THE IMPACT OF THE SARBANES-OXLEY ACT

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ROBERT U. FOSTER, III, *Staff Director*

CONTENTS

THE IMPACT OF THE SARBANES-OXLEY ACT

Thursday, April 21, 2005

U.S. House of Representatives,
Committee on Financial Services,
Washington, D.C.

The Committee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael G. Oxley [chairman of the committee] Presiding.

Present: Representatives Oxley, Leach, Baker, Bachus, Royce, Tiberi, Kennedy, Feeney, Hensarling, Brown-Waite, Barrett of South Carolina, Neugebauer, Price of Georgia, Fitzpatrick, McHenry, Frank, Kanjorski, Waters, Sanders, Maloney, Gutierrez, Velzquez, Watt, Hooley, Sherman, Meeks, Lee, Moore of Kansas, Capuano, Crowley, Israel, Baca, Matheson, Miller of North Carolina, Scott, Green, Cleaver, Bean, Wasserman Schultz, and Moore of Wisconsin.

The Chairman. The Committee will come to order. Pursuant to Rule 3(f)(2) of the rules of the Committee of Financial Services for the 109th Congress, the Chair announces he will limit recognition for opening statements to the Chair and Ranking Minority Member of the full Committee and the Chair and Ranking Minority Member of the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, or their respective designees, not to exceed 16 minutes evenly divided between the majority and minority. The prepared statements of all members will be included in the record. The Chair recognizes himself for an opening statement.

Good morning. And today we meet to discuss the impact of the Sarbanes-Oxley Act of 2002. The Committee will hear from the two regulators, Chairmen Donaldson and McDonough, charged with implementing key provisions of the Act. We welcome both of you back to the Committee and look forward to hearing your views on the benefits, and the costs of Sarbanes-Oxley, affectionately known as SOX.

Although the legislation was passed less than 3 years ago, the benefits to investors and the capital markets have already been quite dramatic. Not entirely measurable in all areas, but dramatic nonetheless. The primary purpose of the Act was to restore investor faith in the reliability of corporate financial reporting. In this regard, the Act has been an unmitigated success. The audit process has clearly been strengthened. Now subject to rigorous oversight and precluded from offering certain non-audit services to audit clients, accountants have refocused on the audit, achieved, greater independence from their clients, and are insisting with success, on more transparent financial reporting.

Replacing decades of ineffectual industry self-regulation, the Public Company Accounting Oversight Board conducts inspections of all registered accounting firms—annually for the largest firms—and has the authority to investigate and discipline accountants and firms that violate Board rules, SEC rules, or securities laws. This oversight by the PCAOB has served and will continue to serve, in my opinion, as an effective deterrent to unethical and illegal conduct.

Oversight of management activities by corporate boards has been significantly improved. Directors, particularly audit committee members, are more engaged, more informed, and more independent of management and working harder. Corporate leaders, subject to stiffer criminal penalties and greater director oversight, are focused on the financial statement like never before. The certification provisions have been successful. Financial statements are more reliable today than they were before the Act was passed.

Does this mean that Sarbanes-Oxley will eliminate fraud altogether? Of course not. No legislation can deliver such a benefit. But we are reducing the opportunities for fraud, making fraud more difficult to commit, and holding accountable those who break the law.

The most famous, or infamous, section of the Act, of course, is section Section 404. Nothing is more central to sound financial reporting than the strong internal controls contemplated by Sarbanes-Oxley. I may have heard a complaint or two about the costs, but the benefits have not been disputed. And make no mistake, the costs associated with section Section 404 are higher than anyone expected. That is a cause for concern, and I am particularly sensitive to any undue burden on small and mid-sized companies whose compliance costs are a higher percentage of total revenues.

The question then becomes, can we achieve the unquestioned benefits of strong internal controls at a more reasonable cost. I believe we can and that we will. For starters, there seems to be a consensus that Section 404 costs will be reduced by as much as one-half next year, due to the fact that systems will be in place and documentation will be completed. I am encouraged by Chairman McDonough's recent comments about costs and his announcement that additional implementation guidance is forthcoming.

The PCAOB standard instructs auditors to exercise professional judgment when performing the attestation required by the statute. Upcoming Board inspections will seek to determine whether a one-size-fits-all approach is being used on some audit engagements. We would also like to commend Chairman Donaldson for his leadership in this area. The Commission has rightly given small companies and foreign companies a delay in complying with Section 404. The Chairman has also organized a useful roundtable discussion on Section 404 to hear concerns from a broad spectrum of market participants and assembled an advisory committee of smaller public companies.

And, finally, I am pleased that there is a consensus, or close to one, on the question of whether legislative modifications are necessary. Congress, regulators, accountants, issuers, and other interested parties generally agree that, to the extent changes are necessary, they can be done within the regulatory framework.

I look forward to the testimony, and I yield to the gentleman from Massachusetts for an opening statement.

Mr. FRANK. Thank you, Mr. Chairman.

I think it is time for us to address a very important issue involving corporate governance, and it is a matter of increasing expense, significantly increasing expense to corporations, and an expense which I do not believe is justified by value given. That is, I agree with some of the critics who think that we are facing a situation in which corporations, public corporations, in particular large ones, are spending far more than they should on something for which they do not get sufficient value and which in fact impinges on the shareholders. I am talking about executive compensation.

Executive compensation is increasingly out of control. I have put up some charts here—actually, I haven't put them up; some very nice people who work for me have put them up at my request, and I appreciate it.

That chart compares what CEOs are doing compared to shareholders. The blue line is CEOs, the red line is shareholders. To the extent that that correlates to red States and blue States, it was unintentional, but it is not a bad mix, as a matter of fact. The enormous increase percentage-wise in CEO compensation is compared to what shareholders are getting. That is, CEO compensation goes up substantially when the S&P index goes down.

The next chart. This one compares the pay of CEO to the average worker from 1980 to 2003. We have a ratio of 42 to 1 in 1980, we have a ratio of 500 to 1 today.

In the next chart, lest people think I am talking here merely about envy, because I think we are talking about a serious social and economic problem. The compensation that is rapidly increasing for the people who run corporations has become macro-economically significant. This chart shows the percentage of company profits that are paid to the top 5 executives in the Fortune 500 companies. It was 4.8 percent in 1993, it was 10.3 percent in 2003, the last year for which we have gotten figures. When you are talking about that significant an increase, you are getting into things that affect performance. And I should say that I raise that in the context of this hearing for two reasons: One, we are told that the compliance costs with section Section 404 Sarbanes-Oxley are a significant drag on corporations. Well, not compared to the money they pay the top people. Now, if it were necessary to pay these people this amount of money to get them to run the corporations, then of course we wouldn't have a problem. I think the evidence is overwhelming that CEOs are compensated far beyond, on the whole, what would be economically justified.

And I want to acknowledge here that I am drawing on work done by Professors Lucian, Bebchuk, and Jesse Freed, and the book that they have published on the subject, and also articles by Professor Bebchuk and Professor Yaneff Grinstein. It is very clear from their studies, it is clear as we see this, there are very few constraints on what the CEOs get. The boards of directors—and this is the second reason I mention this. It is relevant to corporate governance. Some of the corporate leaders have told us that they feel terribly beleaguered that they have been put upon by that unlikely combination, Sarbanes and Oxley; that they have, in fact, had imposed on them staggering burdens which interfere with their ability to function. Well, I think it is very clear that at least in one area of some importance to them, setting their own salaries, Sarbanes and Oxley might as well be Donald and Daisy Duck, because nobody lays a glove on these people when it comes to setting their own salaries, and I think that this is something that we have to address.

We are in a difficult period in America today. We have growth going forward at a reasonable level, but inequality is a concomitant to that growth. Employment growth has stagnated to some extent. As I noted when Secretary Snow testified, in 2004, the President's Council of Economic Advisors said that we would get 325,000 jobs a month in this current growth.

This year's Council of Economic Advisors' report unheraldedly projected 175,000. I asked Mr. Snow, he said, well, the chairman of the Council of Economic Advisors' went back to Harvard; he couldn't fully explain it. The trouble is, he took 150,000 jobs a month with him back to Harvard. Things must be going very well in Cambridge.

But we have this problem of a slowdown in job growth. We have a problem even more so of wages stagnating. And for CEOs to be enjoying skyrocketing compensation which becomes statistically significant, 10 percent to the profits in 2003, at a time when wages also are stagnating, that causes a series of problems politically and socially.

So as we look at the questions of corporate governance, I hope we will look at this. Because I believe that Sarbanes-Oxley has worked well. I think with the distinguished leadership of these two gentlemen, we are going to be able to make some adjustments that would be appropriate, as is always to be expected when you do something new. But the agenda for corporate governance should be, what do we do next? Not, how do we go backwards? Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. I thank the Chairman, and wish to first acknowledge his good work and that of Senator Sarbanes in a time of business corporate governance of which few of us are proud, and that strong action was required and strong action was taken.

I don't think there is any question that the implementation of Sarbanes-Oxley has brought to the corporate board room an awareness of their professional responsibilities and appropriate accountability for actions which are not consistent with the highest of standards. I do believe that there are elements to Sarbanes-Oxley, which have enhanced business function, and I think that on one aspect there is a tangible element to the implementation of Sarbanes-Oxley directly beneficial to shareholders.

Since the passage of the Fair Fund in Sarbanes-Oxley, I am advised to date there have been in excess of $5 billion recouped from those who have engaged in fraudulent conduct for the benefit of shareholders directly. To my knowledge, this is the first time a program has been implemented to use government resources to recoup losses for shareholder benefit without the necessity of going to the trial bar. It is exceedingly successful, and some questioned its validity at the outset saying it would only amount to a small pizza for most shareholders. I would suggest modestly that a $5 billion pizza would be something to behold.

On the other hand, no legislation of this magnitude can possibly be implemented without flaw. And I do believe the chairman's comments with regard to the cost of implementation and compliance of section Section 404 is something that warrants further study by the Committee, and action that might necessarily require legislative effort.

Specifically, with regard to the PCAOB's methodology for assessing cost for the audit function, it is a statutory requirement that the PCAOB would not have the regulatory authority to visit should it even choose to do so. But I would certainly like to hear from the experts if there is an alternate methodology other than market cap, which might be more appropriate. It would seem to me, were there corporate misdoings and the market would respond by a runoff of market cap, that the subsequent assessment resulting from that audit would then be unnecessarily adversely impacted. So it might be an area where this Congress should act if the professionals tell us it is warranted.

And, finally, with regard to the issue of corporate governance and that of executive compensation, I thought for a moment we were talking only about Fannie and Freddie. If they were pulled from the pile, it might bring the bell curve back in more in normal range. I recall just in bonuses only there were $245 million paid out in a 5-year period on which the financials cannot be relied that the earnings per share were indeed accurate. I share the concern about corporate abuse, but think we should go slowly in areas where the United States Congress really has no business.

Mr. Chairman, I compliment you on good work and yield back.

The CHAIRMAN. The gentleman yields back. The gentleman from Pennsylvania, Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, nearly 3 years ago after a surge of corporate and accounting scandals we adopted the Sarbanes-Oxley Act. As you know, I was intimately involved in every stage of the law's development from the first congressional hearing on the collapse of Enron through the final meeting of our bicameral conference committee. We are meeting today to review the effects of this historic law on our capital markets. In general, I believe that the landmark legislation has strengthened responsibility and enhanced investor confidence. In recent months, the Public Company Accounting Oversight Board and the Securities Exchange Commission have continued to pursue an ambitious agenda as they have worked to implement the reforms that Congress mandated.

Today's hearing will help us to better appreciate their hard work in turning this functional statutory outline into an active regulatory system. It will also help us to understand the progress that we have made in bolstering investor confidence, restoring the integrity of financial statements, and rebuilding trust in our securities markets. Since the enact of Sarbanes-Oxley Act, we have also heard regular complaints from some about the cost of complying with the law. Most recently the statutes' provisions regarding internal control audits have become the subject of considerable public debate. I would therefore like to focus my comments this morning on this area of the law.

We designed section Section 404 to require public traded companies and their auditors to assess internal controls, which is a firm's policies, practices, systems, and procedures to prevent abuse, protect against fraud, and ensure proper accounting. This section of the law requires companies to report their material weaknesses and their internal controls and work to fix these problems before financial reporting failures occur. As a result of this mandate, public corporations are decreasing their risk of future shareholder losses.

Section 404 is another important benefit. It is helping corporate executives to better understand the financial reporting shortcomings within their companies, allowing them to recognize the nature of the problems earlier and adopt reforms and account procedures expeditiously. Such internal analysis by a company and external verification by an outside auditor is also helping to provide important assurances to the chief executive and financial officers of public companies who now must sign statements attesting to the accuracy and veracity of their financial statements under section 302 of the very same law.

Today, we are fortunate to once again have before us the leaders of the Securities Exchange Commission and the Public Company Accounting Oversight Board. In their comments. I hope they will examine the implementation of and complaints regarding section Section 404. I know that both organizations have been diligently working to address these concerns, particularly by conducting outreach, holding forums, and providing assistance in these matters.

It is my hope that both organizations will continue with these efforts, particularly for the smaller issuers that will have disproportionate costs in implementing these well-intentioned reforms. I know that the Public Company Accounting Oversight Board intends to issue next month additional guidance in these matters. I expect that such guidance will maintain the spirit of the reforms that Congress envisioned but offer auditors greater flexibility in tailoring their examinations of internal controls to match the size and complexity of the kind. Such guidance should also help to improve the effectiveness of the law.

In closing, Mr. Chairman, we cannot and should not remove the risks associated with investing. Our capital markets work well because of that risk. We should, however, ensure that every corporation plays by the rules; that all investors have access to reliable information needed to make prudent decisions; and that each party who violates our securities laws is held accountable. As the Securities and Exchange Commission and the Public Company Accounting Oversight Board work to achieve these objectives, it is appropriate for us to review their progress. Thank you, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 41 in the appendix.]

The CHAIRMAN. The gentleman yields back.

We now turn to our distinguished witnesses today. And, again, gentlemen, thank you for once again appearing before the Committee. We have always appreciated your information that you bring the Committee and your hard work as dedicated public servants in dealing with some very tough issues.

And, Chairman Donaldson, we will begin with you.

STATEMENT OF HON. WILLIAM H. DONALDSON, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. DONALDSON. Thank you. Chairman Oxley, Ranking Member Frank, and members of the Committee, thanks for inviting me to testify on behalf of the Securities and Exchange Commission concerning the implementation of the Sarbanes-Oxley Act of 2002.

A little over 2 years ago when I became chairman of the Commission, the headlines were still dominated by reports of financial fraud, lapses, and audit, corporate governance responsibilities, and intentional manipulation of accounting rules. Congress acted swiftly in the face of this breakdown by enacting the Sarbanes-Oxley Act which called for the most significant reforms affecting our capital markets since the Securities Exchange Act of 1934.

Since enactment, the Act has affected dramatic change across corporate America and beyond and is helping to reestablish investor confidence and the integrity of corporate disclosures and financial reporting. Your strong support of the Act, along with the support of your counterparts in the Senate demonstrates Congress's demonstration to ensuring the integrity and vitality of our markets.

Before turning to the particular provisions of Sarbanes-Oxley Act, I want to start by saying that I am pleased to be testifying today alongside of Bill McDonough, the chairman of the Public Company Accounting Oversight Board. While he will testify more fully on the board's activities, I can assure you that the PCAOB has developed as a respected and effective organization under Chairman McDonough's leadership, and that Chairman McDonough has personally been instrumental in helping to forge the close bond between our organizations.

The goals of Sarbanes-Oxley are far reaching, and aim to restore investor confidence in and ensure the integrity of the markets. Consequently, reforms in the Act address nearly every aspect of the Act in our Nation's capital markets. The Act called on the Commission to undertake nearly 20 rulemakings and studies. The Act also set ambitious deadlines for the Commission and, in most cases, required us to implement the final rule speedily.

The Commission has completed the required rulemaking under the Act, having considered the thousands of letters of public comment that we received. The Nation's largest companies, comprising more than 95 percent of U.S. market capitalization, are now fully subject to the regulatory requirements of the Sarbanes-Oxley act. Just as the SOX Act was a landmark piece of legislation for Congress, the successful implementation of that legislation will be seen as a watershed in the history of the Commission.

Given the scope and the scale of the task Congress placed before us, I am pleased to report that, with the dedication and hard work of our staff, the Commission's overall discharge of its rulemaking responsibility has been exceptionally on the mark in fulfilling the Act's objectives while avoiding unnecessary problems. Collectively, these accomplishments should have an enormous positive impact on the management and governance of U.S. public companies in the decades ahead, and they will safeguard the fundamental imperative that our markets be characterized by levels of investor confidence and participation that are second to none.

Although most of the Act's benefits have been accomplished without substantial expense for market participants, we should not minimize the cost to public companies and their investors of achieving the full measure of the Act's objectives. In particular, the internal control reporting and auditing requirements which companies are dealing with for the first time have required significant outlays of time and expense. The short-term costs to improve internal control over financial reporting are, in my view, best seen as an investment, because over the long term, these improvements will result in structurally sounder corporate practices and more reliable financial reporting.

While these critical goals now firmly in view call to roll back or weaken Sarbanes-Oxley generally as a result of concern over the cost of internal control reporting are, in my judgment, unjustified. At the same time, the Commission and the PCAOB must be sensitive to the need to recalibrate and adjust our rules and guidance to avoid unnecessary costs or unintended consequences. To this end, the Commission and the PCAOB will remain committed to the implementation of the Act in the most efficient and effective way.

