
STANDING ADVISORY GROUP MEETING

PANEL DISCUSSION – CIFIR PROPOSAL RELATING TO JUDGMENTS MADE BY FINANCIAL STATEMENT PREPARERS AND AUDITORS

FEBRUARY 27, 2008

Introduction

A panel will discuss a proposal of the Securities and Exchange Commission's ("SEC" or "Commission") Advisory Committee on Improvements to Financial Reporting ("CIFiR" or "Committee") relating to accounting and auditing judgments at the February 2008 meeting of the Standing Advisory Group ("SAG"). The SEC established CIFiR in June 2007 to "examine the U.S. financial reporting system with the goals of reducing unnecessary complexity and making information more useful and understandable for investors."^{1/} On February 14, 2008, CIFiR presented to the Commission a progress report ("CIFiR's Progress Report") which included a proposal relating to accounting and auditing judgments.^{2/} Specifically, CIFiR's Progress Report included the following proposal:

^{1/} See Press Release, SEC, "SEC Establishes Advisory Committee to Make U.S. Financial Reporting System More User-Friendly for Investors" (June 27, 2007), available at www.sec.gov/news/press/2007/2007-123.htm.

^{2/} See Progress Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission (February 14, 2008) ("CIFiR's Progress Report"), at 62-69, available at www.sec.gov/about/offices/oca/acifr/acifr-pr-021408-final.pdf. The progress report indicates that the Committee will issue a final report with written recommendations to the Chairman of the SEC after the conclusion of its work.

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

Developed Proposal 3.4: The SEC should adopt a judgment framework for accounting judgments. The PCAOB should also adopt a similar framework with respect to auditing judgments. Careful consideration should be given in implementing any framework to ensure that the framework does not limit the ability of auditors and regulators to ask appropriate questions regarding judgments and take actions to require correction of unreasonable judgments.

The proposed framework applicable to accounting-related judgments would include the choice and application of accounting principles, as well as the estimates and evaluation of evidence related to the application of an accounting principle. We believe that a framework that is consistent with the principles outlined in this developed proposal to cover judgments made by auditors based on the application of the PCAOB auditing standards would be very important and would be beneficial to investors, preparers, and auditors. Therefore, we propose that PCAOB develop a professional judgment framework for the application and evaluations of judgments made based on PCAOB auditing standards.^{3/}

The purpose of the SAG discussion is to hear from panelists about CIFIr's proposal regarding accounting and auditing judgments, and to provide the SAG with an opportunity for discussion.

CIFIr Developed Proposal on Accounting and Auditing Judgments

CIFIr's Progress Report acknowledges that "[p]rofessional judgment is not new to the areas of accounting, auditing, or securities regulation."^{4/} The report also asserts the following:

The recent increased focus on professional judgment, however, comes from several different developments, including changes in the regulation of auditors and a focus on more "principles-based" standards – for example, [Financial Accounting Standards Board] standards on fair value and

^{3/} Ibid., 67. An excerpt of CIFIr's Progress Report is provided in Appendix A to this briefing paper.

^{4/} Ibid., 62.

[International Accounting Standards Board] standards. Investors will benefit from more emphasis on "principles-based" standards, since "rules-based" standards...may provide a method, such as through exceptions and bright-line tests, to avoid the accounting objectives underlying the standards. If properly implemented, "principles-based" standards should improve the information provided to investors while reducing the investors' concern about "financial engineering" by companies using the "rules" to avoid accounting for substance of a transaction. While both auditors and issuers appear supportive of a move to less prescriptive guidance, they have expressed concern regarding the perception that current practice by auditors and regulators in evaluating judgments does not provide an environment in which such judgments may be generally respected. This, in turn, can lead to repeated calls for more rules, so that the standards can be comfortably implemented.

