# SARBANES-OXLEY: TWO YEARS OF MARKET AND INVESTOR RECOVERY

## HEARING

BEFORE THE

## COMMITTEE ON FINANCIAL SERVICES
## U.S. HOUSE OF REPRESENTATIVES

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# SARBANES-OXLEY: TWO YEARS OF MARKET AND INVESTOR RECOVERY

**Thursday, July 22, 2004**

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The committee met, pursuant to call, at 10:04 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Baker, Bachus, Castle, Kelly, Ryun, Biggert, Fosella, Capito, Tiberi, Feeney, Hensarling, Waters, Maloney, Velazquez, Watt, Hooley, Lee, Inslee, Hinojosa, Lucas of Kentucky, Clay, Matheson, Miller of North Carolina, Davis, and Bell.

The CHAIRMAN. [Presiding.] The committee will come to order.

It has been 2 years since the Congress passed and President Bush signed the most sweeping corporate reform law in our nation's history. The Sarbanes-Oxley Act of 2002 was designed to curb accounting fraud, make financial statements more transparent and understandable, and hold company executives and directors accountable. I am pleased to say that the early returns are in and they are positive.

We all know that no law will stop certain determined bad actors from violating the trust of shareholders. Indeed, if that were shareholders we would have passed such legislation a long time ago. But Congress can establish incentives and disincentives for certain behavior. It does have the ability and the obligation to establish a baseline of professional conduct for American business. If these minimum standards are not met, Congress can help ensure that there will be swift, certain and severe punishment.

Sarbanes-Oxley was passed during a period in which a majority of Americans had lost faith in the pillars of corporate life: company executives, public accountants, investment bankers, stock and bond analysts, and attorneys. This mistrust, I would point out, was well founded. Too many failed to act ethically. Indeed, we have learned that many violated criminal laws and will serve time in prison. Sadly, it was more than a few bad apples.

That is the climate in which Sarbanes-Oxley was debated and passed. Remarkably, considering the overheated political environment at the time, it is measured and responsible legislation. Many of its provisions require companies to do things that they were already doing or should have been doing. As companies find that certain mandates like the internal control standard are particularly

costly, maybe that is because they were deficient in that particular area.

Numerous parts of the act appear to be working extremely well. Certifications of company financials by chief executives and finance chiefs, independent and empowered audit committees, officer and director bars, and the FAIR fund have all had a very powerful and positive impact, to cite just a few provisions.

Are there increased costs? Yes. Do the benefits of improved financial reporting, more active and engaged boards and trusted markets outweigh these added costs? I believe yes. But do not take my word for it. Recent surveys indicate that a majority of corporate directors believe the act has had a positive impact on their companies and boards. That is not to say that this is a perfect statute. It certainly is not. No legislation ever is, or at least none have been in my two decades here in Washington. But it does appear to be working quite well and for that we should be very proud.

I look forward to hearing from our distinguished panel today. We have heard from many of you before and we obviously like what we have heard because we have invited you back. Welcome.

I now look to other members for an opening statement. Are there other members seeking an opening statement? The gentleman from Alabama.

[The prepared statement of Hon. Michael G. Oxley can be found on page 44 in the appendix.]

Mr. BACHUS. Mr. Chairman, I do not have an opening statement.

The CHAIRMAN. We will turn then to our distinguished panel. Let me introduce them, from my left to right: Mr. James H. Quigley, chief executive officer of Deloitte & Touche; Mr. Mitchell H. Caplan, chief executive officer of E*TRADE Financial Corporation; the Honorable Roderick M. Hills, former SEC Chairman and White House Counsel, welcome back; Mr. Joseph V. Del Raso, partner of Pepper Hamilton, LLP; and Mr. Richard L. Trumka, secretary-treasurer, AFL-CIO.

Gentleman, to all of you we are in your debt for appearing today and giving us a good review 2 years later of the Sarbanes-Oxley legislation. Mr. Quigley, we will begin with you.

## STATEMENT OF JAMES H. QUIGLEY, CEO, DELOITTE & TOUCHE

Mr. QUIGLEY. Thank you, Mr. Chairman and members of the House Committee on Financial Services.

I am pleased with the opportunity to appear before you on behalf of the partners of Deloitte. Deloitte has 30,000 people in the U.S. and we audit more than 20 percent of the Fortune 1000 companies. I have served in several roles in our audit practice and have first-hand experience on many levels, including as a lead audit partner responsible for signing the firm's name.

As the CEO, I interact with our largest clients and attend approximately 40 audit committee meetings per year, including two this week. I will provide my perspective and insight from the front-line. Sarbanes-Oxley is having a positive impact on the financial reporting process at public companies. I believe the risk of fraudulent financial reporting has been reduced.

The effectiveness of financial reporting requires management, audit committees and auditors each to perform their essential role. The requirements in the act are directed to each participant. Management has strengthened their process in part to support the certifications by CEOs and CFOs of the financial disclosures. In addition, disclosure committees have been put in place and they are working effectively each quarter to improve the transparency and completeness of the financial disclosures. And the internal control documentation and related processes which have attracted significant attention when discussions of cost occur is also having a positive impact. It has led to broader acceptance of the responsibility for controls. Line management no longer defers solely to the controller or the internal audit department with respect to controls. This is progress.

Audit committee effectiveness has also improved dramatically. We have seen many well-intentioned efforts to improve audit committee performance, 15 years ago, the Treadway Commission report and more recently the Blue Ribbon Panel. But I observed many audit committees viewed those best practices as good ideas for someone else. The force of law through Sarbanes-Oxley has made it different this time. I see and feel the difference.

The number of meetings is up by 50 percent. The duration of the meetings has also increased by 50 percent, fundamentally doubling the amount of time that audit committees are spending in overseeing the financial reporting process. Members are better informed. They are better prepared and they better understand their essential role. They ask focused, probing questions. Prior to the act, the audit committee chairman would rarely call the lead audit partner in between meetings or in preparation for an upcoming meeting. Since the act over the past 2 years, this has become a very common practice.

Auditors are also stepping up. They have embraced both the letter and the spirit of this new law. We are working more effectively with audit committees and our new regulator the PCAOB. We have built our capacity to handle the Section 404 attestation requirements. At Deloitte, the number of internal control and systems assurance specialists in our firm have been increased by 20 percent and we have provided extensive training to each of our assurance professionals.

With respect to cost-benefits, some are honestly questioning whether the benefits exceed the costs. Most questions point at the Section 404 requirements. I believe we need to work through a full cycle of implementation before we revisit the standards, the law or the regulations related to Sarbanes-Oxley and then, after we have made our way through that first full cycle of implementation and have all of those learnings under our belt, we can again revisit and ask if changes are needed.

I believe in the cost-benefit question we need to view this in the spirit of the market cap of each of the registrants. Based on a recent survey by FEI that indicates the average cost of compliance, both costs that will be incurred by the registrant as well as costs that they will pay to the auditor, will average about $5 million per member of the S&P 500. When you view that cost in relation to the market capitalization of that group of companies, it is a very, very,

very tiny fraction of 1 percent, .03 of 1 percent of the market cap. When we think about the opportunity that we have to reduce the risk of fraudulent financial reporting, I believe that is a cost that is well paid.

Separate from Sarbanes-Oxley, the SEC issued a rule to shorten the number of days between a company's fiscal year end and the filing of its annual report, from 90 days in 2002 to 75 days in 2003 and to 60 days for 2004. This plan for accelerated filing requirements was conceived before section 404 was enacted. Having to address both these new and significant requirements in the same year is very challenging and will put unusual pressure on all parties concerned that could impact the quality of financial reporting, the audit, and the internal control assessments. Frankly, it might also increase further these costs.

Next week, we will recommend in a letter to the SEC that it delay by 1 year the acceleration to the 60-day filing requirement, making it applicable for 2005 annual reports. This would allow companies and auditors an additional 2 weeks this year to focus on these significant new internal control requirements of the act.

Let me conclude. We are making progress, and I believe anytime you assess the impact of a change as sweeping as Sarbanes-Oxley, it is as important to consider the direction you are moving, as well as assess where we are. The risk of fraudulent financial reporting has been reduced by the actions taken to implement the act by management, by audit committees, by the PCAOB, by auditors. I believe it is time to absorb this massive change represented by Sarbanes-Oxley. Let's sustain our commitment to restore investor confidence and avoid future legislation, regulation, or scope of services limitations.

Costly, yes, but I believe these are costs that registrants should be willing to pay in return for the privilege of being the stewards of the public's money.

Thank you, Mr. Chairman.

[The prepared statement of James H. Quigley can be found on page 111 in the appendix.]

The CHAIRMAN. Thank you, Mr. Quigley.

Mr. Caplan?

## STATEMENT OF MITCHELL H. CAPLAN, CEO, E*TRADE FINANCIAL CORPORATION

Mr. CAPLAN. Good morning. I am Mitchell Caplan, CEO of E*TRADE Financial. We are a leading provider of online, personalized and fully integrated financial services, including investing, banking, lending, planning and advice. A key tenet of our business strategy is to use our proprietary technology and the Internet to deliver an integrated, personalized and value-added financial services experience to all our customers.

I would like to thank Chairman Oxley and the committee for inviting us to share our company's experience with the implementation of the Sarbanes-Oxley Act as your committee examines the law's effectiveness since its enactment 2 year ago. Our experience with this law has clearly been a positive one. At the time this committee was debating the legislation, which became known as Sar-

banes-Oxley, E*TRADE Financial was confronted with a serious corporate governance issue.

Our former CEO had taken an $80 million pay package amidst a number of unfolding corporate scandals. This excessive compensation package was frankly a surprise to many in the company and revealed flaws in our corporate governance policies and structure. Trust is especially important for the customers and shareholders of financial services companies. This breach of trust for us was a call to action. In 2003, the board of directors aggressively put in place changes to restore the confidence of our employees, our customers, our investors and our analysts. With the resignation of our former CEO, E*TRADE's board of directors took action to address those issues.

The board first separated the titles of chairman and CEO. It brought on four new members to our board of directors. We revamped entirely the audit and compensation committees of the board. We eliminated interlocking directors. We rationalized executive pay. We added a chief risk officer to our management team. We greatly enhanced the internal control processes by establishing additional checks and balances in compliance with Sarbanes-Oxley's Section 404, and we rotated our auditors.

When I assumed the role of CEO, we clearly had lost the confidence of both the investment community and our employees. While excessive executive compensation was the obvious problem, it drove the company to recast the composition and structure of the board and to realign incentives by focusing on rewarding actions that add value to our shareholders.

Today, after working to adhere to the strict guidelines of corporate governance, we have restored investor confidence and investor trust. We have been able to refocus on our core strength, providing innovative products and technology to self-directed investors.

Our implementation of Sarbanes-Oxley 404 has progressed very well, although the process has not been painless. The value we have received from documentation and testing has reinforced management's understanding of accountability for processes and financial reporting across the entire company. It has helped us identify where those processes were deficient or inadequate, and we have designed the necessary improvements to correct those inadequacies.

E*TRADE commends the committee for reviewing the Sarbanes-Oxley Act. We would urge you to resist any wholesale changes to the law. No one can fully predict the consequences of a new law until enough time has passed to determine whether it is working as Congress intended. Our management team and our board strongly believe that good corporate governance is a key contributor to shareholder value. The time and effort our management and board has taken to comply with Sarbanes-Oxley has fostered a vigorous, yet healthy internal debate over the company's direction and how to deliver innovative products to our customers, further adding value to our shareholders.

The changes we have implemented reflect the company's transition from a dot com organization into today a mature financial services business. It allows us to focus once again on our business

of bringing the best new innovative products and technology to our customers, such as our rebate program for 12b-1 fees and our mortgage on the move product.

Thank you for the opportunity to testify. I would be happy to answer any questions.

[The prepared statement of Mitchell H. Caplan can be found on page 49 in the appendix.]

The CHAIRMAN. Thank you, Mr. Caplan.

Mr. Hills, welcome back.

**STATEMENT OF HON. RODERICK M. HILLS, FORMER SEC CHAIRMAN AND WHITE HOUSE COUNSEL**

Mr. HILLS. Thank you, Mr. Chairman and members of the committee.

I would like to offer you the perspective of spending 32 years working with 18 audit committees and chairing 10 of them. I suppose the first thing I would say is that as the Enron scandal fades from memory, it is fairly natural that a whole lot of complaints about the act might spring up. It costs too much, say many people. Thousands of honorably run companies should not have to bear the burden caused by a dozen bad companies. Board members and audit committee members have been forced to do much more than they can do. And by the way, some say the public did not really demand this legislation anyway.

The fact is that something was badly broken and it needed fixing. A corporate system, a system of corporate governance that was crafted by the SEC back in the middle 1970s had run out of gas. Back then, there were hundreds of American companies, U.S.-based companies that had off-the-books bank accounts, secret bank accounts where monies were disbursed without oversight. Much of that money was used to pay bribes.

The SEC took three steps. It mandated internal controls. It required external auditors to bring anything of a suspicious nature to the attention of somebody independent of suspicion, and persuaded the New York Stock Exchange to require independent audit committees.

Why did that run out of gas? Well, today a quarter of a century later, we have a knowledge-based economy whose assets are determined in large part by the judgments, the assumptions, the estimates made by management, with some oversight by the auditors. It is not the bricks and mortar economy of the past, where historical costs were used to fix those values. So management today has had much greater discretion in fixing the values used in their financial statements.

As management became more innovative in developing their values, the FASB, the Financial Accounting Standards Board, created ever more complex accounting standards and even more complex interpretations of those standards. Accountants to some degree became rule-checkers and to a large extent the basic audit became a commodity. The growing maze of rules became a magnet for the fertile minds of lawyers, bankers and consultants who created these complex corporate structures that wended their way through the maze of rules, satisfying maybe the letter of the rules, but certainly not the spirit.

Audit committees were passive during that period. Auditors did not sit down with the audit committees and explain the alternatives that were available to management in constructing a financial statement. The audit committees did not play a meaningful role in selecting the auditor or selecting the engagement partner, or in fixing the audit fees except in those rare occasions where they suggested the fee be lowered by 5 percent.

They did not, in short, take charge of the audit. The auditors for the most part knew that and did not expect to be protected from management were they to begin disagreeing with the estimates, assumptions and judgments made by management. A substantial number of companies took advantage of those circumstances and intentionally manipulated their financial statements. An even larger number, probably acting in good faith, regularly presented a more optimistic view of their financial statement than a realistic appraisal would have called for, simply because the rules allowed them to be that optimistic.

So the question is, will the Sarbanes-Oxley Act fix that? In one sense, the act really rejuvenated the three ideas of the SEC in the middle 1970s. Section 404 surely puts strength into the notion that there must be internal controls. The Public Company Accounting Oversight Board puts enormous teeth into the notion that the auditors have a responsibility to come forward when something is wrong, when something is suspicious. Of course, the act institutionalizes the independent audit committee that was created by the New York Stock Exchange.

It has already had a substantial benefit. Auditors now sit down with the audit committees and say, by the way, here are the other alternatives that were available to management. The audit committee really must take a look at those alternatives and conclude that the way management did it was fair. If the act had been in place, I sincerely believe that Enron and Waste Management, two serious cases, would never have occurred.

In addition, the act says in no uncertain terms the audit committee is responsible for the hiring and the firing of the auditors. It has already had a substantial impact. For one thing, the chief financial officers do not get asked to play golf by the engagement partner anymore.

[Laughter.]

Will 404 cost too much? The danger here is that companies will treat 404 as a kind of compliance tax, a word used by Ernst & Young in a publication recently, a bureaucratic requirement of no practical value. Just as too many companies have treated the audit as a commodity, 404 can be an expensive appendage if companies do not understand that it can be used and have positive effects. Ernst & Young recently noted that there are a number of companies that believe their investments in rule 404 can have a meaningful return on that investment. That is my experience and that is the experience of the several chief accounting officers with whom I have spoken in the last couple of weeks. The point is that companies can realize substantial value of the 404 effort if they utilize it as a management tool.

The most persistent and legitimate complaint about 404 relates to timing. A lot of companies just did not understand the degree

of change that was necessary. When they came to understand it, they could not find the talent in the accounting firms needed to complete it. The SEC I hope will give consideration to this problem and where important and necessary, give some extension. That is an issue that I think should be of particular interest to this committee. The problem, of course, is particularly severe with respect to the smaller companies.

Is the burden on directors too great? As Mr. Quigley said, the audit committee members certainly must better understand their responsibility, their job. They have to spend more time at it with more meetings. But the notion that some impossible burden has been created is just not correct. Audit committees need to establish firm control over the external and internal auditors. They have to select their candidates and they have to take charge of the fee negotiations. In particular, they must pay far more attention to the selection, retention and compensation of the internal auditor. If they take those steps, they will have a large, competent and experienced staff that will keep them well informed of all their responsibilities as members of the audit committee.

One final comment, concern has been expressed, particularly by Peter Wallison of the American Enterprise Institute. He expresses a fear that the SEC and the PCAOB will use the act to insist upon strict adherence to existing accounting standards and will therefore preserve that maze of rules that contributed to the accounting problems of recent years. I hope not. Both agencies should take note of the growing body of thought today that seeks fewer accounting rules and more judgment to be used in the constructing of financial statements.

I have attached to my testimony a copy of a report done by an unusually experienced group of professionals with respect to the accounting profession called the Future of the Accounting Profession. It discusses this problem at length and then it endorses a theme the Chairman may have heard me use before, expressed by Economist magazine, that warns us not to continue to rely upon the brittle illusion of accounting exactitude which tends to collapse in periods of economic strain. I very much hope that this committee would accept that theme.

Thank you.

[The prepared statement of Hon. Roderick M. Hills can be found on page 67 in the appendix.]

The CHAIRMAN. Thank you, Mr. Hills.

Mr. Del Raso, welcome back to the committee. I think you were here 2 years ago.

**STATEMENT OF JOSEPH DEL V. RASO, PARTNER, PEPPER HAMILTON LLP**

Mr. DEL RASO. Yes, I was. Thank you.

Good morning, Chairman Oxley and distinguished members of the committee. Thank you for this opportunity to present my views on the impact of the Sarbanes-Oxley Act over the last 2 years.

I am Joseph Del Raso, a partner in the law firm of Pepper Hamilton, LLP. My practice focuses on corporate and securities matters, particularly matters related to securities regulation. I served as an attorney-adviser with the Securities and Exchange Commission in

the 1980s and I have served as a member of the board of directors of both public and private companies. Having experience on the regulatory side, as a lawyer in private practice, and as a corporate board member, I believe I offer the committee an important perspective on the practical effect of the Sarbanes-Oxley Act over the last 2 years.

Overall, I believe the impact has been a positive one. While there are costs, in some cases material costs, and occasionally perceived regulatory overkill associated with the implementation of the act, it has done much to restore the faith of investors in the way in which public companies operate and report financial results.

Just as importantly, it has helped give directors and corporate officers the tool they need to meet their obligations and be accountable to shareholders. I commend the committee for its levelheaded and responsible approach to this act.

On the topic of positive changes. I would first like to address the positive impact of the Sarbanes-Oxley Act on domestic issuers. The act has increased the awareness of the need for corporate accountability and transparency and given greater attention to best practices in corporate governance. It has prompted procedures to establish internal controls to ensure compliance. It has highlighted the need to take prompt remedial action when problems are uncovered in order to reassure the global markets of the safety and integrity of our capital markets in those issuers who access them.

It has increased the protection of shareholder interests, thereby increasing shareholder confidence. It has highlighted the need for improved risk management and should produce the long-term effect of mitigating the costs of insurance, indemnities and potentially large awards, including punitive damages and governmental fines for systemic failure of the corporate entity. It has increased attention to the need for accountability directly to shareholders in matters of corporate governance.

On the topic of costs and the perception of regulatory overkill, the implementation of the Sarbanes-Oxley Act has not entirely been a bed of roses for some. The costs of compliance often can be burdensome. Reviewing internal financial controls, improving those mechanisms when necessary, and ensuring that the processes are well documented is time consuming and costly, in some cases, costing companies millions of dollars and thousands of hours annually. However, I believe that what corporate officers and directors need to keep in mind is that the cost of compliance is not nearly as burdensome as the cost of failing to comply.

What was at risk in 2002? What this act was designed to prevent was the threatened loss of confidence by investors throughout the world in our capital markets. That loss of confidence does not just affect companies with poor corporate governance or negligent or outright criminal leadership. Good companies as well as bad and millions of investors suffer the consequences when people lose faith in how companies operate and result their results.

I look at the costs associated with compliance as a necessary and prudent investment in the long-term stability and success of our capital markets. However, we must be careful not to stifle entrepreneurship and capital formation for emerging businesses. The initiatives of the SEC in the early 1980s to adopt rules to allow

smaller companies's access to the public capital markets produced very positive outcomes. Some may argue that smaller issuers may not be suited for public ownership if they cannot afford the cost of Sarbanes-Oxley compliance. But that is not the appropriate focus. We should always encourage small businesses to grow and not overburden them with intrusive regulation.

On the other hand, we have learned that an environment of careless behavior and lack of respect for both the investor and the government's oversight and regulation produces nothing but financial and societal losses. We must balance the need for entrepreneurial freedom and reasonable government oversight, and for that reason it may be necessary to revisit and fine-tune this legislation from time to time.

I urge this committee as it examines future regulatory actions to be careful not to overburden the average issuer with overzealous enforcement and unreasonable intervention, to not pile on with additional regulations that make compliance more difficult, that are simply not practical. Further regulatory action should be adopted only after a thorough analysis shows that the benefits of the new regulations outweigh the risks that will make compliance overly burdensome on the average issuer.

Overzealous regulatory action and enforcement can also poison the atmosphere between regulators and industry and stifle the discipline and sense of cooperation between the government and those it regulates. The vast majority of corporate officers and directors act ethically and take their fiduciary responsibilities seriously and will welcome legislation, regulation and guidance that helps them meet their obligations to shareholders. However, when the regulators and the regulated find themselves in a constant adversarial atmosphere, the spirit of compliance and good corporate citizenship may erode into one of combat mentality. Operating in that environment is not consistent with our democratic traditions of creativity and free enterprise.

In the area of corporate governance, the impact of Sarbanes-Oxley has been profound. Independent directors are exercising their responsibilities and paying much more attention to detail. I can tell you from personal experience that board meetings are longer and have much broader agendas. Audit committees are meeting more frequently and are increasing the number of executive sessions with auditors. Special committees, especially those charged with internal investigations, are moving very quickly when troubling matters surface. No longer are independent directors satisfied with the assurances of management that everything is in order, or worse, sweeping corporate problems under the rug.

The act has also increased shareholder activism. In general, this may be viewed as a good thing. Boards need to be careful not to confuse, though, the political and social agendas of shareholder initiatives with their obligations to meet the goals of the majority of shareholders and to adhere to best practices.

Impact on global markets. I would like to particularly note that the impact of the Sarbanes-Oxley Act on the global financial markets. When first enacted into law, this legislation was met with some trepidation by foreign issuers. In speaking with foreign diplomats and issuers, I was impressed with their positive reaction to

the responses of our regulators in this area. The SEC in particular worked quickly and effectively to harmonize the effective compliance with the special concerns of foreign issuers.

I had the opportunity last March to organize a symposium related to this topic in Italy at the American University of Rome. The participants included high-level securities regulators and issuers from several foreign countries. The consensus of the participants was to America's credit, when faced with the severity of a crisis such as the corporate scandals of 2002, we are quick to react and remedy situations. The swiftness both in prosecution and in legislation reassured the global markets that America was serious about protecting the interests of all investors.

It is also interesting to note that issuers who sought to bypass their Sarbanes-Oxley responsibilities by listing on foreign exchanges have not been able to find much relief. For example, regulatory requirements for listing companies on the exchange in London have also been intensified.

Long-term effects. Returning for a moment to the cost of compliance, I would offer one more comment. I view the cost of implementing compliance systems as similar to that of installing fire protection systems in buildings. While it may be cheaper to build an office building without sprinklers, in the long run the increased costs of insurance would likely outweigh the initial savings. More to the point, if a fire starts to smolder, it can either be quickly extinguished with little loss when the alarm is tripped if the building is so equipped with an effective fire protection system, or ignite into a raging inferno that consumes the entire edifice. The corporate entity is no different. Early detection and action is obviously preferred to the risk of a catastrophic loss.

I have also noticed an increased interest in developing programs to educate officers and directors. Professional firms, and more importantly academic institutions, have already designed and offered to support corporate directors and executives in these areas.

In conclusion, Mr. Chairman and distinguished members of this committee, thank you again for the opportunity to testify on the impact of this important piece of legislation. Much of the commentary after the passage of the act called it the most sweeping securities reform since the passage of the exchange acts of 70 years ago. I believe that is true. No law can completely prevent scandals such as the collapse of Enron, WorldCom and Global Crossing. In the end, you cannot legislate personal character and morality. But I strongly believe that the Sarbanes-Oxley Act has reduced the risk of such scandals. Like many corporate officers, directors and professionals, they may not agree with or like every aspect of this legislation, but if it continues to have the desired effect, the ongoing restoration of public confidence in the capital markets, then the Sarbanes-Oxley Act has indeed met its objectives.

[The prepared statement of Joseph V. Del Raso can be found on page 61 in the appendix.]

The CHAIRMAN. Thank you, Mr. Del Raso.

Mr. Trumka?

**STATEMENT OF RICHARD L. TRUMKA, SECRETARY-TREASURER, AFL-CIO**

Mr. TRUMKA. Good morning, Mr. Chairman and members of the committee.

Two years after its enactment, the Sarbanes-Oxley Act remains an outstanding example of government acting in the public interest. While the work of reform remains unfinished, America's retirement savings are substantially more secure today because of Sarbanes-Oxley. Both Houses of Congress and both sides of the aisle have reason to be proud of this act.

Working families's retirement security is, in large part, dependent on the integrity of our capital markets. We estimate that union members' pension funds lost over $35 billion in Enron and WorldCom alone. But for those with the bad luck to work directly for those companies and other problem companies, the consequences were far more serious: lost jobs, lost health care, and for many the complete loss of their 401(k) retirement savings invested at the urging of their employer in what ultimately became worthless company stock.

So we are particularly pleased that the Sarbanes-Oxley Act addressed many of the systematic issues that we had urged this committee and the SEC to address in our December 2001 testimony on Enron's collapse, issues like auditor and director independence. But the success of Sarbanes-Oxley stems not only from its specific provisions, but also from the tone it set and the message that it sent. Since its enactment, the act has been impressively augmented by the work of the SEC, the Public Company Accounting Oversight Board that the act created, the New York Stock Exchange and the NASDAQ and the work of state attorneys general, most notably Eliot Spitzer of New York.

Equally important, the message was heard in corporate boardrooms across the country. In the two proxy seasons since the act's enactment, investors themselves have pushed companies to have truly independent boards to rein in executive pay and to manage their audit process more effectively. The AFL-CIO is very proud of the role that unions and worker pension funds have played in the efforts by sponsoring over 360 such proposals, 48 of which received majority votes at company annual meetings.

Of course, Sarbanes-Oxley has its critics. Some companies seem unhappy with the act's requirement in Section 404 that companies strengthen their internal controls. There is no question that compliance with Sarbanes-Oxley imposes costs on American business. But there is ample evidence that these costs are far less than the alternative costs of more Enrons and WorldComs, evidence cited in more detail in my written testimony.

Recently, Senator Sarbanes noted that the job is not done. One could conclude this simply by looking at the data on the one issue of financial statement integrity. Last year, a record 206 public companies revised their annual financial statements according to preliminary figures compiled by the Hudson Consulting Group. And PCAOB Board Chairman William McDonough announced last month that his examiners are still finding significant problems with auditor compliance.

But there is a deeper sense in which corporate reform is an unfinished task, Mr. Chairman. We believe the underlying causes of the corporate governance crisis lie in the weakness of corporate boards and the short-term orientation of public company CEOs. As long as CEOs completely dominate the selection process for company directors, we simply will not see at problem companies the kind of vigorous independent boards that we need and that Sarbanes-Oxley called for.

The SEC has proposed to address this problem by giving long-term investors with a substantial stake in public companies the right to have their board nominees included on management's proxy. The commission's proposed rule on proxy access is an example of real bipartisan leadership. It has received more public comment than any other proposal in the commission's history, over 14,000 comments, with the overwhelming majority supporting the Commission's rule.

Second, investors still have inadequate disclosure of the facts on executive pay and the financial impact of that pay on the companies that award it. The most important step in this area is the proposal by the Financial Accounting Standards Board for mandatory stock option expensing. Executive stock options reward short-term decision-making and, as Enron painfully demonstrated, encourage stock price manipulation through creative and even fraudulent accounting. They should not be subsidized by dishonest accounting rules. Yet we believe, in our opinion, the House bill that passed on Tuesday truly attacks the integrity of our financial accounting system.

It appears that the battle against option expensing is being waged on behalf of CEOs with option mega-grants who frankly want to hide the true costs of their compensation from their shareholders and would-be investors. According to SEC filings, the CEOs of the 11 public companies who are the members of the International Employee Stock Option Coalition hold on paper a combined $977 million in unexercised stock options. The CEOs are going against the express wishes of their shareholders. In 2003, a majority of shareholders at 30 companies voted for stock option expensing. So far this year, shareholders at Hewlett-Packard, Intel, PeopleSoft and Texas Instruments have done the same. Clearly, as reform efforts get closer to the heart of what is going wrong in the corporate governance system, resistance from the CEO community will intensify.

However, only by truly creating transparency and accountability in the boardroom can the underlying dynamics that brought us Enron and WorldCom be addressed and the purposes of Sarbanes-Oxley be fulfilled.

Let me conclude, Mr. Chairman, by expressing my deepest appreciation to the committee on behalf of the working families of the AFL-CIO for not only inviting the AFL-CIO to appear today, but for the actions you have taken in making the pensions of America's working people more secure.

Thank you, Mr. Chairman.

[The prepared statement of Richard L. Trumka can be found on page 137 in the appendix.]

The CHAIRMAN. Thank you, Mr. Trumka. I do not often get that kind of praise from the AFL-CIO. We are recording this.

[Laughter.]

Before I begin the questions, I just want to comment. This is almost the 2-year anniversary now of passage and signing of the Sarbanes-Oxley Act. A lot of folks in this room truly made it happen. This was a classic example, I think, of bipartisan legislation where we faced up to a very severe loss of confidence in our capital markets, something that I had not seen certainly in my lifetime. Our committee was the first committee to hold a hearing on the Enron situation. That was back in December of 2001. That process began with a bill that we introduced early the next year, 2002, that we called the Corporate Accountability and Responsibility and Transparency Act, CARTA.

Ultimately, that was the vehicle that this committee ultimately passed out by a better than three-to-one margin, and then took to the floor a few weeks later with virtually the same success on the floor, with over a three-to-one margin, which I think made all of us on the committee quite proud. I want to say to my colleagues that were participants in that it was one of the best experiences I have had as a legislator here in my 23 years. I think all of us who had a part in that can look back with a great deal of pride. All of you gentlemen were quite praiseworthy and we really do appreciate it. It was, I think, in the best tradition of legislating and hopefully doing it right.

Let me begin with Mr. Hills, who has been here before, and he has been Chairman of the SEC. He has been around the block. He served on boards. We could not have a better witness than Rod Hills. I get a lot of questions, particularly regarding 404 and the costs. The questioner is always careful to couch it in rather benign terms, but the fact is that there are, particularly among smaller and medium-size companies some concerns about costs. I have had some very interesting discussions with corporate CEOs who at least have entertained the thought of going private. Some actually have, although I think it is a relatively small number, about the same number probably of European companies that threatened to de-list after passage of the act.

Let me ask you this. Did we give enough flexibility to the PCAOB and the SEC to try to ameliorate some of those costs with small-and medium-size companies? Or is that something that perhaps we need to study further?

Mr. HILLS. Mr. Chairman, I believe that there is enough flexibility. Just as we have to learn how the act works, we have to learn what the flexibility is. There are a couple of issues that could be dealt with. There is a particularly sore point between the requirement that the external audit attest to the efficacy of the work done internally. In a sense, there is a feeling that you have to do it twice. So the company gets an external consultant, usually one of the big four. They already have a big four company as an external auditor, and then they have the internal auditor do the work. So there is a hesitancy in these organizations to give the attestation that people want.