I would like to review briefly a few specific accomplishments. A central focus of Sarbanes-Oxley was to enhance the integrity of the audit process. We believe the new rules have already had a beneficial effect in strengthening the integrity of the independent audit. We have also seen that audit committees are taking their responsibility seriously, and they are much more sensitive to auditor independence issues.

The Act has strengthened our ability to enforce the Federal securities laws. One of the toughest challenges facing the Commission has been recovering and, when appropriate, returning funds to injured investors. The Act gave the Commission two powerful tools to help meet this challenge: The fair funds provision, and the authority to seek a temporary freeze on extraordinary payments by an issuer. Before the Act, by law all civil penalties were paid into the U.S. Treasury. Now, the Commission has authority in certain circumstances to use civil penalties to help compensate injured investors. The Commission has authorized fair funds in over 100 cases with a total value of over $5.4 billion for anticipated distribution to harmed investors.

Another objective of the Act was to improve executive responsibility and, quote, the tone at the top of public companies, a key theme that dates back to President Bush's 10-point plan of March 2002. Among the government's reform, Sarbanes-Oxley called on us to institute, the CEO and CFO certification provisions that perhaps have perhaps had the greatest immediate impact by reinforcing executive responsibility for the financial reporting process of public companies. While CEOs and CFOs already had responsibility for company disclosures in the filings in question, the certification requirements have focused their attention on the completeness and accuracy of disclosure in new and very important ways.

Complementing the focus on executive responsibility, the Act takes several important steps toward improving disclosure in the old financial reporting process. Accurate and reliable financial reporting is the bedrock of our disclosure-based system of Securities' regulation. Investor confidence and the reliability of information in a company's filings with the SEC is fundamental to the vibrancy of our markets. The Commission has adopted a number of reforms in this area to implement the Act. Although each of the reforms is important in its own right, the reform that has drawn the most attention recently is section Section 404's requirement that management and external auditors report on the effectiveness of a company's internal control over financial reporting. As I have said on other occasions, I believe the requirements of section Section 404 may have the greatest long-term potential to improve financial reporting by companies. Much of the recent discussion about Section 404 has focused on the costs of implementation. There is no doubt costs have been higher than we and public companies anticipated, though I believe it important to note that a substantial portion of the cost may reflect initial startup expenses as many companies for the first time conducted a systemic review and documentation of their internal controls.

In this regard, a number of commentators have suggested that costs in the second and subsequent years will decrease significantly. Nevertheless, we are monitoring the costs of section Section 404 implementation closely to ensure that its benefits are achieved in the most sensible way. We have actively sought feedback about our first-year experiences in implementing section Section 404 requirements in order to determine if commission rules and the PCAOB standards are operating as intended.

Just last week, we held a public roundtable to review the first-year experience with implementation of the internal control requirements. We are paying particular attention to the impact on smaller companies, and our new advisory committee on smaller public companies held its first meeting last week also. Based on this feedback, we are now evaluating ways to make the process more efficient and effective while preserving its benefits. We are closely coordinating with the PCAOB, and I have instructed our staff to consider as quickly as possible how we could improve the guidance available to management and auditors in order to fine-tune the process. While we can and will do more on the subject of section Section 404. Any reflection upon the scandals that gave rise to the Sarbanes-Oxley Act will reveal the enormous costs to investors of corner cutting and internal controls.

As I have said before, I believe that the time, energy, and expense that companies are now investing in their internal controls will earn a handsome return in the years to come.

I have covered our activities under the Sarbanes-Oxley in greater detail in my prepared statement for the Committee, and I, of course, would be happy to elaborate further this morning. Before concluding, however, I would offer my own observation that the real key to achieving the great potential of the Sarbanes-Oxley Act lies not with the Commission or the PCAOB, but with the dedicated and serious efforts of American businesses and their managers who probably have the most to gain from preserving the reputation of our markets as the best place in the world for investment capital.

A wise man once remarked that capital will always go where it is welcomed and stay where it is well treated. I believe that a company that recognizes the true benefits of the Act in strengthening our capital markets will have no trouble seeing that effective compliance with Sarbanes-Oxley, doing the right thing is not only in the best interests of its investors but the long-term interests of the company itself.

In conclusion, let me thank you again for your leadership and vital support in reestablishing and strengthening investor confidence in the integrity of our nation's capital markets. And, of course, I would be happy to answer any of your questions. Thank you.

[The prepared statement of Hon. William H. Donaldson can be found on page 43 in the appendix.]

The CHAIRMAN. Thank you, Chairman Donaldson.

And Chairman McDonough, again, welcome back.

STATEMENT OF WILLIAM J. McDONOUGH, CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Mr. MCDONOUGH. Thank you, Chairman Oxley, Ranking Member Frank, and members of the Committee. I am pleased to appear before you today and once again to be appearing with my friend Bill Donaldson. The President and the Senate brought him to Washington. He brought me here, and most days I am grateful, including today.

With the Sarbanes-Oxley Act, the Congress took a giant step toward restoring investor confidence in financial reporting and auditing. The Act did not merely create a regulatory environment conducive to investor protection, it also reflected the powerful demand of the American people for fairness and honesty in the U.S. markets. I would like to commend this committee under Chairman Oxley's leadership both for its work in passing Sarbanes-Oxley and for its continued stewardship of our markets on behalf of American investors. It is the faith of those investors that fuels the growth and competitiveness of our economy.

In response to the people's demand, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board to oversee the auditors of public companies and bolster investor confidence in public company financial statements. The Act provides a great deal of regulatory flexibility so that we can meet new challenges as they develop. Today, the PCAOB is well on its way to maintaining a continuous program of auditor oversight. The PCAOB staff numbers 319 in 8 cities, of whom 138 are inspectors. By the end of 2005, we expect to have approximately 450 staff, and of those 219 will be inspectors.

Our main growth area is in the experienced accountants who inspect the accounting firms that are registered with the PCAOB. Our goal is to inspect roughly 300 accounting firms per year.

Our highest priority at this time is the continued implementation of our standard for auditing companies' internal control over financial reporting. Section 404 of the Sarbanes-Oxley Act requires public companies annually to provide investors an assessment of the quality of their internal control over financial reporting accompanied by an auditor's attestation on the same subject.

In the simplest terms, internal control provides reasonable assurance that the financial data being collected by a company provide meaningful and reliable information that can be used to produce accurate financial statements. With such assurance about internal control, investors can have much more confidence in the reliability of the corporate financial statement.

Now, although the term internal control over financial reporting has only recently entered our common parlance, internal control is a familiar concept to most auditors who are required, under existing standards, at least to gain a basic understanding of internal control, as part of the financial statement audit. Companies have been required to have internal control over their accounting since Congress enacted the Foreign Corrupt Practices Act in 1977.

However, the Sarbanes-Oxley Act's requirements took the responsibility of management and auditors to a different level. Today, under PCAOB Auditing Standard Number 2, auditors of public companies must not only obtain an understanding of internal control, but they must also examine its design and operation in order to reap the most benefit and to make the overall audit process as efficient as possible.

We designed our standard around an integrated model. An integrated audit combines an audit of internal control over financial reporting with the audit of the financial statements. We believe this approach both enhances the overall reliability of company financial statements and is cost effective. Given the tight deadlines for 2004 implementation, however, many auditors were unable to fully integrate their work. This problem should be corrected for 2005, which should bring costs down considerably.

Many companies have already reaped benefits from the internal control reporting process. For example, 74 percent of 222 financial executives recently surveyed reported that their companies benefited from compliance with the Act. Of those, 33 percent said that compliance lessened the risk of financial fraud. By identifying weaknesses before financial reporting failures occur, these companies are reducing the risk of a future loss of shareholder value.

Although the benefits of enhanced internal control to investor confidence are potentially great, there have been concerns about the associated costs. Through our inspections of registered accounting firms, we will assess whether auditors implement new standards appropriately and effectively. Meanwhile, we have carefully monitored implementation of our internal control standard and on occasion have issued additional guidance to promote a consistent rational approach.

Some have charged that auditors are implementing Auditing Standard Number 2 with a check-the-box mentality that focuses on minutia unlikely to affect the financial statements. Our guidance emphasizes that the focus should be on what is material to the financial statements, not on the trivial. Auditing Standard Number 2 expressly permits auditors considerable flexibility to rely on the work of others, including internal auditors, to complete some of the more detailed, time consuming tasks.

In addition, some smaller companies have charged that they are disproportionately burdened because auditors are not tailoring their audit procedures to the nature and complexity of the client. Smaller, less complex businesses typically need less complex controls. Our guidance continues to reflect that view.

Another area of concern for us is the misconception that companies may no longer look to their auditors for advice on difficult accounting issues. Auditors have long advised public companies on accounting issues and on internal control matters, and Auditing Standard Number 2 does not preclude that kind of advice and discussion.

We are working to help auditors better understand our views on this matter so that they will have the confidence we won't second-guess their reasonable judgments on this area. Last week, we participated in the SEC's Roundtable on Internal Control to explore additional implementation questions. And there I pledged that the PCAOB would issue more guidance on May 16th, including guidance that explains the top-down approach encouraged by auditing standard 2, and more clearly describes how the auditor's assessment of risk affects the amount of work that must be done to comply with the standard.

Although public attention on the work of the PCAOB has recently focused most intensely on section Section 404, the longer term effects of our work will be the product of our inspections and our other oversight activities. PCAOB oversight is causing a profound shift in the character of public company auditing. We have seen changes in auditors' attitudes toward their accountability. The old system relied primarily on enforcement tools after a problem had already occurred. The risk that an auditor's errors would come to the attention of regulators was too often not sufficient to motivate auditors to take the tough stance necessary to head off potential misstatements in financial reports.

Under the new system, auditors understand that their work is much more likely to be reviewed by the PCAOB's inspectors. Last year, our inspectors reviewed portions of more than 500 audits performed by the largest 8 firms. Our inspectors have identified and encouraged appropriate resolution of numerous accounting and auditing problems that will improve the reliability of financial statements.

Now, 2 years of inspecting the audits of the big four accounting firms has done nothing to shake my view that these firms operating at their best are capable of the highest quality auditing, and it has also done nothing to shake my view, Mr. Chairman, that the Congress, this committee led by you, acted wisely in creating independent oversight of the profession to help move firms in the direction of consistently operating at their best.

I cannot say, and I do not believe that you would expect to hear that after only two inspection cycles we have identified and uprooted all the causes of auditing failures, nor would it be prudent to assume that the repercussions of pre-Sarbanes-Oxley failures are behind the firms. But we have plainly made a start that amply vindicates the decision that Congress and this committee made in creating the inspection process.

Over time, I believe this process is the most promising means we have available for protecting firms from their own failures due to audit risks and ultimately restoring investor confidence in the reliability of audits.

In addition to the eight largest U.S. firms, we also oversee more than 900 small U.S. audit firms and more than 550 foreign firms.

Early on, some expressed concern that the Act might pose a barrier to small firms' ability to compete for public company audit clients. However, a number of small firms have actually increased the number of public companies that they audit. As for our oversight of non-U.S. accounting firms, we have used the flexibility afforded us in the Act to develop a framework that relies on cooperation with local country regulators.

Over the past 18 months we have engaged in a constructive dialogue with relevant regulators in certain key non-U.S. jurisdictions. As I speak, PCAOB inspectors are sitting side by side with inspectors from the Canadian Public Accountability Board, reviewing the work of the Canadian firms that audit U.S. public companies. We are also far along in working out similar arrangements with the United Kingdom, Australia, France, and Japan. With our counterparts, we hope to do what we can to reduce overall risk to investors in securities markets throughout the world.

Mr. Chairman, I am happy to answer any questions.

[The prepared statement of William J. McDonough can be found on page 62 in the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman. And thanks to both of you. And particularly, I want to publicly acknowledge and appreciate your sincere efforts to follow the intent of the Act. I think too many times we, as policymakers, legislators pass legislation only to see it totally misinterpreted at the regulatory level much to our disgust. In this case, it is clear from the beginning that both of you gentlemen and the people that you work with have made it a point to follow the dictates of what the Congress passed in the Act and to make it as flexible as possible.

I have to say that I guess all of us would do things differently and certainly in the context of the legislating during that white-hot period of corporate scandal. In looking back on it, I think to give you some more flexibility probably would have been the right thing to do. But having said that, I think there—and from the feedback we get from the roundtable discussions that you both participated in last week, a very positive way of getting to what all of us in the Congress wanted to do was restore investor confidence and make it work, and to that I want to publicly thank both of you.

Let me describe Section 404, and ask you, Chairman McDonough, that it appears to me that maybe most of the cost of the implementation in Section 404 was at least partially due to some deferred maintenance in the internal controls system already existent. Is that a fair assessment?

Mr. MCDONOUGH. I think it is, Mr. Chairman. It varies with the company. Some of the companies which have very complex internal financial structures already had very good internal control, probably had to do some documentation improvement of them. For medium and small-sized firms, very frequently the internal control is existent, but was kind of in the head of the guy who ran the place, and therefore there is deferred maintenance in actually establishing written documentation of what the controls are.

Some of these controls are not very exotic; it is making sure that you are actually reconciling the bank statements with your cash book to make sure your cash account is right.

A lot of this is very straightforward stuff. And I think that in the second year, a lot of companies will find that they have done the deferred maintenance and their internal costs should come down significantly. And we are making it very clear to the auditors that we expect their costs to come down, that there should not be unnecessary work. We also have to be careful at the same time that auditors really have to be working hard to make sure that they are protecting investors' rights. It is a very, very fine balance both for them and for us overseeing them.

The CHAIRMAN. What is your assessment, Chairman McDonough, on the claim that auditors are engaging in perhaps defensive auditing, too conservative of auditing because of the potential threat of litigation? And, in addition, what are your views on whether we ought to look for ways to reduce potential liability particularly in light of the fact that we now have four accounting firms doing about 99 percent of the accounting? And lastly, is there the opportunity or the possibility of some of the mid-level or regional auditing firms to ultimately become one of the top nationwide auditing firms?

Mr. MCDONOUGH. I think there is no question that auditing firms of all sizes, given the Sarbanes-Oxley Act arising out of scandals, that people are running very concerned about the threat of litigation either by civil suits against them or by the criminal authorities at either the Federal or State levels.

Human beings, what we are, if you are scared, you tend to act very defensively. And I think there is no question that there is a certain amount of this defensive posturing, which is taking place.

Whether or not there should be a limitation on liability for accounting firms is a very tough balancing act. On one side, you would say the positive is that it would make the firms less concerned, less scared, and therefore, they would use their judgment more effectively. On the other hand, they ought to do that anyway. And, therefore, I think that when and if the Congress in its wisdom should decide to provide limited liability, I would support it. In the meantime, we will proceed on the basis that the accountants should be doing their jobs properly anyway.

On the very complex issue of whether there will be a number 5 adding to hopefully the big four remaining alive and well, the Government Accountability Office, as required by the Sarbanes-Oxley Act, did a study and came, I think we would all agree, to the conclusion that it is not very likely that any firm in the number 5, 6, 7, or 8 position, or even something which is completely unlikely to happen, that all 4 of them would get together, it would still be a relatively small number 5. What I think should happen is that there are issuers—community banks come to mind—who use very large accounting firms because somehow they think that that is something that maybe their regulators or the rating agencies would like.

And it really seems to me, to be very direct, Mr. Chairman, much more appropriate that they use an accounting firm more appropriate to their size. Therefore, I would like to see the numbers 5 through 8, and then the smaller accounting firms grow, become healthier and stronger, but I don't think we can hold out a realistic likelihood that that will result in another firm anywhere near the size of the big four.

The CHAIRMAN. But you do think that the market can work, that, given time, we can have a leveling; that is, some of our—and I think it is a good point on the community banks, for example; it clearly would be much, and a lot cheaper probably, too, to engage with the mid-sized firms.

Mr. MCDONOUGH. I think the market should evolve in a way that will have stronger accounting firms right through the size structure, and that is very much to be desired.

The CHAIRMAN. Thank you.

Chairman Donaldson, one of the contributions in the conference committee was the addition of the Fair Fund; Chairman Baker offered the amendment during the conference that created this fair fund. And I know you testified that there were $5.4 billion—that is with a B—in that fund. And of course that fund comes from fines and disgorgements for cases that the SEC undertakes. Could you give us a little more detail on how that fund is working and whether, in fact, it needs any kind of amendments at our level? Or can the SEC take care of some of the potential problems with regulatory means?

Mr. DONALDSON. Thank you. I think that, as I said, there is a large amount of money that has been designated for the Fair Funds. I think that the—

The CHAIRMAN. If I could interject. That is less than, what, less than 3 years?

Mr. DONALDSON. Right.

The CHAIRMAN. And it has grown to 5.4 billion, which I guess—there is no way to predict, I guess, by any of us how that fund would grow. But, anyway, I interjected. Go ahead and continue.

Mr. DONALDSON. It is a tremendous benefit that we can now convey to harmed shareholders. The actual distribution of the money is a complicated process. Basically, it requires retroactive reconstruction, if you will, of records as to who the harmed shareholders were at a particular period of time. I think you can see how complicated that gets. Fortunately, now, as we have moved ahead we are able to put the costs of doing that off on the companies that we have fined. In other words, we didn't do that at the beginning. We now have the authority to do that, so that the actual cost of this retrofitting is being borne in addition to the original—or built into the penalty to the company.

