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

[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.