Many regulators also appear to encourage a system in which professionals can use their judgment to determine the most appropriate accounting and disclosure for a particular transaction. Regulators assert that they do respect judgments, but may also express concerns that some companies and auditors may attempt to inappropriately defend certain errors as "reasonable judgments." Identifying standard processes for making professional judgments and criteria for evaluating those judgments, after the fact, may provide an environment that promotes the use of judgment and encourages consistent evaluation practices among regulators.^{5/}

CIFI R's Progress Report suggests that a framework may help address the following issues:

- Investors' lack of confidence in the use of judgment;
- Preparers' and auditors' concern regarding whether reasonable judgments are respected;
- Lack of agreement in principle on the criteria for evaluating judgments; and

^{5/} Ibid.

- Concern over increased use of "principles-based" standards.^{6/}

CIFIIR's Progress Report states that "[t]here are many categories of accounting and auditing judgments that are made in preparing financial statements, and a framework should encompass all of these categories, if practicable."^{7/} The framework describes the following categories of accounting judgment:

- Selection of accounting standard;
- Implementation of an accounting standard;
- Lack of applicable accounting standards;
- Financial statement presentation;
- Estimating the actual amount to record; and
- Evaluating the sufficiency of evidence.^{8/}

Accounting Judgments

CIFIIR's Progress Report proposes a framework for accounting judgments consisting of two components, (1) a critical and good faith thought process and (2) documentation. The report describes those components as follows:

Critical and Good Faith Thought Process – Professional judgment should be based on a critical and reasoned evaluation made in good faith, prior to the exercise of the judgment, of an identified issue, including the nature and scope of the issue based on:

1. An analysis of the transaction, including the substance and business purpose of the transaction;

^{6/} Ibid., 63.

^{7/} Ibid.

^{8/} Ibid., 63-65.

2. The material facts reasonably available at the time that the financial statements are issued;
3. A thorough review and analysis of relevant literature, including the relevant underlying principles;
4. Alternative views or estimates, including pros and cons for reasonable alternatives;
5. The rationale for the choice selected, including reasons for the alternative or estimate selected and linkage of the rationale to investors' information needs and the judgments of competent external parties;
6. Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated;
7. Known diversity in practice regarding the alternatives or estimates;^{fn/}
8. The consistency of application of alternatives or estimates to similar transactions; and
9. The appropriateness and reliability of the assumptions and data used.

The critical thought process should include input from personnel with an appropriate level of professional expertise and should include a sufficient amount of time and effort to properly consider the judgment.

Material issues or transactions that were analyzed pursuant to the application of the framework should be disclosed in accordance with existing disclosure requirements. This disclosure should be transparent so that the investor understands the transaction and assumptions that were critical to the judgment. When evaluating professional judgment, auditors, and/or regulators should take into account the disclosure relevant to the judgment.

Documentation – The alternatives considered and the conclusions reached should be documented contemporaneously. The lack of

contemporaneous documentation may not mean that a judgment was incorrect, but would complicate an explanation of the nature and propriety of a judgment made at the time of the release of the financial statements.

^[fn] If there is not diversity in practice, it would be significantly harder to select a different alternative.^{9/}

Discussion Topics –

Presentations and discussion may address the following topics:

- The objectives and elements of the accounting judgment framework proposed by CIFIIR.
- Whether the SEC's adoption of an accounting judgment framework would have an effect on public company audits and if so, what effect.

Auditing Judgments

As previously mentioned, CIFIIR's Progress Report does not provide a framework for evaluating auditing judgments. Rather, the Committee proposes that the PCAOB "adopt a similar framework with respect to auditing judgments."^{10/}

Judgment is referenced throughout the PCAOB standards. For instance, paragraph .05 of the Board's interim standard, AU section 110, *Responsibilities and Functions of the Independent Auditor*, states that "the independent auditor must exercise his judgment in determining which auditing procedures are necessary in the circumstances to afford a reasonable basis for his opinion. His judgment is required to be the informed judgment of a qualified professional person." Examples in which judgment is used in the audit process include the following:

- Determining the nature, timing, and extent of audit procedures to be performed;
- Evaluating fraud and other risk factors;

^{9/} Ibid., 69.

^{10/} Ibid., 67.