The CHAIRMAN. I see. And are we talking in this case in terms of harmed investors? What is the universe? There are thousands, tens of thousands, millions?

Mr. DONALDSON. Millions.

The CHAIRMAN. Millions.

Mr. DONALDSON. Yes. If you add it all up, millions.

The CHAIRMAN. Okay.

Mr. DONALDSON. And, again, it is a very difficult exercise to identify the exact period, if you will, where the malfeasance took place.

The CHAIRMAN. I understand.

Mr. DONALDSON. And within that to the intellectual exercise of determining who got hurt.

The CHAIRMAN. Thank you.

Mr. DONALDSON. But we are making great progress. I think our administrators of the Fair Funds are getting more and more experienced in doing this.

The CHAIRMAN. Thank you.

The gentleman from Massachusetts.

Mr. FRANK. To begin, to both the chairmen, we talked about this a little bit before. I think Mr. Donaldson had some reference to it. There was a troubling article in The Washington Post earlier this week by David Brown suggesting that the interpretation of accounting rules regarding when you could give yourself credit for receiving revenue were interfering with the ability of the government to stockpile pediatric vaccines. And it did seem to me that this was something that, if it were a real problem, we could solve. And maybe it wasn't a real problem. Although obviously, somebody interpreted it that way. And as you know, I wrote to both of you and asked if there was anything that needed to be done in terms of regulation or legislation to clear that up, but I assumed it was something we could do quickly.

So I would be interested, you said you had a chance to look at that, Mr. Donaldson. Did you have some response on that?

Mr. DONALDSON. Sure. Of course, I read The Washington Post article as did all of our people in charge. The basic thrust of that article, as you know, that many manufacturers have decided to stop participating in part because they may not recognize revenue when vaccines are placed in the stockpile. We are concerned, but I am also concerned that it may be slightly more complicated than just an accounting problem. It is not clear to us that the accounting is the real issue as opposed to perhaps the business economics of the existing program.

But we certainly don't want to be an obstacle. We will sit down with any drug company that comes to us to see if we can work this out. There may be other ways to deal with the problem. For example, the contract with the government could perhaps be restructured to handle a particular problem. But we are willing and will sit down with any drug company and try to work through their particular problem.

Mr. FRANK. Thank you. And let me urge people, any drug company that has said that, and also to the people at the Department of Health and Human Services, if they get that answer, let us have them come and talk to you. And if a change is needed, we can do that. I had my own sense that maybe accounting was being used as an excuse for something else. But people may be erring on the side of being extra cautious, and I understand that. But I appreciate that, and I would hope we could get this one resolved fairly quickly. I don't see any kind of obstacle, if people are getting the money, there isn't a problem.

I have spoken to others here, I have spoken to Henry Waxman who has been very involved in all this. And I appreciate what you are saying. I would hope that we could all follow up now and that the companies involved—I am going to ask HHS to make sure that the companies involved are in touch with you and your people. And I would hope we could get this one resolved pretty quickly. I am encouraged by what you say.

Now, back on the subject of compensation. And I know, I guess there was some reference to whether or not this was really all Fannie Mae and Freddie Mac's fault. I guess, if it rains tomorrow, we will complain to them, too, and send to them for the umbrellas. But, in fact, we are talking about billions of dollars in compensation, so, in fact, their presence perhaps it would make no significant difference. A couple of questions here about that. Because they do go with the accounting. One of the—I am very much persuaded by the very extensive work that is done by the Professors Bedrick and Freed and Grinstein and others that mechanisms for—that CEO pay is largely self-determined. That there are ineffective constraints, and it does look like, if you hire a consulting company, you get more money, because the consulting companies, not wanting to annoy the people who decide whether or not to hire them, tend to give them more.

And there is also this apparent view on a corporation that if you are not paying your CEO above the average, then you must have a below average CEO. And, as everybody tries to get continuously above average, that, in and of itself, is a significant inflationary factor. It is the opposite of where I go with regard to businesses in general in America.

Actually, it is an interesting economic rule, that we have every business in America operating on a constantly downward sloping playing field. That is, every business in America that has ever testified on a committee where I have been sitting has announced that they are on an unlevel playing field and that the competitors have an advantage. And it is striking to me that the universe consists entirely of companies that are at a disadvantage to other companies. I mean, I have never met a company that was at an advantage to any other.

They should get a prize if they come forward. But the main check on executive compensation that gets too high, that it is unrelated to performance, that simply becomes an economic problem, the main constraint is publicity.

Mr. FRANK. In that case, let me ask you, Mr. McDonough, one of the suggestions we have had in the law of unintended consequences, Congress passed a law a few years ago that said if you pay the executive a salary that was way disproportionate to the average worker, that wasn't deductible. And we have encouraged people to get into other forms of compensation not covered by that. And particularly one of these we are told—well, there are two that trouble me.

One is pension arrangements, and those involved in Fannie Mae. The pension arrangements—we had the CEO of Fannie Mae at the time tell us that if there were accounting problems, he would be accountable. At least I thought that is what he said. Apparently, he said his benefits would be uncountable. I didn't hear him right. And they consisted of what seemed to me to be widely excessive pension benefits.

You have the jurisdiction. What is the transparency of pension benefits? I think we are running into a little problem.

And let me ask you, Mr. Donaldson, too. When we have these pension arrangements that kick in—and I appreciate the extra time, and I will try to wrap it up—but this combines with what I think is a perverse incentive effect. We have had a couple of mergers in Boston lately where very successful major enterprises in Boston sold themselves to other enterprises. But, in both cases, the CEOs made well over $100 million solely because of the sale, and that can't be irrelevant. It cannot be that the ability to make over $100 million has no effect on whether or not you make the sale, but it shouldn't be by any rational economic standards. And the problem is that those tie in, because very often the benefits are triggered by that kind of a sale.

Let me ask both of you, finally, of the extent to which current accounting rules make all of the compensation arrangements, including the contingent ones in case of sale, fully transparent and is that something that maybe we could give some more attention to.

Mr. DONALDSON. Let me try to give you an answer on that over the short haul and over the long haul.

Over the short haul, I think the first step in the whole issue of executive compensation should be based and addressed by the independence of the compensation committee. As mandated in Sarbanes-Oxley, as instituted by the stock exchange, we now have independent compensation committees, number one.

Number two is those committees have the authority to hire the outside experts themselves, as opposed to corporate management hiring the compensation advisors. Now the Committees can bring in their own advisors and give those advisors the instructions they want to give them.

Beyond that, I believe there needs to be a fundamental change in the management or rather the boards' and the compensation committee's understanding of exactly what performance is, exactly what are we rewarding people for.

My own view on that is that we are way over too far onto the earnings per share and quarterly results and the numerical measures, if you will, of success in a corporation as opposed to the qualitative judgments on what is good performance, what do you mean by that, over what period of time, quality of products, et cetera, et cetera, et cetera.

Now, having said that, we are taking steps now to increase the transparency of the total compensation package. Alan Beller in our Corporation Finance Division is hard at work now in developing a better way of displaying what the total compensation package is. And, again, you have to be a forensic accountant practically to understand in a current disclosure document exactly what the total package is that a corporate executive is getting in terms of not only salary, bonus and so forth, but post-employment bonuses, benefits and so forth. We will come up with a way of displaying this that we hope that will open the whole process up to the sunlight.

Beyond that, I think it is important to note that we have felt that it was not the SEC's role to dictate compensation measures. It is our role to make each company disclose exactly what they are doing. And of course, I believe—and this is a longer answer than you wanted—I believe that sunlight will have its effect.

Mr. FRANK. It is very much the answer I wanted. I agree with you. This is not a case for us to act, but make sure the information is there.

Mr. McDonough.

Mr. MCDONOUGH. As you may remember, Mr. Frank, I think I was the first public official to speak out describing the excessive compensation when I was honored to give the anniversary of 9/11 speech at Trinity church at the foot of Wall Street.

Mr. FRANK. Your survival has emboldened me.

Mr. MCDONOUGH. It is a matter of considerable concern to me because I live in some fear that since, in addition to your cogent remarks on the subject, I always describe the present level of executive compensation as morally outrageous, which I think it is, I think there is no question that none of us can figure out a way that you could have a law or a regulation that would control executive compensation. My friends at the SEC bringing it out more into the sunshine will help, but mainly what we need is the leadership of the American business community, for to get it through its head that the responsibility that they have to the American people as members of a single society is that this level of executive compensation is nuts. It has no economic theory behind it except one called greed, and it is time for it to get changed.

The CHAIRMAN. Gentleman's time has expired.

The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. I thank the chairman.

I wish to commend you both for taking on the administration of this Act in an aggressive and appropriate manner. I think it has brought about a heightened level of responsibility by those who govern public corporations.

I do share the view that the compensation matter is one that should be brought to public light and we should examine ways to make sure the shareholders fully understand the scope of packages, but I think that is as far as one can comfortably go until some person within either of your organizations figures out a logical way to provide a remedy. However, there are elements to this that I think are pervasive in the system.

CEOs and CFOs have a great responsibility to meet or beat the street every 90 days; and if they don't, they are fired. I think that is an insidious force in perverting compliance with the accounting rules and perhaps making ill-advised business judgments.

If someone spends the money on Section 404 compliance because the law requires it and people are going to look, did that cause us a hit on our earnings, and the only defense you will have is the law made me do it, if by contrast you had spent the same amount of money on internal data processing in order to facilitate that knowledge and not be required by law and take a hit, he would perhaps be in some trouble. We have to incent corporate America to invest for the long haul, just like we try to incent our individual constituents to invest in the markets for decades not days; and I think that is an overhaul task of some immense proportion.

With regard to Section 404 compliance, Chairman Donaldson, there is another way I would like to come at the problem of cost, particularly for moderate to small business enterprises, not necessarily changing the compliance requirements of Section 404 but rather the trigger that brings you into compliance with Sarbanes-Oxley in the first place.

As I understand it, it is a shareholder number or an asset size that brings you into the pot; and that shareholder number is fairly small, at least in my view. Is there any review ongoing as to whether those thresholds which trigger the compliance, because that is the group from which we get the largest complaint, that the compliance costs versus their operating budget is out of whack? Is that an approach that might merit some consideration?

Mr. DONALDSON. As a result of our concern on just that, we formed the Small Business Advisory Committee. That is made up of sitting CEOs and accountants and everybody that is involved in this issue, and they met last week. It is an outstanding committee.

One of the first agenda items for them has been the definition of what is a small business, how do you define. We have had traditional market cap numbers, if you will, but those are misleading in terms of a true definition of what we are talking about when we talk about a small business. And I think you will see, as a result of the work they are doing and their advice to us, we will come up with some better definitions than we have now.

Mr. BAKER. I don't expect a response this morning, your answer to the chairman on the Fair Fund administration to identify for us any operational concerns that going forward we might address and some more detailed status of the operations of the Fair Fund administration today. It would be helpful. Thank you for your good work.

Chairman McDonough, I want to jump quickly, going forward, the Section 404 compliance issue, I understand that May 16 of this year there will be additional guidance issued. Is it inappropriate to ask where we might be going or is that something that should be subject to later disclosure?

Mr. MCDONOUGH. Here is what we are working on first, Mr. Chairman. On May 16, we will come out with all the guidance we can possibly bring to bear on telling auditors it is not a one-size-fits-all, you are supposed to use judgment.

When the people in the issuing companies say, here is the internal controls we have in mind, what do you think, you are not supposed to say, I can't talk about that, but, rather, that there be a relationship between the auditor, very much with the audit committee involved and the issuer that is for the benefit of the growth in our society.

We have a Standing Advisory Group on our audit standards which meets on June 8 and 9. That entire meeting will be dedicated to additional thinking on guidance we bring to bear. The more we can get down to the nuts and bolts so we can tell people, here is the way to go about doing it, we can reach a point where we say here is a checklist—

Mr. BAKER. One of the little elements in the list, would that also apply to the subject of audit independence and tax advice?

Mr. MCDONOUGH. We have a proposed rule. The comment period has ended. We have, I believe, 1,200 pages of comment; and I would hope that say within the next month we will be able to finalize that rule. Then it goes the SEC, and they put it out.

Essentially, what we have in that rule, which I believe strongly in, we want to get auditors out of the business of giving tax advice of how you can pay, you know, take a little risk and pay less tax to Uncle Sam. That is terrible. They never should have been doing that, and we forbid it in this proposed rule.

We also tell them they can't do the individual tax returns for senior executives, especially in the line of financial reporting.

The other, more traditional work that audit firms have done for their issuers, we believe they should be allowed to continue to do. It is much more cost efficient for the issuer, and I think it is just a better way of trying to get as much cost benefit thinking as we can into the American economy and, at the same time, carry out the clear mandates of Sarbanes-Oxley.

The CHAIRMAN. Gentleman's time has expired.

Gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Gentlemen, let me congratulate you on your operations thus far. I can assure—I don't know if I can speak for all the members of the Committee, but I sleep a lot better knowing that both of you are there. You have taken on a tremendous task, and you have been terribly successful to date. So we don't have a tendency to congratulate you as nearly as often.

I am going to take the opportunity to get into two little areas that are really off the record. One is going back to the vaccine question. I have the largest manufacturer of injectable vaccines in my district, Sanofi pasteur. We have been working closely with HHS and the Securities and Exchange Commission; and I would appreciate, Mr. Donaldson, if you could reach down in your organization—and I don't want to put you on the spot to discuss it, but in the omnibus bill we had required a study to be completed by HHS in 90 days, and that has expired on March 15, and that study is not completed by HHS since they did not communicate with your organization until sometime in the middle of February. Just superficially, it appears there may be a tennis match of where the ball is and in whose court.

I think it demands high-level executive talent to make sure that we resolve this issue. Because we are completing, one, to maintain these manufacturers in the United States; and, two, we certainly want to encourage inventories. If there is some accounting problem or it is a contract problem, I really don't care. I am interested in making sure we have the stockpile. So if you could attend to that.

Now the second thing, and I bring it up with a lack of knowledge with all the ramifications, but yesterday we had the announcement of the possible privatization of the New York Stock Exchange. Quite frankly, I am very concerned, first and foremost, that the institution existed so well as a not-for-profit organization now moving into the realm of a for-profit corporation—certainly they have the right to do that and may be the right thing to do. It may enhance the equity action of the whole country, and that may be good.

I am concerned about two things, the self-regulatory organization of the exchange—it seems to me both the Congress and the SEC have some work to do here, and I don't want to put you on the spot because I am sure we are going to be passing on this transaction. But as you are passing on this transaction, I would hope that you would listen to some of these concerns and think about it.

The second concern, which I had detailed discussions with the leadership of the exchange on, is my concern of the national security issue, which I think privatization has not taken into consideration. Now we have for the first time the capacity of foreign corporations or foreign countries being the equity owners of the largest equity market in the United States; and if for some perverse reason profit was not their motive but in fact some devious purpose to accomplish some end, they would have in their vital control 80 percent of the equity of this economy at their disposal.

Under normal circumstances, the SEC is a reactive organization to pass on what has happened. But suddenly now, with little investment, maybe a half a million or a billion dollars, a foreign power or combo could control the largest equity market in the United States and not worry about their investment but be more worried about the advantages of attacking us economically. They could utilize this exchange for horrendous purposes.

When I look at the normal protections that we have against subversion in our economy, profit has so much to do with keeping people on the correct road. But when you have the opportunity with little amount of equity to extraordinarily impact or affect an economy as large as that of the United States, this is sort—I don't know what protection—

I know other exchanges have gone into privatization. I have raised that issue with them. They usually look at me and say, well, we never really thought of that. And they will say, we will know who owns this. But we all know you could own huge amounts of equity in this country in blind trusts or unidentifiable trusts. It is going to be very difficult to pierce this veil and get the transparency.

It seems to me with the hook of self-regulatory control under the auspices of the Securities and Exchange Commission you may have the ability to structure something here and invariably have to work for Congress to establish wherever that regulatory organization will—ultimately may be. But certainly to examine that we are not at a national security risk here, not that it would happen now under the present administration of the exchange or even with countries, but some devious character out there sitting in some foreign land with an awful lot of oil money—I didn't mean that—could think about having a real impact on the American economy in a very cheap way, a lot less expensive than nuclear weaponry. So if you would pay attention that, I would appreciate it. And within the constraints of a regulator, if you would like to give us any of your feelings on that matter, I would appreciate it.

Mr. DONALDSON. Let me begin by saying that I don't and cannot comment on the specifics of the proposal as was just put forward, since it will ultimately come under our jurisdiction, but let me try to answer a couple of your questions.

First of all, on the SRO issue and the whole regulatory side of the exchanges, we have been, as you know, concerned by trying to isolate the regulatory side of the exchanges from the business side, if you will, and we have had a proposal out there for comment, if you will, on just how in the future the regulatory aspect of exchange organization can be isolated from the business aspect.

In the case of New York Stock Exchange, they have a model that has the regulatory side under the purview of independent directors and totally out of the chain of command, if you will. So we have been very concerned with that problem.

We have also been concerned with how the financing of the independent regulatory oversight would take place, the precedents, if you will, of the revenues of the exchange going to the regulatory side.

As far as the national security aspect, again, we have been thinking about this, and we have been working on it. Because it seemed to us that it was inevitable that the issue of public ownership was going to become more and more in the public view. Obviously, the NASDAQ situation is publicly held now; and we have been concerned about the constraints that we can put on, the reassurances we can put on the overall structure to make sure that what you just talked about doesn't happen. We will be incorporating in our—and, again, I am not referring to the present situation—we will be incorporating in our SRO governance standards our conclusions, if you will, on just how to do that.