My own sense is that it is working out, that the external auditors are relaxing a little bit and see that the internal auditors are doing

a pretty good job in creating systems. I do think that when we finish this season, that it may be possible for the PCAOB to see that some relaxation is possible. I am really quite convinced that more and more companies are understanding this can be a management tool.

I have watched the headlines, as you have, from some of the more prominent critics of the act. I have called their chief financial officers to say, well, is it really as bad as your CEO said? On most occasions, I have found that the audit committee of that company has been told by the chief financial officer, well, there are some problems with it, but there really are very positive aspects to 404.

So the question is a good one. I think that this committee should ask it. I am quite confident that both Chairman Donaldson and Chairman McDonough both understand that there may be some flexibility, some adjustment needed. But I am quite satisfied there is the capacity to do that.

The CHAIRMAN. Thank you.

I would like to ask each one of you to comment if you would like. One of the provisions that was added in the other body that was retained in the conference report, which I had some real concerns about, was the whole issue of corporate loans and how they would be addressed. I have heard some legitimate criticisms about that particular provision, how difficult it is in terms of moving expenses for officers of the corporation, that kind of thing, insurance coverage and everything. Is that a legitimate concern? If so, are there ways that we can deal with that problem to make it work?

I think everybody understood the reason for that provision being added in the Senate because it was during the WorldCom meltdown, and this committee had a hearing with Bernie Ebbers and the top people from WorldCom, who took the Fifth, so they were not much help. But the fact is that in this case Bernie Ebbers had gotten a $400 million loan from the board and the amendment that was offered by Senator Schumer I think was going at that issue, that abuse, which is understandable. My sense is it might have gone beyond just that, and included a lot more in that. I just wonder if we could start with Mr. Quigley and just go down the panel as to what kind of reaction you have.

Mr. QUIGLEY. I think that perhaps that is one example where we want to try to swing the pendulum, moving from do not loan $450 million to Bernie Ebbers, to do not loan anyone a penny for any purpose, perhaps is going too far. There are legitimate business purposes where you are trying to relocate an executive and it is very customary to be able to provide some form of an advance to pay the costs associated with that relocation, which is then repaid by the executive at the time that the relocation is completed.

But I think some moderation with respect to that provision would be prudent, and it would facilitate business in the ordinary course. I think we can still have prohibited the abusive practices that that provision was intended to shut down.

The CHAIRMAN. Thank you.

Mr. Caplan?

Mr. CAPLAN. Mr. Chairman, I would tell you at the time that Sarbanes-Oxley was passed, our company was dealing with that. We had an extraordinary number of loans outstanding to our ex-

ecutives for a variety of reasons. We have chosen to actually shut down the process entirely. We are of the view that it is just not appropriate and that, frankly, if we need to recruit somebody who needs compensation for the move, we pay it like we would pay for anybody else. It is part of their compensation and we report it accordingly. So we are actually quite comfortable with it. I think it is easier to adhere going forward to not have any of these loans.

Mr. HILLS. I think there are probably two or three different problems here. One is that understandably law firms give very broad opinions about what you can and cannot do, and law firms are very careful never to be wrong, so I do believe they have pulled the noose too tight. Company credit cards are now coming under fire because the theory is that if I have taken a trip and charged it on my credit card, I might have had my suit pressed. The hotel bill may have been legitimate, but my suit press was an advance or a loan. So some of that can be taken care of just by, I would think, the SEC's general counsel could issue a few statements and you could get there.

I am in agreement with Mr. Caplan's comment. In 1970, I became the accidental chairman of Republic Pictures. The first thing I found was that the stock had gone from $80 to $2. The top five executives of the company had borrowed over $8 million from the bank for themselves using their stock as collateral. That was just the practice throughout America, that you got to be rich, you got your stock blown up pretty high, you borrowed money against it, the collateral was the stock, and the bank that loaned the company money loaned you the money. And it was a disaster.

So saying you cannot do it is a pretty good rule. Chances are that if a year from now the chances are that it will sort out and there may be very well something that this Congress should do to open it up a little bit. But right now, I think it is sweating out some very serious problems.

Mr. DEL RASO. As the lawyer speaking, we are very careful about the opinions we give out. I would say that anecdotally you will hear a lot of these stories, but the example we used at our firm was, if you are traveling on business and you watch pay-for-view, which is not reimbursable, you have taken an impermissible loan from the company. That is where the pendulum I think may have swung too far.

But I think the real core of the problem was the example of the employee relocation. Reasonable and customary expenses of operating the corporation that either if expensed out as compensation or advanced as a loan, were much different than its senior executives using the company's bank lines as their margin account. The problem developed with large fortunes being built up in the company's stock, a reluctance to realize those gains either to pay tax or to not depress the value of the stock in the market, and ultimately leverage works well when it is working, and it is catastrophic when it does not.

I think that is where the idea of some type of safe harbor guidance Q&A from the SEC would help to distinguish appropriate, and especially, I do not want to call them de minimus, but more in the ordinary course of loans for a broader group of employees than just,

again, using the company's bank account as your own margin account for your stock holdings.

Mr. TRUMKA. Yes, Mr. Chairman, we support the existing rule. First of all, we think that there is no way to start policing exceptions to the rule as they start coming up. They may be well intentioned at the beginning, but they quickly get out of hand. We think that corporate reform is only starting to take root right now, and it would send the wrong message to change that provision at this time.

The CHAIRMAN. Thank you. My time has long expired. We appreciate your patience.

We are going to recognize the members in order of appearance. The first questioner is the gentleman from Texas, Mr. Bell.

Mr. BELL. Thank you very much, Mr. Chairman. I greatly appreciate the testimony offered here today, coming from Houston which offered the world the poster child for bad corporate behavior. Obviously, we were glad to see the legislation and I am glad to hear what you all had to say about it today, in that it seems to be having a positive effect.

I do think going forward you have to look at it and see if there is any room for change and look at perhaps some of the negative effects. One thing that I have heard, and Mr. Del Raso I will start with you, and perhaps you have either from clients or from your own personal experience, some smaller corporations, some smaller businesses having difficulty finding qualified people to now serve on boards because of the heightened liability and the fears associated with that increased liability. I am curious as to whether you have heard anything like that, and if you believe that it is a problem that needs to be addressed.

Mr. DEL RASO. It was especially a concern with the passage of the legislation. I think it still is a concern because qualified individuals who would be willing to take a corporate board directorship are going to be a lot more careful about where they want to get involved. The downside to that is if you have a situation where an emerging business is seeking public access to the markets, new technology initiatives or what have you, are these people who really should serve there, too, as the stewards of the corporation going to be willing to step up and take that risk? Because as we all know, the chances for a problem in the smaller startup companies traditionally were thought to outweigh those of the larger, more seasoned companies. In a number of areas we were proven wrong, though, in the last few years because some very large perceived deep companies had their problems.

So I think that that is a problem. But the one thing I would point out is, again, we need the long-term approach. I think we are seeing now a swing in insurance rates for director and officer liability insurance, which was just reported in the last couple of weeks. From a risk management underwriting standpoint, I think the more these best practices and these safeguards are in place, we may find that with the perception that the catastrophic litigation occurs, those losses, either in derivative suits against the directors directly are actions that could really damage the corporation. We may find that this legislation may mitigate that, and you will see then a return of people more willing to step up to those positions.

Mr. BELL. Mr. Hills, do you have any thoughts on that?

Mr. HILLS. I do. It is an extremely good question. For about 60 years or so, directors were brought on board for their resumes, not their knowledge. What has happened in these recent years, both because of Sarbanes-Oxley and because the New York Stock Exchange has stepped up to the question of governance committees is that corporate boards are trying to decide what they need on a board. All of a sudden, the incentives of our capitalistic world work, all the headhunting firms have hired all kinds of people, but look much deeper for candidates.

What you have now is a way better quality of person being considered for boards, not people you may have read about in a headline, but scientists, doctors, professors who have real experience. So you have a growing body of people with the background that should be on these boards. It is an adjustment, as Mr. Del Raso said. We are going through an adjustment period, but there is a body of people coming forward as candidates for boards way better and way bigger than we have ever seen before.

Mr. BELL. And a willingness to serve by those individuals?

Mr. HILLS. Yes. I have, sadly, had more trouble with companies than anybody would ever want to have, and I still see a willingness to step up. If quality is wanted on a board, people of quality will go on the board.

Mr. BELL. So some of the individuals who may be refusing to serve would be of a lesser quality in some instances?

Mr. HILLS. I think this. I get asked a lot about whether they should go on a board. My answer is, who chose you? If there is an intelligent governance committee that is really working the problem to find a competent board, then it is a way better board to serve on. If you are there at the whim of the CEO, even a good CEO who played golf last weekend with somebody and would like that person on the board, then it is probably not a good board to serve on.

Mr. BELL. Mr. Quigley, I was going to ask you. In a recent poll, a slim majority of CPAs said management is more accountable because of Sarbanes-Oxley, but less than a quarter said shareholders are getting better information. Moreover, less than 10 percent said investors are making better decisions. In your opinion, why are the positive effects of Sarbanes-Oxley apparently not trickling down to those it was intended to protect in that particular instance?

Mr. QUIGLEY. I did not hear when you said "more than." I just did not pick up your question exactly. If you would please, just one more time?

Mr. BELL. Less than 10 percent said investors are making better decisions, and then only a slim majority of CPAs said management is more accountable because of Sarbanes-Oxley.

Mr. QUIGLEY. With respect to the majority about management being more accountable, I certainly would be strongly with that majority because I have watched the behavior change as the certification process has unfolded. I have watched how CEOs act. I have watched how those cascading representations move through the organization. I truly believe that management broadly, very, very deep in the organizations, understands the importance of transparent financial disclosures and those financial results. It is no

longer the purview solely of financial management. I think that is very positive.

In terms of the quality of investor decisions, I just do not have a comment on that element of the survey. I think the transparency and the completeness of the financial disclosures that are available to investors to consider as they make their investment decisions, it is absolutely there for them to take advantage of. If they choose not to, I cannot comment on that.

Mr. BELL. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Alabama, Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, my first question, well really I want to make a comment to Mr. Quigley. I want to commend the entire public accounting profession. I believe that public accounting has been really at the forefront of restoring public confidence in corporate governance and investor confidence in financial statements, in auditor independence and in internal controls. I would say that in response to that survey, I think that among knowledgeable people in the financial community, they believe that things are working much better.

So my question is this. In your statement you talked about the PCAOB's oversight of public accounting. Have you had your inspection thus far?

Mr. QUIGLEY. First of all, as I mentioned in the testimony, the PCAOB is the new regulator for the accounting profession. After 100 years of self-regulation, we now have a new regulator. Last year, Deloitte along with the other big four firms voluntarily submitted to a preliminary inspection. We did that without it being required, even though we had just simply registered as a public accounting firm under the act. We were not at that point required to submit to that initial inspection. We, along with the other big four firms, voluntarily submitted to this preliminary initial inspection.

Mr. BACHUS. How did that inspection process work?

Mr. QUIGLEY. I believe it was healthy and helpful in terms of the visibility throughout our firm that our regulator was inspecting our performance on some selected engagements. We are in the process right now of reviewing a draft report from those initial preliminary investigations. Again, I think we are absolutely committed to improving audit quality. I think we are making progress and I believe that our new regulator, the PCAOB, is a very important catalyst in helping us continue to take these steps forward.

Mr. BACHUS. So I take it that the inspection process was, in your opinion, effective?

Mr. QUIGLEY. I think it was constructive and helpful and supplemented the existing internal inspection that we have ongoing every year within our firm. Now our first formal required inspection is currently under way. I have had my interview as the inspectors were reviewing and meeting with me, to assess the tone at the top of our organization. Again, I think they are an important, constructive catalyst to help hold us accountable and to continue our efforts at sustained improvements in audit quality.

Mr. BACHUS. If there anything about them that you would change?

Mr. QUIGLEY. I think it is just too early to tell right now at this point. I really believe and feel strongly that we have a shared responsibility to strengthen investor confidence and to improve trust and confidence that our capital markets require in order for them to be effective. I think there are obligations of the regulated, the accounting profession, and obligations of the regulator to work collaboratively with that goal in mind, improved trust and confidence. I think we are in the right direction right now.

Mr. BACHUS. Okay.

Mr. Caplan, E*TRADE has extensively revamped its board structures, as you indicated. Has it been more difficult to find acceptable board members since Sarbanes-Oxley was enacted?

Mr. CAPLAN. In fact, it has been easier. As a matter of course at the time at which we were revamping our board, quite frankly I had concerns about our ability to get really qualified new board members because of everything we had been through. Although we had no issues whatsoever from either a financial reporting or accounting irregularities perspective, we certainly had a lot of notoriety with respect to executive compensation.

As we went through the process, the board worked very diligently on trying to determine who was missing from a skill set and what we needed to really round out the board exactly, as had been described before. In that process when we went out to look, we were able to find 40 qualified candidates. In fact, when we began we thought we would only add two new board members. As a result, we added four because there were so many really qualified candidates.

Mr. BACHUS. Okay.

Mr. Trumka, there is a recent Harris poll of investors that said almost 60 percent, 59 percent found Sarbanes-Oxley would help them safeguard their investments. Actually, 57 percent of investors say they are unlikely to invest in a company not in compliance with the act. Is that basically your experience?

Mr. TRUMKA. We are finding more and more investors looking to Sarbanes-Oxley as a guideline as the minimum that they do for investment. So the answer is yes, and I think you will see that percentage increase. Shareholders at existing companies are urging that, and many of the private companies that are not subject to Sarbanes-Oxley are now adopting it voluntarily. We think it made foreign investors, it makes things more transparent and more likely that, for instance, pensions funds that do their investing are likely to realize a gain and protect their beneficiaries.

Mr. BACHUS. Okay, thank you.

Mr. TRUMKA. Thank you, sir.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from Oregon, Ms. Hooley.

Ms. HOOLEY OF OREGON. Thank you, Mr. Chair. I have a couple of questions.

We have just heard from Representative Bell that said 10 percent of investors feel they have more information as a result of Sarbanes-Oxley. That is not a very high percentage. Mr. Caplan, what other information might be useful for investors so that would not be terribly burdensome on companies? And what can all of us do to improve transparency in disclosure?

Mr. CAPLAN. One of the things that we were challenged with as we began to go about improving corporate governance was a perception in the marketplace with both our investors and our analysts that we were not as transparent as we could be. So we have taken it upon ourselves not only in dealing with how we report in ours Q's and our A's, but also we do monthly reporting as to a lot of our key metrics in our business. When we do our quarter reporting as a public company, we have attached now our press release in terms of the information. It is about a half a page and we have about nine pages of additional information that we attach, really outlining all of the key drivers of our business and how we are succeeding or doing, both on a quarter-over-quarter basis and year-over-year basis.

So I think it really is incumbent upon companies today to ensure that investors are getting timely information about the key drivers of their business and the success or failure thereof.

Ms. HOOLEY OF OREGON. I think it is really important that we make sure that investors have confidence in the companies. I do not think you can give them too much information. We need to raise that confidence level still now.

Mr. CAPLAN. I agree.

Ms. HOOLEY OF OREGON. Mr. Quigley, what is your assessment of the future of the accounting profession? Has Sarbanes-Oxley changed that perception as a profession? Are you having success in recruiting people to the profession that have the kind of depth that we all count on in the accounting profession?

Mr. QUIGLEY. First of all, I am very optimistic about our future. I believe Sarbanes-Oxley has contributed in a very constructive way to the relationship that we enjoy with our key clients, and especially as has been discussed, this new client, the audit committee. We are finding on campuses very, very qualified candidates looking forward to the challenge of a career in public accounting and the increased visibility that the act has brought has contributed in a positive way to the quality of the students that are attracted to the profession, and I believe the career opportunities that we can provide for them. So we continue to be successful competing in the marketplace for experienced hires and also competing on campuses for the very best students.

Ms. HOOLEY OF OREGON. Thank you.

Mr. Hills, I understand that a number of the provisions of the Sarbanes-Oxley Act are similar to requirements that are already applicable to banks. Are there increased compliance requirements for banks because of these dual layers of requirements? Are there significant costs associated with that requirement? And the second part of the question, many banks are not publicly held and therefore not subject to many of the Sarbanes-Oxley requirements. Are the bank regulators imposing those requirements on private banks?

Mr. HILLS. I can quickly tell you know more than I know.

[Laughter.]

The bank examiner's role is a different role than we have historically had in the publicly traded industries. I do not know anything significant by reason of Sarbanes-Oxley has affected that relationship. I think the question you raise, though, is kind of interesting both because of its own background and because of the nature of

the Public Company Accounting Oversight Board. The Chairman Bill McDonough, was the President of the New York Fed. I think he is approaching the job not unlike the manner in which bank examiners approach the job, by going to the accounting firms and by looking at the high-risk audits to try to find the problems before they erupt, and in one sense of the word substitute prior examination for later enforcement.

So having now ducked the question, I will leave it to somebody else to tell you just exactly what is happening.

[Laughter.]

Ms. HOOLEY OF OREGON. Mr. Del Raso?

Mr. HILLS. I would like to add one more thing, though.

Ms. HOOLEY OF OREGON. Yes?

Mr. HILLS. In my written testimony, I added this report called The Future of the Accounting Profession. I surely would like more people to read it and I hope Mr. Quigley has read it. There is much to be said for the future of the accounting profession.

Ms. HOOLEY OF OREGON. Good.

Mr. Del Raso, do you have anything to add to the question that I just asked?

Mr. DEL RASO. I would say that your observation, comparing the requirements for bank regulatory oversight at the governmental level, there are some similarities, but not all. When you work in the field of financial regulation, whether it is banks, investment companies, broker-dealer operations, you have much more of an aggressive government regulatory scheme within which they operate. Especially with banks, the review goes to safety and soundness, whereas general corporate issuers under our securities laws, both in the sale of and the secondary market trading of the securities, was mostly, it not primarily driving by a disclosure regimen. I think what happened was, when there was a failure of transparency, the disclosure failed, and that is what really impinged the markets.

I do not think you really want to jump into a situation where you include industries that may not require the same level and type of regulation as others. But on the other hand, if you are out from under that very strict and careful regulation, then the mandate in this legislation is, if you are only in a disclosure regimen, make sure that transparency works.

The CHAIRMAN. The gentlelady's time has expired.

Ms. HOOLEY OF OREGON. Thank you.

The CHAIRMAN. The gentlelady from Illinois, Ms. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

My first question is for Mr. Hills. Do you see any perception or feeling in the corporate community that the improved practices of companies, like more frequent and lengthier meetings of the audit committees, are just a temporary effect and soon that the companies and their directors will let down their guard?

Mr. HILLS. I think here is always a possibility that people get bored sometimes with doing the same thing every year. But I think we have created a dynamic with the combination of not only the revitalization of the audit committee, but the extraordinary role now played by the governance nominating committees. This is a real change. We hope that 27 years later that audit committees will

do now what Sarbanes-Oxley has told them to do. But the nominating committee and the governance committee is an extraordinarily vital forum. It will keep people on their feet.

I think we are in good shape. There is a problem that people have mentioned, and that is with all these directors with all this new authority to do stuff with respect to compensation and governance, will they start exercising that with respect to the management of the business? Will they butt in where they really should butt out? That is a problem.

As I say, if you sit down and all of a sudden you are really a powerful person with respect to the outside auditors and the compensation, you are hiring the compensation guy and you are hiring the outside auditors, the temptation is to go in and talk about the engineers and how to design something. So there is a bridge that still has to be crossed properly.

Mrs. BIGGERT. It would be kind of like education, where we all think we know more than we do because we have been parents and been in school. Thank you.

Mr. Del Raso, have there been complaints about the increase in insurance costs? I think you have said something about that, particularly for directors and officers insurance. You state in your testimony that one of the long-term effects of the act is that these costs, along with those of indemnity and fines will decrease. Can you elaborate a little bit more on that? I think it is a point that is not usually brought up in that matter.

Mr. DEL RASO. There was a real spike in premium costs, especially for business lines related to director and officer liability coverage issues and the like. Now, I think what we are going to see, in fact we even see some signs of it now that may be abating. The interesting thing about that is, too, I think from a risk-management standpoint, the more this legislation, is in effect, and again since insurance is written on experience, the experience shows that the system is working and the losses are not occurring, then the premiums will adjust accordingly.

Quite interestingly, I was approached by the dean of a prominent Philadelphia-area business school who asked for some advice on structuring an academy for directors. He was going to start the program. I said one of the things he should really do is consult with the insurance industry because I think that if you actually have a formal program of continuing education for directors and they have an academic program for maintaining close touch with best practices, you may even find from an underwriting standpoint insurers will look at the broader picture of how that whole interplay takes place.

Mrs. BIGGERT. Thank you.

Mr. Caplan, in your testimony you have something about the signing of the certificates regarding internal controls and what your company does. Could you talk a little bit about what your senior management does for the certification? My other question is, could other companies be able to do what E*TRADE does?

Mr. CAPLAN. Within the last year-and-a-half, we have actually put a couple of procedures in place. The first thing we did was we internally built our own financial disclosure committee. It has as its members the most senior of our financial employees in terms of

the accounting department, as well as the internal audit department. So before every certification, that group meets independently to review all of the numbers and all of the reporting.

Immediately thereafter, there is a meeting of the entire senior-level leadership team. At that meeting, we ask each of the senior leaders of the company who represent different business units to attest to their numbers as well, given the comfort that they have reviewed the numbers, as well as their corresponding financial partner in the company. And then only as a result of doing all of that do we actually then attest or sign, both myself as the CEO and also the CFO.

What is interesting is that at that attestation process or certification process, we make it very clear to everybody in the finance department, as well as all the leaders of the company that they can or should consult with anybody in the organization, whether it is outside as the audit committee, whether it is our general counsel, whether it is our internal auditor, if they have any concerns whatsoever.

The other thing that we have done is we have engaged an outside third party company to allow us, and have then broadcast it throughout the entire organization pretty regularly, that if any employee in our company is concerned in any way about anything going on from a financial perspective, they should call that number. It is totally anonymous and then gets reported to the audit committee. I think as a result of that, it has greatly enhanced the level of not only accountability, but also a willingness and an understanding that if there is a concern, they should speak up and express it.

The CHAIRMAN. The gentlelady's time has expired.

Mrs. BIGGERT. Thank you.

The CHAIRMAN. The gentleman from North Carolina, Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Let me first thank the Chair for convening this hearing. As one who voted for the Sarbanes-Oxley bill out of committee, on the floor, and participated in the conference committee, it is always good to hear favorable results of something that we did. We do not get a chance to do that very often. I think sometimes we can also overdo patting ourselves on the back. I would like to raise a couple of questions that may be a little more forward-looking than patting ourselves on the back about how successful we have been in this legislation.

Mr. Caplan and Mr. Trumka put their finger, or at least mentioned in their testimony, an issue that I think by public perception at least is a major, major concern, and that is rationalized executive pay, as Mr. Caplan referred to it, or excessive executive compensation. Most of my constituents when I talk to them liken, it is kind of a visceral response, but it is a public perception at least that athletes are overpaid and corporate executives are overpaid, and something needs to be done about that.

So one question I would have, and I am going to pose both of these questions and then make you all go at them, whoever wants to address them. In your assessment, is there still a problem of irrational executive pay or excessive executive compensation? Is there some way to get a handle on this without doing it legisla-

tively? Or is there some way to get a handle on it legislatively? That would be one question that I have, looking forward. Not that I am advocating anything, I would just like to get your perception about it.

Second, obviously everybody on this panel thinks that Sarbanes-Oxley has been exceedingly successful in a number of areas. I would like for the panel members to identify additional steps beyond Sarbanes-Oxley, either legislatively or from a regulatory perspective, that we should be talking about, not necessarily implementing. But if you were to identify one thing that you perceive to be either still a public perception problem, by public perception, or a real problem that is still in play in this whole corporate governance or accounting process, what would that one problem still be? What ought this committee be talking about or thinking about or having hearings about going forward to try to address that one problem that you would identify?

I will start with Mr. Trumka, since Mr. Quigley has been on the hot seat a lot today.

Mr. TRUMKA. Thank you, sir. My answer succinctly to, is the excessive executive compensation problem still around? The answer is yes. It continues to grow. If you look at the CEO pay, it is still not long-term performance-based. It is still based on things like stock options. That, I think, is one of the reasons why we still need something done with expensing those stock options and reining in that pay, because once it becomes transparent, plus accountable——

Mr. WATT. Be quick, if you can. I know these are two tough questions.

Mr. TRUMKA. The second thing, if you asked me for one thing, I would say for long-term significant shareholders to have the right to nominate directors on management's proxy. The only way you get an independent board is for people to know on that board that there were two routes to get there: one by management, and then if you do a good job by the shareholders, the other one is if you do not do a good job, from the shareholders themselves.

Mr. WATT. Mr. Del Raso?

Mr. DEL RASO. I would be very careful about legislation that tries to regulate executive compensation. I think the call went out after the problems in 2002. I can tell you that compensation committees of boards are paying very careful attention to compensation. I think we should let this legislation ride out longer. I think you are going to see that the long-term effects of it are going to be quite beneficial. But when the government gets in the business of regulating executive compensation, I think that is a slippery slope that we have to be really careful about.

In the area also of expensing options, even though I do have a degree in accounting, I never practiced the way Mr. Quigley did, one question I have is and I think that has confronted a number of those of us who sit in the board room as opposed to the accounting experts, at a time when we are looking for clarity and transparency, I think the idea of attempting to expense an option when you are really trying to deal with a future value could be problematic without a very complex set of rules attached to it.

Mr. HILLS. The compensation committee, which is also new in 2 years, has come to believe I think almost universally that it must have its own consultant, and that that consultant cannot really work for management. That is going to have a leavening effect, whether it is enough or not, I cannot tell you. There are enough speeches going on. There can be more speeches. Chairman Donaldson, Chairman McDonough, Chairman Oxley, all can make note of the fact that pay should be for performance. So we need a bully pulpit and we need the compensation committees to work.

What should we do next? I will just keeping pushing my Future of the Accounting Profession. If you read that, you will see some thoughts that I would love to have any or all parts of this committee be interested in that subject.

Mr. CAPLAN. Although it is hard for me to comment outside of my experience directly at our own company, I will tell you that certainly I have seen dramatic changes with respect to the board and specifically the compensation committee and how they look at executive pay. Very quickly, I will tell you in the past when we had our problem, the executive pay was set entirely by the compensation committee and the full board was unaware of it. Today, not only do all the leaders of the company deal with the compensation committee, but also the full board approves and endorses everything related to me and understands it.

I would agree very much with Mr. Hills that the compensation committees are now looking for outside consultants. They are looking for guidance. They are taking their job very seriously. I think both management and comp committees at well-run companies are understanding it should be performance-linked.

The change, I would tell you that it is probably most imperative, and I think it is happening anyway on its own, is that you need to rotate directors. At a certain age, directors need to leave. At a certain point in time, if they have been on the board long enough, they can become stale in terms of their efficacy. I think it is important to constantly get new talent.

Mr. HILLS. Not age-related.

Mr. CAPLAN. No.

Mr. HILLS. Thank you.

Mr. CAPLAN. No, age in terms of performance.

Mr. QUIGLEY. I would just very briefly say, I believe in the free market system and I believe in the transparency of the executive compensation that is there. I think shareholders have the opportunity to vote with their feet if they do not like the practices that they see. I think the governance processes are becoming increasingly effective, as has been stated. I think we ought to sustain that process.

When I look forward for that future issue, one issue that I think needs more airing is just simply the enormous cost on our economy, certainly the enormous cost on our profession of the explosion of all of the litigation that is out there on every issue. That has an enormous cost and an enormous drag on this economy.

The CHAIRMAN. The gentleman's time has expired.

Mr. WATT. Mr. Chairman, I know my time is over, but I did want to make it clear that most of my constituents think that members

of Congress are overpaid, too. So it is just not athletes and corporate executives. I did want to add that.

The CHAIRMAN. That will be noted.

[Laughter.]

You must be talking about your own constituents.

[Laughter.]

The gentleman from the first state.

Mr. CASTLE. Thank you, Mr. Chairman. If I am going to be overpaid, I would rather be overpaid like an athlete, rather than like a member of Congress, but that is all a different story.

[Laughter.]

I think this is a great panel. I say "great panels" when panels agree with what I am thinking, regardless of what you said, which is the case here. I am one who believes that Sarbanes-Oxley is extraordinarily important, and it may be an inconvenience, I am sure it is an inconvenience and expense for that matter to corporations in America, but the clarity and transparency that we have gotten from that makes it in my judgment abundantly worthwhile. I praise it greatly.

I did hesitate a little bit on praising the panel, though, after Mr. Caplan's comment about the age-related circumstances of directors, because that can be translated to members of Congress as well. I am starting to get a little edgy about that. So I would just as soon keep that discussion down.

Actually, I would like to go back to Mr. Caplan because in his written testimony he struck a chord with something I have introduced and am concerned about, which is a little bit different, Mr. Chairman, than the subject of the hearing directly, but it pertains. It pertains to what corporations are doing, and that is 12b-1 fees. It is something which actually until we prepared for this, I did not know about, that E*TRADE is doing, which is a 12b-1 fee rebate program. I have introduced legislation to eliminate 12b-1 fees for closed funds. If I thought I could get away with it, I would eliminate all 12b-1 fees, to be candid, but I do not think anybody would consider that right now, so I am trying to do it on a more limited basis.

I think by the fact that E*TRADE is doing this, it shows that perhaps there is not a need for this. I think most of us here know that 12b-1 fees are in lieu basically of sales commissions. They were never structured to be that to begin with. They were put into place at a time when more advertising was needed for mutual funds. Now I think they are being used in a way that was unintended. I think it is frankly a burden to the shareholders. I think it comes to close to $10 billion a year now or something of that nature.

So I am very pleased that you are doing this. But I understand that a number of the mutual fund companies you deal with have also dropped you, I guess, or listing E*TRADE as a result of that, which also bothers me somewhat. I would like your comments on the program in general, why you did it, why some are staying with it, why some are dropping out of it. I hope this is an area that evolves and gets changed over the next two or three years.

Mr. CAPLAN. I think we agree with you very much. One of the things that we were quite pleased about is that in this past quar-

ter, in the past three months we were able to give $1 million back to our customers in connection with the 12b-1 rebate. The premise, as I stated in my earlier comments, for E*TRADE and its core tenet was always just using technology to have a lower cost, and taking a significant portion of that cost savings in its operation and putting it back in the hands of customers, and trying to evolve itself as a customer champion.

Earlier this year, we thought one of the interesting and dynamic ways to do that was to look at the fact that we have a lower cost platform and take those 12b-1 fees that we would be paid as a distributor and put 50 percent back in the hands of customers. We were actually quite hopeful when we did it that it would spur competition, and that you would see other distributors thinking about how they wanted to distribute, and really compete head-to-head with us.

Mr. CASTLE. Has that happened?

Mr. CAPLAN. In fact, we are a little disappointed that it has not. It is one of the things that has been most interesting about our core business, for example, on the brokerage side. As you have seen with online brokers, it has spurred competition and you have seen prices come down. To date, anecdotally I guess, we are disappointed because as we have had some fund families withdraw, we are hearing that they may feel pressured from other distributors. I think that disappoints us. We would be much happier if in fact there was a healthy competition out there which benefited each of us as businesses, as well as certainly the customers, by putting money back in their pockets.

To your point, it is about $6 billion a year, and we would love to be able to give $3 billion back. So that has been our premise.

Mr. CASTLE. Good. Do you do this with any funds? I mean, do you do it with closed funds as well as still open funds? You do not distinguish between the two?

Mr. CAPLAN. No, we do not. Our view is that we are just operating as the intermediary, as a platform.

Mr. CASTLE. Good.

I will just close with this. I feel very strongly that if you look at mutual funds, and I think it is over 50 percent of Americans now are someway or another involved with mutual funds, there are just huge cost aspects to it. To the extent that anybody, be it a distributor of the mutual fund itself, the holders of mutual funds can somehow interact in such a way that we can diminish these costs are even eliminate some of these costs which are unnecessary, and perhaps first just understanding them. Who really understands what a 12b-1 fee is? They see it and they do not even know what the heck it is. To the extent that we can do that and still allow all the businesses to be profitable, my judgment is that the American investor is going to be far better off.