- Performing analytical procedures in planning the audit to identify such things as the existence of unusual transactions and events, and amounts, and trends that might indicate matters that have financial statement and audit planning ramifications;
- Assessing the competence and objectivity of internal auditors;
- Determining sample sizes for tests of controls or account balances.
- Evaluating control deficiencies to determine whether a deficiency is a significant deficiency or material weakness;
- Evaluating judgments made by management in determining accounting estimates; and
- Evaluating whether sufficient, competent, evidential matter has been obtained in order to render an audit report.

Discussion Topics –

Presentations and discussion may address the following topics:

- Whether CIFI R's proposal that the PCAOB develop and adopt a framework with respect to auditing judgments would have an effect on public company audits, and, if so, what effect.
- The elements that should be included in any such framework for auditing judgments.
- Suggestions for how the Board could implement any framework so that, as CIFI R proposes, it "does not limit the ability of auditors and regulators to ask appropriate questions regarding judgments and take actions to require correction of unreasonable judgments."

* * *

The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the

interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

APPENDIX A

Excerpt from

**PROGRESS REPORT
of the
ADVISORY COMMITTEE
on IMPROVEMENTS to
FINANCIAL REPORTING
to the
UNITED STATES SECURITIES and
EXCHANGE COMMISSION**

February 14, 2008

CHAPTER 3: AUDIT PROCESS AND COMPLIANCE

III. Professional Judgment

III.A. Background

Overview

Professional judgment is not new to the areas of accounting, auditing, or securities regulation – the criteria for making and evaluating professional judgment have been a topic of discussion for many years. The recent increased focus on professional judgment, however, comes from several different developments, including changes in the regulation of auditors and a focus on more "principles-based" standards – for example, FASB standards on fair value and IASB standards. Investors will benefit from more emphasis on "principles-based" standards, since "rules-based" standards (as discussed in chapters 1 and 2) may provide a method, such as through exceptions and bright-line tests, to avoid the accounting objectives underlying the standards. If properly implemented, "principles-based" standards should improve the information provided to investors while reducing the investor's concern about "financial engineering" by companies using the "rules" to avoid accounting for the substance of a transaction. While both auditors and issuers appear supportive of a move to less prescriptive guidance, they have expressed concern regarding the perception that current practice by auditors and regulators in evaluating judgments does not provide an environment in which such judgments may be generally respected. This, in turn, can lead to repeated calls for more rules, so that the standards can be comfortably implemented.

Many regulators also appear to encourage a system in which professionals can use their judgment to determine the most appropriate accounting and disclosure for a particular transaction. Regulators assert that they do respect judgments, but may also express concerns that some companies and auditors may attempt to inappropriately defend certain errors as "reasonable judgments." Identifying standard processes for making professional judgments and criteria for evaluating those judgments, after the fact, may provide an environment that promotes the use of judgment and encourages consistent evaluation practices among regulators.

Goals of a Framework

The following are several issues that a potential framework may help address:

- a. Investors' lack of confidence in the use of judgment – A professional judgment framework may provide investors with greater comfort that there is an acceptable rigor that companies follow in exercising reasonable professional judgment.

- b. Preparers' and auditors' concern regarding whether reasonable judgments are respected – In the current environment, preparers and auditors may be afraid to exercise judgment for fear of having their judgments overruled, after the fact, by auditors, regulators and legal claimants.
- c. Lack of agreement in principle on the criteria for evaluating judgments – The criteria for evaluating reasonable judgment, including the appropriate role of hindsight in the evaluation, may not be clearly defined and thus may lead to increased uncertainty.
- d. Concern over increased use of "principles-based" standards – Companies, auditors and investors may be less comfortable in their ability to implement more "principles-based" standards if there is a concern over how reasonable judgments are reached and how they will be assessed.

Categories of Judgments that are Made in Preparing Financial Statements

There are many categories of accounting and auditing judgments that are made in preparing financial statements, and a framework should encompass all of these categories, if practicable. Some of the categories of accounting judgment are as follows:

1. Selection of accounting standard

In many cases, the selection of the appropriate accounting standard under GAAP is not a highly complex judgment (e.g., leases would be accounted for using lease accounting standards and pensions would be accounted for using pension accounting standards). However, there are cases in which the selection of the appropriate accounting standard can be highly complex.