I might also say that the competition now between the marketplaces is happening just as it should. We have increased competition between the markets and the bringing together, if you will, of the New York Stock Exchange and the new structure illustrates that competition. It also illustrates the rising importance of electronic execution, if you will.

It also brings forward, in my view, the importance of our recent national market system rulings in terms of individual investor protection. It is very important as we move toward electronic trading that we protect the individual investor, and it is very important that we have rules that are consistent across the marketplace. That is why that was such an important part of Reg NMS, the extension of the rules to not only the New York Stock Exchange but NASDAQ.

The CHAIRMAN. Gentleman's time has expired.

The gentleman from Alabama.

Mr. BACHUS. I thank the Chairman.

Before I go into a more general line of questioning, I have got a bank-related question I want to ask Chairman McDonough. Some audit firms are beginning to require dispute resolution provisions in their engagement letters with the companies they audit, and these provisions prohibit the companies from suing the auditing firm. They require arbitration; and, even more importantly to me, they require the location of those arbitration proceedings. I know the banks have expressed concerns to us and also I think the bank regulators are concerned about possible safety and soundness issues related to this. Has the oversight board focused on this issue and have you had conversations with the bank regulators?

Mr. MCDONOUGH. Mr. Bachus, my understanding is that the SEC has taken a position that when an accountant enters into an indemnity agreement with its audit client that provides the accountant immunity from liability it can jeopardize the accountant's independence. Now, under Sarbanes-Oxley, we now share responsibility for auditor independence with the SEC. We have—at the staff level, but also in our case involving me personally, we have been in discussions at the SEC and the PCAOB with the Federal banking regulators on this issue; and I think I can speak for all of us involved in these discussions by saying we are all concerned about that practice. We understand that the bank regulators intend to issue guidance on this issue in the near future, which I certainly like to see. We will monitor that practice very, very closely.

Mr. BACHUS. I want to focus on the bigger issues. Of the 2,500 companies that filed by March, 8 percent of them reported material weaknesses in their internal controls. I think that alone tells you that Section 404 was necessary and validates the legislation and the need for internal control audits and reports. I think—I hope you agree that will result in a more accurate reporting and enhanced investor confidence. I know that one or two of my colleagues have said these are just a few bad apples, but 8 percent is a pretty surprising figure. Would you all agree?

Mr. DONALDSON. I think it is an important statistic, and it illustrates the positive impact that the whole Section 404 approach takes. I do believe in our conversations with corporate executives that many of them, after they get done complaining about the costs, talk about the improved management oversight they have now and welcome this exercise they have gone through to identify their own weaknesses. So I think it has been positive.

Mr. BACHUS. Let me say this, and I wanted to say that first, that I think that it is necessary. I think it is positive. I think it has led to better confidence by investors, more accurate reporting.

That being said, I think the main concern expressed on Sarbanes-Oxley is focused on Section 404; and I think the main criticism has been on the disproportionate costs to the smaller firms. One figure I saw was that the cost of these internal audit reports to companies of over $5 billion in revenue was $0.06 out of every dollar. But to companies of $100 million in revenue, the cost was $2.50, which is obviously disproportionate. I have read estimates I think from the oversight board and others that that cost ought to drop about 50 percent in the second year.

Having said that, and I know you have forms—and a lot of the criticism is the duplication between the internal audits and external audits, maybe extending the deadlines. I think another criticism is the need for risk-based audits.

Would you like to comment on maybe ways we can lessen the costs on these smaller firms?

Mr. MCDONOUGH. I think it is absolutely essential that we do so.

I was a central banker five times longer than I have been an audit overseer, so maybe it is the central banker in me that says small- and medium-sized companies create all the increase in jobs in our economy. They are absolutely vital to the functioning of the American economy and therefore serve the interests of our people. There is no question that there are ways to reduce the cost. The use of the work of others was put right into our auditing standards.

You may recall when I was here a year ago I said that we invented that cost benefit, thinking it isn't, in fact, in the statute, and Chairman Oxley was nice enough to say that he was glad that we had done so.

I think we are going to be able to say that in our May 16 guidance, that the audit plan should indicate exactly what work needs to be done. That has to be more thoughtfully done by the auditor, figure out how much work can be done by the work of others, especially reward a good internal audit capability by taking more advantage of it. At the end of the day, the auditor has to say, I know enough by my own work to be able to make a judgment.

But taking advantage of the work of others is certainly, in my view, encouraged and, heaven knows, not precluded. We will then continue to work throughout—well, for the indefinite future. But we want to work at it really fast, because the more guidance we get out quicker, the more we improve the 2005 audit season so that some of this unnecessary expense that took place in the last year won't be repeated. Will we get beat out all of the unnecessary expense in 2005? I hope so, but I doubt it.

So this is going to be a project where we have to keep working with the audit firms. That is why our inspections are so valuable. We made it very clear to the auditors that, yes, we would be critical if you didn't do enough work on internal control, but we will also be critical if we have the view that you did too much. Whether it is inspired by fear, as has been suggested earlier in my answer to the chairman, or even if it is a less attractive motivation, which is to run up the hours and the fees, we have to get a much better cost benefit equation into this necessary work to protect investors.

Mr. DONALDSON. Could I add two comments to that?

Number one, I think on the smaller end of the scale, because of the delay and that coming under the implementation, if you will, there has been a learning curve out there as a result of what is going on to date. That learning curve is not only in the companies themselves but with the auditors themselves. I think we will see a natural improvement in the efficiency of the process simply having been through it once.

The CHAIRMAN. Gentleman's time has expired.

The gentleman from Illinois, Mr. Gutierrez.

Mr. GUTIERREZ. Thank you very much, Mr. Chairman.

Chairman McDonough, in response to Ranking Member Frank, you referenced your previous remarks where you predicted that Congress would take action to rein in executive pay; and you also called the gap in pay between executives and workers, quote, grossly immoral. You said, quote, the American dream is in danger. The loss of confidence in private sector leaders by the American people can be restored only if we convince them once again that the private sector at the top is not a closed club of people guided by their own selfishness and agreed, unquote. I thank you for that insightful observation, Mr. Chairman.

As you know, my colleague, Mr. Frank, began and indicated that the first step regarding these obscene salary packages should involve clear disclosure so the shareholders and the public can follow the trail and discover the total compensation packages of these CEOs. I think the real solution is that shareholders should be able to directly decide their CEO's pay package. After all, it is their money footing the bill. What would you think, Mr. Chairman, of this type of proposal where there would be a direct linkage between shareholders and determining the package, pay package of a CEO?

Mr. MCDONOUGH. Well, Congressman Gutierrez, you will recall that I am a native of Chicago, so thank you. I do stand by those remarks that you quoted for me.

Actually, the shareholders do direct the compensation, because the directors of the company are supposed to represent the shareholders. I think if we say that shareholders are not being well protected if CEO compensation is too high that we have to say that the directors of public companies—not all public companies, some public companies—are actually improving their situation by coming up with a methodology which you and I and any other member of the American society can look at and say, well, that makes sense.

But in many, many other cases, you look at the methodology and, essentially, it is what the Ranking Minority Member described as, you bring in an executive compensation consultant and the executive compensation consultant says, no, McDonough, you are a genius because you hired me. Of course, that is why he knows I am a genius; and, therefore, you should be in the top quartile of executive compensation and we will compare you just by chance with a group of companies that happen to pay a lot. That actually is what was happening. That is not a caricature, but, unfortunately, that is the truth. That shouldn't be happening if the directors of public companies are doing their jobs properly.

Mr. GUTIERREZ. In the instances—because you are from Chicago, I thought you were going to give me that answer and go back to the board of directors. So I am happy that we are on the same page.

Having said that, then what about the shareholders being able to veto a mistake made by the board of directors in terms of an excessive package of wages? Let us say the board of directors does something and the shareholders feel, God, look at all that money. What do you think of that instance? A veto process? They don't like it. Is there a procedure in which they should be able to get involved?

In order to seriously address the issue of competence, because as you and Mr. Donaldson have expressed, we are beginning to make inroads after the lack of competence which ensued at the end of the last decade and the beginning of this one, but there are still stories that may continue to unfold. And as you declared, and I agree with you totally and I am happy you stand by those words, grossly immoral. What do you think of that?

Mr. MCDONOUGH. I would be really trampling on the turf if I answered that question of my colleague and friend, Mr. Donaldson, because it has to do with the governance of corporations, which is the SEC area.

I will make the comment, at the present time, a shareholder only has one choice, and that is to sell the shares. That doesn't impress me as the only choice that ought to be available.

Mr. GUTIERREZ. I will take that as an answer.

I would like to ask a question of Chairman Donaldson. You were quoted in Forbes magazine in 2003 where you referred to a, quote, disconnect between executive compensation and performance. You expressed fear that the business was slow to heed the public's outrage, quote. In my view—this is Chairman Donaldson—such cynicism is a major threat to the long-term growth and health of our economy.

You added, without the confidence and participation of mainstream America—I thought that was the shareholders—our markets cannot resume their rightful and necessary place as the engine of American prosperity, end quote.

Company directors must create, according to Mr. Donaldson's quote in the Forbes magazine, a corporate culture based on a philosophy of high ethical standards and accountability. And you said this culture must be engrained in the company's moral DNA, following up on Mr. McDonough talking about morality.

Obviously, there is a serious ethical moral question, as both of you have been so widely quoted about the morality or lack of morality. However, you have CEOs like Robert Allbritton, who presided over Riggs Bank, an institution that systemically failed to comply with Bank Secrecy Act requirements and facilitated transactions for General Pinochet for years before these actions were finally acknowledged by the regulator, the OCC. In addition to his generous salary and sizeable stock options, which he exercised just before his resignation as chairman, earning him $5.7 million in a single day, here is somebody who violated the OCC, and we will let them continue to look at the things.

The CHAIRMAN. Gentleman's time has expired. Could we hear the answer?

Mr. GUTIERREZ. Could you just speak to that issue momentarily before the chairman cuts you off?

Mr. DONALDSON. Well, I think that the issue of compensation has to do—as I tried to say earlier, has to do with an appraisal of what good management is and what effect that has on the performance of the company; and I think it needs to be measured over a longer period of time than is currently there. I think there is a danger that if we somehow do not reward really good performance with really good rewards—and I believe the marketplace must be the determination of that, and that comes from a complete disclosure of just what these rewards are, and then the shareholders can make their own judgment as to whether the rewards they are getting in the marketplace are being fairly compensated. I think the problem is that there are rewards that are not disclosed and if disclosed would excite some shareholders.

Mr. GUTIERREZ. Thank you very much. If I could submit some questions in writing to the two chairmen.

The CHAIRMAN. The Gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman. Let me add my voice to the chorus of those congratulating you for your leadership on Sarbanes-Oxley, a critical piece of legislation at a critical time in our Nation's history. Clearly, accounting firms and executives are held to higher standards, and we have our financial controls strengthened and more transparency, and investor confidence is up. Clearly, that is all the good.

But sometimes when I hear from constituents about the application of Sarbanes-Oxley, it reminds me of some of these miracle drugs we see advertised on TV: Take the green pill. It is 97 percent effective, but side effects include premature baldness, bad breath and nausea. I think to some extent in my 5 minutes I could say that Sarbanes-Oxley is 97 percent effective in curing what ails us, and I want to spend a little time talking about some of these possible side effects.

I represent a Dallas, Texas, based congressional district; and I have seen an uptick in small public companies deciding to go private. Just a couple of examples.

A company named Bestway, a rent-to-own company, they had a net income of $366,000 last year, and they spent almost $600,000 on their Section 404 compliance, and they decided to go private.

Calloways, which is a nursery, had a $4.3 million loss in '03, $113,000 profit in '04, and they are saying that they have to spend an extra half a million dollars a year to meet all the public filing requirements. They have decided to go private as well.

I have a twofold question. Number one, do you have any evidence that this is a trend that increasingly small public companies are choosing to go private because of the compliance costs? And if you do see a trend, what are the implications to the investor community and the economy? Chairman Donaldson?

Mr. DONALDSON. First of all, I think you have to put it in context relative to the numbers of small companies or relative to the number of companies out there. Those that have gone private are quite small. Nonetheless, they are more than they were in the past.

I think you have to relate that to the public ownership boom, if you will, that took place during the escalating markets in the 1990s. There are a number of companies who never should have gone public, who were not ready for it and were not ready to accept the burdens of public ownership. There are obligations for liquidity and capital raising that comes from public ownership. There are burdens of regulation.

Having said that, it is, I believe a natural process here where there are going to be some companies who are going to decide that the burdens and responsibilities are too great and would rather be a private company. And I think for the great majority of companies, there has been—the very reason for Sarbanes-Oxley, there has been inadequate attention to the expenses, the justified expenses of being public.

Mr. HENSARLING. You don't necessarily see a trend, but if you do see a trend you don't see a worrisome trend?

Mr. DONALDSON. I see an increase in companies going private. I think the rhetoric is a little ahead of the actual numbers. I mean, the numbers are very small relative to the thousands of companies that are public.

Mr. HENSARLING. Continuing to focus on the burden on smaller public companies, you get a lot of studies and anecdotal evidence crossing your desk. I happened to pick up a USA Today the other day flying back to Dallas, and they just mentioned a few companies. Priority Health Care, a pharmacy distributor, has 491 percent higher audit fees. Aaron Marantz, audit-related fees up 287 percent. A lumber company, Daletech Timber, 243 percent rise in their audit fees.

Do you have some way to get your arms around all this as far as the size of magnitude, as far as the cost compliance for these smaller companies? Do you have any studies that you believe are valid and worthy of bringing to our attention?

Mr. DONALDSON. We are very concerned about the small company end of the economy. Obviously, that is the engine of growth in our economy, has been and will continue to be. We are very concerned about any sort of disadvantages that come from a one-size-fits-all application of Sarbanes-Oxley, and that is why we formed this advisory committee. And we are going to pay particular attention to smaller companies and the burdens on smaller companies, we are concerned about it and we are concerned about seeing if we can't cut away some of the chaff, if you will, in terms of the implementation of Sarbanes-Oxley.

The CHAIRMAN. Gentleman's time has expired.

The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

First, to you, Chairman Donaldson, I would like to ask you about the New York Stock Exchange and their move of going public. Is it your opinion it is a good move? I think from your earlier comments I think you were saying it would promote greater choice. Transparency might be better for faster transactions. Is that a fair assessment?

Mr. DONALDSON. Again, I am reluctant to comment publicly since we do have to pass, if you will, ultimately on the stock exchange proposal.

Let me say two things. Number one is that I believe the proposal is reflective of the increasing competition between markets; and I think that is very healthy. It is very healthy not only domestically but as we emerge in a world order, if you will, to make the U.S. markets even more competitive on a worldwide basis.

Mr. SCOTT. Let me ask you this. Now it has gone public, it comes under the purview of Sarbanes-Oxley. How do you feel that Sarbanes-Oxley would fall into this? Particularly given the past recent culture of the New York Stock Exchange, the recent scandals, the recent settlement of the $257 million, of the cheating of investors, some of the fallout from the Glasgow situation, how do you feel Sarbanes-Oxley will fit into this? How do you envision that?

Mr. DONALDSON. Clearly, in terms of the independence of the regulatory oversight at the New York Stock Exchange, I think a significant improvement has been made. You are referring now to things that happened before the structure was changed, the fines that we have given, and I would say that we have been very tough in enforcement.

Mr. SCOTT. The culture has improved.

Mr. DONALDSON. And I believe the structure now and the personnel that has been brought in on the regulatory side is just what the SRO concept of oversight is all about.

Mr. SCOTT. Mr. McDonough, let me go to you; and, incidentally, I want to thank you for stopping by my office. I thought we had a delightful visit.

I want to talk about Section 404. Recently, PriceWaterhouse, KPMG and Ernst & Ernst and I think it was Deloitte Touche did a study, a survey, and in that survey it came out that there was an average uniform cost of $7.8 million for compliance with Section 404 and that the bulk of this was one-time costs. Do you have any breakdown on what these one-time costs were?

Secondly, it appears to be quite a bit. Do you foresee the costs or expenses going down?

Mr. MCDONOUGH. Yes, Congressman Scott, I think they will go down. How much they go down will vary a lot by company. If the company had a lot of deferred maintenance, if they had to document internal controls, that was very expensive. That should be a one-time expense, and then they would have a big drop from year to year. If you had a company that had better-developed internal controls, the past year's costs would be lower and, therefore, the likelihood of a big drop would be less.

I think what we have to do—these conglomerate numbers are all very interesting, but they don't tell you much. You have to go in company by company and auditor by auditor and really see if they have the level of internal controls that really make sense for the nature of the issuing company. Some of them, in my view, clearly have more bells and whistles than they need, and that expense is inappropriate.

There is no question that there is enough anecdotal evidence to figure out that some of the auditors have been overdoing it and how much work that they have required. We wished through the guidance through our standards group and then through our inspection process to make sure that that conduct gets improved as well.

Here is one where I think that you really go at it issuer by issuer and audit engagement by audit engagement and try to drive down the unnecessary cost. We still have to protect the investors. That is what Sarbanes-Oxley is all about. But we have to do it where it is most cost effective with the special concern for the small- and medium-sized companies, that they are not spending money that they really don't need to be spending.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from South Carolina.