So I wish you luck and success with this. Frankly, I hope all of your competitors imitate you because I think in the long term it is going to benefit the people who need to be benefited, and those are the shareholders and mutual funds in America.

With that, I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from California, Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman.

I am very appreciative for this hearing. I, too, am very proud of the bipartisan effort that we displayed in this committee as we passed Sarbanes-Oxley. I like the discussion. We are beginning to have some transparency. I think there needs to be a lot more.

I want to ask Mr. Caplan, who indicated that they had taken some steps to help with transparency. You mentioned better composition of board members. What do you mean by that?

Mr. CAPLAN. One of the things that we did for the first time, really and it was spurred on very much by Sarbanes-Oxley, was instead of just taking for granted the board and who was on it, we stepped back and really did an assessment of the strengths and weaknesses of every board member. By way of example, as I said in my comments, we completely transformed our audit committee, our nominating and corporate governance committee, and our compensation committee.

In the process of adding new directors, we really looked for what skill sets were missing and assessed what we needed. I think very much as Mr. Hills said, rather than looking for names out there, we were looking for skill sets. We were looking for people who were interested, who were dedicated, who understood the time commitments. Our board meetings have gone from what would have been as quick as a half-a-day every quarter, to 3 days a quarter now. Last year, we did, including committee meetings, 39 different meetings. So it is an understanding on the part of all of our board members that it is a significant time commitment. We looked for those board members who wanted to give it and also had skill sets that we viewed were missing.

Ms. WATERS. As you know, there are some of us who have been involved at one time or another in trying to diversify America's boards of directors. I still think that it is a problem. It is not to place anyone in any uncomfortable position, but even as I look out among you today, I walk into this room committee meeting after committee meeting, and I just do not see the diversity represented, really, that is synonymous with what America is all about.

What can we do in dealing with the selection of board members of the various boards of companies in this country to diversify them, to get more women, to get more people of color? I think that if boards are to have the kind of input and expertise that is needed, that this diversity is very important. What can be done?

Mr. CAPLAN. I can tell you that when we looked to add new directors, that was one of the key criteria for us. As we were interviewing directors, not only did we look at specific skill sets, but we recognized that we had no African Americans and we had no women on our board and we added both. The view was exactly what you are expressing. There is a diversity of thought and a diversity of opinion which can only help us as we think about how we want to build out our business.

I would certainly encourage all other companies to do the same thing. I think it is imperative. Again, when you were asking before, when I was asked before about what could change, I think as you see turnover, the problem is there is sometimes just not enough turnover on boards, you will see more of a focus. I know on our board it is a topic of conversation as we look at those board mem-

bers who will in turn retire, what are we looking for, and part of that is diversity.

Ms. WATERS. Would you agree with me that it is not difficult to find women and people of color who have expertise, who have the desire, who have the time, all that is required to serve? That is not a problem, is it?

Mr. CAPLAN. I would agree with you completely. When we identified, as I said in my earlier comments, 40 different candidates who were both capable from a skill set and interested in dedicating the time, we had many choices that were both women, as well as African American.

Ms. WATERS. Any of our other panelists have any thoughts about this discussion that I am having with Mr. Caplan about how to diversify boards? What do you do with the power that you have, Mr. Trumka, to encourage boards to diversify?

Mr. TRUMKA. We are very, very cognizant of that in everything we do. We try to diversify more both along racial and gender lines as well. I think one of the things we can do, although Sarbanes-Oxley did not mandate this, the experts now say that it takes about 250 hours per year per board that you sit on. You hit the nail I think right on the head. People with the skill sets and the time, that are willing to do this, we need to make more training available for those people with the expertise and to develop that pool. We are trying to do that.

On one board that I sit on, we have quarterly training for board members, but we opened that training to anybody else who wants to come in as well. I think that is one thing we could do, but also using just our moral suasion as leaders to demand that there be better diversity, and that America is more reflected not only in the streets, but in the boardrooms of America's corporations, and quite frankly, America's unions.

Ms. WATERS. Unanimous consent for 30 more seconds, Mr. Chairman.

The CHAIRMAN. Without objection.

Ms. WATERS. I would like to hear from each of our panelists whether or not you think there is a need to diversify and that absolutely it can be done.

Mr. QUIGLEY. I would encourage you to continue to speak about this very, very real issue. I will say on our own board we have four women, and on our executive committee we have two African Americans, one Latino and then two women. I believe, it is a critical business issue for us because I want everyone in our organization to be able to look up and see someone who looks like them. And then and only then can we become the kind of firm that I want us to be.

Ms. WATERS. Thank you. Anyone else?

Mr. HILLS. I think we can take some comfort from what has happened in the last 25, 26 years. I think we can have some hope that the authority now in the nominating committees of boards, as distinguished from the CEO, will make a big difference. I think if you look on almost every single large consumer company board, you will find African Americans and women. In my own family, my wife sits on more boards than I do, so I am safe.

[Laughter.]

Ms. WATERS. Thank you very much, Mr. Chairman.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

I want to speak again to the task you accomplished with Chairman Sarbanes in a very difficult timed environment to come to conclusions that I think have ultimately shown to be a very wise direction for not only corporate governance, but for investors and our general economic recovery.

Mr. Quigley, I want to just pose a question for your later written response, not today because time is so limited. There has been a great deal of controversy circling the question of auditor independence, scope of service and tax consulting, particularly in creation of taxation opportunities. Can you at some point send me just what Deloitte has propounded as to its own internal policy with regard to that matter going forward?

Mr. Trumka, I listened very attentively, but when you got to page six of your testimony, particularly attentively as to your comment about the stock option expense bill passed by the House. You go on page six to say, it is encouraged that overuse for executive compensation, contributing to widening gaps between executives and ordinary workers, the House is bent again, not just the first time, again, on subverting the integrity of our financial accounting system by giving runaway CEO pay less special legislative protection. This battle is being waged on behalf of CEOs who frankly want to hide the true cost. You then cite, according to SEC filings, which is a required disclosure, the amount of $977 million in unexercised options, the fact that is required to be disclosed, the fact that it is required to be disclosed today in footnotes makes it evident to anyone who chooses to find out they can get that knowledge.

But there is clearly a misread or a no-read of the bill. The bill requires executives to expense. It does not exempt them. In fact, what we are attempting to preserve is the right of employees's ability to participate in broad-based stock option plans. You go on to say a majority of the shareholders at 30 companies voted in favor of expensing. The bill not only preserves, but makes an express declaration that anyone who so chooses, board shareholders or otherwise, the company may be required to expense.

In light of this, I thought it particularly ironic in where my original line of questioning was going with Mr. Caplan, and I have to be brief, relative to E*TRADE's reforms. I noted on page four that you cite that the board had to adopt a requirement that any compensation for its chief executive officer must be approved by the entire board of directors. I found that very enlightening that in today's corporate world that the board may not know what their own CEO is earning in direct compensation.

I, for the purposes of the record, would just only make the point that I would very much appreciate receiving the corporate governance model relative to CEO compensation and other matters that you think appropriate for the committee to be made aware of in going forward, because Mr. Everett from Alabama has proposed a reform for my attention relative to pension plan approvals that I found of some interest.

I think this swirls in the bigger question that maybe was raised by Mr. Watt. We should not be legislating necessarily, but I think the bright focus of examination does a great deal to bring about responsible governance. To the extent you can help us with that effort, I would be most appreciative.

Finally, Mr. Hills, I am very taken by your testimony, and particularly the area where you are discussing non-financial metric disclosure and the analysis of current GAAP standards giving us a retrospective historical analysis, and not much of a forward-looking view about where the company is going. For example, if you know that there were 10,000 units sold in the last quarter at whatever price, but you did not know from customer satisfaction surveys that 8,000 of them were returned for refund, which piece of information might be more helpful in knowing what is going on at that corporation.

You did say, however, that you did not think disclosure of nonfinancial metrics ought to be necessarily a function of required disclosure. I want to get your thoughts where the FDIC is now engaged in a project known as expensible business reporting language, with about 300 banks. Next year, we will roll it out to all 8,000 insured depositories if it works, the idea being we are getting away from beating the street every 90 days with earnings expectations, taking the pressure off the CEO-CFO by having hopefully more real-time, material fact disclosure of things that shareholders should know in a timeframe in which they should know it, as opposed to the arbitrary, beat the street pressure that I think was an inordinate contributor to the problems we now face in trying to rein in through Sarbanes-Oxley.

Can you give me a quick view on that because I am just about out of time?

Mr. HILLS. The demand for more information is pretty clear. The problem is that the buying community, the buy-side analysts and the sell-side analysts, are not causing it to happen. As you have seen from this book, the need to have more nonfinancial disclosure and the need to recognize the so-called brittle illusion that the financial disclosure has is not as helpful as you think it is. Those two things seem to be coming together. There is quite an important committee going on now which I think Paul Volcker, he is not the chairman of it, but it is to develop more incentives for nonfinancial disclosure.

The passage of Sarbanes-Oxley and the role of the audit committee and the obligation now of the auditor to tell the audit committee, hey, the management could have done it differently, they could have said something differently, all of a sudden people understand that we are dealing with ranges of numbers, not precise numbers. The idea that you can have the profits of the company go up by 1 percent every quarter for 50 companies, I think the world now understood that that is ridiculous. It did not happen.

Mr. BAKER. Thank you.

Mr. Chairman, just unanimous consent request, Mr. Everett asked that I insert into the record his statement regarding his proposal on compensation.

The CHAIRMAN. Without objection.

The gentleman from Alabama, Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman.

Let me try to pose three sets of questions for you all, and get you to give fairly succinct answers to them. The first one I would direct to Mr. Caplan and Mr. Hills. It deals with the level of knowledge or intent that is required for a CEO to be liable under Sarbanes-Oxley. Let me get first of all your answer to the question, what do you understand the level of mens rea to be, the level of knowledge to be? Is it sufficient if a CEO signs a financial statement and the statement is false, for that CEO to be liable? Or what is the extra level that is required? Does it have to be a willful disregard standard? That seems to be something that is not 100 percent clear, and we have had so few prosecutions that we have not yet developed a good answer to that.

The follow-up to that, if you feel that the standard is one that is something other than knowledge, if it something other than the usual criminal standard, is that problematic? Is there a discomfort level that we have or should have with holding CEOs liable unless we can show deliberate disregard or willfulness on their parts? This is the first set of questions.

The second one, Mr. Del Raso, I would direct to you. There was a period of time last year when the SEC was considering a new set of regulations involving attorneys. There was a lot of talk about a noisy withdrawal requirement. As you and the other lawyers in the room know, in the overwhelming class of cases around this country attorneys have very little leeway to get out of cases even permissively. Attorneys are able to get out of cases if there is a possibility of imminent physical harm or if a lawyer has knowledge of imminent wrongdoing.

As I understood what the SEC was contemplating, there was some consideration that if an attorney became aware of corporate misconduct, that there was actually not just as permission to get out of the case, but an affirmative duty to withdraw in some instances. As a lawyer, that struck me as a radical change from the normal rule of special responsibility. Can you briefly comment on that?

The final set of questions would be to Mr. Hills and Mr. Del Raso. It deals with the sentencing guidelines. We know because of the recent decision that the guidelines are very much in flux right now. We do not know what will eventually come about. But one of the things that was worked in the Sarbanes-Oxley, as I understand it, is a dramatic ratcheting-up of the penalties and the collapse of any distinction between theft and between fraud. As I understand the guidelines right now, pre-Blakely, if a wrongdoer causes a certain amount of loss, whether or not he or she receives any direct financial benefit from it, it is treated the same as if he or she had received benefit. Are we comfortable with collapsing fraud and theft together? Does it create problems either in terms of getting plea bargains efficiently? Or does it create some broader problem if we dramatically ratchet-up the sentences for people who are not financially benefiting themselves from the fraud?

Those are the three sets of questions. The first would be to Mr. Hills and Mr. Caplan.

Mr. HILLS. The standard for Sarbanes-Oxley compliance with respect to signing the document, the principal change, which is so im-

portant, is that the CEO cannot win simply if he says, I did not know anything about it. He has to be bloody certain that that company has done everything possible to uncover the problem. That is what 404 does also. He has to make certain that every possible effort has been made to surface problems with it.

So if he sits there and says, I did not know anything about it, and he does not have a compliance situation in place, he is in trouble. I think that is the way to look at that part. I am sure somebody else is going to answer the second question.

Mr. DAVIS. Mr. Caplan, do you have anything to add to that?

Mr. CAPLAN. I would agree completely. I think that Sarbanes-Oxley has worked quite effectively in terms of its intent. There is very little doubt in my mind that in certifying either on my behalf as a CEO or the CFO, there really is an understanding of the severity that is intended when you certify, whether it is quarterly or whether it is with respect to 404. I would tell you that it is impossible, particularly the larger the organization gets, to know everything that is going on at all times. But the duty to investigate, as Mr. Hills has said, is dramatically escalated. The amount of work that goes into the processes I described earlier, whether it is quarterly or with respect to 404, has really transformed the way companies are looking at these checks and balances.

Mr. DAVIS. Mr. Del Raso, can you comment on the attorney issues?

Mr. DEL RASO. Sure. One of the more discussed aspects of Sarbanes-Oxley was the notion of the responsibility of the attorney, this concept of reporting up and then reporting out. The responsibility of reporting up at the attorney level inside the corporation is one that was a little easier to deal with. But the idea that if you are not listened to and then reporting out, as you know, the American Bar Association and even some states really took opposite positions from what was required in the act. They are issues that I think were very troubling to a number of practitioners at the time, but I think we are working our way through them.

I would recommend to you one of my partners was actually appointed by the court to be the special SEC examiner in the Spiegel case last year. A large part of that report deals with the role of the attorneys in reporting. That was probably one of the last major cases before the enactment of legislation that dealt with these issues.

Mr. DAVIS. Can you just quickly comment on the fraud-theft issue?

Mr. DEL RASO. I think that is one that really does require attention. I am sure you are referring to the Dynegy case and maybe the sentence that was imposed there, big distinction between outright fraud or negligent responsibility in the chain of command in the certification process, and really quite frankly weighing and balancing the societal effects again, too. I mentioned even in my testimony, one of my concerns is that outside of the framework of the legislation, when you get to regulatory enforcement, if you have prosecutorial misjudgment and in discretion, you could really start then to have a deleterious effect on this legislation if it is not properly enforced.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

I have long since been convinced of the absolute necessary and profound benefits of Sarbanes-Oxley and what it means to the protection of our free market system. But let me take my limited time to focus on what some may perceive as the cost or risk and unintended consequences of the legislation.

Obviously, the subject of corporate board independence, independent members of the board, is discussed often these days. Sarbanes-Oxley has required that the audit committee be comprised totally of independent members. If we look at what I think my colleague from Houston described as the poster child for corporate malfeasance, Enron, I am told that 86 percent of their board was independent and had a dozen non-employee outsiders. This included four CEOs, four academics, and the board was chaired by an accounting professor from the Stanford Business School.

Just for the sake of argument, I am told Berkshire Hathaway would not pass anybody's test of having an independent board, yet I do not believe they have had a hint of corporate scandal, and except for 4 years out of 40, they have always beat the S&P 500.

So my question really focuses on where theory meets empiricism. The question is, with our limited history, what do we know about the impact of having independent members and what that means to corporate governance? Why don't we start with you, Mr. Quigley.

Mr. QUIGLEY. I believe that we need independent directors, but we also need audit committee effectiveness, understanding and executing their effective role. If it is an audit committee composed on the golf course, the likelihood of it being effective is much, much lower.

Mr. HENSARLING. Mr. Hills, how about you?

Mr. HILLS. Independence does not at all guarantee quality. I think if you go back to 1976 and just see the impact on corporate America by simply having an audit committee be required, so you had three independent people on the board at least, it has had a substantial impact. But independence is not enough. You need to have a sufficiently independent quality on every board to deal with those matters that need that independent quality. I do not see anything wrong with having employees on the board. It is a matter that each company is not the same.

But if the background for the question is, can we carry the independence question too far, of course we can. I think if we stay with the principle that every board needs a sufficiently independent quality to deal with those things that need that independence, then we are fine. At Berkshire Hathaway, the board is a very good example. They do have a substantial independent quality on that board.

Mr. HENSARLING. I have a lot of different studies crossing my desk. I am never quite sure of their reliability or their methodology. But I saw a Wall Street Journal article that dates back to about a year-and-a-half ago saying that since the advent of Sarbanes-Oxley, D&O insurance has quadrupled. I have seen another study saying that the cost of going public for mid-size companies has now doubled. Directors's fees have doubled. Accounting, audit and legal fees have doubled.

Again, I am uncertain of the methodology and reliability of these reports, but I am curious about the hard data out there on the cost of compliance. More specifically, what does that mean as far as companies making their decision to go public, not to go public, and the impact of that on job and wealth creation? Do you have any hard data on what these actual costs may be and how CEOs and boards are deciding on the decision of going public? Again, why don't we start with you, Mr. Quigley.

Mr. QUIGLEY. I view the cost of Sarbanes-Oxley compliance as a new element of the cost of capital. It is an issue that management must evaluate as they look at their various financing alternatives for their growth plans. I believe that in return for the privilege of becoming the steward of the public's money, if that is in fact the vehicle you use to finance your growth plans, you have to be willing to step up and pay these costs that go with that stewardship responsibility.

There is lots of liquidity in private equity. There is lots of liquidity in banks and insurance companies to finance growth plans through private transactions if you do not want to pay the cost of participating in the public markets.

Mr. HENSARLING. I see my time is just about to run out. Perhaps other answers could be submitted in writing. I had one other question. I saw a particularly critical report from a study from the Cato Institute on Sarbanes-Oxley that says it has so many ambiguities and contradictions that companies are faced with draconian punishments for vaguely defined offenses, which is somewhat following up on my colleague Mr. Artur Davis' line of questioning. I was just curious to know to what extent do you see ambiguities and contradictions that need to be addressed in the legislation? Having said that, I see I am out of time, Mr. Chairman, so those answers will have to wait for a later time.

The CHAIRMAN. I would have the witnesses respond, if anybody has a particular response. Mr. Del Raso?

Mr. DEL RASO. As the lawyer, I would tell you that this is not really a lot different than any other regulatory or legislative act that we work with. We have had the securities laws around for all these years, and Mr. Hills knows this all too well. That is why you have a system in place where you deal with the regulators. You either request positions from them, either in interpretive letters or through rulemaking, or you come back to the legislative side and ask for changes.

But I think what you are finding here is every day that passes since the act went into effect, the questions are probably a little more easily answered. There was a lot of work that was done in the very beginning. So I think that you will never get to ground zero with respect to having no issues or no questions with regard to any type in either the legislative or regulatory framework you are working in.

The CHAIRMAN. Thank you.

The gentlelady from New York.

Mrs. MALONEY. Thank you.

Mr. McDonough in testimony before this committee brought up the idea that possibly we should have two standards, one for larger companies and one for smaller companies for the enforcement of

Sarbanes-Oxley. Many smaller companies are complaining that the burden is too great for them. I would like a response in writing to that.

But in my brief time, I would like to focus on something that Mr. Trumka brought up in his testimony and ask the other witnesses to comment on it further. We made a promise in Sarbanes-Oxley, but broke it this week on the floor. That promise was our promise to insist that companies tell investors the truth about their financial status. We said that we would insist on transparency and that we would empower the SEC to enforce that promise.

Yet just 2 days ago, the House passed legislation that has the exact opposite purpose and effect. H.R. 3574, the stock options bill, walks away from our commitment to investors. It walks away from our commitment to independent standard setting, in the interest of a few companies that do not want to show investors the true cost of their stock options that they pay their employees. The bill passed the House overwhelmingly, despite the opposition from every single financial luminary from Alan Greenspan, who reiterated his opposition to the bill yesterday literally in this room before the committee in a hearing, to Arthur Levitt, to Warren Buffett, to John Bogel, to Bill Donaldson, John Snow, all four big accounting firms and many others.

Today, it is getting slammed in the financial press precisely because that bill violates the premise of Sarbanes-Oxley. I request permission to place that article in the official record of this committee.

The CHAIRMAN. Without objection.

Mrs. MALONEY. I deeply believe, and I have really been extremely upset about this vote, that Sarbanes-Oxley is the most important and significant corporate governance bill that Congress has passed since the 1934 act. Like the 1934 act, it was a necessary response to a grave situation in order to restore investor confidence.

Although we have made some improvement, we have some unfinished business. My main question to the panel today is, do you believe that the principle of independent standard setting and SEC oversight was a critical part of Sarbanes-Oxley, and I would say the 1934 act? And if so, how much damage did we do with the stock options bill? On this precise point, I had an amendment which likewise failed on the floor, which merely reinstated the authority that the SEC has had since 1934 to override rules if they see fraud or the public interest jeopardized. That failed on the floor.

So I invite all the panelists to answer. I would like to start with Mr. Trumka and Mr. Hills, since he is a former chair of the SEC, and then of course the big four, Deloitte Touche, and everyone if you would like. Thank you.

Mr. TRUMKA. My testimony, I think you have just reiterated most of my written testimony. We think it sends the absolute wrong message at this time. We think it paints a roadmap for CEOs that want to cover and prevent investors and would-be investors from knowing what the real costs of their salary is, and what the real costs to the corporations are, and allows them to hide it.

The bill that was passed only purports to make the top five people report those expenses. The other people at the bottom, it pretends like it does not exist, so it is intellectually incompatible. Then it does something that I think is the world's greatest fiction. It says that stocks are nonvolatile. If anybody believes that stocks are nonvolatile, I have some beachfront property in southwestern Pennsylvania that I would sell them.

We think it has done tremendous damage and we think it sends the wrong message. It says to CEOs that if you put on a big enough effort, you can overturn all the good and the momentum that has been built up by Sarbanes-Oxley and in fact reverse what the experts in the field say is necessary.

The CHAIRMAN. The gentlelady's time has expired. We would ask for just some brief responses to the gentlelady's question. We are going to have votes momentarily on the floor of the House and I would like to complete the hearing.

Mrs. MALONEY. Mr. Hills?

Mr. HILLS. Of course, it has not done any damage yet. I am very much in favor of independent standards. I am very much in favor of allowing information in, not keeping it out. The fight over options pricing is in many respects a sad fight. The information in a balance sheet in the 10Ks tells any analyst worth his salt how many options are there and what it costs. The question is, why not put it in the profit-and-loss statement? It should be in the profit-loss statement because everything else is in there.

The issue is how do you treat the profit-and-loss statement. I will just go back to the quote I gave you at the end of my testimony, and that is this constant reliance upon the brittle illusion of accounting exactitude. The problem is that by throwing it in there, too many analysts are going to take more from it than they should, and therefore much of the industry does not want it in there. My own view is that the world has wised up to the fact that whether it is in or not is not going to make much difference because the analysts now do understand that stock options have a cost.

So I am in favor of it. I am sorry there is such a fight about it.

Mr. QUIGLEY. Congresswoman, I would just quickly comment that I, along with the other three CEOs of the big four firms, signed the letter that you referenced. I support fully private sector standard setting and believe it is one of the factors that has made our capital markets the envy of the world.

The CHAIRMAN. The gentleman from Ohio, Mr. Tiberi.

Mr. TIBERI. Mr. Del Raso, we have heard since the passage of Sarbanes-Oxley from some different public companies complaining about the legislation. You have counseled foreign companies. You have traveled overseas. What are you telling them? Can you give us the state of foreign affairs right now with respect to this issue?

Mr. DEL RASO. I think when the legislation first passed, there was some real concern and trepidation about the fact that the foreign issuers, especially larger ones, thought it was intrusive. Why should they have to comply? Well, if they want to access our capital markets, that is a cost of doing business here, but more importantly it was to stabilize global markets because we are such a large player.

I think, though, in the light of some of their own scandals that came home to roost in their countries, most notably just in the last year or so, the Parmalat scandal in Italy and some others, they are even more keenly aware of what we were faced with and the importance of this type of legislation. If you do take a look at what has happened overseas, they will in their legal process set up their own investigation and prosecution. I do hear from the diplomats or even the foreign business executives, than they do envy our system because it works much more efficiently and fairly than their inquisitorial systems which in some countries are worse.

Mr. TIBERI. Thank you.

Mr. Quigley, in your testimony you stated that a final human resources aspect of Sarbanes-Oxley that is worthy of note is the increased personal risk that our partners and professionals perceive about our profession. The stress creates long-term impact on the ability to attract and retain people.

In addition to that statement, are you concerned about the future of the your industry, with that issue and the issue of the increase of liability that you face and your partners face?

Mr. QUIGLEY. It is the single biggest cloud associated with the future of the profession. I, though, am very optimistic about that future and believe we will find a way to try to manage our way through that. I hope one day we can have meaningful securities law and other tort reform that can take that very, very large cloud off the horizon.

Fifteen cents of every audit dollar that we collect is required for litigation, claims and insurance costs. That is an enormous cost on our business, on our operation, and frankly does reflect somewhat the burden that our partners feel associated with this aspect of practicing public accounting.

Mr. TIBERI. Mr. Chairman, I yield back my time.

The CHAIRMAN. The gentleman yields back.

The gentleman from Staten Island.

Mr. FOSSELLA. Thank you, Mr. Chairman. Welcome and thank you to the panel. I thank you, Mr. Chairman, being the last, I know I get unlimited amount of time to ask questions. I appreciate that as always.

The CHAIRMAN. Yes, we always play that game.

[Laughter.]

Mr. FOSSELLA. I thank the panel, and especially welcome Mr. Caplan in moving so aggressively at E*TRADE and doing the right thing. And my friend Mr. Quigley, thank you for coming and offering as always insightful testimony.

Briefly following up on what Mr. Tiberi just talked about, and that is, to what degree, if at all, should we be concerned with the flow of capital from foreign countries? For example, I know John Thain, who is the CEO of the New York Stock Exchange, has argued that some of the new governance requirements may scare some of the foreign firms. I think he has indicated that the number of IPOs have been down relative to prior years. Whereas the head of NASDAQ has said there should not be concern, or more to the point, has not slowed down the IPO pipeline.

Just out of curiosity, why is there a disconnect? Is it because, as has just been indicated, that now these nations are going to their

own problems, so therefore we should not lower our standards until they raise theirs? I was wondering if you can offer anything on that.

Secondly, from Mr. Quigley, a two-prong question. One, in your testimony you seem concerned about the new requirements, the shortening of filing time, as opposed to the concern regarding internal control assessments and attestations. I guess as you say, you are concerned about the quality of financial reporting, again not intended, but that could be in place. And next week, you are going to offer to the SEC that that extension on the filing deadline be delayed by a year.

If you can shed some light on why you think that is a concern and why that should be modified. I will just leave it at that. So for the first question, if someone can chime in.

Mr. CAPLAN. I would say it is probably not the first and it will not be the last time you will have a difference of opinion between NASDAQ, Mr. Greifeld and Mr. Thain with respect to the New York Stock Exchange. Having lived first-hand some of the issues around governance, I would tell you that certainly our view is that corporate governance really should have no boundaries. Watching first-hand in the part of our business that deals with equity trading, the importance of investor confidence and the return of that investor confidence, nothing should be allowed to shake that.

I think if you do not extend it to companies who want to access capital in the United States, regardless of where they are abroad, you really pose too great a risk, because if ultimately there is a problem, it will shake investor confidence again. I have watched the behavior of our customers in these last 2 years. One of the things that is interesting is that we sent a survey out to our customers about a year after Sarbanes-Oxley was enacted, and asked them were they more willing in light of general governance to trade. There was a 37 or 38 percent increase as a result of that.

So generally speaking, I think you are seeing the recovery in the marketplace due to what is happening economically, but I also think you are beginning to see a rebound in confidence. I really feel confident that we should not allow anything to shake that. If somebody wants to access capital in the United States, it is the cost of doing business.

Mr. QUIGLEY. Just to comment quickly with respect to the Sarbanes-Oxley 404 and its impact with respect to the accelerated filers, as we shorten that filing period to 60 days, I do not know how many, but some registrants are going to find as we get towards the end of February an enormous pressure. I believe that additional 2 weeks could be valuable to the registrants, to the auditors and could contribute to the quality of reporting this year. Accelerating from 75 to 60 days and overlaying the internal control reporting are two very significant changes that were not contemplated at the time the initial accelerated dates were put in place by the SEC. That is why we are going to recommend deferring for 1 year.

Mr. FOSSELLA. Just finally, Mr. Quigley, are there any State provisions that in your opinion conflict with Sarbanes-Oxley? If so, is this a problem?

Mr. QUIGLEY. There are States that are talking about broadening the application of Sarbanes-Oxley provisions to other than public

companies. There are some States that are also debating whether they need their version of Sarbanes-Oxley. I am concerned about the complexity and the cost that continuing to layer additional levels of regulation on top of this through the States would not be a good move at this juncture.

Mr. FOSSELLA. Okay. Thank you, Mr. Chairman.

Thank you, gentlemen.

The CHAIRMAN. The Chair wants to thank all of you profusely for what has been an excellent tutorial and review of the Sarbanes-Oxley Act. I think it was an opportunity for all of us to talk about the highlights and perhaps some of the changes ultimately that we need to make, though it has never been perfect legislation. For that, we are most appreciative of your candor and your expertise.

The committee stands adjourned.

[Whereupon, at 12:21 p.m., the committee was adjourned.]

# A P P E N D I X

July 22, 2004

**Opening statement**

# Chairman Michael G. Oxley

## Committee on Financial Services

**"Sarbanes-Oxley: Two Years of Market and Investor Recovery"**
**July 22, 2004**

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It has been two years since the Congress passed, and President Bush signed, the most sweeping corporate reform law in our nation's history. The Sarbanes-Oxley Act of 2002 was designed to curb accounting fraud, make financial statements more transparent and understandable, and hold company executives and directors accountable.

I am pleased to say that the early returns are in. And they are positive.

We all know that no law will stop certain determined bad actors from violating the trust of shareholders. Indeed, if that were possible, we would have passed such legislation a long time ago.

But Congress can establish incentives and disincentives for certain behavior. It does have the ability – and the obligation – to establish a baseline of professional conduct for American business. And if these minimum standards are not met, Congress can help ensure that there will be swift, certain, and severe punishment.

Sarbanes-Oxley was passed during a period in which a majority of Americans had lost faith in the pillars of corporate life – company executives, public accountants, investment bankers, stock and bond analysts, and attorneys. This mistrust, I would point out, was well-founded. Too many failed to act ethically. Indeed, we have learned that many violated criminal laws, and will serve time in prison. Sadly, it was more than a few bad apples.

That is the climate in which Sarbanes-Oxley was debated and passed. Remarkably – considering the overheated political environment at the time – it is measured and responsible legislation. Many of its provisions require companies to do things that they were already doing or should have been doing. If companies find that certain mandates like the internal control standard are particularly costly, maybe that is because they were deficient in that particular area.

Numerous parts of the Act appear to be working extremely well. Certifications of company financials by chief executives and finance chiefs, independent and empowered audit committees, officer and director bars, and the FAIR Fund have all had a very powerful – and positive – impact, to cite just a few provisions.

Are there increased costs? Yes. Do the benefits of improved financial reporting, more active and engaged boards, and trusted markets outweigh those added costs? I believe so. But don't take my word for it. Recent surveys indicate that a majority of corporate directors believe the Act has had a positive impact on their companies and boards.

That is not to say that it is a perfect statute. It is not. No legislation ever is, or at least none have been in my two decades here in Washington. But it does appear to be working quite well, and for that we should be proud.

I look forward to hearing from our distinguished panel today. We have heard from many of you before, and we obviously liked what he heard, because we have invited you back. Welcome.

I now turn to the Ranking Member for his opening statement.

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July 22, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Full Committee Hearing entitled "Sarbanes-Oxley: Two Years of Market Investor Recovery"

Thank you, Mr. Chairman, for holding this hearing and for your important leadership in the wake of the largest corporate scandals in our nation's history leading to the passage of the Sarbanes-Oxley Act, arguably the most comprehensive corporate reform law in US history.

As we come upon the second anniversary of the passage of Sarbanes-Oxley, it is appropriate that we convene today to review the Act and its implementation. I look forward to hearing from our distinguished witnesses on Sarbanes-Oxley's effects on public companies and the public's confidence in their corporate governance.

This committee has heard previously from Chairman William J. McDonough on the progress made by the Public Company Accounting Oversight Board (PCAOB), established in Sarbanes-Oxley to bring an end to the self-regulation of the accounting profession.

