 20% sample gave a sample population of 97. Of these, 37 firms chose not to respond – perhaps feeling that there was nothing to be gained by responding to the regulator; seven responses were not made public, due to sensitive issues in them; and 15 firms either simply acknowledged that they had read the report or said they were pleased with the results of the inspection. Of the remaining 38, no fewer than 26 believed that at least some of the deficiencies raised by the PCAOB resulted from differences in professional judgment. The following quotes are excerpted from these responses, as examples.

> *The Report comments reflect differences between judgments made by audit engagement teams during the real-time process of the audit and those of inspectors during an inspection performed after such audits were completed. Our audit philosophy has been principles-based with emphasis on use of professional judgment, and application of professional judgment is required in many decisions in every audit. The audit inspection process necessarily involves evaluation of those judgments and may result in differing views on certain judgments made during the conduct of an audit.*

> *Professional judgment is inherent throughout our profession. Consequently from time to time differences of opinion occur between professionals regarding the interpretation, recording and or implementation of authoritative accounting literature. Our ultimate goal is to interpret, record or implement accounting transactions in a manner similar to our peers. We believe that the findings in question were interpreted in a manner similar to how our peers would have interpreted these transactions.*

Some commentators have sympathized with the accounting firms inspected by the PCAOB. For example, *The Economist* (January 28, 2006) observed that the inspectors focused on grey areas, such as the calculation of the fair value of assets, that could be criticized by anybody who looked hard enough for a potential misapplication of accounting rules.

It is not clear how well the 26 firms asserting professional judgment differences had documented the steps they had followed in making the disputed judgments, or whether the judgments had been the subject of consultation.

In our view, advice from the Advisory Committee on documentation of professional judgments so that they will stand up to subsequent second guessing would be very helpful. This may be particularly important as the use of fair values increases. Also, the issuance by the Committee of a set of examples of sound application of professional judgment would provide valuable guidance, if each set out (a) the assumed facts/circumstances; (b) the relevant accounting or auditing standards; and (c) the application of the standards to the facts, demonstrating how professional judgment was applied.

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If you wish to discuss any of the above comments, please contact Alister Mason at 416-522-1804.

Yours truly,

Keith Boocock
Chief Executive Officer