Mr. BARRETT OF SOUTH CAROLINA. Thank you, Mr. Chairman.

Thank you, gentlemen, for being here today. Travel light and hit hard.

Got two questions, real quick. Let us turn our attention to Section 404, the SEC-issued guidance to the accounting industry on certain treatment of the lease accounting practices. I have gotten several letters. I have gotten one from the Retail Leaders Industry Association, the National Restaurant Association, even the Chamber. They have expressed concern that retroactively applying these interpretations could have a tremendous adverse effect on the economy. Why did SEC insist on the interpretation being applied retroactively in the ninth inning for the form 10-K?

Mr. DONALDSON. On February 7, our chief accountant issued a response to the AICPA in which he clarified the staff's understanding regarding several lease accounting practices that were not compliant with pre-existing and long-standing accounting rules. These issues were initially identified by a few companies and their auditors who had already concluded without our staff involvement that certain leases had been accounted for in error based upon long-standing GAAP accounting.

So, basically, the restatement raises the issue of whether a material weakness in internal controls exists for Section 404 reporting. The issue of whether a restatement constitutes a material weakness in a particular instance is a matter to be resolved through discussions between a company's management and its auditors. It would be very difficult for us to categorically conclude that a particular type of restatement is never a material weakness. But the issue here was us trying to face up to this inconsistency as quickly as we could, particularly as the Section 404 compliance measures were coming.

Mr. BARRETT OF SOUTH CAROLINA. I guess this leads into my second question. When you are talking about material weakness, due to some of the timings on these things, a lot of these companies are having reports written about them that they do have material weakness. My question is, how do I separate a company like that from the Enrons out there that have some serious material weaknesses? How do I differentiate between those two?

Mr. DONALDSON. Well, I think—and Chairman McDonough may want to answer this. I think the material weakness is an accounting concept, and it is something that must be arrived at with the accounting profession according to auditing standards. Beyond that, I mean, it is a matter of some judgment here as between the auditors and the company itself and the company's financial officials. I think the real issue here is the correction of the material weaknesses; and, again, I think we are going to see corrections coming quite rapidly.

Did you want to add to that.

Mr. MCDONOUGH. The decision of whether something is a significant deficiency or material weakness has to be done case by case.

Let us assume that the decision is made by the issuer and the auditor it is a material weakness. The important thing is that there be disclosure, disclosure, disclosure, disclosure. Say exactly what happened, why it happened, what you plan to do about it; and then the auditor should also opine that, yes, we think that it is fixable in this way.

We have just brought out a proposed standard, Congressman, that would say that if in the course of the year following a fiscal year in which an issuer has a material weakness the issuer says, I fixed the material weakness, and the issuer says, but I think I better get my auditor to agree with me, we are creating a methodology through a new rule that will establish how the auditor goes about that.

In the real world, there are material weaknesses and material weaknesses. Some of them would probably make any sensible investor say, this is not a good company to be investing in. Others you would say, okay, they made a mistake, they admit it, and they are saying how they are going to fix it, and I have confidence they will fix it.

The interesting thing is the securities market, if you watch the stock market performance, some companies come out and state a material weakness of the kind I described and explain it well; stock market reaction is not detectable. On the other hand, if they say that they have serious problems, the stock market reaction is indeed predictable; it is down. I think it is an indication that markets work.

Mr. DONALDSON. As a former security analyst, one man's or woman's material weakness may not be another's. There is an accounting concept here, and then there is the marketplace. As Chairman McDonough says, the marketplace will evaluate whether an accountant's concept of material weakness is really significant; and that will play out in the price of the stock.

The CHAIRMAN. Gentleman's time has expired.

Gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

First, I want to thank Chairman McDonough for taking the time to visit me in my office and establishing a relationship when he first became the chairman of PCAOB; and I want to thank you and your staff for arranging to have a meeting in your offices, particularly Mary Hamlick. I want to thank you also for your frankness and your testimony, a frankness that is not often heard at this committee today.

Let me ask you a couple of quick questions, given that I have heard the bells.

Mr. McDonough, in response to Chairman Oxley a short while ago, you mentioned that more firms could be involved in auditing if more issuers used auditing firms that match their size instead of large firms. I was wondering, is there a way that regulators or Congress can encourage this to happen? Because one of my thoughts was there is only four firms that are doing all of the auditing and to increase the number of firms that are involved here, do you think there is any way that we could encourage this to happen?

Mr. MCDONOUGH. I think we are actually doing it in this dialogue and the one I had earlier with the chairman.

I think when the chairman of the PCAOB says that a smaller-sized company or a community bank really ought to have an auditor that is more appropriate to its size, that rather says to that community bank or small company, well, if the chairman of the PCAOB and Congressman Meeks agree that that is appropriate, it kind of tells them it is okay. It isn't necessary to have some big fancy auditing firm if it really doesn't make a whole lot of sense for you.

Mr. MCDONOUGH. So I think that we are both using the bully pulpit to get that message across.

Another thing I think that these smaller firms can do, and this is a conversation we had with that very nice group that came to see us at your arrangement. We want, because we think it is most cost efficient, that you have an audit, which is an audit of both the financial statement and of internal controls. But a lot of companies actually need expert advice in establishing internal controls, and that is something that a smaller auditing firm could develop a real expertise at and be able to get a nice flow of income by being an expert adviser on people getting up good internal control mechanisms. And we at that meeting, and now, I am really encouraging that development.

Mr. MEEKS. What about, do you think they would bring down the cost of Section 404 by having the primary auditor subcontract out to smaller firms? Do you think that that would be a possibility, or do you believe that the regs are written in such a way that subcontractor joint ventures are not viable?

Mr. MCDONOUGH. I don't think that would work. I was just turning to Laura Phillips, whom we call Miss Internal Control, and is my expert on this subject. The integrated audit we think is really the way to go, and therefore to subcontract part of the work, I just don't think it works. That is why I like the idea better that the issue were, say, if we really need some help in designing the internal controls, first of all, they ought to hire another firm. Their auditor shouldn't do that because you destroy independence in the process. So I think that is how we can bring some new business to the smaller firm as an expert adviser on the creation of internal controls.

Now, I do recognize that that is probably a one-time proposition, but at least it brings them into the picture in as constructive a way as I think I can figure out.

Mr. MEEKS. Let me just ask this question. What are your thoughts on mandatory auditor rotation? And should the SEC or PCAOB have the authority to demand a change in auditors for a company where they suspect the relationship may be too cozy or where certain legal violations may have occurred?

Mr. MCDONOUGH. I believe that the SEC could order an issue or two to change audit firms. So they have that authority. The larger question, should we have a general requirement for rotation of audit firms, unfortunately, I don't think it works because if you look at the large number of larger companies that deal with one of the big four audit firms, they would have a real problem in moving to one of the others because of the independence issue as we currently define it. If they have used one of the other three firms—and the chances are pretty high they have probably used all three of them for some kind of a consulting project, that new firm to which they might think of moving would flunk the independence test. It is one of the reasons that, since we have only four very large firms, I have a sincere continuing belief that we continue to have four very large firms and that no accident will come along which would present us with the enormous public policy challenge of what would we do if we had three.

The CHAIRMAN. The gentleman's time has expired.

The Chair would indicate that because we have three 15-minute votes pending on the floor of the House, which is somewhat unprecedented, at least lately, and I have also been informed that we would have to pay Mr. McDonough overtime— Since you are paid by the taxpayers as I am, we would still retain the same amount of pay, but Mr. McDonough is in a different category. Having said that, we will plan to adjourn the hearing.

Let me first thank both of you again for an excellent hearing and excellent contributions, as usual, and indicate that some members may have additional questions for the panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to those witnesses and to place their responses in the record. And, without objection, correspondence from the American Bankers Association regarding the implementation of the Sarbanes-Oxley Act will be made part of the record.

[The following information can be found on page 90 in the appendix.]

The CHAIRMAN. No further business coming before the Committee, the Committee stands adjourned.

[Whereupon, at 12:05 p.m., the Committee was adjourned.]

A P P E N D I X

April 21, 2005

Opening Statement

Chairman Michael G. Oxley

Financial Services Committee

The Impact of Sarbanes-Oxley
April 21, 2005

Good morning. Today we meet to discuss the impact of the Sarbanes-Oxley Act of 2002. The Committee will hear from the two regulators, Chairmen Donaldson and McDonough, charged with implementing key provisions of the Act. We welcome both of you back to the Committee and look forward to hearing your views on the benefits, and the costs, of Sarbanes-Oxley.

Although the legislation was passed less than three years ago, the benefits to investors and the capital markets have already been quite dramatic. Not entirely measurable in all areas, but dramatic nonetheless.

The primary purpose of the Act was to restore investor faith in the reliability of corporate financial reporting. In this regard, the Act has been an unmitigated success. The audit process has been strengthened. Now subject to rigorous oversight and precluded from offering certain non-audit services to audit clients, accountants have refocused on the audit, achieved greater independence from their clients and are insisting, with success, on more transparent financial reporting.

Replacing decades of ineffectual industry self-regulation, the Public Company Accounting Oversight Board conducts inspections of all registered accounting firms — annually for the largest firms — and has the authority to investigate and discipline accountants and firms that violate Board rules, SEC rules, or securities laws. This oversight by the PCAOB has served, and will continue to serve in my opinion, as an effective deterrent to unethical and illegal conduct.

Oversight of management activities by corporate boards has been significantly improved. Directors, particularly audit committee members, are more engaged, more informed, and more independent of management.

Corporate leaders, subject to stiffer criminal penalties and greater director oversight, are focused on the financial statement like never before. The certification provisions have been successful. Financial statements are more reliable today than they were before the Act was passed.

Does this mean that Sarbanes-Oxley will eliminate fraud altogether? Of course not. No legislation can deliver such a benefit. But we are reducing the opportunities for fraud, making fraud more difficult to commit, and holding accountable those who break the law.

Oxley, page two
April 21, 2005

The most famous, or infamous, section of the Act is of course 404. Nothing is more central to sound financial reporting than the strong internal controls contemplated by Sarbanes-Oxley. I may have heard a complaint or two about the costs, but the benefits have not been disputed. And make no mistake, the costs associated with Section 404 are higher than anyone expected.

That is a cause for concern. I am particularly sensitive to any undue burden on small and mid-size companies, whose compliance costs are higher percentage of total revenues.

The question then becomes, can we achieve the unquestioned benefits of strong internal controls at a more reasonable cost? I believe that we can and that we will. For starters, there seems to be a consensus that 404 costs will be reduced by as much as one-half next year, due to the fact that systems will be in place and documentation will be completed.

I am encouraged by Chairman McDonough's recent comments about costs and his announcement that additional implementation guidance is forthcoming. The PCAOB standard instructs auditors to exercise professional judgment when performing the attestation required by the statute. Upcoming Board inspections will seek to determine whether a one-size-fits-all approach is being used on some audit engagements.

I would also like to commend Chairman Donaldson for his leadership in this area. The Commission has rightly given small companies and foreign companies a delay in complying with 404. The chairman has also organized a useful roundtable discussion on 404 to hear concerns from a broad spectrum of market participants and assembled an advisory committee of smaller public companies.

Finally, I am pleased that there is a consensus, or close to one, on the question of whether legislative modifications are necessary. Congress, regulators, accountants, issuers, and other interested parties generally agree that, to the extent changes are necessary, they can be done in the regulatory context.

I look forward to the testimony.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
COMMITTEE ON FINANCIAL SERVICES
"THE IMPACT OF THE SARBANES-OXLEY ACT"
APRIL 21, 2005

Chairman Oxley and Ranking Member Frank,

I want to express my sincere appreciation for you holding this important oversight hearing today. I was appointed to this prestigious Committee at a time when all of the corporate scandals were occurring that ultimately led to the need for enactment of the "Sarbanes-Oxley Act." I am familiar with the underlying legislation and now am interested, as well as concerned, about the impact it is having on the financial services sector. Having heard from several of my constituents on this legislation, I think this hearing is more than timely. It is desperately needed, and I thank the Chairman again for holding it.

One of the letters I received from a constituent was rather provocative. In it, he said that he was sending the letter to appeal to me to do something about the "Sarbanes-Oxley Act," particularly Section 404 the statute's provisions regarding internal control audits that have become the subject of considerable public debate.

In his letter, my constituent argues that the Act is the "most ineffective piece of legislation that has come out of Congress in recent years." He further contends that the financial burden the legislation imposes on public companies is "outrageous, resulting in virtually no gain." According to the letter I received, which I site because it is typical of most of the others, the cost of complying with the Act tripled his company's audit and associated fees and diverted a massive amount of his company's internal time from productive work to compliance. My constituent concluded his letter stating rather bluntly that "The bottom line – with regard to the "Sarbanes-Oxley Act" - is that Section 404 is a huge waste of resources."

The author of that letter attached a Letter to the Editor from The Wall Street Journal dated Monday, March 21, 2005. He highlighted certain sections of the letter, particularly the ones on Section 404 of SOX. The letter contends that the Section 404 procedures to audit corporations' internal controls do little to prevent high-level fraud, which was the case in Enron and WorldCom; the 404 audits are almost entirely focused on the micro-operational details of the firm and are likely to miss the kind of financial legerdemain orchestrated at the top that previously led to the Enron, WorldCom and other bankruptcies; and the "Sarbanes-Oxley Act" will levy $35 billion of additional costs on corporate America in the coming year – 20 times more than the SEC originally estimated.

Some contend that Section 404 costs will be reduced by as much as one-half next year, due to the fact that SOX systems will be in place and documentation will be completed. Certain of my constituents does not agree, and, based on assertions, even I question that contention. Although I have reminded my constituents that the SEC has given small companies and foreign companies a delay in complying with 404, this has not addressed the concerns and complaints of the larger companies.

In the end, the author of the letter to me recommends making Section 404 mandates on internal controls voluntary, while keeping intact the rest of the "Sarbanes-Oxley Act."

There is also a ABA proposal related to the Sarbanes-Oxley Act that I am reviewing. They propose updating the shareholder threshold that determines which businesses are subject to SEC reporting requirements. The proposal also includes a recommendation that the role of the external audit in internal testing required by the Sarbanes-Oxley Act be re-examined. ABA goes on to propose that the SEC, the Public Company Accountability Oversight Board and industry work together to improve guidelines clarifying that the external auditors' role is to test work done by companies' own auditors, and not to replicate the internal audit step-by-step.

Chairman Oxley, I have the utmost respect for you, Senator Sarbanes, Chairman Baker, Ranking Members Frank and Kanjorski and my fellow colleagues who worked so diligently and deliberatively with me and others to enact SOX. However, I believe that a serious review of the ABA's proposal, and others, is merited at this time. I would recommend that the Committee hold a hearing on this and similar proposals.

In the meantime, and to that end, I would request that SEC Chairman Donaldson and PCAOB Chairman McDonough respond to my attached questions as expeditiously as possible, preferably before the PCAOB issues additional guidance in these matters. I also ask that the questions and the responses be included in the official hearing record.

Mr. Chairman, I yield back the remainder of my time.

Statement for the Record
Congresswoman Darlene Hooley
April 21, 2005
FSC Hearing
"The Impact of the Sarbanes-Oxley Act"

Thank you Chairman Oxley and Ranking Member Frank:

Today, as we discuss the impact of Sarbanes-Oxley, including the cost and the burden that has been placed on American businesses, our attention has been turned to executive compensation. And rightfully so, because for the sums many of America's top corporate officers are being paid, the very least we should ask of them is to certify the books in which their compensation packages are held.

In fact, the trends which we see in executive compensation are a prime example of the lack of corporate responsibility that brought about Sarbanes-Oxley. Many of these packages show a general lack of accountability to shareholders, in which the benefits to a few outweigh an honest accounting to shareholders.

In 1993, the total compensation paid to the top five executives of U.S. Public companies was 4.8% of company profits. Now, only twelve short years later, that amount has more than doubled to 10.3% of company profits.

I find the complaints of some companies about the costs of compliance with section 404 somewhat disingenuous; when many of these very same companies are spending far more on elaborate compensation packages for top five executives.
Shareholders are far more willing to foot the bill for proper accounting and continued investor confidence, than they do for providing golden parachutes to top ranked executives.

But my unease about executive compensation goes beyond the mere dollar amounts and the percentages of company profits, although that alone should be troubling enough to investors.

I'm more alarmed with the compensation that many executives receive, after turning in performances that would in many cases have landed the average employee out on the street at best, and at worst in jail.

A lack of transparency and openness in the way top corporate executives are being compensated is leaving investors worried once again. Earnings manipulation, questionable mergers and acquisitions, and camouflaged compensation are not the recipe for rebuilding investor trust.

It would be foolish to forget the enormous setback our markets faced only a few short years ago due to a lack of accountability to shareholders and badly shaken investor confidence. Public companies should keep the lessons of Sarbanes-Oxley close to heart, as they consider future compensation packages for top executives.

Thank you.

OPENING STATEMENT OF
CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

HEARING ON THE EFFECTS OF
THE SARBANES-OXLEY ACT

THURSDAY, APRIL 21, 2005

Mr. Chairman, nearly three years ago after a surge of corporate and accounting scandals, we adopted the Sarbanes-Oxley Act. As you know, I was intimately involved in every stage of this law's development, from the first congressional hearing on the collapse of Enron through the final meeting of our bicameral conference committee. We are meeting today to review the effects of this historic law on our capital markets. In general, I believe that this landmark legislation has strengthened corporate responsibility and enhanced investor confidence.