I joined Chairman Oxley in his praise of the PCAOB and Securities and Exchange Commission (SEC) for their successful completion of one of the main tasks set for them in the Sarbanes-Oxley Act; finalizing a rule requiring companies to include in their annual reports, a report by management on the company's internal control over financial reporting and an accompanying auditor's report.

The actions of the PCAOB and implementation of other provisions of the Sarbanes-Oxley Act are reported to have gone a long way in improving the accuracy of public companies' financial statements and most importantly rebuilding investor confidence is such reports. However, I look forward to a full discussion this morning of any industry concerns with the implementation of Sarbanes-Oxley.

Thank you again, Mr. Chairman, for calling this important hearing and I look forward to an informative session.

**OPENING REMARKS OF THE HONORABLE RUBÉN HINOJOSA**
**HOUSE FINANCIAL SERVICES COMMITTEE**
**"SARBANES-OXLEY: TWO YEARS OF MARKET AND INVESTOR RECOVERY"**
**JULY 22, 2004**

Chairman Oxley and Ranking, thank you for holding today's hearing. You have held numerous hearings this session of Congress, but this one is among the most important.

In the late 1990s and early this century, the United States experienced what may constitute a record number of corporate governance problems and accounting fraud. These frauds wreaked havoc on the financial services markets, virtually eliminated investor confidence in the marketplace, and, in some instances, wiped out the retirement funds for almost all the employees at one of the largest corporations in Texas and in America. I am speaking, of course, about Enron.

I was very pleased to learn that those responsible for the failure of corporations such as Enron are finally being brought to justice.

Having served twenty years as President and Chief Financial Officer of a company, I know all too well how important it is for a company's executives to adhere to accounting guidelines and to monitor the activities of my colleagues.

Consequently, I am particularly interested in the activities of the Public Company Accounting Oversight Board (PCAOB) the Sarbanes-Oxley Act created that brought to an end decades of self-regulation for the accounting profession.

Companies are reportedly taking much more care in preparing their financial statements as a result of the Sarbanes-Oxley Act, and the audit has regained its place as the central focus for accounting firms.

One concern I have is that certain companies contend that it has been more difficult to find acceptable board members since Sarbanes-Oxley was enacted. I hope the witnesses will address this concern.

Mr. Chairman, I want to thank you again for holding this timely hearing, and I yield back the remainder of my time.

Sarbanes-Oxley: Two Years of Market and Investor Recovery

Mitchell H. Caplan

Chief Executive Officer, E*TRADE FINANCIAL

before the

U.S. House Financial Services Committee

July 22, 2004

Good Morning. Chairman Oxley, Ranking Member Frank and Members of the Committee, I am Mitch Caplan, Chief Executive Officer of E*TRADE Financial. E*TRADE Financial is a leading provider of online personalized and fully integrated financial services including investing, banking, lending, planning and advice.

I would like to thank Chairman Oxley, Ranking Member Frank and the Committee for inviting us to share our company's experience with the implementation of the Sarbanes-Oxley Act as your Committee examines the law's effectiveness since its enactment two years ago.

**Background**

E*TRADE Financial was founded in Silicon Valley twenty years ago on the proposition that technology, properly applied, could revolutionize and democratize the financial services industry. E*TRADE has invested over a billion dollars in the development of its technology and its brand, establishing itself as a champion of the average American investor. In order to do that, it was essential that E*TRADE earn and

maintain the trust of its customers, its employees, its shareholders and the marketplace at large. The investment paid off. Our business boomed through the "dot-com" era.

Having revolutionized the brokerage industry, E*TRADE turned its attention to other aspects of financial services. With the acquisition of Telebank in 2000, the company began offering an array of online banking products and services. The company also began offering its own proprietary mutual funds in addition to a mutual fund supermarket. In 2001, the company became the third largest provider of online mortgages. In 2002, the company enhanced its proprietary trading platform for active investors and offered a broader array of consumer financing products, including automobile, boat and recreational vehicle loans. E*TRADE brought down costs and made sophisticated financial products and services more accessible to the average investor.

E*TRADE's work as a customer champion was put at risk in 2002. As the public became increasingly leery of all decisions being made by major corporations on their behalf, our shareholders raised serious concerns about the compensation package granted to the CEO. The company's annual proxy disclosed the total value of the CEO's package and immediately made E*TRADE a prime example of the discrepancy between executive management rewards and shareholder value. The total value of the CEO compensation package as compared to shareholder value had not been thoroughly considered by the company's board as a whole and as such revealed clear flaws in our corporate governance policies and structures.

**Corporate Reforms**

1) *Increased Board Independence*

Working closely with counsel, our Board undertook a thorough review of all corporate governance practices. The Board created the position of Lead Director to organize and lead regular meetings of the Board without the presence of any management, including the CEO. These meetings of independent board members and outside counsel, and the free and open dialogue they promoted, formed the genesis of much of the change in the Company's corporate governance practices.

2) *Board Structure and Composition*

The Board continues to find great value in this independent dialogue; so much so that they separated the positions of CEO and Chairman when I was appointed as CEO.

The Board also looked closely at its own composition. With its new CEO in place, the Board worked with outside counsel and third party advisors to examine the strengths and weaknesses of each Board member and the Company's management team. We developed a "profile" of our ideal Board candidates in the context of the requirements of Sarbanes-Oxley, the Corporate Governance Guidelines of the New York Stock Exchange, and the needs of our business.

We initially identified over forty candidates who were both qualified and interested in serving on our Board. The available pool of candidates was so strong we retained four new Board members, rather than the two we had originally sought to recruit. The new Board members bring a wealth of experience and perspective to our Board.

These new Board members participated in a rigorous new director orientation program. This program provided new directors an overview of the company's various

lines of business, its corporate and management organizational structure, human resource policies and practices as well as a detailed discussion of the legal and business obligations of directors, including a review of the Company's insider trading policies and Code of Professional Conduct.

We consolidated and centralized the work of the various committees of the Board so all board members would fully understand and participate in the Board's most important actions. We reduced six standing committees of the Board to three: an Audit Committee, a Compensation Committee and a Nominating and Corporate Governance Committee. The Board adopted a new requirement that any compensation program for the Chief Executive Officer must be approved by the entire Board of Directors. Any new plan or program is reviewed only in the context of the CEO's total compensation. We have developed thorough Corporate Governance Guidelines and post them on our website where they are publicly available at any time.

3) *Committee Structure*

The Nominating and Corporate Governance Committee next ensured that at least one individual who would qualify as an "audit committee financial expert," and that person would be elected to chair the audit committee. Today our Audit Committee is led by an individual who is a former investment analyst and CEO with extensive experience on numerous boards. The other members of our Audit Committee bring a diversity of perspective to their positions and have led a methodical and detailed review of each of our business lines, examining it for risk and risk controls. Our Compensation Committee is led by a member with numerous years of experience as a leader in the financial services industry, a CEO of her own company and past experience as a compensation

committee chair. Our Nominating and Corporate Governance Committee is led by a member who has over twenty years' experience as an investor in the Company. The Committee leads extensive and detailed analyses of the regulatory requirements in the corporate governance area and the use of those practices to effectively perform the oversight role the board is intended to play.

4) *Board Meetings*

Having reconfigured the composition of the Board and its committees, the Board then reconfigured the structure of its quarterly meetings. It meets over a three day period at a different company worksite each quarter so board members can see the operations and meet employees. There is a general business review attended by the board and senior management, a meeting of the independent board members without any management present and stand-alone meetings of each standing committee. The Audit Committee meets with the Company's internal and independent auditors without the presence of management. The meetings also include a general session in which one aspect of the company's business is discussed, including the internal controls associated with that business, and ends with a final session of the independent board members without management.

5) *Independent Auditor Relationship*

Together with changes to our Board's corporate governance practices in compliance with the Sarbanes-Oxley Act and our own growth and development as a company, we have closely examined our relationship with our independent auditors. We reviewed our relationship with our independent auditors to ensure they do not to perform any work for us that could jeopardize independence, such as bookkeeping services,

financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing, management functions, human resources consulting, broker-dealer or investment banking services or expert services.

Having ensured the relationship met all definitions of independence, our Audit Committee and management team worked with Deloitte & Touche to rotate Lead Audit Partners. The Audit Committee will regularly review that relationship to determine whether to rotate external auditors.

6) *Financial Reporting Practices*

We also focused on transparency of our financial reporting. Investors had criticized our financial reporting as difficult to read and felt our reporting did not provide enough information for an investor to determine whether our business model was truly working. Over a one year period, we aggressively addressed our financial reporting practices. In accordance with Sarbanes-Oxley requirements, in 2003 we began reconciling all non-GAAP measures, such as "earnings per share from ongoing operations" with our GAAP results. Going beyond the requirements of the Act, we stopped reporting non-GAAP results such as "earnings per share from ongoing operations" altogether. We simplified the descriptions of our business and our accounting standards in our annual and quarterly financial reports so they would be more understandable for the average investor and so that financial analysts could create more accurate models of our business to provide better information to investors. Further, we identified the key metrics driving our business and began reporting our performance against those metrics on a monthly basis. We have even taken a leadership role in

establishing financial reporting standards for our sector to enable investors to compare the performance of businesses in the sector on an "apples to apples" basis.

**Section 404 Implementation**

At the same time we implemented these governance practices, we also prepared for the attestation of the adequacy of internal controls as required by Section 404 of the Sarbanes-Oxley Act.

The process of complying with Section 404 has been beneficial to the overall growth of our company. The process has functioned as an additional check on our existing infrastructure. The requirement that we closely identify and review all internal controls and remedy any gaps has brought additional urgency to a process that was already underway.

To comply with Section 404, we spent several months in the investigation and learning process as to both the requirements of the law and emerging best practices in implementing the law. The risk control guidelines created by the Committee of Sponsoring Organizations ("COSO") constituted the basis of our internal control framework. We have identified approximately twenty separate entities whose processes were examined. For each of those entities, we documented the design of significant controls and focused on identifying gaps within those controls. We then defined and implemented corrective measures to tighten process gaps identified while documenting the controls. We conducted extensive testing to evaluate the design and operating effectiveness of the internal control structure. While we focused on the controls over financial reporting as required under Section 404, we also recognized that under the COSO model there is frequently an overlap between operational and compliance controls.

This process has helped us to review each set of controls and we are correcting deficiencies uncovered during the evaluation and testing process. Once this process is completed in August of this year, our independent auditors will audit our internal controls in preparation for the attestation period in early 2005. We anticipate this process will be completed by the end of this year.

*Costs of Compliance*

The total cost in 2004 for our Section 404 compliance program will be approximately $4.5 million, or roughly three tenths of one percent (.3%) of our estimated annual revenues of approximately $1.7 billion. Going forward, we expect the cost of annual compliance with Section 404 to be about one-half of the first year cost, or roughly $2.2 million. These estimates include the cost of any consultants, as well as additional staff requirements and the time commitment of existing staff, plus the incremental costs associated with our independent auditors' attestation process.

*Significant Benefits to Compliance*

The process of complying with Section 404 has had many incidental and beneficial effects. It has reinforced management's understanding of accountability for processes and financial reporting across the business. It has provided management with a better understanding of various processes. We have identified necessary control design improvements and identified where processes were deficient, inconsistent or inadequate. It has allowed us to look at all internal controls across the company with a consistent approach to process controls and also strengthened internal controls between business units that had previously been overlooked. For a company at our stage of growth, the Section 404 process came at a perfect time. Our business is large enough and our

systems are mature enough to require significant internal controls and yet it is young enough that there is not institutional inertia or resistance to changing processes to implement controls.

*CEO Certification*

The Section 404 process is just one check in our risk control matrix. As part of the certification process required by Section 302 of the Act, we have established a Disclosure Control Committee consisting of the leaders of the organization responsible for financial reporting. Before any public filing of a financial report, that committee meets to discuss the Company's disclosures and disclosure procedures in depth. Following approval of the financial reports by the Disclosure Control Committee, all leaders of the organization certify that they have reviewed the financial report and can attest the report does not contain any untrue statement of material fact or omit to state a material fact. Each leader is given the opportunity to have a private discussion with the company's general counsel, general auditor, external counsel or external auditor to raise any issues of concern. Further, each of our employees responsible for financial reporting has been provided the contact information for each of the members of the Audit Committee of the Board. The company has established a relationship with an independent third party that provides a forum for employees to anonymously report any act they believe may be illegal or inappropriate. Any claim is promptly investigated and appropriate remedial action is taken if necessary. The Chair of the Audit Committee is directly informed of any report of improper conduct leveled against the company's senior executives, including the CEO.

**Impact Of Governance Changes For Investors and Customers**

Investors have unequivocally rewarded us for improving our corporate governance. As an example, in 2002, the California Public Employees Retirement System ("CalPERS") placed E*TRADE on CalPERS' 2003 Monitoring List. The Monitoring List is a group of companies identified by CalPERS as potentially benefiting from improvements in corporate governance. The Company worked with CalPERS and kept it closely apprised of its progress in the governance area, and in January 2004 CalPERS publicly commended E*TRADE for its corporate governance accomplishments, noting specific changes to its governance practices and also noting that the company's stock performance in the one year period from November 29, 2002 through November 28, 2003 increased by 90.67% and outperformed its peer index by 64.38% in the period.

Our customers have also noted the impact of improved corporate governance, not just for E*TRADE but for the industry as a whole. In October 2003, just over one year after the passage of the Sarbanes-Oxley Act, we conducted our quarterly customer survey of their opinion of the markets and the economy. Asked whether they felt more confident that the information they receive as an investor is accurate, over 33 percent of our customers confirmed they were more confident in the accuracy of financial information reported by companies.

For E*TRADE, shifting the focus from corporate governance problems allowed us to return to our core strength – creating a strong and growing business that leverages our technology platform to deliver value and innovation to our customers. Since January

2003 we created and delivered a number of innovative products that directly benefit the average American investor. In June of 2003 we introduced our "portable mortgage" product allowing home buyers to lock in today's mortgage rate and then transfer that rate to their next home purchase, potentially saving buyers thousands of dollars in interest payments in an environment of rising interest rates.

In the mutual fund arena we have made a number of important innovations. In December of 2003 we introduced a 12b-1 Fee Rebate Program. As a mutual fund distributor that has leveraged technology to lower costs, we are able to rebate half of the 12b-1 and shareholder service fees we receive to our customers, ultimately creating greater value for our mutual fund investors. The program was launched in late 2003 and the first rebates were made to our customers in June of this year. For investors in the proprietary E*TRADE Mutual Funds, we announced this June that we have cut expenses to offer an S&P 500 Index Fund, a Russell 2000 Index Fund and an International Index Fund that have the lowest expenses in the industry; in some cases as much as 75% below industry averages. At a time when investors have watched expenses rise and scandals plague the mutual fund industry, we are proud to be an innovator who champions the average investor while at the same time creating solid value for our own shareholders.

**Summary**

Two years following the implementation of the Sarbanes-Oxley Act, E*TRADE commends Congress for its passage. Any well-run company should embrace the principles of corporate governance the Sarbanes-Oxley Act represents. The Act provides guidance to help companies grow with good governance and provides a check for more mature companies. As companies live under the Act over time, there will undoubtedly

need to be some further modification and regulatory guidance, but we do not recommend any wholesale change of any of the Act's provisions.

Markets are cyclical, and there is no way to protect against downturns. There is also no way to completely eliminate mistakes or scandal from business. However, we can all work harder to ensure that markets are not brought down by scandal and mistakes that could be avoided by the adoption of the principles of good corporate governance and internal control represented by the Sarbanes-Oxley Act. E*TRADE Financial is proud to stand as an example of how a company can embrace good corporate governance to create value for employees, customers and shareholders.

**Statement of Joseph V. Del Raso, Esq.**

**Partner, Pepper Hamilton LLP**

**to the**

**House Financial Services Committee**

**On "Sarbanes-Oxley: Two Years of Market and Investor Recovery"**

**July 22, 2004**

Good morning Chairman Oxley, Ranking Member Frank and distinguished members of the Committee. Thank you for this opportunity to present my views on the impact of the Sarbanes-Oxley Act over the last two years.

I am Joseph V. Del Raso, a partner in the law firm of Pepper Hamilton LLP. My practice focuses on corporate and securities matters, particularly on matters related to securities regulation. I served as an attorney/adviser with the Securities and Exchange Commission in the 1980s, and I have served as a member of the board of directors of both public and private companies. Having experience on the regulatory side, as a lawyer in private practice and as a corporate board member, I believe that I offer the Committee an important perspective on the practical effect of the Sarbanes-Oxley Act over the past two years.

Overall, I believe that impact has been a positive one. While there are costs – in some cases material costs – and occasional perceived regulatory overkill associated with implementation of the Act, it has done much to restore the faith of investors in the way in which public companies operate and report their financial results. Just as importantly, it has helped give directors and corporate officers the tools they need to meet their obligations and be accountable to shareholders. I commend the Committee for its level-headed and responsible approach to this Act.

**Positive Changes**

I first would like to address the positive impact of the Sarbanes-Oxley Act on domestic issuers. The Act has:

- Increased the awareness of the need for corporate accountability and transparency, and given greater attention to best practices in corporate governance.
- Prompted procedures to establish internal controls to ensure compliance.
- Highlighted the need to take prompt remedial action when problems are uncovered, in order to reassure the global markets of the safety and integrity of our capital markets and those issuers who access them.
- Increased the protection of shareholder interests, thereby increasing shareholder confidence.
- Highlighted the need for improved risk management and should produce the long-term effect of mitigating the costs of insurance, indemnities and potentially large awards (including punitive damages and governmental fines) for systemic failure of the corporate entity.
- Increased attention to the need for accountability directly to shareholders in matters of corporate governance.

**Costs and the Perception of Regulatory Overkill**

Of course, the implementation of the Sarbanes-Oxley Act has not entirely been a bed of roses. The costs of compliance often can be burdensome. Reviewing internal financial controls, improving those mechanisms when necessary and ensuring that the processes are well-documented is time-consuming and costly, in some cases costing companies millions of dollars and thousands of hours annually.

I believe that what corporate officers and directors need to keep in mind is that the costs of compliance is not nearly as burdensome as the costs of failing to comply. What was at risk in 2002 – what this Act was designed to prevent – was the threatened loss of confidence by investors throughout the world in our capital markets. That loss of confidence doesn't just effect companies with poor corporate governance, or negligent or outright criminal leadership – good companies as well as bad, and millions of investors, suffer the consequences when people lose faith in how companies operate and report their results.

I look at the costs associated with compliance as a necessary and prudent investment in the long-term stability and success of our capital markets.

However, we must be careful not to stifle entrepreneurship and capital formation for emerging businesses. The initiatives of the SEC in the early 1980s to adopt rules to allow smaller companies access to the public capital markets produced very positive outcomes. Some may argue that smaller issuers may not be suited for public ownership if they cannot afford the cost of Sarbanes-Oxley compliance, but that is not the appropriate focus. We should always encourage small businesses to grow, and not overburden them with intrusive regulation.

On the other hand, we have learned that an environment of careless behavior and lack of respect for both the investor and the government's oversight and regulation produces nothing but financial and societal losses. We must balance the need for entrepreneurial freedom and reasonable governmental oversight, and for that reason it may be necessary to revisit and fine-tune this legislation from time to time.

I urge this Committee as it examines future regulatory actions to be careful to not overburden the average issuer with overzealous enforcement and unreasonable intervention. Do not pile on with additional regulations that make compliance more difficult or that are simply not practical. Further regulatory action should be adopted only after a thorough analysis shows that the benefits of the new regulations outweigh the risks that it will make compliance overly burdensome on the average issuer.

Overzealous regulatory action and enforcement also can poison the atmosphere between regulators and the industry, and stifle the discipline and sense of cooperation between the

government and those it regulates. The vast majority of corporate officers and directors act ethically and take their fiduciary responsibilities seriously, and will welcome legislation, regulation and guidance that helps them meet their obligations to shareholders. However, when the regulators and the regulated find themselves in a constant adversarial atmosphere, the spirit of compliance and good corporate citizenship may erode into one of combat mentality. Operating in that environment is not consistent with our democratic traditions of creativity and free enterprise.

**Corporate Governance**

The impact of the Sarbanes-Oxley Act in the area of corporate governance has been profound. Independent directors are exercising their responsibilities and paying much more attention to detail – I can tell you from personal experience that board meetings are longer and have much broader agendas. Audit committees are meeting more frequently and are increasing the number of executive sessions with auditors. Special committees, especially those charged with internal investigations, are moving very quickly when troubling matters surface. No longer are independent directors satisfied with the assurances of management that everything is in order, or worse, sweeping corporate problems under the rug.

The Act also has increased shareholder activism. In general, while this may be viewed as a good thing, boards need to be careful not to confuse the political and social agendas of shareholder initiatives with their obligation to meet the goals of the majority of shareholders and to adhere to best practices.

**Impact on Global Markets**

I would like to particularly note the impact of the Sarbanes-Oxley Act on the global financial markets. When first enacted into law, this legislation was met with some trepidation by foreign issuers. In speaking with foreign diplomats and issuers, I was impressed with their positive reaction to the responses of our regulators in this area. The SEC in particular worked quickly and effectively to harmonize the effect of compliance with the special concerns of foreign issuers.

Also, I had the opportunity last March to help organize a symposium related to this topic in Italy at the American University of Rome. The participants included high-level securities regulators and issuers from several foreign countries. The consensus of the participants was that to America's credit, when faced with the severity of a crisis such as the corporate scandals of 2002, we are quick to react and remedy the situation. The swiftness, both in prosecution and in legislation, reassured the global markets that America was serious about protecting the interests of all investors.

It also is interesting to note that issuers who sought to bypass their Sarbanes-Oxley responsibilities by listing on foreign exchanges have not been able to find much relief. For example, regulatory requirements for listing companies on the Exchange in London also have been intensified.

**Long-Term Effects**

Returning for a moment to the costs of compliance, I would offer one more comment. I view the costs of implementing compliance systems as similar to that of installing fire protection systems in buildings. While it may be cheaper to build an office building without sprinklers, in the long run the increased cost of insurance would likely outweigh the initial savings. More to the point, if a fire starts to smolder, it either can be quickly extinguished with little loss when the alarm is tripped (if the building has an effective fire protection system) or ignite into a raging inferno that consumes the entire edifice. The corporate entity is no different – early detection and action is obviously preferred to the risk of a catastrophic loss.

I have noticed an increased interest is developing programs to educate officers and directors. Professional firms and academic institutions have already designed and offered support to corporate directors and executives in these areas.

**Conclusion**

Mr. Chairman and distinguished members of the Committee, thank you again for the opportunity to testify today on the impact of this important piece of legislation. Much of the commentary after the passage of the Act called it the most sweeping securities reform since the passage of the Exchange Act some 70 years ago. I believe that is true. No law can completely prevent scandals

such as the collapse of Enron, WorldCom and Global Crossing. In the end, you can't legislate personal character and morality. But I strongly believe that the Sarbanes-Oxley Act has reduced the risk of such scandals. Like many corporate officers, directors and professionals, I may not agree with or like every aspect of this legislation, but if it continues to have the desired effect – the ongoing restoration of public confidence in the capital markets – then the Sarbanes-Oxley Act has indeed met its objectives.

I welcome your questions.

For release on delivery
10:00 a.m. EDT
July 22, 2004

# STATEMENT

# OF

# THE HONORABLE RODERICK M. HILLS

# BEFORE THE

# COMMITTEE ON FINANCIAL SERVICES

# UNITED STATES

# HOUSE OF REPRESENTATIVES

Partner, Hills & Stern, LLP
and
Chairman, Hills Program on Governance,
Center for Strategic International Studies

**Washington, D.C.**
**July 22, 2004**

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# *SARBANES-OXLEY*
## *Did we need it?*
## *Does it work?*
## *Does it cost too much?*

With the Enron scandals fading a bit from memory it is not surprising that a chorus of complaints about the Sarbanes-Oxley legislation has formed. Critics have pointed out that the stock market went up following disclosure of most of the scandals but went down after the passage of the Act. A fact they say demonstrates that the public kept its faith in our markets. There was, they say, no public demand for the legislation.

A point, often stressed, is that we have about 10,000 publicly traded companies in the United States. A dozen or so corporate scandals, they say, is no justification for saddling thousands of honorably run companies with the burdens of this legislation.

Another point made quite often is that the obligations put on board members, in general, and on audit committee chairs, in particular, are so great that no one of sound mind will take such assignments. It has been alleged, for example, that a director that might wish to purchase personal insurance, to protect from being sued for conduct as a director, would pay more for the insurance than the income he or she would receive as a director.

Section 404 of Sarbanes-Oxley is the object of the most complaints. Companies have stated that the costs of 404 can be in the tens of millions of dollars; that as much as 25% of their profits will be consumed by the tasks imposed by the section.

From these arguments it is surmised that companies contemplating a public offering will stay private and that some now public will choose to "go private" to avoid the cost and "hassle" of Sarbanes-Oxley. There is some evidence to support this view.

Another, more subtle but perhaps more significant objection to the Act, is that Regulation G adopted by the SEC restricts the ability of companies to use non-GAAP measures of financial performance. It is argued by Peter Wallison of the American Enterprise Institute that the regulation will limit the willingness of companies to develop new, and very much needed, measures of performance.

Mr. Wallison also argues that the emphasis placed by the Act and the New York Stock Exchange on the role of independent directors could cause them to interfere with matters that should be left to management and cause management to be unduly risk adverse.

And there is yet one more complaint. Many companies say that their relationship with their external auditor has become difficult. Auditors fearful of giving advice seem to act more like regulators than as business advisors.

I will attempt a response to each of these concerns as I deal with the three questions that frame my presentation. First:

***Was It Needed?***

Critics of Sarbanes-Oxley say no because "the public had not lost confidence in the system". That really is not the issue. The question to be asked is

***"What Went Wrong and Does it Need Fixing?"***

A simple explanation of what went wrong is that a system of corporate governance crafted by the SEC in the 1970's ran out of gas.

Back then the Commission discovered that hundreds of U.S. companies had created "off the books (secret) bank accounts" from which corporate officers dispensed funds without any oversight. A great many of those funds were used to make questionable payments (bribes) to foreign officials.

It became clear then that our system was broken. There would be little left of securities regulation if books and records could not be trusted. To remedy the situation the Commission took three steps in 1976:

1. It mandated that corporations construct internal controls;

2. It caused the auditing profession to adopt much tougher standards requiring auditors to be certain that any suspicious item found in an audit be cleared with someone free of the suspicion; and

3. Caused the New York Stock Exchange to require its listed companies to have independent audit committees.

The three steps made a great difference. Auditors were required to be alert for any misuse of funds and were given both the duty and the ability to report such misconduct to an independent audit committee. CEO's found themselves challenged far more often by this new breed of independent directors. Over the next 25 years a lot of accounting scandals were either prevented or disclosed and remedied.

But, as I said, this once new system ran out of gas. Several problems developed:

- First, we have been moving at an ever-quickening pace from the bricks and mortar economy of the past to the knowledge based economy of today. As a result a very large percentage of corporate assets are intangible. Estimates and assumptions are used to establish balance sheet values of such assets rather than historical costs. Even tangible assets are increasingly subject to judgment as companies change strategies with rapidity. As a result managers have acquired wide discretion in constructing their financial statements. A bottom line can vary enormously depending on the estimates and chosen.

- As the establishment of valuations became more complex the Financial Accounting Standards Board ("FASB"), abetted by the accounting profession, responded with more complex standards and even more complex interpretations of those standards. Accountants, leery of being sued, encouraged the trend by seeking the comfort of a new FASB rule or interpretation rather using the judgment needed to reason from existing standards.

- During these years, as accountants became more like rule checkers, the basic audit became treated more and more like a commodity. Few CEO's saw intrinsic value in the audit and competition for the work was increasingly based on price rather than on quality.

- As the rules became more complex and as the auditors retreated into that rule checking role it became all too common to believe that a matter not prohibited was permitted.

- The growing maze of rules became a magnet for the fertile minds of bankers, lawyers and consultants who were paid millions of dollars to create new corporate structures that may have satisfied the letter of our accounting rules but certainly not their spirit.

- For example, the auditor's opinion states that the financial statement of management fairly presents the company's financial position in accordance with GAAP. The plain meaning of that statement was tortured into meaning only that a financial statement was fair if it was in accordance with GAAP.

- Audit committees remained passive during this period of change. They saw their job as listening to whatever the auditors and management chose to give them. Auditors rarely explained that management had significant options in constructing their financial statements; that the bottom line could be materially affected if different judgments were made. Audit committees seldom asked if there was a different way to present a statement and hardly ever played a meaningful role in selecting either the audit firm or the engagement partner. They left the fee negotiation to management except on those occasions when they persuaded the auditor to reduce the fee.

- In short, audit committees did not take charge of the audit. As an understandable reaction the auditors came to understand that their fate was in the hands of management. They could not count on the audit committee to protect them were they to openly question the estimates and assumptions made by management.

- And so, some engagement partners yielded and allowed financial statements to be filed that obviously did not fairly present the financial position of their clients.

These problems notwithstanding, I accept that the vast majority of publicly traded U.S. companies are honorably run and that they make a good faith effort to explain their

financial position in a realistic fashion. ***But, a substantial number of companies have used these circumstances to intentionally manipulate their numbers, and an even larger number have, perhaps in good faith, regularly presented a more optimistic financial position than a realistic appraisal would allow simply because the rules allowed them to do so.***

My service on 18 boards of directors over a period of 32 years, during which I have chaired 10 audit committees and had the need to write off more than $5 billion of improper income recorded on the books of 7 different companies long ago convinced me that something was very wrong and very much needed fixing.

That our securities regulatory system needed a serious adjustment should have been apparent to every one whether or not the general investing public had lost faith in the system.

***Will Sarbanes-Oxley Do the Job?***
***Will it Work?***

We need to understand that a large number of companies are having real problems with the Act. Substantial issues need to be resolved. Nonetheless, the Act is responsive to the problem and ***can*** work in a manner that will not, over time, be unduly burdensome.

In one very real sense the Act has rejuvenated the efforts taken by the SEC in the mid-70's:

1. Section 404 is a dramatic, some will say too dramatic, reaffirmation of the SEC's action in requiring internal controls;

2. The Public Company Accounting Oversight Board gives initial control over the creation and enforcement of auditing standards to an organization that has the ability to give real teeth to the SEC's effort to make auditors report misconduct; and

3. The sweeping authority given to audit committees and the significant responsibility placed on audit committees by the Act is the logical extension of the Commission's action that persuaded the NYSE to require independent audit committees.

Before I get to the question of whether the "book is worth the candle" (does it cost too much) I suggest that the Act has already had an enormous and beneficial impact on corporate governance with little or no added expense.

In layman's terms the Act compels the external auditor to explain to the audit committee the alternatives that were available to management in its construction of a financial statement. It compels the audit committee to look at those alternatives and decide

whether, given the alternatives, management has chosen a fair way to present its financial position.

Arthur Andersen's downfall came largely from its work with two clients: Waste Management and Enron. In both cases the auditors knew there was a far preferable way to present the financial statements. It is highly unlikely that the scandals of those two companies would have occurred had Sarbanes-Oxley been in effect, requiring Andersen to explain those alternatives to the respective audit committees.

The other most immediate impact of Sarbanes-Oxley comes from its mandate that audit committees be solely responsible for the hiring and firing of the external auditor. It is no longer acceptable for the audit committee to rubber stamp management choices of the audit firm or the engagement partner. Audit committees by the scores are now asking for resumes from their external auditors and they are doing the initial interviews and making the final hiring decisions. As the trend continues we can foresee the time when there is not the slightest doubt in the minds of the auditors that they are subject only to the authority of the audit committee.

Already Chief Financial Officers find that they are not being invited for an afternoon of golf.

### *Will It Cost Too Much?*

Whether the Act is too expensive is, of course, important, but the issue is not just money. Will Sarbanes-Oxley stop companies from going public? Will companies now public retreat from the market? Will able people refuse to take the chairmanship of audit committees? Will they simply refuse to sit on boards? Will managers, intimidated by independent boards, become risk adverse? Will too aggressive staffs of the SEC and the PCAOB seek unrealistic regulatory goals? Will they, for example, force the accounting profession to maintain the maze of rules that is, to a large extent, a cause of the scandals that the Act is meant to stop?