For example, the standards on accounting for derivatives contain a definition of a derivative and provide scope exceptions that limit the applicability of the standard to certain types of derivatives. To evaluate how to account for a contract that has at least some characteristics of a derivative, one would first have to determine if the contract met the definition of a derivative in the accounting standard and then determine if the contract would meet any of the scope exceptions that limited the applicability of the standard. Depending on the nature and terms of the contract, this could be a complex judgment to make, and one on which experienced accounting professionals can have legitimate differing, yet acceptable, opinions.

2. Implementation of an accounting standard

After the correct accounting standard is identified, there are judgments to be made during its implementation.

Examples of implementation judgments include determining if a hedge is effective, if a lease is an operating or a capital lease, and what inputs and methodology should be utilized in a fair value calculation. Implementation judgments can be assisted by implementation guidance issued by standards-setters, regulators, and other bodies; however, this guidance could increase the complexity of selecting the correct accounting standard, as demonstrated by the guidance issued on accounting for derivatives.

Further, many accounting standards use wording such as "substantially all" or "generally." The use of such qualifying language can increase the amount of judgment required to implement an accounting standard. In addition, some standards may have potentially conflicting statements.

3. Lack of applicable accounting standards

There are some transactions that may not readily fit into a particular accounting standard. Dealing with these "gray" areas of GAAP is typically highly complex and requires a great deal of judgment and accounting expertise. In particular, many of these judgments use analogies from existing standards that require a careful consideration of the facts and circumstances involved in the judgment.

4. Financial Statement Presentation

The appropriate method to present, classify and disclose the accounting for a transaction in a financial statement can be highly subjective and can require a great deal of judgment.

5. Estimating the actual amount to record

Even when there is little debate as to which accounting standard to apply to a transaction, there can be significant judgments that need to be made in estimating the actual amount to record.

For example, opinions on the appropriate standard to account for loan losses or to measure impairments of assets typically do not differ. However, the assumptions and methodology used by management to actually determine the allowance for loan losses or to determine an impairment of an asset can be a highly judgmental area.

6. Evaluating the sufficiency of evidence

Not only must one make a judgment about how to account for a transaction, the sufficiency of the evidence used to support the conclusion must be evaluated. In practice, this is typically one of the most subjective and difficult judgments to make.

Examples include determining if there is sufficient evidence to estimate sales returns or to support the collectability of a loan.

Levels of Judgment

There are many levels of judgment that occur related to accounting and auditing. Preparers must make initial judgments about uncertain accounting issues; the preparer's judgment may then be evaluated or challenged by auditors, investors, regulators, legal claimants, and even others, such as the media. Similarly, planning and performing an audit requires numerous judgments. These judgments are also potentially subject to evaluation and challenge by investors, regulators, legal claimants and others, especially when, in hindsight, it has become clear that the auditor failed to detect material errors in the financial statements. Therefore, in developing a potential framework, differences in role and perspective between those who make a judgment and those who evaluate a judgment should be carefully considered. A framework should not make those who evaluate a judgment (auditors, regulators, and others) re-perform the judgment according to the framework. Instead, a framework should provide guidance to those who would evaluate a judgment on factors to consider while making that evaluation.

Hindsight

One appropriate tool used in auditing is hindsight – the ability of the auditor to use facts that are available through the completion of the audit work to evaluate the sufficiency of management's estimates and assumptions based on actual facts that become available after those estimates are made.

For example, auditors will frequently test the accuracy of the company's accounts payable balance at period-end by looking at cash disbursements made after the period-end. This evidence allows the auditor to determine whether the accrual for unpaid expenses at year-end is adequate.

However, the use of hindsight to evaluate a judgment where the relevant facts were not available at the time of the initial release of the financial statements (including interim financial statements) is not appropriate. Determining at what point the relevant facts were known to management or the auditor, *or should have been known*,^{59/} can be difficult, particularly for regulators who are often evaluating these circumstances after substantial time has passed. Therefore, the use of hindsight should only be used based

^{59/} We believe that those making a judgment should be expected to exercise due care in gathering all of the relevant facts prior to making the judgment.

on the facts reasonably available at the time the annual or interim financial statements were issued.