In recent months, the Public Company Accounting Oversight Board and the Securities and Exchange Commission have continued to pursue an ambitious agenda as they have worked to implement the reforms that Congress mandated. Today's hearing will help us to better appreciate their hard work in turning a functional statutory outline into an active regulatory system. It will also help us to understand the progress that they have made in bolstering investor confidence, restoring the integrity of financial statements, and rebuilding trust in our securities markets.

Since the enactment of the Sarbanes-Oxley Act, we have also heard regular complaints from some about the costs of complying with the law. Most recently, the statute's provisions regarding internal control audits have become the subject of considerable public debate. I would therefore like to focus my comments this morning on this area of the law.

We designed Section 404 to require publicly traded companies and their auditors to assess internal controls, which are a firm's policies, practices, systems and procedures to prevent abuse, protect against fraud, and ensure proper accounting. This section of the law requires companies to report their material weaknesses in their internal controls -- and work to fix these problems -- before financial reporting failures occur. As a result of this mandate, public corporations are decreasing their risk of future shareholder losses.

Section 404 has another important benefit. It is helping corporate executives to better understand the financial reporting shortcomings within their companies, allowing them to recognize the nature of the problems earlier and adopt reforms in accounting procedures expeditiously. Such internal analysis by a company and external verification by an outside auditor is also helping to provide important assurances to the chief executive and financial officers of public companies who now must sign statements attesting to the accuracy and veracity of their financial statements under Section 302 of the very same law.

Today, we are fortunate to once again have before us the leaders of the Securities and Exchange Commission and the Public Company Accounting Oversight Board. In their comments, I hope that they will examine the implementation of and complaints regarding Section 404. I know that both organizations have been diligently working to address these concerns, particularly by conducting outreach, holding forums, and providing assistance in these matters.

It is my hope that both organizations will continue with these efforts, particularly for the smaller issuers that will have disproportionate costs in implementing these well-intentioned reforms. I know that the Public Company Accounting Oversight Board intends to issue next month additional guidance in these matters. I expect that such guidance will maintain the spirit of the reforms that Congress envisioned, but offer auditors greater flexibility in tailoring their examinations of internal controls to match the size and complexity of the client. Such guidance should also help to improve the effectiveness of the law.

In closing, Mr. Chairman, we cannot and should not remove the risks associated with investing. Our capital markets work well because of that risk. We should, however, ensure that every corporation plays by the rules, that all investors have access to the reliable information needed to make prudent decisions, and that each party who violates our securities laws is held accountable. As the Securities and Exchange Commission and the Public Company Accounting Oversight Board work to achieve these objectives, it is appropriate for us to review their progress.

TESTIMONY
OF

WILLIAM H. DONALDSON, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
THE IMPACT OF THE SARBANES-OXLEY ACT

BEFORE THE COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

APRIL 21, 2005

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
WILLIAM H. DONALDSON
CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION
CONCERNING THE IMPACT OF THE SARBANES-OXLEY ACT
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES
April 21, 2005

Chairman Oxley, Ranking Member Frank, and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission concerning the impact of the Sarbanes-Oxley Act of 2002. I appreciate the opportunity to discuss this important matter with you.

I. Introduction

A little over two years ago, when I became Chairman of the Commission, the headlines were still dominated by reports of financial fraud, lapses in audit and corporate governance responsibilities, and intentional manipulation of accounting rules. Congress had acted swiftly in the face of this breakdown by enacting the Sarbanes-Oxley Act, which called for the most significant reforms affecting our capital markets since the Securities Exchange Act of 1934. Since its enactment in the summer of 2002, the Act has effected dramatic change across corporate America and beyond, and is helping to re-establish investor confidence in the integrity of corporate disclosures and financial reporting. Your strong support of the Act and our efforts to implement its sweeping reforms, along with the support of your counterparts in the Senate, demonstrate Congress's dedication to ensuring the integrity and vitality of our markets.

Before turning to the particular provisions of the Sarbanes-Oxley Act, I want to start by saying that I am pleased to be testifying today alongside William McDonough, the Chairman of the Public Company Accounting Oversight Board. While he will testify more fully on Board activities, I can assure you that the PCAOB has developed as a respected and effective organization under Chairman McDonough's leadership.

The goals of the Sarbanes-Oxley Act are far-reaching, and aim to restore investor confidence in and assure the integrity of our markets. Consequently, the reforms in the Act address nearly every aspect and actor in our nation's capital markets. The Act affects every reporting company, both domestic and foreign, as well as their officers and directors and other key participants in our capital markets. The principal objectives addressed in the Act can be grouped into the following themes:

- To strengthen enforcement of the federal securities laws;
- To strengthen and restore confidence in the auditing profession;
- To improve executive responsibility and the "tone at the top" at companies;
- To improve disclosure and financial reporting; and
- To improve the performance of gatekeepers, such as accounting firms, research analysts and attorneys.

The Act called on the Commission to undertake nearly 20 rulemakings and studies. The Act also set ambitious deadlines for the Commission, and in most cases required us to implement the final rules speedily. The Commission completed the bulk of the rulemaking within six months and completed all required rulemaking in less than a year after the Act's enactment, having considered the thousands of letters of public comment that we received. 2004 marked the first year that the nation's largest companies, comprising more than 95% of U.S. market capitalization, were fully subject to all of the new regulatory requirements of the Sarbanes-Oxley Act.

Just as the Sarbanes-Oxley Act was a landmark piece of legislation for Congress, the successful implementation of that legislation will be seen as a watershed in the history of the Commission. Given the scope and the scale of the task Congress placed before us, I am pleased to report that with the dedication and hard work of its staff, the Commission's overall discharge of its rulemaking responsibilities has been exceptionally "on the mark" in fulfilling the Act's objectives while avoiding unnecessary problems. Among the many benefits have been CEO and CFO certifications, accelerated electronic insider transaction filings, independent audit committees with increased responsibilities, and strengthened internal controls. Collectively, these accomplishments should have an enormous positive impact on the management and governance of U.S. public companies in the decades ahead, and should help to safeguard the fundamental imperative that our markets be characterized by levels of investor confidence and participation that are second to none.

Although most of the Act's benefits have been accomplished without substantial expense for market participants, we should not minimize the cost to public companies and their investors of achieving the full measure of the Act's objectives. In particular, the internal control reporting and auditing requirements, which companies are dealing with for the first time, have required significant outlays of time and expense. We expect that the short-term costs to improve internal control over financial reporting will over the long-term result in structurally sounder corporate practices and more reliable financial reporting. With these critical goals now firmly in view, calls to roll back or weaken Sarbanes-Oxley generally as a result of concern over the costs of internal control reporting are, in my judgment, unjustified.

At the same time, the Commission and the PCAOB must be sensitive to the need to recalibrate and adjust our rules and guidance to avoid unnecessary costs or unintended consequences. To this end, the Commission and the PCAOB will remain committed to the implementation of the Act in the most efficient and effective way.

I would like to review a few specific accomplishments.

II. Restoring Confidence in the Accounting Profession

A central focus of the Sarbanes-Oxley Act was to enhance the integrity of the audit process and the reliability of audit reports on issuers' financial statements. The Commission has taken the actions directed by the Act in this area and, when appropriate, pursued additional measures with the goal of restoring public confidence in the independence and performance of auditors of public company financial statements. The Commission's actions in this area in response to the Act include:

- Adoption of new rules related to auditor independence;
- Adoption of new rules related to improper influence on auditors;
- Adoption of new rules related to retention of records relevant to audits and review of financial statements;
- A study on principles-based accounting standards;
- Recognition of the Financial Accounting Standards Board as an accounting standard-setting body under the Act; and
- Oversight of the PCAOB.

Based on the information we have received, we believe the new rules have begun to have a beneficial effect in strengthening the integrity of the independent audit. We also have seen that audit committees are taking their responsibilities seriously and that they are much more sensitive to auditor independence issues.

Because Chairman McDonough is here today, I will not review with you the important work of the PCAOB, but I do want to emphasize that the Commission and the Board have forged a close working relationship. In addition to coordinating with us on major projects related to auditing matters, the PCAOB has agreed to prepare a long-range strategic plan for its operations and budget as well as a self-assessment of the internal controls for its operations and budget. In addition, the Commission is preparing to conduct its initial examination of the PCAOB, as contemplated by Section 107(a) of the Act. We anticipate receiving the strategic plan and self-assessment and commencing our initial examination of the PCAOB prior to our review of the PCAOB's 2006 budget, in accordance with our statutory responsibility to oversee the PCAOB.

III. Strengthening the Enforcement of the Federal Securities Laws

The Act also has helped the Commission to restore investor confidence in the capital markets by strengthening enforcement of the federal securities laws. The Act added a number of new weapons to the Commission's enforcement arsenal to better deter would-be securities wrongdoers and compensate injured investors.

Overall, the Act has strengthened the Commission's ability to obtain meaningful remedies as well as powerful but fair sanctions against wrongdoers, aided in the greater return of investor funds, created new causes of action, provided the Commission with more flexibility in choice of forum, and enhanced the Commission's ability to continue to conduct thorough, effective, and fair investigations.

One of the toughest challenges facing the Commission has been finding, recovering, preserving and, when appropriate, returning funds to injured investors. Two of the most powerful tools that the Act gave the Commission to help meet this challenge are the "Fair Funds" provision under Section 308(a) of the Act and the authority to seek a temporary freeze of extraordinary payments by an issuer under Section 1103 of the Act.

The Fair Funds provision authorizes the Commission to take civil penalties collected in enforcement cases and add them to disgorgement funds for the benefit of victims of securities law violations. Before the Act, by law, all civil penalties were paid into the U.S. Treasury. Now, the Commission has authority, in certain circumstances, to use civil penalties to help compensate injured investors. The Commission has authorized Fair Funds in over 100 cases, with a total value of over $5.2 billion for anticipated distribution to harmed investors.

There is still room for improvement, however. First, Fair Funds authority is limited to cases in which disgorgement is ordered against the same individual against whom we are imposing a penalty. There are cases, however, in which there is no ill-gotten gain – or disgorgement – to be obtained from a particular individual but against whom it is appropriate to impose a penalty. In these cases, under the existing Fair Funds provision, we do not have authority to use the civil penalty to compensate injured investors. In reports pursuant to Sections 308(c) and 704 of the Act, we recommended several amendments to the current law that we believe will assist our collection program, strengthen our enforcement efforts generally, and provide more compensation for injured investors. These recommendations were incorporated in the Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179. We appreciate your extraordinary efforts and support and are hopeful that these proposals will eventually become law.

As we continue to use the Fair Funds provision, we have faced some challenges in administering the program – and doing it fairly, expeditiously, efficiently, and with the greatest possible return to injured investors. It is a learning process for us as well, and over the past year, we have taken a number of steps to increase the amounts returned to harmed investors including:

- in administrative orders, requiring settling respondents to pay the costs of distribution for complex distributions;
- where appropriate, consolidating individual verdicts and funds in related cases; and
- whenever possible, seeking to ensure that Fair Funds monies awaiting distribution are earning interest.

The other provision I would like to highlight is Section 1103, which allows the Commission to seek a temporary order to escrow extraordinary payments by an issuer to its directors, officers, partners, controlling persons, agents, or employees. Section 1103 allows us to prevent the payment of "extraordinary" rewards to executives and others while the company is subject to a Commission investigation. Whereas, previously, top executives potentially had the ability to remove and dissipate company assets while an investigation was ongoing, the Act, under appropriate circumstances, allows us to preserve the status quo while our enforcement staff concludes its investigation and gathers evidence to determine whether such payments are warranted.

"Congress designed Section 1103 to add necessary teeth to the Commission's ability to perform its mission. It ensures that recovery by way of disgorgement, etc., is effective rather than empty." That is what the Court of Appeals for the Ninth Circuit recently stated in its opinion affirming the freeze of extraordinary payments to the CEO and CFO that we sought in the Gemstar-TV Guide International case. Needless to say, Section 1103 will continue to be a valuable and powerful tool.

IV. Improving Executive Responsibility and the "Tone at the Top"

Another critical objective of the Act was to improve executive responsibility and the "tone at the top" of public companies — a key theme that dates back to President Bush's ten-point plan of March 2002. The tone set by top management of a company contributes greatly to the integrity of a company's financial reporting process. The provisions of the Act that the Commission has implemented addressing this theme include:

- Certification by CEOs and CFOs of company reports;
- Required disclosure regarding codes of ethics for CEOs and senior financial officers;
- Electronic filing within two days after securities transactions by insiders; and
- Prohibition on trading by insiders during pension fund blackouts.

Among these, the certification provisions have perhaps had the greatest immediate impact. The Act affirms senior executive responsibility for the financial reporting process of public companies by requiring CEOs and CFOs to certify the financial and other information in their reports filed with the Commission. In addition, as discussed below, 2004 marked the first year that many companies have had to comply with the requirements of Section 404 of the Act, and the certification provisions reflect that requirement. While CEOs and CFOs already had responsibility for company disclosures in the filings in question, the certification requirements have focused their attention on the completeness and accuracy of disclosure in important ways.

In implementing Section 302 of the Act, the Commission complemented the certification provisions with a requirement that companies maintain adequate disclosure controls and procedures. These are controls and other procedures designed to ensure that information required to be disclosed is recorded, processed and accurately reported within the required time frame. This requirement is intended to ensure that information is captured, evaluated as to materiality, and disclosed, if required, in a timely manner, and we believe it also has had a key role in making the certification requirements more effective.

V. Improving Disclosure and Financial Reporting

In addition to increasing focus on executive responsibility, the Act takes several important steps toward improving disclosure and the financial reporting process. Accurate and reliable financial reporting is the bedrock of our disclosure-based system of securities regulation. Investor confidence in the reliability of information in a company's filings with the SEC is fundamental to the vibrancy of our markets. The rules the Commission adopted in this area to implement the Act include those requiring:

- Enhanced disclosure of off-balance sheet transactions;
- Disclosure regarding the use of non-GAAP financial measures;
- Increased disclosure of material current events affecting companies; and

- Public reporting on companies' internal control over financial reporting by both management and auditors.

Although each of these reforms is very important in its own right, the reform that has drawn the most attention recently is Section 404's requirement that management assess the effectiveness of a company's internal control over financial reporting and that external auditors attest to, and report on, that assessment. This requirement went into effect for large public companies in the 2004 audit cycle. Companies representing over 95% of total U.S. market capitalization are now obligated to comply with Section 404's reporting requirements.

An effective system of internal control over financial reporting is very important in producing reliable financial statements and other financial information used by investors. The establishment and maintenance of internal control over financial reporting has been required of public companies since the enactment of the Foreign Corrupt Practices Act of 1977. The Sarbanes-Oxley Act has brought a new focus to internal controls and encouraged companies to devote adequate resources and attention to the maintenance of those controls. The requirements of Section 404 may have the greatest long-term potential to improve financial reporting by public companies by helping to identify potential weaknesses and deficiencies in internal controls. In addition, although no system of internal controls can detect every instance of fraud, good internal controls may help companies deter fraudulent financial or accounting practices or detect them earlier and perhaps minimize their adverse effects.

Much of the discussion about the Section 404 requirements recently has focused on the costs of implementation and the number of companies that have announced that they or their auditors have been unable to complete their assessments or audits of internal controls, or that they have discovered material weaknesses in their internal controls as a result of their first assessments. While important, neither of these issues should distract from the underlying benefit of the new requirements.

With regard to the implementation costs, there is no doubt costs have been higher than we and public companies anticipated, though I believe it important to note that a substantial portion of the cost may reflect initial start-up expenses as many companies, for the first time, conducted a systematic review and documentation of their internal controls. In this regard, a number of commentators have suggested that costs in the second and subsequent years will decrease substantially.

On the other hand, we also heard that some costs may have been unnecessary. For example, it appears that some participants in the initial implementation phase may have taken an approach that resulted in excessive or duplicative effort. The Commission and the PCAOB are working to provide appropriate guidance in order to clarify these issues for the 2005 audit cycle.

In any event, implementing Section 404 has not been easy for public companies and has required significant outlays of time and expense. Even companies that started with a sound system of controls have faced the task of documenting and comparing them against an objective benchmark. This is a complex undertaking for a small company, and exponentially more so for a firm with multiple lines of business, thousands of employees and global operations.

While we can and will do more on the subject of Section 404, there is undoubtedly enormous cost to investors of corner-cutting in internal controls. The

Section 404 effort should improve not only the quality of information to shareholders, but also the quality of information management relies on to make decisions. So while investors benefit, they also may find that the companies they are invested in are better managed.

As for material weaknesses and other deficiencies that have been reported during this first year of implementation, it is important to note that investors will benefit from receiving full disclosure regarding any material weaknesses that are found — disclosure about the nature of any material weakness, their impact on financial reporting and the control environment, and management's plans for remediating them. Section 404 was intended to bring such information into public view. This increased level of transparency should also ensure that the disclosure of a material weakness is the starting point and not the ending point of investors' analysis.

There can be many different types of material weaknesses and many different factors may be important to the assessment of any particular material weakness. A material weakness in internal controls should not alone necessarily be motivation for immediate or severe market reaction. When armed with sufficient information about weaknesses and remediation plans, investors appear to be making reasoned judgments about whether those disclosures affect the mix of information they use to make investment decisions. The goal should be continual improvement in controls over financial reporting and increased investor information and confidence.