On the basis of what we know today there is a substantial risk that it will cost some companies more than they can afford.

My overall view, however, is that careful implementation of the Act by resourceful managers and intelligent regulators will make the "book worth the candle".

### *Section 404*

I need not add to the complaints this Committee has received from so many companies about the cost of Section 404. A very large number of companies believe they are wasting a very large amount of money for no good reason. That some small companies are postponing a public offering because of the real or perceived cost of 404 and that

others are contemplating a going private transaction are real problems. If the condition persists our capital markets will surely suffer.

How serious is the problem? Does the Act need amending?

The real danger right now is that many companies will treat 404 as a kind of "compliance tax" a bureaucratic requirement of no practical value. Just as the audit became treated as a commodity by too many companies, 404 can become an expensive appendage for those companies that ignore its positive aspects.

A recent bulletin from Ernst & Young (see Appendix A) noted that there are a number of companies that believe the investments in Rule 404 can produce a measurable return. I serve now as Chairman of the Audit Committee of Chiquita Brands International. Our Chief Executive Officer has just tasked his financial team to do just that. Presently, we see substantial value from the 404 exercise. Whether we will conclude that the entire effort is worthwhile remains to be seen.

In the past week I have spoken to the chief accounting officers of three multibillion corporations who believe that, on balance, Rule 404 compliance is, on balance, worth the effort. Even some of the most severe critics of the Rule concede that it has positive aspects.

The point is that companies can realize substantial value from the 404 effort if they utilize it as a management tool.

It is, however, far too early to conclude that all is fine. Actual implementation may demonstrate that too much is being required. For example, some companies complain that their external auditors are insisting that they do too much additional work before attesting to the work done internally.

The most persistent complaints relate to timing. For many companies the change will be dramatic. Some have been slow to understand the amount that needs to be done, and there are not enough trained accountants to meet the demand. The Big Four are turning away clients.

The problem with smaller companies is particularly severe. Many have meager controls now. It may prove to be impossible for them to comply on the present time schedule.

The SEC will, hopefully, give careful consideration to whether existing timing requirements should be relaxed. This may be an issue for consideration by this Committee.

It may be that some companies will choose to stay private to avoid the 404 requirements. Whether that is a serious problem remains to be seen. Many of them may, after time, see the positive aspects of the Rule

The Ernst & Young bulletin quotes an authoritative source as saying:

> "[S]mall-cap companies are gaining real value from the implementation of Section 404. Many of these companies are putting in place internal controls that should always have been there. Others are finding value in what one member described as 'reducing do-over work and manual routines in the finance function and controller's office'. He added 'They will have made a wise investment'."

It is also quite possible that some of the companies that choose to stay private are not ready to have their stock traded.

### *The Burden on Directors*

It is widely said that Sarbanes-Oxley puts a great a burden on directors and a close to impossible burden on audit committee members; particularly the chairpersons of audit committees. Numerous commentators are advising boards to hire their own lawyers and consultants to assist them in their duties and at least one major company is contemplating the creation of a significant staff to support its board.

The Act certainly spotlights the need for audit committee members to understand their job. And, audit committees that have been meeting for an hour or so on two or three occasions a year surely know now that they must have significant meetings in person at least 4 times a year supplemented by several telephonic meetings.

It is no doubt important for audit committees to have some contact with separate counsel and to seek occasional advice from other consultants. However, the notion that a dramatic increase in the duties of a director has been imposed by the Act and the idea that a separate staff is needed to support the independent directors of boards is baseless.

If audit committees establish firm control over external and internal auditors they will have all the staff they need; they will find their task quite manageable. Firm control means that committees must select their own candidates for these jobs by interviewing multiple candidates. They cannot leave the job to management. They need also to take charge of the audit fee negotiation.

In particular the committees must pay far more attention to the role of internal auditors. If they do not take responsibility for the selection, retention and the compensation of the internal auditor they can hardly complain if the internal auditor is reluctant to criticize management.

Audit committees that assure themselves of the support of external and internal auditors will be alerted to the subtle problems of the audit process. Their job then is to take whatever time is necessary to deal with those problems.

I offer my 32 years of experience with audit committees in support of my firm belief that the Act is not imposing an unreasonable burden on audit committee members or on other board members.

***Interference with Management***

There is, of course, a risk that directors told that they must exercise far more authority over the audit process and in the development of compensation policies will seek to exercise the same kind of authority over the management of the business and cause management to be unduly risk adverse. Peter Wallison of the American Enterprise Institute is wise to express his concern over this issue.

Hopefully this Committee and all those concerned about better corporate governance will repeat his warning. Sensible directors will respond.

***Preservation of Rules Based Accounting Standards***

The Act does not deal directly with the problems associated with our rules based approach to the establishment of accounting standards. Mr. Wallison's other concern is that the SEC and the PCAOB will insist upon strict adherence to existing accounting standards and will be, therefore, preserving the "maze of rules" that contributed to the accounting problems of recent year.

His is a legitimate concern. There is a large and growing body of thought that wants fewer accounting rules and the exercise of far more judgment in the construction of financial statements. I have attached to my testimony a copy of a report issued by a group with broad experience in accounting on the **"Future of the Accounting Profession"** (see Appendix B). The report discusses the issue at length and endorses a theme expressed by the ***Economist*** magazine last year that warns us not to continue to rely:

> "[U]pon the brittle illusion of accounting exactitude
> which tends to collapse in time of economic strain".

I very much hope that this Committee will review the report and agree with the view of the ***Economist.***

# APPENDIX A

## Forward View: In Search of ROI for Section 404

The latest cost estimate[1] of complying with Section 404 is just under $2 million per company, or $4.6 million for companies with over $5 billion of revenue. It is hardly surprising that some boards of directors and their audit committees are considering whether what they had initially perceived as a "compliance tax" might instead be considered an investment-with a measurable return.

These companies believe that their Section 404 work will produce a return. One audit committee chair told us that he has asked all of the companies on whose boards he sits to keep good records on the costs, and to keep track of the sources of value in process reengineering and cost savings. However, he admitted that none of the companies has a precise framework for a return on investment (ROI) analysis.

So, where are the potential benefits likely to emerge? In our recent conversations with audit committee chairs, chief audit executives, and CEOs, we identified the following potential sources of value:

- As we reported in the March 2, 2004, edition of InSights, many CEOs view Section 404 as an "enabling vehicle" for process reengineering and have already tied internal controls work to "broader systemic process reforms" such as Six Sigma programs.
- Some companies have also reported an improvement in risk management. One executive told us that members of the corporation's management team "... claim it was a useful process because it forced them to look at risks."
- Other corporations are using Section 404 to help standardize global business processes. One chief audit executive referenced an investment in software that was not delivering ROI until the implementation of best practice standards identified for Section 404 compliance.

In a recent meeting of the Audit Committee Leadership Network (ACLN), members stated their belief that small-cap companies are gaining real value from the implementation of Section 404. Many of these companies are putting in place internal controls that should always have been there. Others are finding value in what one member described as "reducing do-over work and manual routines in the finance function and controller's office." He added, "They will have made a wise investment."
Some ACLN members felt that larger companies' international subsidiaries will gain similar value. One audit committee chair commented, "The lesson for me is that some subsidiaries were not as well documented as they should have been."
That said, many audit committee chairs with whom we have spoken do not believe there can be any return from what they characterize as a costly, "check the box" compliance activity. One audit committee chair commented that there was simply no point in calculating the ROI on Section 404 "since we have to do it anyway." When asked about the value of Section 404, a chief audit executive for a Fortune 500 company replied, "In the end having the CEO and CFO able to sign the [financial] reports has to be enough."
That also seems to be the view of the regulators. The SEC's own cost/benefit analysis indicates that the ultimate benefit is "improving investor confidence in the reliability of a

company's financial disclosure and system of internal control over financial reporting. These benefits are not readily quantifiable."

Even so, over the next few years many corporations will attempt to quantify their ROI for Section 404, if only to explain to shareholders what returns they might expect for their required ongoing investment.

**Footnote**

[1] A January 2004 Financial Executives International (FEI) survey of 321 companies estimates the compliance costs for Section 404 will consist of 35,000 hours of internal manpower, $1.3 million of external consulting and software, and additional audit fees of $1.5 million for the largest companies in its sample.

*Forward View is written by Tapestry Networks. Ernst & Young works with Tapestry Networks to orchestrate private dialogues, including the Audit Committee Leadership Network (ACLN), and develop practical insights and solutions to help enhance the functioning of financial markets. The ACLN is a group of audit committee chairs from some of America's leading companies.*

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# APPENDIX B

**The American Assembly**
**Columbia University**

**"The Future of the Accounting Profession"**
**American Assembly Report**

**103rd American Assembly**

## FOREWORD

America is many things. At our core we are a commercial society. Our commercial society underwrites our prosperity. It is the basis not just for jobs and for wealth creation unparalleled in history, but more broadly it is a vehicle for consumer choice and upward mobility, the financier of our great cultural and educational institutions, and the basis for the income of a democratic government that has provided the world with its longest-lived constitution and history's most open and free society.

American business is the source of 138 million jobs held by Americans. It is the source of the financial security of the 91 million Americans who are invested in stocks directly or through mutual funds or via employer sponsored retirement plans. It is the tax basis of every city and state as well as the federal government. It backs our currency, which is used to pay for over $1.5 trillion in imports every year, sustaining the global economy. It pays for the world's defense and is the basis for the hard power that our Commander in Chief can unleash in the defense of freedom. It is also the basis of the soft power that America projects worldwide.

The bedrock of our commercial system is reliable accounting. Without high quality accounting standards, the lifeblood of capital cannot be efficiently allocated to its best use in building and sustaining our economy and our way of life. The integrity of capitalism depends on the integrity of our accounting system.

Accounting standards may not grab the general public's attention as readily as nuclear arms control or improving health care delivery systems or reforming Social Security, but it is nonetheless important to the livelihoods of all Americans. It was with this in mind that the 103rd American Assembly was convened to consider the future of the accounting profession. The brainchild of Roderick M. Hills and Russell E. Palmer, this Assembly pulled together the profession's most eminent practitioners and policy makers, to consider the current pathology of the accounting profession and remedies needed to restore its vibrancy.

While The American Assembly takes no position on the recommendations made in this report, it takes pride in having been the enabler of this important project. The Assembly commends the participants for providing substantial food for thought on this timely and vital topic and very much hopes this report will be utilized as an important input into current public deliberations.

Richard W. Fisher
Chair
The American Assembly

**PREFACE**

On November 13, 2003, fifty-seven men and women, including leaders from the worlds of accounting, finance, law, academia, investment banking, journalism, non-governmental organizations, as well as the current and former regulatory officials from The Federal Reserve Board, the Securities and Exchange Commission (SEC), the General Accounting Office (GAO), the Public Company Accounting Oversight Board (PCAOB), The Financial Accounting Standards Board (FASB), and the International Accounting Standards Board (IASB) gathered at the Lansdowne Resort, Leesburg, Virginia, for the 103rd American Assembly entitled "The Future of the Accounting Profession." Over the course of the Assembly, the distinguished professionals considered three broad areas of the accounting profession: its present state, its desired future state, and how it might reach that future state.

This Assembly project was co-directed by Roderick M. Hills, Partner, Hills & Stern, and former Chairman of the SEC, and Russell E. Palmer, CEO, The Palmer Group, former CEO, Touche Ross & Co. Initiated by the co-directors in fall 2000, this project showed an extraordinary prescience of the material events that subsequently unfolded. The project benefited greatly from the advice and active guidance of an eminent steering committee, whose names and affiliations are listed in the appendix of this report.

In preparation for the national meeting, a volume of background material was compiled by the co-directors with assistance from Roman Weil, V. Duane Rath Professor of Accounting, University of Chicago. This material included papers by Mr. Weil and Kathleen Fitzgerald, lecturer at the University of Chicago Law School; George J. Benston, John H. Harland Professor of Finance, Accounting, and Economics at Emory University; an address by Arthur R. Wyatt, Adjunct Professor of Accountancy at the University of Illinois College of Business; and an article from *The Economist* magazine. The participants were also provided with a set of detailed questions to guide their discussions during the Assembly. This critical component was prepared by Katherine Schipper, Board Member, FASB, with assistance from Ralph C. Ferrara, among others.

During the 103rd American Assembly, participants heard two keynote addresses, from William H. Donaldson, Chairman of the SEC, and Professor Weil, which provided background and informed their discussions. Russell Palmer moderated a panel discussion among Shaun F. O'Malley, Chairman Emeritus of PricewaterhouseCoopers, Ray J. Groves, former CEO of Ernst & Young, and James E. Copeland, former CEO of Deloitte & Touche. Paul A. Volcker, Chairman of the International Accounting Standards Committee Foundation, moderated a panel amongst Robert H. Herz, Chair of the FASB; Tom Jones, Vice Chairman of the IASB; Stanley Fischer, Vice Chair, Citigroup; and William McDonough, Chairman and CEO of the PCAOB. On November 15th, the participants reviewed and amended as a group an outline of this report, which contained their findings and recommendations. This report is available on the Accounting project's web page on The American Assembly's web site (www.americanassembly.org) along with reports from The Assembly's other projects. Visitors to the web site can also view some of the background reading distributed to the participants.

The American Assembly gratefully acknowledges the generous support for this national initiative and for the Lansdowne meeting from The Starr Foundation, Roderick and Carla Hills, Russell E. Palmer, The New York Stock Exchange Foundation (NYSE), Charles

Munger, the GE Foundation, the JP Morgan Chase Foundation, Sol Price, and an anonymous donor. Additional funding, received after completion of the report, was provided by Merrill Lynch & Co., Inc., The ChevronTexaco Corporation, Deloitte & Touche LLP, Ernst & Young LLP, PricewaterhouseCoopers LLP, The May Department Stores Company, The Williams Companies, Inc., and Marsh Inc. We owe our special gratitude to the project's co-directors, Roderick Hills and Russell Palmer, for their leadership in every aspect of this project. We also express our appreciation to Katherine Schipper for her contribution during the planning stage of the Assembly. The Assembly is indebted to the discussion leaders and rapporteurs for their fine work in guiding the participants through their discussion sessions: W. Steve Albrecht, James R. Doty, David Haddock, Simon M. Lorne, Katherine Schipper, Jonathan R. Tuttle, and Roman Weil.

The American Assembly takes no position on any subjects presented here for public discussion. In addition, it should be noted that participants took part in this meeting as individuals and spoke for themselves rather than for organizations and institutions with which they are affiliated.

David H. Mortimer
The American Assembly

## DISCLAIMER

At the close of their discussions, the participants in the 103rd American Assembly on "The Future of the Accounting Profession," at The Lansdowne Resort at Leesburg, Virginia, November 11-13, 2003, reviewed an outline of this statement. This report represents general agreement; however, no one was asked to sign it. Furthermore, it should be understood that not everyone agreed with all of it. Several of the participants who presently serve in a regulatory position are listed separately. In view of the fact that some of the issues considered by the Assembly may be presented to them in the future for resolution they have refrained from voting on the report.

## INTRODUCTION

Never, in its lengthy history, has the accounting profession been required to deal with the kinds of challenges that it must confront today. A seemingly unending series of sensational accounting scandals has grabbed newspaper headlines over the last three years, eroding public confidence in the accounting profession and leading to the most sweeping amendments to United States securities law since the Securities Act was passed by Congress in 1934. The Sarbanes-Oxley Act of 2002, as well as the Public Company Accounting Oversight Board (PCAOB) established as a result of the Act, now force the profession – and all of those who rely on its services – to rethink its most fundamental principles and practices.

The members of the Assembly who gathered in November 2003 to discuss these challenges and the changes that must follow included representatives of all those affected by the scandals, including present and former regulators, investment analysts, money managers, investment bankers, chief executive officers of major corporations, scholars and accounting professionals. As a group, we were generally satisfied with the new

regulatory trends and the moves by corporate America toward reforming its own practices. We also feel the accounting industry is moving to improve its own business, after acknowledging that auditors have far too often yielded to management pressure to paint the most favorable picture possible of a corporation's financial health.

But much remains to be done. In an article published last April, *The Economist* described current models of financial reporting as producing little more than a "brittle illusion of accounting exactitude." The reality is that producing and auditing a complete set of financial statements in our increasingly complex global economy is now more of an art than a science, and one that must be, by definition, reliant on judgments that flow from experience and a sophisticated understanding of business and accounting. This, however, goes unrecognized all too often. Rather, investors and others who continue to rely on audited statements to give them a degree of certainty, have been disappointed – and have demanded redress.

The conference attendees believe that too much may be demanded of the auditing process. Auditing financial statements, by definition, requires more judgment and more subjectivity than has been recognized. It is unrealistic to now demand a greater degree of certainty. Rather, we believe we must demand greater use of judgment – particularly the judgment of experienced auditors most likely to detect the early signs of fraud or malfeasance – of the accounting profession in the years to come. Simultaneously, we must revitalize the professionalism of accountants and attract more highly qualified people with diverse skills to the field. We recognize that by making this call for an increased use of judgment, we expose the auditing profession to more litigation. We recommend that the SEC and the newly created PCAOB explore ways in which the profession may be protected from frivolous lawsuits.

However great the risks of this strategy appear, we believe that a failure to move in this direction carries with it still greater hazards. The profession already suffers from a loss of confidence. That has contributed, in turn, to a loss of confidence in the financial integrity of our corporations and put at risk the bedrock of our financial system.

To ensure that auditors are best-positioned to employ their best judgment and to ensure that financial statements abide by the spirit as well as the letter of the law, we believe corporate boards must take steps to guarantee the independence and integrity of the auditing process, both internally and externally, by appointing qualified audit committee members who will take full control of that audit process.

We strongly recommend also, that the industry take a hard look at the way it deals with the recruiting, retaining, and compensation of audit professionals. We believe significant changes are necessary.

**What Went Wrong?**

***As the bubble economy encouraged corporate management to adopt increasingly creative accounting practices to deliver the kind of predictable and robust earnings and revenue growth demanded by investors, governance fell by the wayside. All too often, those whose mandate was to act as a gatekeeper were tempted by misguided compensation policies to forfeit their autonomy and independence.***

The technology stock bubble of the late 1990s – and the puncturing of that bubble in 2000 – coincided with significant failures in corporate governance. Those, in turn, contributed to the accounting scandals and led to the loss of public confidence in the accounting profession. The catalyst for these events was a fierce battle by many managers and directors to meet investors' expectations that the corporations in which they purchased stock would report a steady stream of high and ever-increasing quarterly profits and revenues. In the struggle to deliver what their shareholders clamored for, management and directors, as well as the investment bankers, analysts, and lawyers working alongside them, lost sight of their responsibility to present as full and fair a picture of the company's financial position as possible. As market indexes like the Dow Jones Industrial Average and the Nasdaq Composite index rocketed to one new high after another, all too many independent auditors lost their autonomy and their judgment – and ended by blurring the line between right and wrong. It is true that the capitalist system requires lawyers and other consultants to serve the interests of their corporate clients as advocates. But that role in no way excuses their lapses; these professionals must shoulder their share of the blame for the failures that many have too easily blamed entirely on the auditors.

Accountants who serve as auditors of publicly traded companies have a different responsibility. Far from being advocates, auditors are gatekeepers whose primary allegiance must be to the public. The auditing profession serves as the public protector of the integrity of financial statements, upon which rests public confidence in our financial markets.

Nonetheless, on too many occasions professionals in our largest and most respected accounting firms have yielded to management pressure, permitting management to file incomplete or misleading financial statements. To some extent, we can blame these lapses on the way accounting firms structured compensation policies and other incentives, rewarding those partners who generated the greatest amount of new auditing or consulting assignments rather than those who delivered the best quality audit work.

It is not only the accounting profession that is at fault. Lawyers, investment bankers, among others, must share the blame. And, our regulatory system was ill prepared to detect and correct serious weaknesses that had developed in the audit process. In the eyes of corporate officers and some accounting professionals, the audit began to appear as a commodity with little intrinsic value and accounting firms began competing for audit business based far too much on price. Auditors who came under pressure by corporate management to accept unduly aggressive accounting policies in many cases found audit committees of little help: their primary concern appeared to be reducing the cost of the independent audit rather than increasing its quality. The result: audited

financial statements that hyped revenues, artificially smoothed earnings and increased earnings per share.

Most Assembly participants believe our system has too many rules. To some extent, the existence of these rules can be traced to the fact that the auditing profession has become a favored target of trial lawyers, who have found charging auditors with using faulty judgment can be a surefire way of securing large monetary settlements. Sometimes, the auditors bore little or no responsibility for the problems, but the potential for a 'runaway jury,' grappling with a complex set of facts, to make enormous awards to plaintiffs was too great a risk for the accounting firms to run. Unsurprisingly, accounting firms began turning increasingly to the Financial Accounting Standards Board (FASB) in search of 'bright line' rules that would help them minimize the degree to which they had to rely on their judgment – and make them vulnerable to trial lawyers. Some Assembly participants also believe that FASB and other rule-makers became increasingly prescriptive.

As a result, a maze of increasingly complex and prescriptive rules and interpretations of rules emerged. This trend created among corporate managers, and – most significantly – accountants, a mindset that if a practice is not prohibited, it is in fact permitted. This web of rules also spawned intricate corporate structures, conceived by the innovative minds of lawyers and investment bankers and aimed at satisfying the letter of the rules and regulations but not their spirit.

Every set of audited corporate financial results is accompanied by this traditional phrase:

> "In our opinion the financial statements prepared by management fairly present, in all material respects, the financial position of the company, in accordance with generally accepted accounting principles."

But accountants increasingly have sought to avoid making independent judgments about fairness. Rather than alerting the public to aggressive financial statements by rejecting or qualifying them, independent auditors transformed themselves into rule-checkers. If the rules were satisfied, they concluded, then the statements were fair. This conclusion is ill-founded and improper.

The bubble economy also produced a corporate culture that treated financial reporting as little more than a numbers game. Managers made increasingly aggressive assumptions and estimates about their business and selected those alternative accounting practices that allowed them to report results that would match the unrealistic analyst expectations those managers had earlier promoted.

During the dynamic market environment of the 1990s, the capital markets rewarded those companies whose financial statements displayed consistent upward momentum in revenue and earnings. Stockholders and investment analysts alike suspended their normal skepticism, accepting as normal the 'fact' that corporations could produce steadily increasing earnings quarter after quarter, despite obvious changes in the economic backdrop.

Throughout the bubble, far too many auditors remained silent as changes occurred in the accounting profession's culture and in the process of financial reporting—changes that they should have protested and resisted in their role as gatekeepers.

**Regulation and Oversight in Flux**

***There must be a widespread recognition that the concept of exactitude and precision in an audit is, as The Economist described it, little more than a "brittle illusion." While participants welcomed most of the new regulatory initiatives, the most important change must be one of attitude: a recognition that audits are not and cannot be as precise as investors have believed and would like them to be.***

Much of the blame for the current problems confronting the auditing profession can be placed on the shoulders of the "brittle illusion of accounting exactitude" so aptly described by *The Economist.* Too many members of the investing public believe financial statements can portray – with precision – the assets, liabilities and financial performance of an issuer. Moreover, too many are confident that a properly-performed audit can determine, with a high degree of accuracy, whether or not management has accurately portrayed a company's finances.

In its April 2003 article, *The Economist* observed that this "brittle illusion" is most likely to collapse during periods of "economic strain." Indeed, the bursting of the technology bubble contributed, directly or indirectly, to the revelations of corporate malfeasance by Enron, WorldCom, and others. Company after company discovered accounting errors, forcing them to restate financial statements. The SEC continues to bring enforcement actions against a myriad of those companies, their managers and directors – and their auditors. Amidst calls for decisive action, Congress enacted the Sarbanes-Oxley Act which created the PCAOB.

Unsurprisingly, regulation and oversight of the accounting profession is in a state of flux. Corporate managers and directors have spent the last eighteen months trying to understand and comply with Sarbanes-Oxley. That legislation requires the SEC to introduce more rules to address specific problems disclosed or perceived in the worst of these financial collapses. That work has begun, but while many of these rules were finalized during the six months that preceded the convening of the Assembly, a large proportion of those have not yet become effective and the SEC continues to work on finalizing others. Similarly, the PCAOB is beginning to fulfill the role spelled out for it by the Sarbanes-Oxley Act.

Discussing the recent reforms undertaken as a result of the Sarbanes-Oxley Act, we generally concluded these initiatives were positive. Similarly, the Assembly participants believe the PCAOB has the potential to become an effective regulator of the accounting firms that audit public companies.

Still, one big hurdle remains. Much of the discussion surrounding accounting standards is circumscribed by the apparent dichotomy that exists between the system supported by the International Accounting Standards Board, or IASB – a system generally characterized as "principles based" – and that of the United States, which is perceived to be "rules based." We reject what seems to many of us to be an artificial,

linguistic division. In practice, we believe that principles must accompany rules, and vice versa.

Another challenge is the fact that different bodies-- the PCAOB, the General Accounting Office (GAO), the IASB, the American Institute of Certified Public Accountants (AICPA), the SEC—all set standards or otherwise affect industry standards. It is, however, encouraging to note that the FASB and IASB are making progress toward harmonizing, or at least coordinating, their standards.

**The Value of the Audit**

***It is hard to conceive of a system of corporate governance and financial reporting that does not involve an audit of a company's financial statements by an independent auditor from the private sector, Assembly participants agreed. But the public and corporate audit committees may be demanding a level of certainty and precision of those audits that is unrealistic, while auditors' best professional judgment must play a greater role in those audits.***

A well-performed audit by a diligent auditor remains the best way to identify – subject to the limitations we note below – that the financial statements prepared by management do represent – as fairly and fully as possible – the financial condition and performance of the company in question. Those well-performed audits will continue to play a valuable role in governance and in financial reporting.

Despite the audit's inherent value, there are serious limitations in the manner in which they are designed and performed. Financial statements, simply because of the way they are presented to the user, appear to claim a degree of exactitude that is, in fact, unrealistic. As a result, a large part of the investing public believes these reports – when properly audited – are precise and accurate. In fact, they are the result of a long series of judgments by managers, accountants and auditors. Nearly every number on a balance sheet or income statement requires an initial judgment or estimate by management, followed by a review of that judgment by an auditor. In the bricks-and-mortar economy of the past, those judgments may have been simpler to reach and more precise. Today's knowledge-based economy is more complex, with a larger proportion of corporate assets being intangible and corporate management being far more imaginative when it comes time to ascribe a value to those assets. Despite the creation of rules aimed at bringing precision to the auditing process, that exactitude remains both elusive and illusory.

The truth of the matter is unpalatable to some, but unavoidable: no matter how carefully financial statements may be prepared and no matter how competent the auditors, neither the financial statistics nor the underlying transactions that create those figures are as 'hard and fast' as the public has presumed them to be.

Many of our recent accounting scandals can be traced to auditors' failure to resist management pressure to accept misleading financial statements. Others, however, appear to have been the result of fraud and collusion. While auditing depends on verifying data by checking it with a number of independent sources, it is possible for company personnel bent on deceit (and sometimes with the assistance of individuals outside the

company) to defeat the auditing function. Not even the best of audits and the most honorable of auditors will be able to protect investors from such conduct in all cases.

The barrage of corporate scandals and the passage of the Sarbanes-Oxley Act have highlighted the importance of a well-conducted audit and caused more audit committees to increase their oversight of the audit process. But participants voiced concern that audit committees may be asking the audit process to accomplish goals for which it was not designed. They believe auditors cannot reasonably be required to provide a certainty into the quality of the financial reporting prepared by management, into management's ability to run the business of the issuer, and into the issuer's business model. We believe that the public must, in some way, understand this crucial point.

## Structural Challenges Facing the Accounting Profession

***To remain a profession, auditors need to address issues ranging from the potential problems or conflicts created by the consolidation of their industry to the need to restore their credibility to attract the 'best and the brightest' of college graduates.***

Assembly participants agreed that professionalism within the accounting industry has declined and that many auditors both feel and exhibit less pride in their work. With so many different agencies setting the rules and standards by which auditors must abide, the public accounting profession risks becoming a quasi-arm of government agencies if it does not act quickly and decisively to reclaim and reassert its professional status.

In some respects, the nature and structure of the industry today is more likely to hamper than help in that process. Specifically, we noted the geographic dispersion of the Big Four's accountants, the many different cultures in which they practice, and the many legal systems to which they are subject. All of these factors make it extremely difficult to maintain uniform audit and performance standards. Participants also voiced concern about the characteristic organizational structure of a Big Four firm, an amalgam of partnerships with separate legal identities operating under the same brand name. While it may be unrealistic to demand that each such confederation of partners become a single partnership, we believe each firm can do far more to raise standards and levels of expertise at each of these related partnerships globally.

In order for the profession to thrive, participants agreed it would need to attract the 'best and the brightest' university and college graduates, while simultaneously voicing concerns about its ability to do so. In years past, significant numbers of graduates of the most respected business schools opted to join the accounting profession. Today, few are following in their footsteps, opting for alternative career paths. To some extent, the profession's lack of appeal can be traced to the fear of being held liable – even, perhaps, facing unlimited financial liability – for an audit failure found in the work of partners with whom the newly-minted accountant is barely acquainted and has never worked. Moreover, the recent crop of scandals has tarnished the profession's reputation, making it less attractive to top candidates.

For the profession to regain its luster, more experience and expertise must be devoted to the 'field work' of an audit. For example, the process of ascribing a value to exotic assets and comprehending how unique derivative securities and hedging strategies

are used are beyond the skills of even some of the most sophisticated and experienced certified public accountants (CPAs), much less the recently graduated auditors most often dispatched to the field. Participants noted that the auditors in the field are in the best position to see the red flags of fraud and other problems but too often they are the least trained to recognize those flags. The fact that experienced auditors who could recognize warning signals are too seldom on the spot is a sign that auditing firms may not be deploying their resources as effectively as they might.

A number of participants also believe that the complete separation of the consulting arms from the accounting function of some Big Four accounting firms has created too restrictive an environment. Accounting firms must be able to hire and retain a significant number of professionals whose primary disciplines are not accounting, but whose areas of expertise may be invaluable in the audit process. Young professionals who contemplate joining large accounting firms may be deterred by the prospect of being pigeon-holed in the accounting profession at the outset of their careers, giving them less opportunity for further professional development in other businesses or particular skills that may prove beneficial to their core accounting practices.

Few question that, in some cases, auditors allowed themselves to be swayed from their responsibilities by the size of the consulting fees being offered by corporations. However, the notion that auditors must shun all consulting assignments in order to avoid conflicts of interest is far too drastic a remedy.

## SETTING ACHIEVABLE GOALS

***The debate over rules-based and principles-based accounting is based on the false premise that the two systems are mutually exclusive. We believe that they are tied together inextricably.***

A current debate about the future of accounting swirls around the issue of whether or not the profession should replace the rules-based system exemplified by Generally Accepted Accounting Principles (GAAP) with the so-called principles-based system favored by IASB. We believe this debate has been neither productive nor illuminating. The principles-based systems adopted internationally are far from devoid of rules, while U.S. GAAP has numerous guiding principles.

The either/or debate over principles and rules-based accounting is, we believe, simply a proxy for a more important and more subtle issue: to what degree do we expect the preparers and auditors of financial statements to exercise judgments? With the question posed in this way, participants agreed they favored accounting standards that contained fewer rules and permit more judgment than the standards that currently govern the accounting profession in the United States.

**What Should Financial Reporting Look Like in the Future?**

***The balance sheet of the future will be a more flexible instrument, able to adapt to a wide variety of industries and circumstances. It will include a variety of non-financial information, and should encompass a wider array of numbers so that users recognize when management and auditors are making judgments on transactions and asset valuations that are not, and cannot be, 'hard and fast.'***

It is clear that any future financial reporting system must shatter the "illusion of exactitude" if it is to successfully address the flaws of the current approach. Given that financial reporting necessarily entails reaching estimates and making judgments, it seems apparent that permitting companies and their accountants to value assets using a variety of methods and to present those financial results with varying degrees of certainty would permit many of those judgments and estimates to appear in the financial statements themselves rather than being banished to the footnotes. That would be a significant step forward toward the goal of reducing the misleading degree of certainty that is implied in today's financial reporting system.