Form of Framework

Some have proposed that a "safe harbor" be developed that protects the exercise of judgment in accordance with a specified framework. That approach would seem to provide greater support to auditors and preparers than a statement of policy. However, it is unclear to us whether a legal or regulatory safe harbor (i.e., an effective legal or regulatory defense based on conformity with the framework) could be adopted by the SEC or whether it would require changes to existing statutes.

Another approach is for the SEC and the PCAOB to issue policy statements that describe a framework for the exercise of professional judgment and state that auditors, the SEC or the PCAOB, as applicable, would take into account the implementation of the framework in evaluating a judgment made by a registrant or an auditor. The SEC has utilized similar frameworks in the past with success. Examples of previous frameworks by the SEC include the "Seaboard" report (October 23, 2001) on the relationship of cooperation by a company to taking action in an enforcement case and the SEC's framework for assessing the appropriateness of corporate penalties (January 4, 2006).

While not an automatic defense of the registrant's or auditor's judgment, a framework would provide more support to registrants and auditors that the applicable regulator would be likely to accept a judgment made if the registrant or the auditor had fully implemented the framework. The framework is likely to enhance the quality of judgments by providing incentives to follow a rigorous process for making accounting and auditing judgments. The increased use of this rigorous process should, in turn, provide more comfort to investors about the quality of accounting judgments made in connection with financial statements.

It is unclear to us whether, as a matter of regulatory strategy, this judgment framework should be implemented through a safe harbor or policy statement. We leave to the SEC and its staff the resolution of these difficult issues.

The Nature and Limitations of GAAP:

Some have suggested that the standard in a potential professional judgment framework for the selection and implementation of GAAP be a requirement to reflect the economic substance of a transaction or be a standard of selecting the "high road" in accounting for a transaction. We agree that qualitative standards for GAAP such as these would be desirable and we encourage regulators and standards-setters to move financial reporting in this direction. However, such standards are not always present in financial reporting today and we cannot recommend the adoption of such standards in a

professional judgment framework without anticipating a fundamental long-term revision of GAAP – a change that would be beyond our purview and one that would not be doable in the near- or intermediate-term.

For example, there is general agreement that accounting should follow the substance and not just the form of a transaction or event. Many believe that this fundamental principle should be extended to require that all GAAP judgments should reflect economic substance. However, reasonable people disagree on what economic substance actually is, and many would conclude that significant parts of current GAAP do not require and do not purport to measure economic substance (e.g., accounting for leases, pensions, certain financial instruments and internally developed intangible assets are often cited as examples of items reported in accordance with GAAP that would not meet many reasonable definitions of economic substance).

Similarly, some would like financial reporting to be based on the "high road" – a requirement to use the most preferable principle in all instances. Unfortunately, today a preparer is free to select from a variety of acceptable methods allowed by GAAP (e.g., costing inventory, measuring depreciation, and electing to apply hedge accounting are just some of the many varied methods allowed by GAAP) without any qualitative standard required in the selection process. In fact, a preferable method is required to be followed only when a change in accounting principle is made, and a less preferable alternative is fully acceptable absent such a change.

We believe that adopting a requirement that accounting judgments reflect economic substance or the "high road" would require a revolutionary change not achievable in the foreseeable future. Our suggested judgment framework could and we believe would enhance adherence to GAAP, but it cannot be expected to correct inherent weaknesses in the standards to which it would be applied.

III.B. Developed Proposals

We have developed the following proposal:

Developed Proposal 3.4: The SEC should adopt a judgment framework for accounting judgments. The PCAOB should also adopt a similar framework with respect to auditing judgments. Careful consideration should be given in implementing any framework to ensure that the framework does not limit the ability of auditors and regulators to ask appropriate questions regarding judgments and take actions to require correction of unreasonable judgments.

The proposed framework applicable to accounting-related judgments would include the choice and application of accounting principles, as well as the estimates and evaluation of evidence related to the application of an

accounting principle. We believe that a framework that is consistent with the principles outlined in this developed proposal to cover judgments made by auditors based on the application of PCAOB auditing standards would be very important and would be beneficial to investors, preparers, and auditors. Therefore, we propose that the PCAOB develop a professional judgment framework for the application and evaluations of judgments made based on PCAOB auditing standards.