Of course, the Commission has been and will continue to evaluate the implementation of our rules and the auditing standard issued by the PCAOB to ensure that these benefits are achieved in the most sensible way. Section 404 reporting is too important not to get right. We have issued several measured extensions over this past year to accommodate the first wave of reporting under the Section 404 provisions. In each case, our motivation was to be sure that companies and their auditors have the time and resources necessary to implement the new requirements correctly. Our staff also issued several rounds of guidance in the form of answers to frequently asked questions about application of the new provisions.

In addition, we have actively sought feedback about first year experiences in implementing the Section 404 requirements, in order to determine if the Commission rules and PCAOB standards are operating as intended. Just last week, we held a public roundtable to review the first year's experience with implementation of the internal control requirements, and we are continuing to assess feedback from the public regarding companies' and auditing firms' implementation of these new reporting requirements.

At the roundtable, we heard from a distinguished and diverse group of panelists, including company management, audit committee members, auditors, investors and analysts, about their experiences with the implementation of the internal control requirements. The roundtable discussion revealed that many companies have experienced benefits and improvements to their internal controls as a result of implementing these requirements, and these requirements also have led to an improved focus on internal controls by all. However, as I mentioned earlier, we also heard there are some areas related to implementation of the new requirements that need further attention or clarification.

We currently are evaluating whether there are ways we can make the process more efficient and effective while preserving the benefits. Throughout our evaluation we are closely coordinating with the PCAOB, and I have instructed our staff to consider, as quickly as possible, whether and how we can improve the guidance available to management and auditors in order to improve the effectiveness of the process. Chairman McDonough also announced at the roundtable that the PCAOB envisions issuing its first set of guidance as early as May 16th. In addition to any guidance or potential rulemaking the Commission or the PCAOB may consider, there also has been an expressed desire for the sharing of best practices so that companies and auditors can benefit from the substantial learning that has taken place from the first year of implementation. We wish to encourage and facilitate these efforts. I also am supportive of the PCAOB's announced efforts to review and evaluate the results of the first year of auditor internal control reports.

The responsiveness we are demonstrating with Section 404 represents a critical aspect of the Commission's approach to implementation of the Act—that we can and must address unnecessary costs and unintended consequences while rigorously ensuring that we maintain the investor safeguards of good disclosure and transparency. We are actively engaged in other activities to evaluate and assess the effects of the internal control reporting rules, and other disclosure provisions of the Act, especially on smaller companies. For example, we established the Securities and Exchange Commission Advisory Committee on Smaller Public Companies, which held its first meeting last week. The committee will conduct its work with a view to protecting investors, considering whether the costs imposed by the current regulatory system for smaller public companies are proportionate to the benefits, and identifying methods of minimizing costs and maximizing benefits. In addition, at our request a task force of the

Committee of Sponsoring Organizations (COSO) of the Treadway Commission has been established. The task force anticipates publishing additional guidance this summer in applying COSO's framework for internal control over financial reporting to smaller companies. I also am supportive of the PCAOB's efforts to be sensitive to the special challenges smaller companies face in the implementation of Section 404.

We also are cognizant of the regulatory challenges our foreign registrants face. In addition to accommodations we made for foreign companies in our rules, we recently extended the compliance date for internal control reporting for an additional year for foreign public companies, as well as smaller companies. We are seeking input from foreign registrants regarding their experiences to date, including at last week's roundtable. In addition, review of the first year experiences of larger U.S. registrants should help identify issues and best practices for foreign registrants.

VI. Improving the Performance of "Gatekeepers"

In addition to addressing auditors and the accounting profession, as discussed above, the Sarbanes-Oxley Act and our new rules have required better focus by other gatekeepers in our capital markets on their proper roles, and I believe we are seeing a positive effect as a result. The effective operation of gatekeepers in the marketplace is fundamental to preserving the integrity of our markets. Unfortunately, revelations from the recent corporate and accounting scandals revealed that these parties did not always fulfill their role. The actions the Commission took in response to the Act in this area included:

- Rules governing research analyst conflicts of interest;
- Standards of conduct for attorneys practicing before the Commission;

- A study on rating agencies and proposed Commission rulemaking in this area; and
- Rules requiring that companies disclose whether they have a financial expert on their audit committees.

Recognizing that financial statements, financial reporting and the audit itself form the bedrock upon which full and accurate disclosure is built, the Act further recognized the importance of the audit committee in these processes. In addition to the disclosure requirements regarding audit committee financial experts, Section 301 of the Act called for, and the Commission adopted, rules directing the nation's exchanges to prohibit the listing of any security of a company that is not in compliance with the audit committee requirements established by Section 301. Under the new rules, listed companies must meet the following requirements:

- All audit committee members must be independent;
- The audit committee must be directly responsible for the appointment, compensation, retention and oversight of a company's outside auditors, and the outside auditors must report directly to the audit committee;
- The audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting and auditing matters, including procedures for the confidential, anonymous submission of concerns by employees; and

The company must establish funding for the audit committee, including the means to retain and compensate independent counsel and other advisors, as the audit committee determines necessary to carry out its duties.

The new rules apply to both domestic and foreign companies that have securities listed in the United States. Based on significant input from and dialogue with foreign regulators and foreign issuers, however, several accommodations for foreign issuers were included in the final rules to address potential conflicts with foreign legal requirements, where consistent with fulfilling the investor protection mandate of the Act.

Following-up on Commission requests that pre-dated Sarbanes-Oxley, the New York Stock Exchange and the Nasdaq both amended their listing standards to fulfill the principles underlying this provision of the Act. In late 2003 the Commission approved listing standards that increased board independence and effectiveness by, among other things, mandating that boards be composed of a majority of independent directors, requiring executive sessions outside the presence of management and requiring strong audit, compensation and nominating/governance committees composed of independent directors. In addition, separate from Sarbanes-Oxley, we approved changes to listing rules to require shareholder approval of equity compensation plans.

These are significant changes that should have a lasting impact on improving responsibility and accountability in our markets. In terms of impact to date, we know that many companies have restructured at least part of their boards to satisfy the new stricter independence standards for directors, the majority independent director requirement and the requirement that only independent directors be involved in processes relating to auditing, director nominations, governance and compensation. These requirements have continued the movement to refocus attention on the importance of independent directors. We expect that the markets will be evaluating the performance of companies under these new requirements.

VII. Conclusion

Before concluding, I would offer my own observation that the real key to achieving the great potential of the Sarbanes-Oxley Act lies not with the Commission or the PCAOB, but with the dedicated and serious efforts of American businesses and their managers, who probably have the most to gain from preserving the reputation of our markets as the best place in the world for investment capital. A wise man once remarked that "capital will always go where it is welcome, and stay where it is well treated." I believe that a company that recognizes the true benefits of the Act in strengthening our capital markets will have no trouble seeing that effective compliance with Sarbanes-Oxley – doing the right thing – is not only in the best interests of its investors, but the long-term interests of the company itself.

Let me again thank you for your leadership and vital support in re-establishing and strengthening investor confidence in the integrity of our nation's capital markets. Throughout the massive rule-making projects directed by the Sarbanes-Oxley Act, the goals of the Commission and its staff have been to protect investors and restore confidence in our securities markets. The Commission has been and will continue to monitor carefully the implementation and effects of the new rules and requirements, and we will continue to take actions as appropriate to ensure that the objectives of the Act are achieved, while unnecessary burdens on companies, auditors, advisers and other market participants, as well as the economy, are avoided.

Thank you for inviting me to speak on behalf of the Commission. I would be happy to answer any questions.

Testimony Concerning
The Public Company Accounting Oversight Board

PCAOB
Public Company Accounting Oversight Board

William J. McDonough
Chairman
Public Company Accounting Oversight Board

Before the
Committee on Financial Services,

United States House of Representatives

April 21, 2005

Chairman Oxley, Ranking Member Frank, and Members of the Committee:

I am pleased to appear today before the House Financial Services Committee on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board").

I want to begin by taking a moment to thank the Committee for its strong bipartisan support of the PCAOB. We benefit greatly from your wisdom and encouragement, and from our positive working relationship.

Through the Sarbanes-Oxley Act, the Congress took a giant step toward restoring shaken investor confidence in financial reporting and auditing of public companies. The Act did not merely create a regulatory environment conducive to investor protection; it also reflected the powerful demand of the American people for fairness and honesty from those participants in the U.S. markets who benefit from the people's investments. More than half of all households in America have invested in our securities markets,[1/] and the resources those investments provide to business is a driving force behind the U.S. economy. The more confidence that investors have in the financial information available to them about the issuers of securities, the more resources they will pour into our businesses, both large and small, to fuel the growth and competitiveness of our economy.

I. Introduction

The PCAOB is well on its way to maintaining, as required in the Act, a continuous program of auditor oversight "in order to protect the interests of investors and further the

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[1/] Marianne A. Hilgert and Jeanne M. Hogarth, "Household Financial Management: The Connection between Knowledge and Behavior," Federal Reserve Bulletin July 2003, at 317.

public interest in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."[2] The Board has hired a staff of 319, including auditors, analysts, attorneys, and others, and we expect to have approximately 450 employees by the end of this year. Roughly half of our staff is based in our headquarters in Washington, D.C. In addition, we have offices in New York City and the Atlanta, Chicago, Dallas, Denver, San Francisco, and Orange County (California) areas to support our ongoing inspections of registered accounting firms. We also have an office near Dulles, Virginia, to support our significant investments in technology.

With that brief background, let me now turn to the three main topics that I would like to address today. First, I will discuss our work to ensure a smooth implementation of the Act's requirements that public companies and their auditors provide investors with annual assessments of, and related attestations concerning, the companies' internal control over financial reporting. Second, I want to address the impact that independent oversight is having on the practice of public company auditing for both large and small auditing firms. And, finally, I will describe our vision and progress in building an auditor oversight model that meaningfully reduces the risks of financial reporting and auditing failures in U.S. public securities markets.

2/ Sarbanes-Oxley Act, Section 101(a).

II. Internal Control Assessments and Related Audit Work

The Sarbanes-Oxley Act has had a profound effect on the integrity of financial reporting in U.S. capital markets and the reliability of public company audit reports. The Act has touched virtually every aspect of the financial reporting process, from preparers' certifications of accuracy to the independence of third-party analysis, covering the integrity of gatekeepers such as lawyers and auditors in between. Although some of these changes took effect immediately and have been in place for some time, the participants in the financial reporting process are now implementing one of the most challenging but also most promising provisions of the Act.

Specifically, Section 404 of the Act requires public companies annually to provide investors an assessment of the quality of their internal control over financial reporting, accompanied by an auditor's attestation on the same subject. In the simplest terms, investors can have much more confidence in the reliability of a corporate financial statement if corporate management demonstrates that it maintains adequate internal control over bookkeeping, the sufficiency of books and records for the preparation of accurate financial statements, adherence to rules about the use of company assets and the possibility of misappropriation of company assets. Companies have been required to have internal control over their accounting since the Congress enacted the Foreign Corrupt Practices Act in 1977. There is no doubt, however, that the Sarbanes-Oxley Act's requirement for annual assessments, and auditor attestations to those assessments, took corporate responsibilities for internal control over financial reporting to an entirely different level.

A. The Act's Internal Control Requirements Have Fundamentally Changed the Way Public Company Audits are Conducted

As directed by Section 404, in June 2003 the Securities and Exchange Commission established rules describing the required assessments by public companies, and in March 2004 the PCAOB followed with a new auditing standard – Auditing Standard No. 2 ("AS No. 2") – providing for an integrated audit of both internal control over financial reporting and the financial statements themselves.[3/]

We are now in the midst of the first round of annual assessments and attestations. For large, established companies – which the SEC calls accelerated filers – the initial assessments and attestations were required by SEC regulations to be included in their annual Form 10-K filings for fiscal years ending after November 14, 2004. Calendar-year companies were thus required to file their reports on or before March 16 last month. The SEC has allowed accelerated filers with market capitalizations below $700 million an additional 45 days to file their internal control reports.[4/] For non-accelerated filers – which are essentially the smallest public

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[3/] See Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238 (June 5, 2003); PCAOB Auditing Standard No. 2 ("AS No. 2").

[4/] See Order under Section 36 of the Securities Exchange Act of 1934 Granting an Exemption from Specified Provisions of Exchange Act Rules 13a-1 and 15d-1, Exchange Act Release No. 50754 (Nov. 30, 2004); see also PCAOB Rule 3201T (temporarily permitting auditors of certain issuers not to date theirs reports on internal control the same date as their reports on financial statements).

companies – and foreign companies with securities traded in the U.S., Section 404 reporting will begin in 2006.[5/]

Although the term "internal control over financial reporting" has only recently entered our common parlance, internal control is a familiar concept to most auditors. As auditing evolved from a process of detailed examination of individual transactions and account balances toward a process of testing samples, greater consideration of a company's internal controls became necessary in planning an audit.[6/] If an internal control had been adequately designed and was operating effectively, then longstanding auditing standards permitted the auditor to rely on less costly and time-consuming procedures.[7/] Conversely, if an auditor determined that a control was inadequate in its design or operation, then the auditor could not rely upon that control.[8/] In this event, the auditor would take a considerably more detailed approach by relying almost exclusively on detailed tests of account balances and transactions.

[5/] See Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-accelerated Filers and Foreign Private Issuers, Securities Act Release No. 8545 (March 2, 2005).

[6/] Accounting Series Release No. 21, 11 F.R. 10921 (Feb. 5, 1941) (amending Reg.S-X to provide that "in determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff.").

[7/] See AU Section 317.03. Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, temporary rules that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"), including AU Section 317. These standards, originally codified by the American Institute of Certified Public Accountants, are reproduced on our Web site at http://www.pcaobus.org/standards/interim_standards/Auditing_Standards_TOC.asp.

[8/] See AU Section 317.04.

Sections 103 and 404 of the Act, and the PCAOB's Auditing Standard No. 2, changed that audit model. Today, auditors of companies subject to Section 404 must not only obtain an understanding of internal control, but they must also examine the design and operating effectiveness of internal control sufficient to render an opinion as to that effectiveness, as required by Section 103(a)(2)(A)(iii). In order to reap the most benefit from this examination, and to make the overall audit process as efficient as possible, we designed in Auditing Standard No. 2 an integrated audit model.

An integrated audit combines an audit of internal control over financial reporting with the audit of the financial statements. In an integrated audit, the auditor's examination of internal control is validated by the auditor's findings in the audit of the financial statements. In addition, the auditor's findings and conclusions reached in the audit of internal control help the auditor better plan and conduct the auditing procedures designed to determine whether the financial statements are fairly presented. The two processes are mutually reinforcing. In this way, the integrated audit helps to achieve the Congress's intention to improve the quality and integrity of both corporate controls over financial reporting and of independent financial statement audits.

We adopted the integrated audit model in March of 2004, and it was approved by the SEC in June 2004. For the past year we have been working with auditors and issuers to understand the challenges they encounter and, where appropriate, to provide additional interpretive guidance and rules to facilitate implementation.[9/] Since March

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[9/] PCAOB staff have formed informal, ad hoc working groups of auditors and issuers to assist the staff in understanding the challenges both auditors and issuers face. In addition, the Board has

2004, the PCAOB staff has issued four sets of interpretive guidance that answer 37 frequently asked technical questions on the implementation of Auditing Standard No. 2. Moreover, the Board has embarked on two additional rulemakings. First, the Board adopted a temporary rule to complement a Commission rule that provides companies that are considered accelerated filers but have market capitalizations of less than $700 million with an additional 45 days to file their internal control reports. The Board's rule provides auditors extra time to complete their internal control audits of those companies.[10/] Second, just last month the Board proposed a new auditing standard that would permit auditors to attest to company managements' assertions that they have corrected material weaknesses in between annual assessments.[11/]

In addition, on April 13, 2005, we participated in the SEC's daylong roundtable discussion with issuers, auditors, investors and others about the challenges of implementing Section 404 requirements. As I announced after that meeting, we will issue additional guidance to respond to the matters raised there on May 16. Finally, we will also devote the entirety of our next meeting with our Standing Advisory Group – on June 8 and 9 – to this topic, to further explore implementation issues.

While the first internal control reports have just begun to be released over the last month, public companies and their auditors have been hard at work to prepare for these

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held public discussions with its Standing Advisory Group to consider implementation and other issues related to internal control reporting.

10/ See PCAOB Rule 3201T.

11/ See PCAOB Release No. 2005-002 (March 31, 2005).

first assessments and attestations. For many public companies, this has meant major efforts to improve their internal controls over financial reporting. For auditing firms, this has meant a major effort to develop new audit methodologies and train staff to perform a different kind of audit.

In light of this work, many companies have already reaped benefits from the internal control reporting process. For example, 79 percent of 222 financial executives recently surveyed by Oversight Systems reported that their companies have stronger internal control after complying with Section 404. Seventy-four percent said that their companies benefited from compliance with the Act and, of those, 33 percent said that compliance lessened the risk of financial fraud.[12/] Preliminary analyses show that eight percent of companies' 2004 annual assessments filed as of April 5, 2005, reported material weaknesses in their internal control over financial reporting.[13/] By identifying

[12/] "Financial Executives Call Sarbanes-Oxley Compliance a 'Good Investment,' According to Oversight Survey," Press Release of Oversight Systems, Inc. (December 14, 2004).