We envision the balance sheet of the future containing line items similar or identical to those used today by companies and within specific industries, including comparisons to prior years. But this new balance sheet would permit the display of different kinds of numbers – either in a range, or presented as alternatives. This approach could be used to portray cash transactions for which audit assurance is highest, the historical cost allocations of prior cash transactions, market values from actual arms'-length transactions, where available, or other market pricing mechanisms, as well as estimated fair values when no reliable market pricing mechanism exists. The result of such a change in approach, we believe, would be to offer investors a broader array of information.

Still, we recognize that financial reports prepared in such a fashion would ***appear*** to be considerably more volatile, complex and subjective than the financial reports we are accustomed to scrutinizing today. Secondly, they would ***appear*** to allow for fewer comparisons, either historically or between companies in the same industry.

We stress the use of the word ***appear*** because it is the ***illusion*** of exactitude that carries with it the false perception that financial reports are relatively stable and easily comparable. Those of us who attended the Assembly believe the current emphasis on reducing volatility, complexity, and subjectivity and on seeking a greater degree of comparability needs tempering. The world, the economy, and the business environment are in a constant state of flux and any financial reporting system that tries to distill all the data contained in increasingly complex financial statements into one verifiable, static number such as GAAP EPS flies in the face of reality. In some cases, trying to do so has been an exercise in futility: to this day, disagreements over the proper way to value options or recognize revenues can become fierce disputes. The users of financial reports have striven, fruitlessly, to reach a single number, per share, that accurately reflects a company's financial health and prospects.

A new and more flexible approach to preparing financial statements, such as that suggested at the Assembly, would allow corporations and their auditors to fairly present this inherent uncertainty. In cases where an item has a relevant historical cost (such as depreciable fixed assets), or where the item has a real market value (such as securities for

which there is a trading market capable of absorbing a position of the size held) it is reasonably straight forward. But for those line items for which historical cost is irrelevant, and for which no ready market exists, there needs to be a different notation. The premise is simple: give preparers and auditors of financial statements the freedom and flexibility they need to inform the users of those balance sheets and income statements when the information contained in them is, by definition, uncertain.

Including additional non-financial performance metrics to financial reports could help future users compare companies within a specific industry. Of course, that non-financial information will tend to differ from one industry to the next: Hotel chains may flag their occupancy rates, useful for understanding the financial health of that business but irrelevant information for most other businesses. While Assembly participants do *not* believe that non-financial metrics should be a required part of future financial statements, we do urge management to adopt such indicators of value that can help give users of those financial statements greater insight into the company's past performance and future prospects.

This desire for greater insight into the information upon which management is relying in shaping its future plans was a recurring theme of this Assembly. Much of the discussion of GAAP accounting surrounded the issue of what GAAP accounting did not say about a business. This lack explains the conviction of many participants that these non-financial indicators need to be developed in order for analysts and investors to better understand a company's business model and gauge the effectiveness of its management. Such an initiative would give users a clearer sense of a company's future prospects, while today's financial reports generally provide insight only into its historical performance.

## Improving Auditing and Financial Reporting Standards

***New attestation standards are needed. The current standard is appropriate for some, but not all, transactions. Going forward, auditors should be prepared to offer, and investors to accept, more limited attestations when the facts require them.***

In order for this new kind of financial reporting model to be implemented, a new kind of audit opinion must also exist, one that allows external auditors to adhere to different attestation standards for different parts of the financial statements. The current system, with its single, over-arching attestation, cannot adequately address the discomfort that an auditor would feel – justifiably – if he or she were asked to attest to some of the more subjective terms that the participants propose to include in future financial statements. This recommendation of a new attestation flows logically from our broad argument that the business community, accounting profession and the public at large come to accept that some aspects of financial statements require more judgment than do others.

Ideally, auditors would use the current wording to vouch for the most concrete, non-speculative aspects of future financial statements, such as those items for which historical cost is an adequate accounting metric. For information that is more subject to individual judgments by managers and auditors, those auditors would give a significantly more limited attestation, perhaps nothing more than a procedural attestation. In these instances, the audit function could be structured in such a way as to verify that a company

has reached these judgments with respect to estimated fair value using a clear and seemingly reasonable process. The auditor would not, however, have to attest to the estimate itself. It may be that some of these values are better presented as a range of numbers rather than as a single number. This approach is one auditors currently use to deal with management forecasts.

A variety of other attestation standards may also prove helpful and relevant when it comes to reflecting varying degrees of certainty that are part of the new financial reporting system advocated by Assembly participants. We do not take any position with respect to any specific attestation standard and how such an individual attestation standard might be applied to specific kinds of financial information. Rather, we propose a broad principle: The attestation standard should match the nature of the information to which the auditor is expected to attest. Just as expectations regarding the exactitude of financial statements must change, expectations of what the audit opinion means must change to reflect the varying degrees of attestation that will be appropriate for the new information in financial statements.

A recent report released by the SEC staff, entitled "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" and released in July 2003, is another good starting point for discussion of the merits of both principles and rules within the accounting profession. It contains the interesting suggestion that new standards should be developed with an eye to the objectives being sought. We believe these recommendations, which include the consistent application of these standards and a shift away from bright-line rules permitting technical compliance while violating the spirit of the standard, are a step in the right direction.

**Licensing Issues: More Firms, More Depth**

***The consolidation of the accounting industry has come at a cost for the profession. With fewer alternatives, companies may have few options to their current auditors. This may be a situation that is difficult to correct, but it is one that demands that regulators seek to maintain public confidence in the surviving Big Four accounting firms, and where auditing firms themselves strive to overcome the limitations created by their market dominance.***

In an ideal world, the accounting profession should consist of more international accounting firms than the Big Four of today. To be sure, it is unclear that the number of global players can be increased without reducing the resources and adversely affecting the effectiveness of the existing Big Four. But many domestic corporations do not require the global reach of a Big Four firm. Their needs can be served quite admirably by one of the many other domestic accounting firms.

The Big Four's dominance, however, significantly limits an audit committee's freedom of action when it comes to changing accounting firms and thus to ensuring directors' oversight of the audit process. For example, the Sarbanes-Oxley Act prohibits accounting firms from providing many non-audit services to their audit clients. As a result, multinational companies typically engage two of the Big Four--one to provide audit services and the second for non-audit assignments. That means if directors later

wish to change auditors, it has only two firms available from which it may pick. If one of those audits a direct competitor and the second of those lacks sufficient expertise, management and directors are left with few options, other than taking the drastic step of switching *both* its audit and non-audit engagements – a move which may put the former advisory firm in the uncomfortable position of auditing its own work. Assembly participants found no ready answer to this quandary, despite extensive discussion and a significant degree of concern.

It may be unrealistic to expect a new competitor to vault the high barriers to entry and join the Big Four on the global playing field any time in the near future. For further insight into this subject, we recommend reviewing the GAO study, "Public Accounting Firms – Mandated Study on Consolidation and Competition," prepared pursuant to Section 701 of the Sarbanes-Oxley Act. The consolidation of the accounting firms, followed by the demise of Arthur Andersen, has created a precarious situation. The collapse of another member of the Big Four would exacerbate the problem, creating a serious problem for the accounting profession, the audit function, and the public at large.

We hope the PCAOB will recognize these risks, and the severity of the problem. Assembly participants believe the PCAOB should adopt a supervisory approach to regulation. We define that "supervisory" role as a preventative one, as contrasted with the enforcement role, where regulators arrive on the scene only after malfeasance has been alleged or detected. A supervisory format would permit accounting regulators to operate protected by the same degree of confidentiality that currently governs the proceedings of bank examiners. The greater the publicity surrounding these complex matters, the harder it becomes for members of the accounting and auditing profession to both retain their focus on the tasks at hand and maintain the confidence of their clients and the public. Of course, the SEC with its rule making, administrative proceedings, and speeches also plays a preventative role.

The accounting profession must be able to draw from a large pool of highly trained and talented professionals when it comes to conducting an audit. The flaws of the current system have been thrown into sharp relief by the recent scandals: the separation of the consulting arms of accounting firms has reduced the depth and breadth of expertise within the Big Four. For example, if firms possessed a greater knowledge of forensic auditing, and if they had used it more proficiently, some of the recent scandals may have been averted. We suggest that accounting firms increase their use of forensic auditors on all engagements where they perceive there to be a heightened risk of fraud – and perhaps even on lower-risk clients as well.

Participants also noted that the state-by-state licensing system imposes unnecessary burdens on the accounting profession. We think that the profession could benefit from a coordinated effort to reduce disparities between these systems.

We all seek a profession that will be governed by better-designed and better-protected standards maintained on a global basis by the profession itself, acting through the AICPA and other professional organizations, as well as national and regional firms.

## REACHING OUR GOALS

### Changing the Current Regime

***Regulators and others must address the issue of auditor liability in order for the profession to forge ahead with the recommendations made in this report. One alternative may be for the PCAOB to oversee potentially problematic audits to ensure they are completed to the highest possible standards.***

Most, if not all, of the Assembly participants strongly believe that preparers and auditors of financial statements must rely less on specific rules and more on judgment in the future. The numerous reforms we propose here will, we believe, create a more transparent, open and effective financial reporting system.

But we also believe that to implement these proposals, regulators, legislators and others must recognize and address the fresh risks that will be created by these proposals. Specifically, if auditors are allowed, even required, to use more judgment, to change the format of financial statements and the nature of attestation standards – not to mention making changes in their audit opinions – regulators must bring a greater degree of rationality to the issue of auditor liability.

The development of a complete and cohesive plan to tackle this issue was beyond the scope of the discussions at the Assembly. Certainly, extensive study will be required before such a plan can be designed. We do, however, believe that the system, if it recognizes the inherent uncertainty involved in financial reporting, must, logically, concede that judgments made in good faith should not be treated as infallible. Moreover, it should be recognized that plaintiffs who have placed an unreasonable degree of reliance on auditors' judgments should not be allowed unlimited legal recourse against the auditors of those statements.

Assembly participants offered a number of suggestions that may help in the process of rethinking auditor liability:

- When the PCAOB's inspection and evaluation of auditors finds an auditor has satisfactory quality control, that auditor could be given a measure of protection from civil liability.

- The PCAOB plans to scrutinize audits of companies deemed to have a higher risk profile. When these examinations find the audits satisfactory, the auditors could receive an additional measure of protection.

- The SEC, PCAOB, and FASB can work together to implement, as they see fit, the changes we have proposed in reporting formats and attestation. Such changes should reduce auditor liability, because the nature of the presentation of financial information, and what auditors are required to say about that information, would serve as a warning that the attestations have limitations of which investors and other users must be aware.

- We hope the PCAOB will operate under a supervisory model comparable to that of bank regulators, whose goals include the enhancement of public confidence in the firms that are supervised.

- Ultimately we hope that the SEC, the PCAOB and the FASB will develop specific ways to shield the profession from litigation when that litigation unduly challenges fairly made judgments.

Ultimately, we believe that the PCAOB can supplement, and replace, a significant percentage of SEC enforcement actions against accountants and thereby prevent accounting firms from being tried unnecessarily in the court of public opinion before they have been judged derelict in their responsibilities. The Assembly is encouraged by the work thus far by the PCAOB, and anticipates that, once fully-staffed and operational, it will take an effective, yet cooperative, approach to overseeing accounting firms.

## Adjusting Auditing Practices

***Auditing firms must place the appropriate value on the partners who conduct top-quality audits, not solely on those 'rainmakers' who bring in the most new business. The goal must be to maintain top-notch auditing standards.***

The accounting profession must continue to reject the kind of compensation culture created in part by the bubble economy, a compensation culture that placed undue emphasis on generating new business and cross selling of non-audit services. In its place, the profession must establish a different system of incentives, one that rewards an increase in the quality of the auditing process by, for example, awarding bonuses to those partners who perform top-quality audits. Of course, rewards for generating new business may be a part of this compensation structure, but the focus should be squarely on audit quality.

The exact definition of a top-quality audit must be determined by the PCAOB as part of its overhaul of what constitutes generally accepted auditing standards. We believe that the PCAOB would be an appropriate body to verify the quality of audits, should it choose to undertake such a role. The Assembly participants understand that the PCAOB, in addition to inspecting auditors themselves, might also examine the audit processes used for high-risk clients. The body also might opt to review audits of companies accused of misrepresenting their financial performance or condition in the past, a kind of 'post-mortem' review that could help limit auditor liability if regulators found those audits had been performed diligently and professionally. This kind of second-level inspection will allow the PCAOB to detect any early-warning signals that auditing standards are inadequate and, we believe, will help prevent a recurrence of the kind of systemic breakdown we have witnessed in recent years.

The well-known attestation standard that is a feature of nearly every audited financial report by a corporation will, if the profession sees fit to adopt our recommendations, undergo some alteration. Specifically, we believe that the audit opinion should state (i) that the financial statements present fairly, in all material respects, the financial condition and performance of an issuer, and (ii) that the financial statements were prepared in accordance with GAAP, or if and to the extent that they were not, why not. The form and content of these opinions must reflect the multiple judgments made by management and external auditors and overseen by qualified audit committees. They must also dispel the notion that it is acceptable to use an accounting treatment of a transaction that may be in technical compliance with a GAAP rule but which presents a

clearly misleading result. Naturally, where a strict GAAP presentation is not, in the auditors' opinion, a fair presentation, some thought must be given as to whether and how to implement a fair presentation override.

**Reinvigorating Audit Committees**

***Audit committees must be continually upgraded, so that their members are both qualified and able to challenge management and auditors alike on the reasons behind particular judgments or auditing decisions. Audit committees must reassert their pre-eminence in the audit process, and ensure that they provide full backing and support to independent external auditors as well as to internal auditors in the event of clashes with management.***

The new listing standards adopted by both the New York Stock Exchange and NASDAQ in response to the Sarbanes-Oxley Act establish exacting standards that audit committees must meet when it comes to both their composition and their activities. A key criterion for audit committee membership is, unsurprisingly, financial literacy. A keynote speaker at the Assembly proposed going beyond that requirement to oblige audit committee members to meet an enhanced financial literacy standard that may more aptly be described as 'accounting literacy'. The speaker went further, suggesting that auditors should study audit committees in action, and advise management and shareholders on the degree of the financial literacy of those committee members.

The PCAOB has proposed a rule requiring auditors to determine whether audit committees meet the standards now established by stock exchanges and by the SEC. We support such a rule, since it is apparent that the lack of a competent and independent audit committee represents a material weakness in a company's internal controls.

While the Assembly as a whole stopped short of recommending specific standards which audit committee members should meet, a number of participants suggested companies and their investors will be best served by audit committees whose members can understand the following:

- The transactions that require management to choose between accounting practices and/or use judgment in making an assumption or an estimate;
- The choices available to management when reporting such transactions;
- The choices made and the reasons for the choices; and
- Whether the choices made present, overall, a fair presentation of the transaction.

Adopting such standards need not be burdensome. Audit committees can charge their auditors with identifying the assumptions, estimates and accounting practices that have been chosen by management. Many participants in the Assembly believe that it is

incumbent on audit committees to engage in meaningful discussions with both management and auditors in order to ensure the financial positions of their companies are presented fairly.

The Sarbanes-Oxley Act sets numerous mandates for audit committees and for corporate governance generally. The Act, however, does not require issuers to switch auditing firms every few years and allows audit committees to exercise discretion in determining what non-audit services a company may decide to engage its auditors to provide – other than prohibited services, of course. We hail these policies for leaving in the hands of audit committees the power to make these decisions, and believe that is where those decisions belong as audit committee members are the best qualified to make them. For instance, if rotation of auditors was made mandatory, much of the authority of audit committees over auditors would be forfeited.

Similarly, we encourage audit committees to exercise their discretion in deciding what non-audit services an external auditor might provide that could be beneficial for their companies. Some have adopted a blanket prohibition on external auditors providing non-audit services, a trend that we regret. Within limits, authorizing auditors to undertake complementary services can be beneficial to a company. However, since auditors cannot audit their own work, audit committees must remain vigilant and devote a greater degree of scrutiny in situations where non-audit services are being provided.

Audit committees must continue to assert their central role in corporate governance. In addition to maintaining a high level of financial and accounting literacy, committee members should invest the time necessary to develop a full understanding of the company's business: accounting knowledge, unless it is accompanied by insight into the corporation and industry, will not suffice. Moreover, audit committee members must develop and display a healthy degree of skepticism to prevent them from being lulled into a sense of false security by compelling presentations made by management or auditors. Audit committees also must strive to protect auditor objectivity. The Sarbanes-Oxley Act requires that audit committees be responsible for retaining the company's external auditor, and stipulates that that auditor must report directly to the audit committee. Indisputably, creating that reporting relationship is a pre-requisite. However, for this relationship to work well, it must be nourished. Audit committee members must seek out their auditors and make clear to them that the committee is the client and its members will support the auditors, even in the case of a conflict between auditors and management.

In short, audit committees must take charge of the audit, control the selection of both the audit firm and the partner engaged to lead it, and make the final decision when it comes time to set the audit fee. Above all else, they must protect the auditor's independence.

The audit committee must also be in charge of the internal audit function. While the chief internal auditor may report for administrative purposes to the CEO or CFO of the company, the audit committee must supervise the decisions to hire, compensate, and retain the personnel engaged in the internal audit function. The committee must be the body responsible for determining bonuses and for protecting their career paths. Internal auditors can undertake their responsibilities effectively within the company only if the audit committee assures them that they need not fear reprisals from those whom they audit.

## Preparing the Next Generation of Professionals

***Accounting firms must seek out job candidates with a strong knowledge of business and finance. We believe that the Big Four accounting firms are ideally positioned to establish the 'gold standard' when it comes to subsequent professional training.***

The accounting profession needs to position itself to compete with others to attract the best and brightest among each fresh crop of college graduates. A student with a strong broad general education that has demonstrated a capacity to excel in a variety of subjects is an ideal candidate. Students do not need to be specialists in accounting in order to enter the profession: accounting courses may be taken later and the CPA test taken after joining an accounting firm. What is important is that new accountants must develop a strong understanding of business, both in theory and practice. Candidates should have a strong grounding in economics, finance, writing, and information technology, all of which will be important to their future work as auditors and accountants. Assembly attendees agreed that the ideal candidate would emerge from college or university with a working knowledge of finance and business and, although auditing skills are best learned on the job, at least one basic auditing course to their credit.

Most of these proposed educational standards are incorporated into the state licensing process for accountants, in some fashion and at some level. Nonetheless, we believe there is a need for a heightened and consistent focus on these skills.

The accounting firms, particularly the Big Four, should take the lead in promulgating a system in which ethics and professionalism are paramount. Just as they encourage their audit clients to abide by the highest standards, accounting firms themselves must maintain an internal culture in which the only acceptable behavior is the most ethical. Accounting firms, therefore, must be prepared to train their personnel, both at the time they are first recruited and periodically thereafter, in the importance of ethical conduct and professionalism.

The Big Four have the opportunity to take the lead in training the accounting profession in a more general sense as well. Given the resources at their disposal, they could become the 'gold standard' when it comes to continuing professional education. We believe that efforts in this direction would be their own reward, leading to a heightened degree of professionalism in the accounting profession and repairing the damage done by the recent scandals.

Finally, it is vital that firms place greater emphasis on developing forensic accounting skills. While most firms have experts dedicated to this function, all auditors need to have basic training in techniques designed to uncover fraudulent financial reporting.

### Development of Directors

***Not every good businessperson makes a good director. We urge that directors be both financially literate enough and knowledgeable enough about the business itself to be able to challenge management when needed.***

We support the current developments in general director training. While a successful background in business prepares a corporate director well in many respects for his or her new role as a board member, in other ways, the skills demanded may be quite different. For instance, even senior executives must function within a corporate hierarchy and may not necessarily be prepared for the task of challenging management or auditors on the financial reporting process or the results of an audit.

As a result, we urge further training of directors to ensure that they bring to the table a complete set of skills. We also propose that companies insist on having qualified directors seated around their boardroom table, ones fully capable of discussing all dimensions of the company's business and financial operations. These steps, we believe, will enhance good governance practices already in place.

## CONCLUSION

The ideas advanced in this report are not revolutionary—they have been put forward by other individuals or promoted in other forums. This report's value lies in the fact that its determinations were reached by more than fifty participants, who were drawn from the top ranks of business, government, academia, the law, and the profession.

Collectively, these individuals have spent tens of thousands of hours studying these issues, and in the years that have elapsed since the accounting scandals first attracted headlines, have intensified their scrutiny. Indeed, this Assembly is the product of more than three years' preparation by its organizers, conceived long before Enron's demise, to address the challenges presented to the accounting profession by the ongoing technology-stock bubble and the evolution of the knowledge-based economy.

In proposing a financial reporting system that demands of external auditors a reliance on their judgment rather than merely on rules and procedures, we recognize that we are requiring a great deal of all members of the current system. Regulators must be prepared to address the consequences of such a shift; companies must be prepared to adhere to the spirit of the law rather than simply its letter, while the investing public must recognize the flaws in the system that spring from an understandable human urge to achieve certainty – or at least the 'brittle illusion' of exactitude – in financial reports.

The final piece of this puzzle is ensuring that independent and financially literate audit committees take the role they should in making the system work. Without them, it will, in practical terms, remain difficult to maintain the independence of auditors from management when the latter chooses to breach the wall that should separate them. The support of audit committees – all too often missing in the past – must be an integral part of any future system.

Most importantly, the accounting profession itself must recognize and expand its role, its responsibility, and its dedication to fulfill its mission to provide accurate and complete information to the investing public.

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Former Deputy Secretary of State, President Clinton

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Former Chairman of the SEC

Ω CO-DIRECTOR
* DISCUSSION LEADER
* * RAPPORTEUR
◊ DELIVERED FORMAL ADDRESS
• PANELIST
♦ OBSERVER

REGULATORS*

◊**William H. Donaldson**
Chairman
Securities and Exchange Commission
Washington, DC

•**Robert H. Herz**
Chairman
Financial Accounting Standards Board
Norwalk, CT

•**Tom Jones**
Vice Chairman
International Accounting Standards Board
London, UK

•**William McDonough**
Chairman & CEO
Public Company Accounting Oversight Board
Washington, DC

**Charles D. Niemeier**
Board Member
Public Company Acounting Oversight Board
Washington, DC

***Katherine Schipper**
Board Member
Financial Accounting Standards Board
Norwalk, CT

*Regulators participated at The Assembly but did not vote on the report.

## AMERICAN ASSEMBLY STEERING COMMITTEE

The Future of the Accounting Profession

- Derek Bok, 300th Anniversary University Professor and President Emeritus, Harvard University
- Robert E. Denham, Partner, Munger, Tolles & Olson; Former Chairman & CEO, Salomon, Inc.; public member of the Professional Ethics Executive Committee of the American Institute of Certified Public Accountants
- James R. Doty, Managing Partner, Baker Botts, LLP; Former General Counsel, Securities Exchange Commission
- Gary P. Fayard, CFO and Executive Vice President, The Coca-Cola Company
- Ralph C. Ferrara, Managing Partner, Debevoise & Plimpton; Former General Counsel, Securities Exchange Commission
- Roderick M. Hills, Hills Enterprises; Former Chairman, Securities Exchange Commission
- Arthur Levitt, Riverstone Holdings; Former Chairman, Securities Exchange Commission; Former Chairman, American Stock Exchange
- Judy C. Lewent, Executive Vice President & CFO, Merck & Co., Inc.
- Simon M. Lorne, Munger, Tolles & Olson; Former General Counsel, Securities Exchange Commission
- David H. Mortimer, Chief Operating Officer, The American Assembly
- Russell E. Palmer, The Palmer Group; Former Dean, Wharton School
- Katherine Schipper, Member Financial Accounting Standards Board; Former L. Palmer Fox Professor of Business Administration, Fuqua School of Business, Duke University
- Washington SyCip, Founder, SGV & Company
- Sir David Tweedie, Chairman, International Accounting Standards Board
- Paul A. Volcker, Trustee, The American Assembly; Former Chairman, Board of Governors, Federal Reserve Board; Former Chairman & CEO, Wolfensohn & Co., Inc.
- Roman L. Weil, Professor of Accounting, Graduate School of Business, University of Chicago
- Clifton R. Wharton, Jr., Trustee, The American Assembly; Former Deputy Secretary of State; Former Chairman & CEO, TIAA-CREF

# APPENDIX C

**RODERICK M. HILLS**

**GOVERNMENT**

Chairman, Securities & Exchange Commission, 1975-77;
Counsel to the President of the United States, 1975;
Law Clerk to Justice Stanley F. Reed, Supreme Court of the United States, 1955-57.

**BOARD OF DIRECTORS (PRESENT & FORMER)**

Beck Industries, Director, 1970.
Republic Corporation, Chairman of Board, Audit Committee Member, 1971-75;
Anheuser-Busch Companies, Inc., Director, Member, Audit Committee, 1977-89;
Santa Fe International, Director, Chairman of Audit Committee, 1977-86;
Federal-Mogul Corporation, Director, Chairman Governance Committee, Chairman of Audit Committee, 1977-2002;
Alexander & Alexander Services, Inc., Director, Chairman of Audit Committee, 1978-87;
Gulf Resource, Inc., Director, Member Audit Committee, 1978-81;
Oak Industries Inc., Director, Vice Chairman of Board, and Chairman of Audit Committee, 1985-2000;
Drexel Burnham Lambert, Inc., Director, Member, Oversight Committee, 1989-90;
Mayflower Group, Inc., Director, Audit Committee Member, 1993-96;
Sunbeam-Oster, Director, Audit Committee Member, 1991-96;
Waste Management, Inc. Director (merged with USA Waste and renamed Waste Management, Inc. in July, 1998), Chairman of Audit Committee, 1997-2000;
Per-Sé Technologies, Director, Chairman of Audit Committee, 1999-2001;
Regional Market Makers, Director, 2000-;
Chiquita Brands International, Inc., Director, Chairman Audit Committee, 2002-;

**CURRENT ACTIVITIES**

Partner, Hills & Stern, Attorneys at Law 1996-;
Chairman, Hills Program on Governance (CSIS) 2003-
Vice-Chairman (former Chairman) US-ASEAN Business Council, 1984-;
Chairman, Hills Enterprises, Ltd. (formerly The Manchester Group, Ltd.), 1984-.

**PREVIOUS PRIVATE EMPLOYMENT**

Partner, Munger, Tolles & Hills, 1962-75;
Chairman, Republic Corporation (NYSE) 1971-75, Chief Executive Officer, 1974-75;
Chairman and Chief Executive Officer, Peabody Coal Company, 1977-78;
Partner, Latham, Watkins & Hills, 1978-82, Of Counsel, 1982-84;
Chairman, Hills Enterprises, Ltd. (formerly The Manchester Group, Ltd.), 1984-.
Chairman, Federal-Mogul Corporation, 1996;
Partner, Hills & Stern, Attorneys at Law 1996-.

**ACADEMIC EXPERIENCE**

Distinguished Faculty Fellow & Lecturer (International Finance), Yale University, School of Organization & Management, 1985-7;
Professor, Harvard University, School of Law & School of Business, 1969-70;
Lecturer in Law (Visiting), Stanford University School of Law, 1960-70.

**EDUCATION**

Stanford University, B.A. 1952, LL.B. 1955; Order of the Coif, Comment Editor, *Stanford Law Review*, 1953-55.

**Deloitte**

# Testimony of James H. Quigley
# Chief Executive Officer
# Deloitte & Touche USA LLP

"Sarbanes-Oxley: Implementation Progress in Restoring Investor Confidence"

House Committee on Financial Services

July 22, 2004

Audit.Tax.Consulting.Corporate Finance.

# Deloitte

## James H. Quigley

### Chief Executive Officer

James H. Quigley was named Chief Executive Officer of Deloitte & Touche USA LLP in June 2003.

Jim was most recently Vice Chairman of the Firm and regional managing partner of our New York practice, with responsibility for service to companies in the metropolitan region of New York, New Jersey, and Connecticut.

With 30 years of experience, Jim has a distinguished track record of service to many of the firm's leading clients in a range of industries including BASF, Huntsman Chemical, International Paper, ITT Industries, Kohlberg Kravis Roberts & Company, Monsanto Company, and Northeast Utilities. Jim was also National Industry Leader for the Firm's Manufacturing Practice.

In addition to his client service responsibilities, Jim is a member of Deloitte's Executive Committee and the Boards of Directors of both Deloitte & Touche and its global parent, Deloitte Touche Tohmatsu. He has been Chairman of the U.S. Firm's partner compensation and benefits committee and its mergers and acquisitions committee.

Since becoming a partner, Jim has held numerous leadership roles in Deloitte's National Office, including assistant to the Chairman, Secretary to the Board of Directors and the Operating Committee, and Chief of Staff in the Office of the Chairman (now the Global Strategic Clients program).

Jim serves on the board of trustees of Central Park Conservancy, The U.S. Chamber of Commerce, NYC2012 Olympic Committee, Lincoln Center Consolidated Corporate Fund, Partnership for New York City, The Forum for Corporate Conscience, and National Advisory Committee - Brigham Young University.

Jim has served on numerous committees of the American Institute of Certified Public Accountants, including the Environmental Issues Task Force, the Committee on Structure and Governance, the Future Issues Committee, and the Strategic Planning Committee.

He has also been a member of the boards of the Business Council of New York State, Professional Housing Resources, the Southwestern Area Commerce and Industry Association of Connecticut, and Junior Achievement of New York City. He has chaired the audit committee and served as treasurer for the National Council for the Better Business Bureau in Washington, D.C. Jim is actively involved with the Boy Scouts of America, and he has been a member of the task force on role and mission for United Way of Tri-State. He is a member of the Economic Club of New York and the Union League Club.

# Deloitte at a Glance

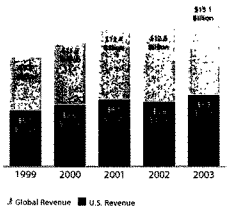
## Our Organization in the United States

- Approximately 30,000 people
- Offices in more than 80 cities
- Fiscal 2003 revenues of U.S. $6.5 billion
- First of the Big Four firms to focus on the career development of women, who now constitute 17 percent of our partners—the highest ratio among the Big Four
- Ten consecutive years on *Working Mother* magazine's list of the 100 best companies for working mothers

## Our Global Organization

- Approximately 120,000 people
- More than 650 offices in nearly 150 countries
- Global revenues of U.S. $15.1 billion in fiscal 2003
- Fastest-growing Big Four firm

**Revenue Statistics: 1999-2003**




## Representative Attest Clients of Our Organization in the United States

*3Com*
*A.G. Edwards*
*Abbott Laboratories*
*Albertsons*
*The Allstate Corporation*
*Baker Hughes*
*Berkshire Hathaway*
*The Boeing Company*
*Cendant*
*The Charles Schwab Corporation*
*City of Chicago*
*Comcast*
*Commonwealth of Massachusetts*
*Computer Sciences Corporation (CSC)*
*Deere & Company*
*Delphi*
*Delta Air Lines*
*Dillard's*
*Dole Food*
*The Dow Chemical Company*
*Duke Energy*
*E*TRADE FINANCIAL*
*Entergy*
*Fidelity Investments*
*Flextronics*
*General Motors*
*The Hartford Financial Services Group*
*The Hearst Corporation*
*Huntsman*
*Hyatt*
*International Paper*
*Kimberly-Clark*
*Kohlberg Kravis Roberts & Co.*
*Lowe's Companies*
*McKesson*
*Merrill Lynch & Co.*
*MetLife*
*Microsoft*
*Monsanto*
*Morgan Stanley*
*The Neiman Marcus Group*
*The New York Times Company*
*NiSource*
*Northrop Grumman*
*Office Depot*
*PETSMART*
*PG&E*
*The PNC Financial Services Group*
*PPG Industries*
*The Procter & Gamble Company*
*Public Service Enterprise Group*
*Rockwell Automation*
*Schering-Plough*
*Sears, Roebuck and Co.*
*Sempra Energy*
*TXU*
*UAL Corporation*
*United Parcel Service*
*UnitedHealth Group*
*Verizon Wireless*
*Vulcan Materials*
*Washington Mutual*

**About Deloitte**

Deloitte, one of the nation's leading professional services firms, provides audit, tax, financial advisory services, and consulting through nearly 30,000 people in more than 80 U.S. cities. Known as an employer of choice for its innovative human resources programs, the firm is dedicated to helping its clients and its people excel. "Deloitte" refers to the associated partnerships of Deloitte & Touche USA LLP (Deloitte & Touche LLP and Deloitte Consulting LLP) and subsidiaries. Deloitte is the U.S. member firm of Deloitte Touche Tohmatsu. For more information, please visit Deloitte's Web site at www.deloitte.com/us.