We propose that the framework for accounting judgments be consistent with the following concepts:

Framework for Professional Judgment in Accounting

The Concept of Professional Judgment

Professional judgment, with respect to accounting matters, should be the outcome of a process in which a person or persons with the appropriate level of knowledge, experience, and objectivity form an opinion based on the relevant facts and circumstances within the context provided by applicable accounting standards. Professional judgments could differ between knowledgeable, experienced, and objective persons. Such differences between reasonable professional judgments do not, in themselves, suggest that one judgment is wrong and the other is correct. Therefore, those who evaluate judgments should evaluate the reasonableness of the judgment, and should not base their evaluation on whether the judgment is different from the opinion that would have been reached by the evaluator.

This framework would serve as the primary, though not exclusive, approach to evaluating the process of making professional judgments. While regulators would strongly support the principles of this framework, the mere completion of the process outlined in the framework in making a judgment would not prevent an auditor and/or regulator from asking appropriate questions about the judgment or asking companies to correct unreasonable judgments. A judgment framework would not eliminate debate, nor should it attempt to do so. Rather, it organizes analysis and focuses preparers and others on areas to be addressed thereby improving the quality of the judgment and likelihood that auditors^{60/} and regulators will accept the

^{60/} It should be noted that, while auditors should be using the framework to evaluate a client's judgments and should respect reasonable judgments, they still have a requirement to follow PCAOB auditing standards, which would include expressing an opinion regarding whether the client's financial statements are fairly presented, in all material respects, in accordance with GAAP. Therefore, this framework would not require auditors to issue an unqualified audit opinion when they disagree with a judgment.

judgment. Conversely, not following the framework would not imply that the judgment is unreasonable.

This framework reflects the fact that GAAP does not always reflect the economic substance of a transaction and that it may be difficult to determine how the accounting would meet the needs of investors. In addition, this framework would be applicable to accounting matters only to the extent that judgments were required in the choice or application of accounting principles, in estimating the amount to record, or in evaluating the sufficiency of the evidence.

In applying the components of the framework, it would be expected that the amount of documentation, disclosure, input from professional experts,^{61/} and level of effort in making a professional judgment would vary based on the complexity, nature (routine versus non-routine) and materiality of a transaction or issue requiring judgment.

Components of a Framework

Critical and Good Faith Thought Process – Professional judgment should be based on a critical and reasoned evaluation made in good faith, prior to the exercise of the judgment, of an identified issue, including the nature and scope of the issue based on:

1. An analysis of the transaction, including the substance and business purpose of the transaction
2. The material facts reasonably available at the time that the financial statements are issued
3. A thorough review and analysis of relevant literature, including the relevant underlying principles
4. Alternative views or estimates, including pros and cons for reasonable alternatives
5. The rationale for the choice selected, including reasons for the alternative or estimate selected and linkage of the rationale to investors' information needs and the judgments of competent external parties

^{61/} In many cases, input from professional experts would include consultation with a preparer's independent auditors.

6. Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated
7. Known diversity in practice regarding the alternatives or estimates^{62/}
8. The consistency of application of alternatives or estimates to similar transactions
9. The appropriateness and reliability of the assumptions and data used.

The critical thought process should include input from personnel with an appropriate level of professional expertise and should include a sufficient amount of time and effort to properly consider the judgment.

Material issues or transactions that were analyzed pursuant to the application of the framework should be disclosed in accordance with existing disclosure requirements. This disclosure should be transparent so that the investor understands the transaction and assumptions that were critical to the judgment. When evaluating professional judgment, auditors, and/or regulators should take into account the disclosure relevant to the judgment.

Documentation – The alternatives considered and the conclusions reached should be documented contemporaneously. The lack of contemporaneous documentation may not mean that a judgment was incorrect, but would complicate an explanation of the nature and propriety of a judgment made at the time of the release of the financial statements.

^{62/} If there is not diversity in practice, it would be significantly harder to select a different alternative.