Deloitte Touche Tohmatsu is an organization of member firms devoted to excellence in providing professional services and advice. We are focused on client service through a global strategy executed locally in nearly 150 countries. With access to the deep intellectual capital of 120,000 people worldwide, our member firms, including their affiliates, deliver services in four professional areas: audit, tax, consulting, and financial advisory. Our member firms serve more than one-half of the world's largest companies, as well as large national enterprises, public institutions, locally important clients, and successful, fast-growing global companies. For regulatory and other reasons, certain member firms do not provide services in all four professional areas.

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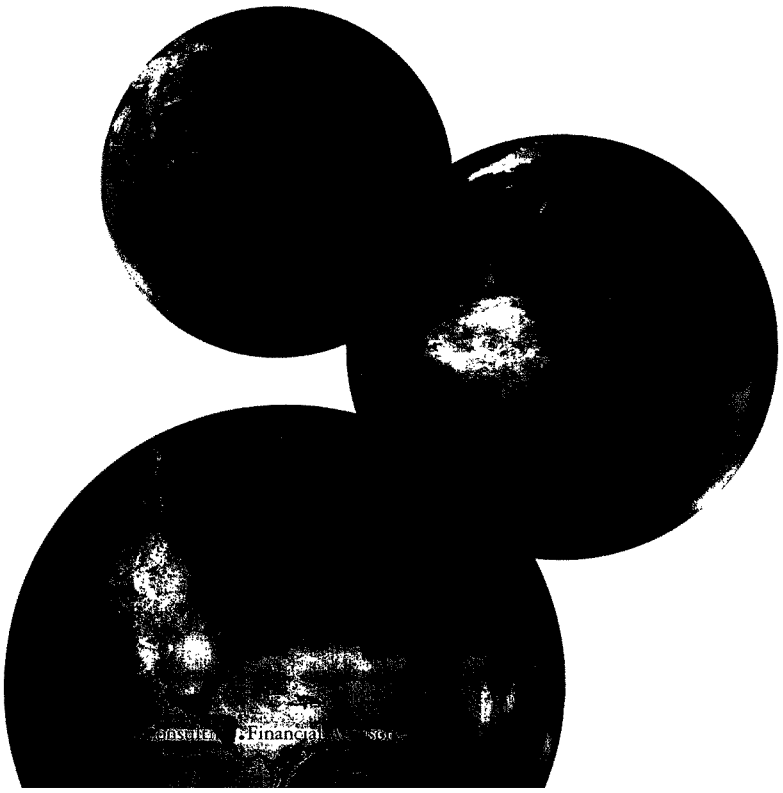
One Very Different Approach.



# Who we are

Deloitte Touche Tohmatsu is an organization of member firms devoted to excellence in providing professional services and advice. We focus on client service through a global strategy executed locally in nearly 150 countries. With access to the deep intellectual capital of 120,000 people worldwide, our member firms, including their affiliates, deliver services in four professional areas: audit, tax, consulting, and financial advisory.

Our member firms serve more than one-half of the world's largest companies, as well as large national enterprises, public institutions, locally important clients, and successful, fast-growing global companies. For regulatory and other reasons, certain member firms do not provide services in all four professional areas.

**Shared Values.**
**Our way of doing business.**
Our Shared Values — *integrity, outstanding value to clients and markets, commitment to each other, and strength from cultural diversity*—inspire Deloitte to foster a collaborative culture that enables the clients and the people of our member firms to excel. Deloitte's member firms have distinguished themselves in more than 20 countries as an *Employer of Choice* or *Best Company to Work For.* We are proud of our recognition and regard it as one of our most important measures of success.

**Ethics. Independence. Trust.**
At Deloitte, our signature qualities of ethical behavior, independence, and trust are fundamental to serving capital markets and managing our business processes so that we can generate stakeholder value. These qualities help Deloitte build public trust, which is the foundation of our approach to client service, corporate social responsibility, and our commitment to serve as a positive influence in our global communities.

To advance the issues of responsible globalization, Deloitte has also engaged in strategic commitments and alliances with organizations such as the United Nations Global Compact, the World Business Council for Sustainable Development, the Global Reporting Initiative, the International Business Leaders Forum, and the World Economic Forum's Global Corporate Citizenship Initiative. Our participation in such arenas provides appropriate avenues through which Deloitte can engage others in significant dialogue. Such proactive engagement is a vital aspect of Deloitte's commitment to corporate social responsibility. By sharing the expertise, time, and talents of our member firms beyond our borders, we can realize Deloitte's full potential—and fulfill our individual and corporate responsibilities as citizens of the world.

**360-degree thinking.**
**The Deloitte Difference.**
Deloitte offers clients a multidimensional approach to addressing their issues. We draw upon a combination of services in accounting, tax, consulting, and financial advisory to understand and evaluate those issues more broadly and more deeply than our competitors. This unique 360-degree perspective is what we call the *Deloitte Difference.* By applying this approach every day, we provide greater value for the clients we serve.

**Working globally. 24/7.**
**Deloitte OnLine™, our e-work-space of secure, private websites, gives clients immediate Internet access to their global engagement team, as well as the team's project status reports and schedules of project-related events, tasks, and milestones. This powerful tool enhances communication and collaboration between our clients and Deloitte—anytime, and anywhere.**

Deloitte's integrated, holistic approach to client service combines expertise and innovative insights from multiple disciplines and industries. Under the leadership of a Lead Client Service Partner (LCSP), our client service teams provide powerful business advice for global organizations operating in multiple geographies. The LCSP provides valuable oversight by assessing client needs globally, and by bringing together appropriate resources to help clients achieve sustained excellence around the world. The result—effective, coordinated service that creates greater value across the enterprise.

**Insight. Experience. Knowledge.**
Deloitte's unique service offerings are delivered through targeted industry programs. Our member firm professionals know the marketplace and are armed with in-depth industry knowledge of specific business sectors and the technologies that drive them. These professionals stay at the forefront of both industry developments and technical practices to provide our clients with advice and solutions of the highest quality and integrity.

The global industries we serve are:

- Aviation & Transport Services
- Consumer Business
- Energy & Resources
- Financial Services
- Life Sciences & Health Care
- Manufacturing
- Public Sector
- Real Estate
- Technology, Media & Telecommunications

**Thought leadership.**
**More than just a phrase.**
Deloitte Research—a think tank of leading economists and researchers—identifies, analyzes, and explains the major issues that drive business dynamics today and will shape the marketplace tomorrow. From provocative points of view about strategy and organizational change to straight talk about economics, regulation, and technology, Deloitte Research delivers innovative, practical insights companies can use to improve their performance and gain a competitive advantage.

For information on how we can provide value to your business, visit us at www.deloitte.com

***The Innovator's Solution—***
***Creating and Sustaining Successful Growth***

**Written by Deloitte Research's Michael E. Raynor and Harvard Business School's Clayton M. Christensen, this book argues that innovation is not as unpredictable as most managers have come to believe, but more importantly, the book identifies the processes that can generate and sustain long-term growth through innovation. Acclaimed by *Forbes*, the *Financial Times*, and *BusinessWeek*, *The Innovator's Solution* has also earned praise from leading corporate innovators such as Nokia and Intel.**

## Well positioned to serve and respond.

**Global Overview** (in billions)

| | 2003 | 2002 |
|---|---|---|
| Revenues | US$ 15.1 | US$ 12.5 |
| People | 120,000 | 98,700 |
| Countries | 148 | 141 |
| Offices | 656 | 686 |

**Regional Overview**

**North America**
36,000 people in 2 countries

**Latin America Caribbean**
12,000 people in 28 countries

**Europe, Middle East, Africa**
51,000 people in 92 countries

**Asia Pacific**
21,000 people in 26 countries

## The clients we serve

Deloitte is proud of the client relationships we have established. Here is a representative list of clients our member firms serve around the world.

Abbey National
Abbott Laboratories
AEP
AES
Aetna Inc.
Agilent
Air France
Alcatel
American Airlines
Anglo American plc
Aventis
Banco Bilbao Vizcaya Argentaria (BBVA)
Banco Nazionale del Lavoro
Bayer Corporation
BCE Inc.
Berkshire Hathaway Inc.
Blackstone Real Estate Partners
Blue Cross Blue Shield of North Carolina
Boeing Corporation
BP
Bridgestone Firestone Group
British Telecommunications plc
Cable & Wireless Plc
Cendant Corporation
Central Japan Railway
ChevronTexaco
Continental Airlines
Delta Air Lines
Deutsche Telekom AG
Dole Corporation Group
Dow Chemical
Duke Energy
Eastman Kodak
Eisai Co. Ltd.
Electricité de France
Endesa
Equity One, Inc.
Exelon
Ferrovie dello Stato
Fidelity
France Telecom
General Electric
General Growth Properties, Inc.
General Motors
Glencore International AG
Harrah's Entertainment, Inc.
HCA Inc.
Hewlett-Packard Co.
International Paper Company
John Deere Limited
Johnson & Johnson
JP Morgan Chase
Kaiser Foundation Health Plan
Kajima International Inc.
Kansai Electric Power
Kao VN
Lafarge
Layne Christensen
Lennar Corporation
Loews Corporation
London Underground
Mandalay Resort Group
Marsh & McLennan
MCI
McKesson
Merrill Lynch & Co., Inc.
MetLife
MGM Mirage
Microsoft Corp.
Mitsubishi Tokyo Financial Group
Morgan Stanley
Norsk Hydro ASA
Nortel Group
Northrop Grumman
PacifiCare Health Systems
Pfizer Inc.
Raytheon
RBC Financial Group
Reliance Industries Ltd.
Repsol YPF S.A.
ResortQuest International
Royal Bank of Scotland Group
Royal Dutch/Shell Group
Saudi Aramco
SBC Communications
Schering-Plough Corp.
Siemens AG
Skandia
Société Générale
Stagecoach Holdings Ltd
STERIS Corporation
Suez
Sun Life Financial
Takeda Chemical Industries, Ltd.
Telefonica
The Hartford Financial Services Group, Inc.
The Related Companies
Time Warner
Tufts Health Plan
United Airlines
UnitedHealth Group
UPS
Verizon Communications
Vietnam Daewoo Motor Co., Ltd
Vodafone Group
Vornado Realty Trust
Warnaco Group
Washington Group International
Weingarten Realty Investors
WellPoint Health Networks, Inc.
WPP Group
Yamaha Motor Europe BV

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06/04

Deloitte
Touche
Tohmatsu

James H. Quigley Testimony
July 22, 2004

Chairman Oxley, Ranking Member Congressman Frank, and members of the House Committee on Financial Services:

It is an honor and a pleasure to appear before you today on behalf of the 30,000 partners and professionals of Deloitte in the United States.

The signing of the Sarbanes-Oxley Act into law represented a landmark event for investors, registrants, and other participants in the capital markets served by the public accounting profession and by our Firm. The results of this legislation are transforming many aspects of corporate governance. With the Act's second anniversary upon us, I believe that it is appropriate to reflect on the impact of Sarbanes-Oxley thus far, its future, and the responsibility that firms like Deloitte & Touche have to support the central purpose of the legislation: restoring investor confidence.

Before proceeding, allow me to tell you a little about Deloitte & Touche and my professional career, to provide some reference for my testimony today. Deloitte is a professional services organization, providing clients with audit, tax, consulting, and financial advisory services with offices in more than 80 U.S. cities. We audit approximately 3,000 U.S. public registrants each year, inclusive of mutual funds, and about 220 of the Fortune 1000.

During my career at Deloitte, I have served in many roles related to our audit practice: as a lead audit partner on some of our largest accounts, as a national office technical consultation practitioner, as an advisory partner, as a regional practice leader, and as a member of our board of directors. In my role as CEO, I continue to have interaction with many of our largest clients, which includes attending approximately forty

audit committee meetings per year. As a result of this direct experience and that of my partners, I can report on the effects of the Act from the front line.

Sarbanes-Oxley grew out of a tumultuous period for investors and our profession. For all of us, the resulting erosion of public trust and confidence in the capital markets and in our profession is one of our time's most significant and troubling legacies.

To state it simply, the Act is working to address these issues. Although implementing something of this scope and scale always involves challenges and costs, the Act is already having a significant impact and it should, over time, help in fulfilling its intended purpose of restoring investor confidence. All stakeholders in the capital markets have an obligation to work constructively to fully implement the Act and to help realize its objectives.

Today, I will address implications arising from Sarbanes-Oxley in the areas of corporate governance, internal control reporting, auditor independence, and financial reporting. I will also discuss the PCAOB's oversight of our profession, how the Act affects Deloitte & Touche, and conclude with some thoughts about the future.

## Corporate Governance

While there are many areas in which Sarbanes-Oxley is addressing and improving corporate governance, I would like to focus specifically on two that I see frequently—the working relationship among the audit committee, management, and auditors; and the improving effectiveness of audit committees.

***Working Relationships***

Audit committees have always been responsible for oversight of the financial reporting process, but the Act has strengthened their authority in many respects. We view the audit committee, financial management (including the internal audit function), and the auditor as three important pillars in the financial reporting process. Each must have a robust and vital relationship with the others to make the process work effectively. Here is a simple example of what the enhanced relationship and more involved role of the audit committee has meant in practice. Prior to the Act's implementation, an audit committee chairperson would rarely telephone the lead audit partner with questions or meet privately to prepare for meetings. In the past two years, however, this has become much more common. As a result, audit committees are better prepared for their oversight role, and their expectations of the lead audit partner are much higher, in terms of supporting and informing the audit committee chair on important details.

The audit committee preapproval provisions of the Act have also had a profound effect on the relationship between the audit committee and the auditor. Audit committees are now required to preapprove all services that the independent auditor provides—a responsibility they take very seriously. They have assumed and continue to assume more control of the auditor relationship and act in the investors' best interest by exercising judgment in the active oversight of the relationship. In making decisions on whether to engage us for services, we have observed that audit committees are not only considering the independence rules, but are also going beyond the letter of the law and considering investor, public, and regulatory perceptions. This is particularly true as it pertains to tax services.

Although Sarbanes-Oxley solidified the direct reporting line between the independent auditor and the audit committee, the importance of our interface with the chief financial officer (CFO) and other financial management has not diminished. The CFO and other financial management remain the principal driver of the financial reporting process as preparers of the financial statements. In fact, the financial reporting process works most effectively when the audit committee, management, and the auditor each have a distinct relationship with the others, that is based on mutual respect and the common objective to serve the long-term best interests of the company's investors.

Chief executive officers (CEO's) are also much more involved in the financial reporting process now. An interesting indication of this was revealed in a recent survey concerning the quarterly earnings process. We asked certain of our audit client service partners if their clients' CEO's participated in the audit committee meetings to review the quarterly financial statements prior to their public release and filing with the SEC. Approximately 80 percent replied that CEO's are participating frequently, with most of those indicating that the CEO's "always" participate. Although we do not have a comparable statistic from two years ago, based on my personal experience, this is a substantial increase from that time period.

***Audit Committee Effectiveness***

A second corporate governance improvement resulting from the Act is that audit committees are increasing their time commitment and overall effectiveness. The changes in audit committee behavior demonstrate that members are becoming more sensitive to their responsibilities to shareholders and to the board. Specifically, we see that audit committees are:

- Devoting more time to their responsibilities, both during meetings and in preparation for them
- Concentrating on the appropriate, critical financial reporting areas and asking more probing questions
- Increasingly engaged in the financial reporting process and the activities of the internal audit function
- Actively seeking and participating in continuing education, often taking advantage of their authority granted by the Act to engage outside advisors
- Increasingly composed of "audit committee financial experts," as that term is defined by the SEC's rules
- Executing self-assessments of their performance more often and in a more rigorous manner
- Consulting proactively on issues of auditor independence.

As evidence of increased time commitment, a January 2004 survey of selected Fortune 1000 Deloitte clients found that the number of audit committee meetings held annually has increased by more than 50 percent since the Act was signed. The results also revealed a similar increase in the average duration of each meeting. These longer and more frequent meetings, plus the increasing depth of the material covered, are demanding more advance preparation by audit committee members.

One consequence of improved advance preparation is better alignment of meeting time allocation with priority issues. Audit committee members are spending more time in the right areas—those that are of high risk and complexity. Another consequence is that they are asking more relevant and insightful questions in these areas, not only to us as

independent auditors, but also to management, thereby facilitating more dialogue on financial reporting issues of significance.

The full audit committee now almost always reviews the 10-Q before it is filed with the SEC. Three or four years ago, it was often just the audit committee chair who did this. In a Deloitte survey conducted in 2002 and updated in 2003, we learned that the full audit committee is increasingly involved in advance review of the company's earnings press releases—up from 52 percent in 2002 to 64 percent in early 2003. More recently, in a May 2004 survey among our major clients, we found that approximately 85 percent of the audit committees surveyed hold pre-issuance meetings to review their press releases, an increasingly positive trend.

Audit committees are becoming more actively involved in the oversight of the internal audit function, a function that is now required by the new NYSE Corporate Governance Listing Standards. In addition to having a better understanding of the scope of its work, audit committees are inquiring whether the function is appropriately staffed and qualified. They are also spending more time with the chief internal auditor and are asking more questions about the function's risk assessment process, results of procedures, and remediation of findings.

In light of the complex technical and regulatory environment, audit committees are engaging in continuing education with greater frequency in order to improve their effectiveness. Many are turning to third parties to gain insights on industry issues and technical accounting "hot topics." To help in this area, Deloitte & Touche provides board education through a Web-based classroom for corporate directors and executives. Furthermore, through Audit Committee Online, we provide a comprehensive, one-stop

resource to help audit committee members stay current on trends in corporate governance.

Lastly, a significant number of "audit committee financial experts" are serving on audit committees, and there is an increased frequency of annual performance reviews. For perspective, in a recent survey of our largest audit clients, the total number of audit committee members who met the SEC's definition of "audit committee financial expert" was 55 percent, with an average of 2.3 audit committee financial experts on each committee covered by the survey. Audit committee roles are increasingly being filled by retired auditors, chief financial officers, and controllers—individuals who can fill these roles with a high level of competence. Audit committee performance self-assessments are often now being conducted not just as a compliance activity, but as a comprehensive process to increase effectiveness.

The bottom line here is that progress is being made—the need for increased financial reporting oversight and enhanced safeguards for investors has been recognized, and companies are responding. We see it in the formation and role of disclosure committees that are scrutinizing company disclosures for clarity and completeness. We see it in the CEO and CFO certification processes, with many CEO's and CFO's requiring multiple levels of financial management to sign representations confirming the accuracy and completeness of their reporting information. Finally, as discussed above, we see it in the increased involvement, focus, and effectiveness of audit committees.

One final thought concerning audit committees: Sarbanes-Oxley empowered audit committees to oversee the auditor relationship on behalf of investors and company stakeholders. It is imperative that regulators support this requirement, by showing

confidence in the competence and judgment of corporate audit committees, affording them the opportunity to fulfill this important oversight duty. Further legislation and regulation could undermine the Act's intentions in this regard. As an example, the PCAOB is currently evaluating possible scope of service restrictions on tax services provided to audit clients by the independent auditor. We strongly believe that certain structured tax strategies that do not have a business purpose, or basis in the tax law, should not be provided by auditors, or any other advisor for that matter. However, we firmly believe that other traditional tax services do not impair auditor independence. We believe that decisions regarding approval or restrictions in this area are best made with full knowledge of the facts and circumstances that exist for specific registrants, and therefore should be overseen by audit committees. The authority of the audit committee to make decisions with respect to tax scope of services should be supported, particularly given the special designation that Congress gave tax services in the Act. We believe that audit committees are in the best position to weigh potential auditor independence issues and the appropriateness of tax services; this oversight function would be lost if such services could only be performed by providers who were not subject to this audit committee preapproval process.

## Internal Control Attestation

### *Section 404 Implementation*

In recent months, the most visible and perhaps controversial component of Sarbanes-Oxley has been the internal control management reporting and auditor

attestation, otherwise known as the requirements of Section 404. In particular, various stakeholders have recently debated the cost/benefit of these provisions, questioning whether and to what degree the cost of compliance has made this a value-added activity on balance, or merely a regulatory burden.

My viewpoint is that, although costly, the internal control management reporting and auditor attestation are valuable, meaningful safeguards that, as businesses and auditors gain experience complying with the requirements, will become more efficient .

Based on our experience with more than 650 engagements to advise companies on their obligations with respect to internal control reporting, many public companies are finding the internal control management reporting and auditor attestation requirements harder to implement than expected. This is due to various factors. For example, many companies started later than they should have. The time lapse between the proposed and final rulemaking, while certainly understandable, contributed to this. Over time, though, public companies have come to understand the new requirements. They are investing in the effort to identify and fix problems, and they are seeking the most effective way to implement the internal control requirements and fulfill the objectives of the Act.

Although many companies may not have initially responded to the requirements of Section 404 as quickly as would have been desirable, many now seem to truly understand the importance of not merely complying, but of maximizing the benefits of implementation. They are devoting the appropriate time and resources to not only get the job done, but also to do it properly; and this is proving to be a lot of hard work.

As companies look forward, many are mindful that Section 404 is not just a one-time event. They realize that the efforts must be sustainable, and that achieving

sustainability requires both an up-front and an ongoing investment. As perspective, a May 2004 survey by the Institute of Internal Auditors revealed that 30 percent of respondents are approaching Sarbanes-Oxley with long-term plans for achieving sustainable compliance that goes beyond the attestation. Further, some 41 percent indicate that they are seeking not only to achieve sustainable compliance, but also to use Sarbanes-Oxley as an opportunity to create value for the company.[1] Companies that take this approach are those likely to benefit the most from Section 404. Such an approach may allow companies to move beyond compliance to enhance business performance through streamlined business processes, elimination of redundant systems, and improved corporate governance. This can lead to increased investor confidence in the financial reporting process, as intended by the Act, as well as to improved return on investment.

At Deloitte, we too are making investments to address these new internal control requirements—many well before the enactment of Sarbanes-Oxley. These include training, technology enhancements, and most importantly, professional resources. Several years ago, we modified our audit approach to increase our focus on systems controls. Recognizing the importance of internal controls and computer system assurance specialists to our audit approach, we adjusted our human resource model to recruit and develop a group of professionals who focus almost exclusively on these competencies. Consequently, upon the enactment of Sarbanes-Oxley, we had a strong foundation of these specialists already in place. Since the Act was signed into law, we have enhanced this portion of our professional capability through additional hiring and we have expanded training for other audit professionals. We are confident that our efforts and

[1] *SOX 404 Tools*, Institute of Internal Auditors, May 2004

investments both before and after the passage of the Act will serve us well in meeting the requirements of Section 404.

***Cost/Benefit Observations***

Without in any way minimizing the overwhelming importance of investor confidence, we must also be sensitive to the costs and effort required to comply with the Act. In terms of cost, a 2004 survey by Financial Executives International of 321 companies found that, for the 20 percent of respondents with more than $5 billion in revenues, the first year compliance costs will average $4.7 million. For all respondents, the average first-year compliance costs were found to be approximately $2 million.[2] These are big numbers, but one must also consider the size and complexity of these companies and the capital that investors have at stake. For example, even if the total average compliance cost for each company in the Standard & Poors 500 was $4.7 million, their collective implementation cost would be approximately $2.4 billion, which is less than three hundredths of one percent of their approximately $10 trillion market capitalization. If one were to include public debt securities, the percentage would be even lower. Given the degree to which investor confidence has been shaken in the past two years and to the extent we can work together to favorably affect financial reporting and consequently investor trust, an additional cost of three hundredths of one percent of capital seems reasonable.

We note that a 2002 study by McKinsey & Co. concluded that investors are willing to pay a premium for improved corporate governance. Specifically, in the United States,

[2] *The Cost of Compliance, An Implementation Survey of Sarbanes-Oxley Section 404*, Financial Executives International, 2004

investors are willing to pay a 14 percent premium.[3] Further, as demonstrated in a study by Governance Metrics International, in a recent three-year period, companies with corporate governance ratings well above-average outperformed (in terms of stock price) those with below-average ratings.[4] This demonstrates that there is a willingness of many investors to incur incremental cost to reduce the possibility of financial fraud and improve corporate governance.

Although we are already making progress in realizing the benefits and rewards of Sarbanes-Oxley, it will take some time before we see the full effects. For this reason, and in order to avoid undue confusion and complexity, I would discourage any further regulation or legislation until the markets experience at least one complete implementation cycle with all of the Sarbanes-Oxley provisions in place, in accordance with SEC and PCAOB rulemaking. After a full cycle of complying with the internal control requirements, which is the final portion of the Act to become effective, we will be in a position to assess whether fine-tuning or additional measures are necessary.

***Accelerated Report Filing Requirements***

However, there is one area in which a small change in the requirements could significantly facilitate implementation. Separate from the Sarbanes-Oxley Act, in 2002, in order to achieve more timely annual financial reporting, the SEC finalized a rule that would shorten the number of days between a company's fiscal year-end and the filing of its report with the SEC—from 90 days to 75 days (which took effect for 2003 annual reporting), and then finally to 60 days (which will take effect for 2004 reporting). For

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[3] *2002 Global Investor Opinion Survey*, McKinsey& Co., 2002
[4] *2003 Global Performance Analysis*, Governance Metrics International, 2003

calendar year-end companies, the rule requires the 2004 annual filing, including the audited financial statements and the internal control report and attestation, to be made within 60 days of the end of the year—a 15 day reduction from last year. This plan for acceleration of the filing requirements was conceived before Section 404 was enacted. Shortening the filing period serves to provide more timely information to investors, but further shortening the deadline *this year* places pressure on public company management, legal counsel, financial reporting staff, and audit committees, in addition to the time constraints placed on the independent auditor.

While public companies and the audit profession are working diligently to effectively comply with all applicable requirements, having to address both of these new and significant requirements in the same year is very challenging. Although it certainly would not be intended, it is possible that the shortened filing time, coupled with the initial internal control requirements, could negatively impact the quality of financial reporting, audit, and internal control assessments and attestations, and may further increase the costs of accomplishing these new requirements. Next week, we will recommend in a letter to the SEC that it delay by one year the acceleration to the 60-day filing requirement, making it applicable for fiscal years ending after December 15, 2005. This would allow companies and auditors an additional two weeks this year to focus on the significant new internal control reporting and attestation requirements of the Act.

***Implications of Internal Control Findings***

As many companies complete their initial internal control assessments and as auditors perform their attestation engagements for the first time, it will be helpful if investors have a basis for understanding these requirements and what the results mean. A

significant minority of public companies could have internal control issues highlighted in their reports, if they are not able to complete documentation or testing, for example, or if they are unable to sufficiently remediate control weaknesses identified in this process in a timely manner. We should make sure that companies provide sufficient background information and context to support the accurate interpretation of these reports, and that all stakeholders refrain from extreme statements regarding the results of these assessments, which could make it difficult for investors to accurately understand their significance for a specific registrant.

## Implications of the Act for Deloitte

Having presented our observations on the effects of the Act on public companies and our clients, I will briefly address the implications of the Act for Deloitte. These include the new oversight structure for our profession, changes in firm policies in response to the Act, and the effects this new environment has had on our people.

***Oversight of the Public Accounting Profession***

Clearly the biggest change for the public accounting profession resulting from the Act has been the new requirements of the PCAOB. From the PCAOB's inception, Deloitte has been committed to working cooperatively and collaboratively with it, recognizing that its independent oversight role was designed by Congress and is valued by the investing public, and that we have a common interest in restoring public trust. After an extensive process, we completed our first registration with the PCAOB in October 2003. Also in that month, the PCAOB concluded its initial inspection of

Deloitte & Touche, as part of its first-year limited reviews. In late June 2004, we were given electronic access to this report and are in the process of formulating our response. Currently, the PCAOB is visiting several of our offices across the country for its 2004 inspections. These inspections are obviously new to the profession and emanate from the powers and responsibilities granted to the PCAOB by Section 104 of the Act. We view the results of these inspections as an opportunity for continuously improving audit quality.

***Ethics and Compliance Program***

Deloitte places the highest value on ethics and ethical conduct—it is embedded in our culture and has always been the way we conduct business. We have recently updated our ethics and compliance policies in light of the Act, added resources to these important activities, and launched a significant, intensive internal communications plan. We have introduced a formal ethics and compliance program as an essential component of the firm's dedication to rebuilding public trust. Last year, we appointed a Chief Ethics and Compliance Officer, whose responsibilities include overseeing a new firm-wide ethics program, carrying out disciplinary matters, and embedding ethics training in all of our continuing education courses. To safeguard objectivity and prevent conflicts of interest, the Chief Ethics and Compliance Officer has direct access to me and to our board of directors.

Our ethics program defines the standards of ethical behavior for all of the people of Deloitte. It offers guidance for appropriate professional conduct on matters with respect to integrity, objectivity, confidentiality, competence, and fair business practices. To promote a broader understanding of the issues surrounding ethics and compliance, we are

launching an aggressive training curriculum. To help our people arrive at answers to difficult ethical questions, we are establishing an "Integrity Helpline," which can be accessed by both telephone and the internet. The objective of our ethics program is to stress the importance of ethical conduct and to provide support within the Firm to help all of our professionals make the right ethical decisions when faced with tough business situations.

***Client Retention and Acceptance Process***

Historically, Deloitte has had a robust process for assessing client acceptance and retention. We have also required special reviews for attest clients we identify as high risk. To enhance our client retention and acceptance process, we instituted a national-level review for attest clients that fit a certain risk profile. Through this process, we review these clients on an ongoing basis to determine if we should continue or terminate our relationship.

Though the general public is often unaware of resignation situations, when circumstances warrant, we have walked away from client relationships—and will continue to do so. The reasons for auditors and clients to sever relationships is typically not clear cut. However, over the past year, we have discontinued serving approximately 700 public and private companies, representing about $40 million in audit revenues last year. In some cases, we simply could not reconcile our perception of the value of the risk premium versus the company's perception. In other words, we did not share the same values for transparent financial reporting. Examples of factors giving rise to this included inappropriate or overly aggressive accounting policies that the client refused to modify; concerns regarding management's commitment to integrity in financial reporting; and

audit committee members lacking the necessary background and experience to perform their roles effectively.

***Human Resources Matters***

Because our most valuable asset is our people, I would be remiss if I did not highlight how Sarbanes-Oxley has affected them. Initially, like many of our clients, our people were somewhat daunted by the magnitude of the Act. However, those feelings have generally been replaced by a focus on accomplishing the new requirements, in particular on the internal control attestation engagements. This change was facilitated, in part, by extensive training and leadership communications about the legislation—especially the internal control attestation and the implications for audit committee relationships. In each of the last two years, our audit professionals have participated in intensive training sessions focused on internal control attestations. We have also continued our practice of providing technical, case-based training to all of our audit partners and managers at the start of each busy season.

We have found that the background, knowledge, and experience of our professionals are highly valued by public companies seeking employees to assist in the effective implementation of Section 404. Our people have been heavily recruited by public companies for this reason. They have also been recruited by the PCAOB as it builds its staff. In addition, our expanded responsibilities translate into increased demands on the already full schedules of our people. Together, these factors have magnified a challenge that our profession constantly faces—retaining our talented resources. We have implemented human resources programs that help counter these

effects and we are continually focused on the challenge of recruiting, rewarding, and retaining the best people.

At the partner level, a particularly notable effect of Sarbanes-Oxley has arisen from the requirements for partner rotation. Because these requirements now apply to more partners and rotations are more frequent, our partners are moving to new assignments more often. These rotations often require relocation, particularly for partners in smaller markets. Our relocation costs for partners in the audit function increased approximately 30 percent between fiscal year 2003 and fiscal year 2004, which ended in May. Relocation can have significant personal and family implications, and we are doing our best to address these issues.

A final human resources aspect of Sarbanes-Oxley that is worthy of note is the increased personal risk that our partners and professionals perceive about our profession, the stress this creates, and its long-term impact on our ability to attract and retain people. While complying with the new requirements is clearly our job and we have extensive experience with implementing changing standards, it is imperative that the regulators and leaders of our profession maintain a mutually respectful relationship. There are very high standards that we clearly must follow, and we recognize our importance to the capital markets. However, maintaining a constructive relationship with the PCAOB, particularly during the inspection processes, will be instrumental to attracting and retaining highly talented people in our profession. It will be important that inspections are fair and balanced, and the results are not politicized. We are confident that our relationship with the PCAOB and its staff will continue to be constructive.

## Conclusion

On the second anniversary of the Act, there is every indication that the legislation is achieving its objectives. We at Deloitte fully embrace the letter and spirit of the law and are committed to working with all concerned parties to restore investor confidence.

Nothing that forces such a dramatic change in corporate accountability can escape intense input or different points of view. Any law that mandates changes in business culture and processes of such magnitude will take some time to accept and implement—after all, the problems being addressed by Sarbanes-Oxley developed over many years.

Restoring investor confidence in the capital markets, corporate leadership, and the public accounting profession will not be easy, immediate, or without cost. However, based on the marketplace observations that I have shared with you today, I believe that we are beginning to realize the objectives of Sarbanes-Oxley. As the markets experience the first full-year cycle of complying with the internal control requirements, we should be cautious as we assess the results. We recommend against further legislation or regulation that would complicate implementation—we should give Sarbanes-Oxley time to work, and to reach its full potential. After a full implementation cycle, we should then be open-minded to evaluate fine-tuning that might be beneficial.

On behalf of the partners of Deloitte, I appreciate being able to share our thoughts about the progress being achieved in response to the Sarbanes-Oxley Act. We look forward to working together in our collective effort to rebuild and sustain confidence in the capital markets and our profession. Thank you.

**STATEMENT FOR THE RECORD OF RICHARD L. TRUMKA**
**SECRETARY-TREASURER**
**AMERICAN FEDERATION OF LABOR AND**
**CONGRESS OF INDUSTRIAL ORGANIZATIONS**
**Before the**
**FINANCIAL SERVICES COMMITTEE**
**UNITED STATES HOUSE OF REPRESENTATIVES**
**JULY 22, 2004**

Good morning, Chairman Oxley and Congressman Frank. My name is Richard Trumka and I am the Secretary-Treasurer of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO). On behalf of the AFL-CIO and our affiliated unions' 13 millions members, I am pleased to have the opportunity to participate in these hearings to mark the second anniversary of the "Public Company Accounting Reform and Investor Protection Act of 2002," better known as the Sarbanes-Oxley Act. This Act is the cornerstone of a dramatic reform effort over the last several years addressing both corporate governance and capital market regulation. That effort is unfinished, and there are those who would undo the good that has been done already. But two years after its enactment, the Sarbanes-Oxley Act remains an outstanding example of government acting in the public interest.

Union members participate in benefit plans with over $5 trillion in assets. Pension plans sponsored by unions affiliated with the AFL-CIO hold almost $400 billion in assets, and union members also participate in the capital markets as individual investors. America's working families' retirement security is, in large part, dependent on the integrity of our capital markets. Consequently, the systemic failures in our corporate governance system led to serious losses for union members' pension funds—we estimate more than $35 billion in losses in Enron and Worldcom alone.

But for those with the bad luck to work directly for companies like Enron and Worldcom, the consequences were far more serious—lost jobs, lost health care, and for many the complete loss of their 401(k) retirement savings, invested at the urging of their employer in what ultimately became worthless company stock.

The AFL-CIO came to the aid of the laid off non-union employees at Worldcom and Enron, helping them to win more than $100 million in severance to which they were entitled. But the labor movement recognized that this victory addressed only a fraction of the harm done, and that systemic corporate governance and capital market reform was necessary to restore confidence in our capital markets and to ensure others did not go through the experience the Enron and Worldcom workers endured.

And so in the wake of Enron and other corporate scandals, the labor movement strongly backed the reform legislation that became the Sarbanes-Oxley Act. We were particularly pleased that the Act addressed many of the systemic issues we urged this Committee and the SEC address in

our December, 2001 testimony on Enron's collapse—issues like auditor and director independence.[1]

I would like to review the key features of the Act that have markedly improved investor protections.

- the Act puts an end to most consulting by public company audit firms;
- the Act created the Public Company Accounting Oversight Board, which after a controversial start has proven to be a strong, yet flexible independent regulator;
- the Act requires independence and expertise on company audit committees, and makes clear the importance of strong and independent boards generally;
- the Act bans loans to insiders at public companies, putting an end to a key executive compensation abuse; and provides for disgorgement of executive stock profits in certain circumstances; and
- in a variety of ways, the Act reinforces the fundamental principle of our securities law—that companies must disclose to investors what a reasonable investor would want to know before making an investment decision, and that the obligation to do so truthfully rests on senior management.

But the success of Sarbanes-Oxley stems not only from the specific provisions of the Act, but also from the tone it set and the message it sent. Since passage of this landmark legislation, these provisions have been impressively augmented by the work of the SEC, the Public Company Accounting Oversight Board the Act created, the regulatory arms of the major exchanges, and the work of state attorneys general, most notably Eliot Spitzer of New York. Equally importantly, the message was heard in corporate boardrooms across the country.

In the two proxy seasons since the Act passed, investors acted themselves to push companies to have really independent boards, to reign in executive pay, and to manage their audit process more effectively. The AFL-CIO is very proud of the role that unions and worker pension funds have played in these efforts by sponsoring 360 such proposals, 48 of which received majority votes at company annual meetings. These proposals led to real changes in executive compensation at companies like General Electric, Coca Cola, Tyco, Hewlett-Packard and Alcoa.

Of course Sarbanes-Oxley has its critics. Many companies seem unhappy with the Act's requirement in Section 404 that companies strengthen their internal controls, together with the PCAOB's regulations addressing this area.[2] Even the new administration at the New York Stock Exchange has spoken out on this subject. These critics say that having outside auditors certify that a public company has adequate internal controls is too expensive.

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[1] Testimony of Richard L. Trumka before the House Financial Services Committee on the Impact on Markets of Enron Bankruptcy, December 11, 2001.
[2] See Judith Burns, "Is Sarbanes-Oxley Working?" *Wall Street Journal,* June 21, 2004.

But I can tell you as the chief financial officer of the AFL-CIO that proper financial controls are critical to the responsible management of any large organization. The events of the last few years have shown the need to strengthen these controls at public companies, and to give company management who are trying to do the right thing some guidance as to what are appropriate safeguards.

Of course there is no question that compliance with Sarbanes-Oxley imposes real costs on American business. But there is ample evidence that incurring these costs is better than the alternative. Last year, internal control problems were reported by outgoing auditors at 58 public companies -- six percent of companies that switched auditors.[3] A recent survey found that after an initial investment of approximately $5 million, large companies expect to spend roughly $1.5 million a year to comply with Section 404.[4] Though $1.5 million may sound like a substantial sum, each of the S&P 500 companies could spend a hundred times that sum and the cost would still be less than the direct shareholder losses associated with Enron or Tyco.[5] A Financial Executives Institute study found that the first-year cost of Section 404 compliance was less than one percent of revenues,[6] and much of this was a one-time investment.

It is often noted that General Electric spent $30 million last year upgrading its internal controls to comply with Section 404. Few, however, mention that General Electric Chief Financial Officer Keith Sherin has said he is pleased with the results: "We have seen the value in the 404 work. It helps build investors' trust and helps give them more confidence," reported Sherin.[7] Likewise, Jeff Henley, Chairman of Oracle, said new internal control drills were worthwhile, despite the cost.[8]

Critics also allege that Sarbanes-Oxley deters companies from going public or from listing on US stock exchanges. New York Stock Exchange Chairman John Thain, for example, has blamed Sarbanes-Oxley and the PCAOB for the fact that fewer foreign companies are choosing to list their shares on the Big Board.[9] However, NASDAQ CEO Robert Greifeld has pointed out that Sarbanes-Oxley has not deterred foreign companies from listing on *his* exchange.[10]

The managers of some small public companies have announced plans to go private, blaming the expense of Sarbanes-Oxley compliance. We do not view this as an unwelcome development, since we believe many of these companies should never have been public in the first place. During the technology boom, many immature and unprofitable companies participated in initial public offerings, and most of these did not fare well when the market collapsed.[11] In any case,

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[3] Adrian Michaels, "Survey Reveals Changing Culture at Big Four Firms," *Financial Times*, February 9, 2004.
[4] Paul Volcker and Arthur Levitt Jr., "In Defense of Sarbanes-Oxley," *Wall Street Journal*, June 14, 2004.
[5] Direct shareholder losses from the Enron and Tyco scandals were each in the $90 billion range, which is more than $150 million multiplied by 500. (Paul Volcker and Arthur Levitt Jr., "In Defense of Sarbanes-Oxley," *Wall Street Journal*, June 14, 2004; Anthony Bianco, William Symonds, and Nanette Byrnes, "The Rise and Fall of Dennis Kozlowski," *Business Week*, December 23, 2002).
[6] Judith Burns, "Is Sarbanes-Oxley Working?" *Wall Street Journal*, June 21, 2004.
[7] "Corporate Regulation Must Be Working -- There's a Backlash," *Wall Street Journal*, June 16, 2004.
[8] Adrian Michaels and Dan Roberts, "Compliance Brings Business Benefits," *Financial Times*, April 23, 2004.
[9] John Thain, "Sarbanes-Oxley: Is the Price Too High?" *Wall Street Journal*, May 27, 2004.
[10] Andrei Postelnicu, "Sarbanes-Oxley Act 'not harming Nasdaq'," *Financial Times*, June 1, 2004.
[11] Stavros Peristiani and Gijoon Hong, "Pre-IPO Financial Performance and Aftermarket Survival," *Federal Reserve Bank of New York Current Issues in Economics and Finance*, February 2004.

the *New York Times* reports that while some companies are going private to avoid the tougher accounting standards required under Sarbanes-Oxley, other private companies are adopting these standards voluntarily.[12]

The attack on Section 404 and its implementing rules is only the latest example of a series of unwarranted criticisms directed against the Act. Before the law was passed, its opponents warned that audit fees would skyrocket, a prediction that has not been borne out. Even including one-time implementation costs, Glass Lewis found that audit fees at large companies rose just 16 percent in 2003.[13]

Similarly, those who opposed the Act's independent director requirement warned the Act would interfere with the functioning of public company boards. Instead, a recent survey of directors by *Corporate Board Member* magazine found that over 70 percent thought Sarbanes-Oxley had had a positive effect on their boards -- and this is the view *inside* boardrooms.[14] And another recent study found (not surprisingly) that the greater the number of independent directors on a board and its key committees, the lower the likelihood of corporate fraud.[15]

Senator Sarbanes recently noted that "the job is not done."[16] One could come to that conclusion simply by looking at the data on issues like financial statement integrity. Last year, for example, a record 206 public companies revised their annual financial statements, according to preliminary figures compiled by the Huron Consulting Group;[17] and PCAOB Chairman William McDonough announced last month that his examiners are still finding significant problems with auditor compliance.

But there is a deeper sense in which corporate reform is an unfinished task. Our corporate governance and capital market system is supposed to result in investors and company management having the information and the incentives to make decisions that create value in the long run for our society in the form of jobs, profits, and economic activity. In recent years, that system failed to function at multiple levels. Sarbanes-Oxley addressed some of the most egregious aspects of that failure—compromised public company audits and weak audit committees, corporate executives who did not take responsibility for their financial statements, and corporate lawyers who looked the other way while their client, the corporation, was harmed. The Act was passed at a time of crisis, when many doubted the reliability of any U.S. company's financial statements, and it was designed to address that crisis.

However, the job begun by Congress in 2002 is not complete, and, as a result, fundamental root causes of the corporate governance crisis remain unaddressed. In the remainder of my testimony, I would like to lay out some key elements of what remains to be done.

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[12] Anne Field, "Some Private Companies Embrace Tougher Rules," *The New York Times*, July 15, 2004.
[13] Gretchen Morgenson, "Counting the Hats on Auditors," *The New York Times*, June 27, 2004.
[14] Paul Volcker and Arthur Levitt Jr., "In Defense of Sarbanes-Oxley," *Wall Street Journal*, June 14, 2004.
[15] Hatice Uzun, Samuel H. Szewczyk, and Raj Varma, "Board Composition and Corporate Fraud," Financial Analysts Journal, May-June 2004, as cited in the Wall Street Journal, "Two New Studies Could Provide Ammo Vs Governance Backlash," June 29, 2004.
[16] Judith Burns, "Is Sarbanes-Oxley Working?" *Wall Street Journal*, June 21, 2004.
[17] Jonathan D. Glater, "Financial Restatements Rose To Record in 2003, Study Says," *The New York Times*, January 13, 2004.

First, our legal system continues to suffer from real deficiencies in the extent to which both individuals and institutions can defraud the investing public and get away with it. In many circumstances lawyers, accountants and investment banks can still aid and abet companies that commit securities fraud and enjoy immunity from investor lawsuits. This is wrong, and really only Congress can fix it.

There are also areas where the Private Securities Litigation Reform Act ("PSLRA") has made it easier to defraud the investing public and get away with it. Sarbanes-Oxley addressed one such area by lengthening the statute of limitations, but there are others such as the PSLRA's repeal of joint and several liability for securities fraud and the blanket immunity it grants for "forward looking statements" that remain. Again, these problems with the PSLRA can only be addressed by Congress.

However, as important as litigation can be to both deterring corporate wrongdoing and dealing with its consequences, it cannot substitute for real working corporate governance and accountability on the part of company management. And as long as CEO's dominate the selection process for company directors, we simply will not see at problem companies the kind of vigorous independent boards that we need and that Sarbanes-Oxley called for.

That's why the labor movement believes the most important effort now underway to address the continuing governance problems at our public companies is the SEC's rulemaking initiative to give long-term investors with a substantial stake in public companies the right to have their board nominees included on management's proxy.

Today, it is practically impossible for even the largest long-term investors -- the TIAA-CREF's and CALPERS -- to nominate and run their own candidates for the boards of public companies. So we have elections in name only. At one company we know of, Lockheed Martin, a former Enron director continues to be nominated by management despite unprecedented shareholder opposition, and the only thing shareholders can do is withhold their vote. They have no alternative candidate for whom to vote.

And of course, CEO's know that investors have limited options. They know they can ignore shareholder votes on runaway executive compensation or company audit policies, and there is little that shareholders can do.

Under the current system, directors essentially pick their successors, though companies are required to go through the motions of having a shareholder vote. All it takes is one vote to be elected to a corporate board, and that vote can be the CEO's.

Investors who want to support dissident candidates must shoulder the cost of soliciting votes by mail, since management can exclude opposition candidates from the proxy ballot. Imagine if the same were true of political elections! This is why we strongly support the SEC's proposal to allow candidates nominated by substantial groups of shareholders to appear on proxy ballots that are mailed to all shareholders.

The Commission's proposed rule is a moderate proposal that gives long-term investors the right to nominate one or two directors, facilitating independent voices but not subsidizing takeovers. The proposed rule includes serious hurdles before this right can be exercised. For example, the SEC would limit who would be allowed to nominate candidates, and under what circumstances. For example, shareholders with a longstanding, significant ownership stake in a company might be allowed to place an opposing candidate on the proxy ballot if more than 35 percent of votes were withheld from the incumbent in the previous election. Such a high "no" vote is a rare occurrence and generally signals a deeply troubled company. Last year, for example, directors at fewer than five percent of large companies received such a vote of no confidence.[18] And, of course, any successful candidate under the rule would have to receive the votes of more shareholders than management's candidate received.

The Commission's proposed rule on proxy access is an example of real bipartisan leadership, and it received more public comment than any other proposal in the Commission's history—over 14,000 comments, the overwhelming majority supporting the Commission's rule.

In recent weeks, the press has reported that there is internal division within the Commission on this rule, perhaps as a result of the extreme pressure being brought to bear by the CEO community and its political allies. In that context we were very pleased to note the recent statements by the Division of Corporation Finance that the Commission remains focused on bringing a final rule to a Commission vote in the near future. At the end of the day there is no way to have corporate boards that are accountable to long term investors if long term investors have no economical way to select board members.

Finally, I would like to note that despite everything that has happened, we still have inadequate disclosure to investors of the facts of executive pay and what financial impact that pay has on the companies that award it.

The most important step in this area is the proposal by the Financial Accounting Standards Board ("FASB") for mandatory stock option expensing. The fact that stock options do not have to be deducted from earnings as a compensation cost has encouraged their overuse for executive compensation and has widened the pay gap between executives and ordinary workers. Stock options create perverse incentives that are not in the best interests of shareholders -- promising all the benefit of share price increases with none of the risk of share price declines. Most importantly, options reward short-term decision-making, and, as Enron demonstrated, create a strong incentive to manipulate company stock prices through creative and even fraudulent accounting.

This is an area where FASB has known the right answer for more than a decade, and yet at every turn has been prevented by political pressure from restoring integrity to our accounting system in the area of executive compensation. This week the House appears bent on once again subverting

[18] "Forty-six Russell 1,000 companies had at least one director who received withhold votes from at least 35 percent of those cast at 2003 meetings." (Richard J. Daly, ADP Investor Communication Services, as cited in "Panelists Discuss Proxy Access, Brokers Votes at ASCS Annual Conference," IRRC *Corporate Governance Highlights*, July 9, 2004.)

the integrity of our financial accounting system by giving runaway CEO pay special legislative protection by passing intellectually dishonest and economically irresponsible legislation.

The battle against option expensing is being waged on behalf of CEOs with option megagrants who, frankly, want to hide the true cost of their compensation from their shareholders. According to SEC filings, the CEOs of the eleven public companies who are members of the International Employee Stock Option Coalition ("IESOC") hold on paper a combined $977 million in unexercised stock options.

These CEOs are going against the express wishes of shareholders. In 2003, a majority of shareholders at 30 companies voted in favor of proposals sponsored by worker funds to require stock option expensing. So far in 2004, shareholders at Hewlett-Packard, Intel, PeopleSoft and Texas Instruments have all voted in favor of expensing options, despite strong opposition from management. Intel, for example, is one of eleven companies belonging to the IESOC, and Intel CEO Craig Barrett and Chairman Andy Grove have led the fight against option expensing.

We have waited long enough to close this accounting loophole. The latest rationale for delay being proposed by irresponsible elements in the business community is that companies are still reeling from the cost of Sarbanes-Oxley. This is frankly ludicrous, since the cost of mandatory option expensing is *nil.* Companies are already obliged to calculate the cost of stock options in a footnote, and the only difference is that all companies would now be required to deduct this cost from earnings.

Clearly, as reform efforts get closer to the heart of what has gone wrong in our corporate governance system, resistance from the CEO community intensifies. However, only by truly creating transparency and accountability in the boardroom can the underlying dynamics that brought us Enron and Worldcom be addressed and the purposes of Sarbanes-Oxley be fulfilled.

Yet even though Sarbanes-Oxley is not a completed effort, we should not fail to recognize its enormous contribution to repairing our system of corporate governance, both through its substance and through the message its enactment sent to CEO's and boards, and to the range of institutions charged with administering our corporate governance system. Both Houses of Congress and both sides of the aisle have reason to be proud of the Sarbanes-Oxley Act.

Let me conclude by expressing my deepest appreciation to the Committee on behalf of the working families of the AFL-CIO for inviting the AFL-CIO to appear today, and our hope that we will continue to be able to work together on these vital issues for all Americans. Thank you.

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AHEAD OF THE TAPE

# Not an Option

By JONATHAN WEIL
Staff Reporter of THE WALL STREET JOURNAL
*July 22, 2004, Page C1*

The post-Enron era could be on the verge of giving way to the Richard Baker era. And that can't be good for investors.

Mr. Baker is the congressman who proposed that only stock options paid to a company's top five executives should count as an expense on the company's income statement. The Louisiana Republican calls this "a common sense compromise." Not that there will be much expense since he also would have companies assume their stock prices never fluctuate. That would render the value of their options at virtually zero.

Never mind that this has no basis in accounting theory. (Imagine stipulating that only a company's five biggest bank accounts should be included in cash, or that Enron's stock never moved.) Members of the House know a lucrative compromise -- Read: humongous Silicon Valley campaign contributions -- when they see it. They passed the bill overwhelmingly.

This from the same House that, in a fit of outrage two years ago, passed Sarbanes- supposedly reinforced the Financial Accounting Standards Board's independence. Rep. Michael Oxley himself voted for Mr. Baker's bill. Meanwhile, FASB is plow with its proposal to count options pay as a real expense, instead of a mere footnote FASB Chairman Bob Herz calls the Baker bill "seriously flawed" and "a dangerou

Conventional wisdom holds that the FASB can survive an overthrow of its rules tl if it ever happens again, the board might as well close shop. Alabama's Richard Sl chairman of the Senate banking committee, and others promise to block the Baker Senate. Still, FASB supporters fear that the tech lobby's water carriers in Congress sneak a rider into some must-have appropriations measure, possibly the Labor De budget bill.

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During 2002's summer of fraud, politicians passed lots of reforms. Now that they t investors have shaken off losses, many politicians are doing what their big tech do instead.

Surely, some investors may wish to relive the pretense that fantasy accounting is tl build wealth. Should Mr. Baker's bill become law, prosecutors understandably ma excitement over accounting-fraud cases. After all, why bother prosecuting illegal a when the legal variety is just as noxious?

Another wink here, another nod there, and soon the book-cookers may figure that they are officially condoned.

• Send comments to Jonathan Weil at jonathan.weil@wsj.com

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# Deloitte

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September 22, 2004

The Honorable Richard Baker
United States House of Representatives
Washington, DC 20515

Dear Representative Baker:

It was an honor and a privilege to testify before the House Committee on Financial Services during the July 22 hearing entitled "Sarbanes-Oxley: Two Years of Investor Recovery." I am writing on behalf of the partners of Deloitte & Touche USA LLP ("Deloitte") in response to your request for our perspective on the provision of tax services to attest clients. Specifically, this letter will:

- Provide context for current issues regarding tax services provided to an audit client by the independent auditor;
- Outline Deloitte's position on this important subject; and
- Discuss the negative implications on audit quality and transparency that would result from restricting a registrant's ability to engage its independent auditor for tax services.

**CURRENT DIALOG AND DELOITTE PERSPECTIVES**

On July 14, 2004, the Public Company Accounting Oversight Board ("PCAOB") hosted a roundtable discussion to review existing tax services provided by auditors to public company audit clients and to discuss the effect that these services may have on auditor independence. Acknowledging that the United States Securities and Exchange Commission ("SEC")—as part of an unprecedented deliberation—considered and ultimately dismissed the possible restriction of tax services when drafting its final auditor independence rules, the PCAOB noted that over the past year there has been considerable attention to tax services, specifically tax shelters.[1]

Deloitte shares the PCAOB's goal of strengthening auditor independence and restoring confidence in our nation's capital markets. However, we believe that substantial new restrictions on the permissibility of tax services provided by the independent auditor would result in reduced audit committee oversight and transparency of corporate tax planning, the imposition of unnecessary costs on registrants, and the need for the auditor to incur additional costs to achieve a comparable level of audit quality. We believe that the underlying core issue regarding tax services is the nature of the service, not who provides it.

[1] Auditor Independence and Tax Services Roundtable Briefing Paper, Public Company Accounting Oversight Board, 2004 TNT 134-36 (July 12, 2004).

Because of the strong linkage between a company's financial accounts and its tax affairs, the provision of tax services to an audit client by the financial statement auditor has been seen as a natural extension of the audit function for many years. Consequently, audit firms and the accounting profession have developed strong capabilities in the provision of tax services.

In developing our tax capabilities, Deloitte recognized the importance of considering the appropriateness of our tax services not only as it relates to independence, but also—for both audit and non-audit clients—to make sure that advice that we give has solid basis in the tax law and that transactions have appropriate business purpose other than the avoidance of tax. When we observed the trends in tax strategies being developed in the mid-1990's, Deloitte implemented a national tax quality control process that has served us well and helped us avoid the excesses that we sometimes saw in the profession.

The provision of tax services to an audit client has not historically been viewed as an "independence" issue by regulators or the public. As the SEC concluded in its rulemaking, the provision of tax services to audit clients, "generally [does] not create the same independence risks as other non-audit services." In part, the SEC's conclusion was based on the detailed guidance provided by and the scrutiny that tax work receives from the tax authorities. Tax returns of issuer audit clients are prepared pursuant to widely published rules; they are also subject to examination by the tax authorities and enforcement mechanisms that are available to the regulators, including suspension of practice for the practitioner, as well as his or her firm, and loss of license or authority to practice.

Furthermore, it is important not to confuse the audit independence implications involved in tax advice with the revenue, fairness, and public policy issues regarding aggressive, abusive tax structures. The issue of such strategies transcends independence concerns, touching upon ethical and legal considerations not unique to the audit arena. Indeed, no advisor, be it a lawyer, accountant, banker, or other promoter, should be permitted to market abusive strategies that have no basis in the tax law or business purpose other than the avoidance of tax. Accordingly, Deloitte believes that the issue at hand would more appropriately be and is being addressed by tax regulation, legislation, and the courts, rather than through independence regulation with a sole focus on auditors.

Finally, we believe the benefits of providing tax services to audit clients—audit committee oversight, increased transparency, and enhanced quality of audits—far outweigh the risks associated with possible conflicts or threats to auditor independence. An analysis of these benefits is set forth below.

**INCREASED TRANSPARENCY**

There is much greater transparency and scrutiny when tax services are provided by the audit firm due to a number of safeguards in place to help investors understand the nature of the relationship between a company and its audit firm and to prevent the audit firm from losing objectivity. These safeguards include audit committee and market oversight.

**a) Audit Committee Oversight**
The Sarbanes-Oxley Act ("the Act") requires the audit committee to pre-approve all services provided by a public company's independent auditor. To inform investors how services are pre-approved, the Act also requires registrants to disclose the audit committee's pre-approval policies and procedures. This pre-approval requirement ensures that the audit committee understands the nature and scope of the tax services that are performed by the audit firm. The board of directors has a duty to ensure the independence of auditors on behalf of the shareholders. The board of directors also has a duty to oversee management. The board of directors, audit committee, or other governance body, should ensure that management has made independent and informed decisions on tax and accounting issues, and can do so through a pre-approval or reporting process.

Audit committee pre-approval of non-audit services, including tax services, is an effective regulator of those services. Furthermore, the pre-approval policies and procedures disclosure allows the investor to understand and assess the audit committee's actions in this area. The experience with pre-approval since it became required on May 6, 2003, indicates that audit committees are giving much greater scrutiny to the nature and amount of non-audit services being provided by the audit firm and are using pre-approval in the following ways:

- *As a means to understand the SEC rules on independence* - audit committees choosing to continue using their auditors for tax services do so after gaining an extensive understanding of the SEC rules and guidance in the area, as well as a thorough understanding of the proposed service;
- *As a process by which audit committees can tailor auditor-provided tax services to comport with their views on auditor independence* - audit committees are instructed to use a prudent man standard in exercising their pre-approval authority; in the exercise of their discretion, the committees often place restrictions on auditor services to ensure they do not approach the boundaries of the SEC rules; and
- *As an opportunity to gain an understanding of the company's tax position in order to exercise oversight* - audit committees are using pre-approval to gain an understanding of the company's tax position and to evaluate that position; the audit committee's involvement in the tax affairs of the company is simply good governance.

This added layer of review and the disclosure transparency only apply when the company's auditor (as contrasted with other outside advisors including law firms and boutique specialty firms) renders the tax services, and are effective preventative controls that help to prevent companies from pursuing abusive tax transactions.

**b) Market Oversight**
The disclosure of fees paid to the auditor in the annual proxy provides public visibility to the nature and amount of tax services provided by the audit firm. This creates market pressure on the issuer to ensure the appropriateness of tax services. The proxy fee disclosure rules require the issuer to disclose the tax fees (and other fees) paid to the audit firm. This disclosure affords investors an added level of transparency and scrutiny. In fact, the market pressure has forced issuers to disclose not only the amount, but also the nature of the tax services provided by the

auditor. Because of this pressure, audit committees and management are more closely examining both the amount and the nature of tax services provided by the auditor.

Moreover, with the creation of the PCAOB, audit is now a regulated activity and auditors are subject to inspection, investigation, and discipline. This oversight provides additional assurance that registered public accounting firms (i.e., audit firms) are fulfilling both the letter and spirit of the Sarbanes-Oxley Act, including the independence requirements and scope of services restrictions. The provision of tax advice is not regulated to the same degree. A firm that provides tax advice to its audit clients is likely to consider the audit and proper financial reporting as a priority, and is likely to ensure that those partners providing the tax services do not give aggressive tax advice that pushes the boundaries of what is acceptable.

Finally, independent oversight of the client's tax position by tax authorities provides an additional safeguard. As noted above, the SEC has identified that the existence of the independent "check" from the tax authorities considerably reduces the possibility of a conflict of interest.

Any action that discourages the provision of tax advice to audit clients by accounting firms would undermine the benefit that comes from audit committee and market oversight, pushing corporate tax advice into an environment with far less scrutiny and transparency.

**ENHANCED QUALITY AUDITS**

The level of audit regulation has increased dramatically since the passage of the Sarbanes-Oxley Act. In the United States and many other countries, audit is a regulated activity and auditors are subject to monitoring, investigation, and discipline. An audit firm that provides tax advice to its audit clients must consider the audit and proper financial reporting as a priority when providing tax services to the audit client. In fact, the partner providing tax services to the audit client has a responsibility to notify the audit partner of anything of which he or she is aware that impacts the financial statements. Non-audit providers of tax services are under no obligation to inform the auditor of such information and have no reason to be knowledgeable of the client's financial statement treatment of the transaction or tax position. For example, outside counsel engaged to provide tax services might be inclined to assert privilege in order not to share such information with the auditor.

Today's audit depends more frequently on specialists, and the tax area is no exception. The ability of the auditor to tap into an extensive pool of tax expertise when necessary is widely acknowledged as critical to a high-quality audit. The auditor must make important judgments concerning a client's tax matters, which, in many cases, are among the most significant expenses in a client's income statement.

Due to the complexity of tax law and financial accounting rules, particularly in relation to international trade, specialist expertise is needed to understand financial accounting standards, on the one hand, and tax law and its related accounting rules, on the other. Tax specialists at audit firms have developed, through working with their audit colleagues, a considerable ability to understand the differences between financial accounting and tax accounting principles and to

determine whether these differences are properly accounted for in the financial statements. In examining the tax accounts of a large multinational organization, the audit team relies heavily on the skills of the tax personnel in countries across the world to gain the necessary audit assurances.

When a non-audit provider of tax services is involved in tax planning and advice, it is incumbent on the auditor and its tax specialists to consider the implications of that advice on the financial statements and challenge the significant tax and business assumptions. This additional layer of review will add further burden to registrants. More importantly, audit quality is improved when there is a sharing of knowledge related to an audit client's tax accounting between the audit firm's tax professionals and the audit professionals. This occurs when the auditor has access to a tax professional who, in formulating his or her tax advice for the client, has acquired a deep understanding of the aspects of the business affecting the client's tax liability. In fact, a recent study found a negative correlation between tax services provided by the independent audit firm and financial restatements, implying net benefits in acquiring tax services from the independent auditor. [2]

Notably, the ability of the audit firm to render tax services is likely to have a positive impact on tax service quality as well. Historically, audit clients have chosen their audit firms to perform tax services because the auditor has a unique understanding of their company. By auditing a company's accounts, the accounting firm develops the deep understanding of the business and its accounting policies that is critical to fulfilling the company's tax responsibilities. That knowledge base is invaluable to the issuer audit client in the normal cycle of tax planning, compliance, and tax audit assistance. There is a direct relationship between the level of historic knowledge a service provider has of an issuer audit client's business and the quality of tax advice the client receives, the quality of tax returns it files, and the level of cost savings resulting from efficiencies achieved. These quality and efficiency benefits directly preserve and enhance shareholder value.

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We appreciate the opportunity to discuss Deloitte's views in this important area. I would be happy to discuss the provision of tax services to audit clients in more detail or answer any questions you may have.

Sincerely,

James H. Quigley
Chief Executive Officer
Deloitte & Touche USA LLP

[2] Auditor Independence and Non-Audit Services: What do Restatements Suggest, William R. Kinney Jr., Zoe-Vonna Palmrose, and Susan Scholz, (April 2003).



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