[13/] Source: Audit Analytics; see also Remarks of SEC Chairman Donaldson at Roundtable on Implementation of Sarbanes-Oxley Internal Control Provision (April 13, 2005), available at http://www.connectlive.com/events/secicrp/. So far, the types of material weaknesses we are seeing suggest that the process leads to disclosure of meaningful information for shareholders. For example, according to Compliance Week, approximately 50% of the material weaknesses disclosed in both 2004 and 2005 related to financial systems and procedures, including problems with the financial close process, account reconciliation, or inventory processes. Another significant area is personnel problems, including poor segregation of duties (which can lead to employee misappropriations in addition to financial reporting problems), inadequate staffing and expertise, and related training and supervision problems. See "Material Weakness, Deficiency Disclosures in February 2005," Compliance Week (Apr. 2005), at 22. When companies provide robust disclosure about the relationship between a reported weakness and the reliability of the financial statements, in addition to disclosure about the company's efforts to correct the weaknesses, report users have shown confidence in the company's actions. See Special Comment, Section 404 Reporting on Internal Control: Our Early Experience, Moody's Investors Services (Ap. 2005) ("In general, despite material weaknesses, we are finding that rating actions are not needed in many cases because: control problems appear to be specific, localized and correctable within a short period; the rating already reflects our impression of control weakness; or management's plan for remediating the control problem appears credible.")

material weaknesses before financial reporting failures occur, these companies are reducing their risk of future loss of shareholder value, as well as personal risks to their board members and managers.

In addition, investors in our capital markets now, for the first time in our history, have the benefit of both management's assessment, and the independent auditor's opinion concerning, the effectiveness of internal control over the preparation of the financial statements. This should increase investor confidence in the reliability of those reported results.[14/] And that, in turn, should reduce the cost of capital for companies with effective internal control over financial reporting.

B. PCAOB's Efforts to Address Cost and Other Concerns

Although enhanced internal control has the potential to bestow significant benefits, there have been concerns about the cost of those enhancements and about whether those enhancements create counterproductive, unintended consequences. No doubt you have heard complaints that the way auditors have implemented the new requirements has exacerbated some of these concerns. We have an opportunity, in our inspections of registered firms, to assess whether auditors implement new standards

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[14/] According to Moody's Investors Service, strong internal control is key to restoring investor confidence:

> We believe that reports on internal control are a significant development in restoring investor confidence in financial reporting, which has been badly shaken in recent years. We perceive that companies are strengthening their accounting controls and investing in the infrastructure needed to support quality financial reporting. Most of the control problems disclosed in the reports do not appear to be new, and are coming to light because of closer scrutiny – not because new problems are occurring.

Special Comment, Section 404 Reporting on Internal Control: Our Early Experience, Moody's Investors Services (Ap. 2005), at 1.

appropriately. As described above, however, we are not waiting for our inspections to guide auditors away from inappropriate implementation when we learn of it. Throughout this first year of implementation of Section 404, we and our staff have carefully monitored implementation issues as they have arisen and, where appropriate, have issued additional guidance to promote consistent and rational implementation.

For example, some have charged that auditors are implementing Auditing Standard No. 2 with a "check-the-box" mentality about control testing that focuses on minutiae that are unlikely to affect the financial statements. Auditing Standard No. 2 requires testing of controls that are designed to make it probable that the financial statements are fairly presented in all material respects. While it is necessary for the auditor to understand the overall control system and to "walk through" the operation of all significant control processes, the focus should indeed be on what is material to the financial statements, not on the trivial. Auditors should not allow an unthinking emphasis on computer systems, for example, to distract them from the more qualitative risks of misconduct by top management. Further, while Auditing Standard No. 2 does not ignore overall systems, it expressly permits the auditor considerable flexibility to rely on the work of others, including, for example, by "us[ing] internal auditors to provide direct assistance in the audit of internal control over financial reporting."[15/]

In addition, some smaller companies have charged that they are disproportionately burdened because auditors are not tailoring their audit procedures to

[15/] Staff Questions and Answers: Auditing Internal Control over Financial Reporting (rev. Nov. 22, 2004), Q&A No. 36 at 12-13; AS No. 2, ¶ 108.

the nature and complexity of the client. Smaller, less complex businesses typically need less complex controls, and the work of the auditor should reflect that fact. Auditing Standard No. 2 is no different from any other auditing standard in that it does not prescribe detailed audit programs for specific sizes of companies. For as long as the profession has established auditing standards, auditors have used those standards to fashion audit plans in a manner that addresses the nature and complexity of the audit client. The fact that the Sarbanes-Oxley Act did not expressly establish classes of audit clients in no way limits the auditor's ability – indeed, responsibility – to use judgment to plan an audit that is appropriate to the circumstances. In the case of small companies, this should include the special considerations outlined by the Committee of Sponsoring Organizations of the Treadway Commission (also referred to simply as "COSO") for internal control in such companies.

As Chairman Oxley has said, "Today's small companies are tomorrow's large ones, and it's important that all of us work together to address their specific needs and to properly guide them toward compliance."[16/] I believe strongly in that maxim. In that regard, we stressed in both the proposing and adopting releases for Auditing Standard No. 2 that auditors should tailor their audit programs to suit the size, complexity and nature of the audit client,[17/] and my fellow Board members and I have stated publicly

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[16/] Sarbanes-Oxley: Making the Investment, Reaping the Rewards, Remarks by Chairman Michael G. Oxley, House Financial Services Committee, at Georgetown University Law Center Corporate Counsel Institute (March 10, 2005).

[17/] See PCAOB Release No. 2003-17 (Oct. 7, 2003) ("Internal control is not 'one-size-fits-all,' and the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company. . . . For a smaller, less complex company, the Board expects that the auditor that we will use our inspection program to make sure that smaller companies are not subjected to needless cost and burdens.

While we are committed to giving interpretive guidance where we can, we expect auditors and issuers alike to exercise judgment in applying Auditing Standard No. 2 in a manner that is appropriate given the context of the audit. Our goal in providing implementation guidance is not to create a detailed checklist for conducting an audit. Rather, our goal is to help auditors and others better understand the principles underlying the standards and better appreciate why it is important that they use judgment in applying them.

Another area of concern for us is the misconception that companies may no longer look to their auditors for advice on difficult accounting issues. Auditing Standard No. 2 provides that an auditor's detection of a material misstatement in financial statements is a "strong indicator" of a material weakness in internal control. In addition, the prospect of PCAOB inspectors enforcing longstanding rules on auditor independence, which prohibit the auditor from preparing a client's financial statements and from making financial reporting decisions on behalf of management,[18] seems to

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will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control."; see also PCAOB Release No. 2004-001 at 9 (March 9, 2004) ("In smaller companies, or in companies with less complex operations, the ethical behavior and core values of a senior management group that is directly involved in daily interactions with both internal and external parties might reduce the need for elaborate internal control systems.").

[18] See SEC Regulation S-X, Rule 2-01(c)(4)(i) (stating that an auditor is not independent of an audit client if it "prepar[es] the audit client's financial statements"); Rule 2-01(c)(4)(vi) (stating that an auditor is not independent of an audit client if it "perform[s] any decision-making, supervisory, or ongoing

have led some to conclude that management and the auditor should not consult on accounting and internal control questions.

Auditors have long advised public companies on accounting issues and on internal control matters, however, and Auditing Standard No. 2 does not preclude that kind of advice and discussion. Be assured that we have no intention of discouraging discussion and debate between corporate managements and auditors through a game of "gotcha"; rather, our inspection program for reviewing integrated audits calls for inspectors to look for and encourage robust substantive discussions among the auditor, management and the audit committee. To help dispel confusion on this issue, our staff has issued specific guidance on this point, making clear that, in fact, "information-sharing on a timely basis between management and the auditor is necessary."[19/]

Before leaving this subject, I want to emphasize the unique importance of the PCAOB's inspection function in connection with our ability to monitor the implementation of Auditing Standard No. 2. We have numerous channels for feedback

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monitoring function for the audit client"); see also Meeting of PCAOB Standing Advisory Group, February 16, 2005, available at http://www.connectlive.com/events/pcaob/.

[19/] Staff Questions and Answers: Auditing Internal Control over Financial Reporting (rev. July 27, 2004), Q&A No. 7 at 5. This guidance explains that AS No. 2 requires an auditor to judge whether, once all applicable controls have operated, the company is able to prepare financial statements that are free of material misstatements. This means that the auditor's own involvement, including "the results of auditing procedures[,] cannot be considered when evaluating whether the company's internal control provides reasonable assurance that the company's financial statements will be presented fairly in accordance with generally accepted accounting principles." Id. In addition, the guidance suggested ways that company management can share and discuss draft financial statements without confusion as to whether the auditor's own work served as a part of the control process, by engaging in "clear communications (either written or oral) with the auditor about the . . . state of completion of the financial statements; [the] extent of controls that had operated or not operated at the time; and [the] purpose for which the company was giving the draft financial statements to the auditor." Id. At 6.

about how issuers, auditors and others feel Section 404 implementation is going, including our informal working groups, the SEC's recent roundtable discussion, our Standing Advisory Group's meetings, and other ad hoc meetings.[20] No one else, however, has the opportunity and mandate that the PCAOB has to see how auditors are implementing the standard first-hand by reviewing individual engagements in our inspections. Our inspections and standards-setting functions are in a continual feedback loop, so to speak. The Congress showed great wisdom in structuring the Board in this fashion. This structure gives us the opportunity to investigate what we have heard anecdotally. Through inspections we can assess claims that auditors do not seem to be making good decisions, ascertain the cause, and then do something about it. On the other hand, we may – and I expect we will – find evidence that the best practices of some auditors have helped to reduce the risk of financial reporting failures.

III. The Impact of Independent Oversight on the Auditing Profession

Although public attention to the work of the PCAOB has recently focused most intensely on the PCAOB's role in implementing Section 404, the more significant, long-term effects of our work will be the product of our oversight activities. The Act requires all accounting firms that prepare or issue audit reports on the financial statements of public companies to be registered with the PCAOB.[21] Once registered, the public

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20/ In addition, one of our Board members, Dan Goelzer, has been named as an observer to the SEC's Advisory Committee on Smaller Public Companies, which has been convened to examine the impact of the Sarbanes-Oxley Act and other aspects of the federal securities laws on smaller companies.

21/ Sarbanes-Oxley Act, Section 102(a).

company auditing practices of such firms are subject to periodic inspection by the PCAOB and, when necessary, to PCAOB disciplinary proceedings to enforce applicable auditing and related professional practice standards as well as other relevant laws.

PCAOB oversight has already changed the environment of registered public accounting firms and their partners and staff that participate in audits and triggered a profound shift in the overall character of public company auditing. Most important, our oversight has changed auditors' attitudes toward their accountability. Under the old system, which relied primarily on the enforcement tools of federal and state regulators after a problem had already occurred, the risk that an auditor's failure to identify and address a financial reporting error would come to the attention of regulators was relatively low. If such a problem did come to a regulator's attention, the consequences were grave – often ending the careers of auditors involved if not the practice of the firm itself. The risk of detection, however, was too often not sufficient to motivate firms and auditors to take the tough stance necessary to head off potential misstatements in financial reports. This was especially true when the firm and the issuer could, at least in the early going, rationalize the problem away as involving only immaterial amounts.

Under the new system, auditors understand that their work is much more likely to be reviewed within months or even weeks by the PCAOB's well-experienced, full-time inspectors. Last year, we reviewed portions of more than 500 audits performed by the largest eight firms. We chose those audits, and the particular aspects we reviewed, on the basis of our own assessment of the risk of material misstatements or significant auditing deficiencies. We also often select additional audits during the course of the inspection, enabling our inspectors to follow leads to the root causes of poor auditing. For example, if we find a poor quality audit that passed the muster of a firm's own internal quality control reviews, we will review additional work performed by the same audit partner and engagement team. We will also review other work performed by the internal reviewers who missed the reviewed partner's errors. Not surprisingly, we have found that this approach leads to uncovering additional problems. It also gives auditors a good bit more anxiety, and correspondingly greater incentive to stay on their toes, than a mere random sample of engagements.

Another important catalyst for change in the new system is that, unlike traditional enforcement models that focus on punishment after financial reporting and auditing failures become exposed, our inspections provide new tools to identify and resolve problems early in their development. First, when our inspectors find potential material accounting errors or significant auditing deficiencies, we invite the auditing firm to comment on the accounting and auditing work involved. This assessment process not only helps us to verify our own assessments, but it also helps the firm to identify the causes and scope of the problem. Second, throughout this comment process, our inspectors discuss the problems we identify with representatives of the firm, including members of the engagement team, the firm representative responsible for the firm's handling of the inspection, national office experts, and ultimately, the managing partner or chief executive of the firm. Although serious problems that we identify are ultimately described in our inspection reports, it is our discussions with the firms that drive them to redress the problems on the spot, through performing missed auditing procedures, enhancing internal quality control requirements, discussing the problem with the client involved, and other actions.

Two years of inspecting the audits of the Big Four accounting firms[22/] has done nothing to shake my view that these firms, operating at their best, are capable of the highest quality auditing. But it has also done nothing to shake my view that the Congress acted wisely in creating independent oversight of the profession to help move firms in the direction of consistently operating at their best. Through our inspections, we have already identified, and encouraged appropriate resolution of, numerous accounting and auditing problems. And we feel confident that we are, as the Congress intended, helping to move the profession steadily in the right direction – toward reducing the risks of material misstatements or unreliable auditing. I cannot say – and I do not believe that you would expect to hear – that after only two inspection cycles we have identified and uprooted all the causes of recent auditing failures and all the risks of future auditing failures. Nor would it be prudent, given the time that regulatory, judicial, or law enforcement processes can take, to assume that auditing firms are necessarily beyond the possibility of repercussions for pre-Sarbanes-Oxley failures. But between our preliminary limited inspections and our first full inspections, we have plainly made a start

[22/] In 2003, we conducted limited procedures on the Big Four accounting firms' audit practices. The firms submitted to these procedures on a voluntary basis, before any firm was required to be inspected. In 2004, we commenced our first round of regular inspections of the largest eight firms.

that amply vindicates the decision the Congress, and this Committee, made in creating the inspection process.

Although our inspections work to-date has focused primarily on the largest firms' annual inspections, over the last year, we have devoted considerable effort to developing appropriate oversight that takes into account the diversity of the auditing firms that have registered with the Board. As of April 21, we have registered 1,488 firms, including the nation's largest firms, hundreds of medium-sized regional firms and small firms, and 567 non-U.S. firms. We are working hard to structure our inspections program so that it is equipped to efficiently and effectively address this universe.

Our oversight programs cover three distinct groups of firms: the eight largest U.S. firms, all of which audit more than 100 U.S. public companies and therefore are subject to inspection on a continuous annual basis; 913 small U.S. audit firms, 715 of which audit the financial statements of fewer than five public companies and 313 of which audit no public companies; and 567 non-U.S. firms that wish to be positioned to audit – or play a substantial role in preparing audit reports on – the financial statements of U.S. public companies, including both foreign private issuers and U.S.-based multinational companies. Under the Act and the Board's rules, firms that have more than 100 public company audit clients are subject to annual inspections. Firms that have between one and 100 such audit clients are subject to regular inspections every three years.[23]

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[23] See Sarbanes-Oxley Act, Section 104(b); PCAOB Rule 4003.

While the Big Four accounting firms audit most public companies,[24] they have reduced their public company audit client base over the past two years.[25] At the same time, the next four and even smaller firms have increased the number of public companies that they audit.[26] Early after the enactment of the Sarbanes-Oxley Act some expressed concerns that the Act's requirements for oversight of accounting firms might pose a barrier to small firms' ability to compete for public company audit clients. In fact, however, a number of these small firms have actually increased the number of public companies that they audit, as the larger firms have reduced their number of smaller public company clients.[27] According to one study:

> Small accounting firms were the winners of market share in 2004. While small accounting firms in general vehemently opposed the passage of SOX, it appears that in reality, they may be one of the largest beneficiaries of the Act. The larger firms appear to be more selective these days in accepting smaller companies to audit, perhaps as they typically involve much lower revenue and profit potential.[28]

24/ According to the Government Accountability Office, as of 2003 the Big Four firms audited more than 78 percent of all U.S. public companies, and their clients produced almost 99 percent of public company sales revenue. See United States General Accounting Office, Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, Public Accounting Firms, Mandated Study on Consolidation and Competition, July 2003, GAO-03-864.

25/ See Yellow Card Trend Alert, Glass, Lewis & Co., at 1 (Feb. 15, 2005). According to this study by Glass, Lewis & Co., in 2004, Big Four firms reduced their public company audits by 400, the next four firms added overall, net, 117 public company audit clients, and all other accounting firms had a net gain in public company clients of 217.

26/ See id.

27/ See id. at 1 ("Big Four firms continued to remove smaller companies from their client list. The Big Four were dropped as auditors for 357 companies with less than $100 million in revenues while picked up for only 77 audits of such issuers.").

28/ Id. at 17.

Accordingly, we expect to see smaller firms seizing opportunities to expand their business by taking on new clients appropriate to the size and sophistication of the firms' practices. At the same time, we know that for that growth in their business to be fully successful, the firms must understand, and know what is expected of them within, the Sarbanes-Oxley and PCAOB framework. We recognize that, for smaller firms, the adjustment to that framework gives rise to many issues and questions of a different nature than those of principal concern to the larger firms.

To try to address those questions, we embarked in late 2004 on an ambitious outreach effort directed toward small registered public accounting firms. Specifically, we have conducted six two-day discussion sessions with small firms and their audit clients, focusing on the topic "Auditing in the Small Business Environment." I have asked Board member Kayla Gillan to spearhead this initiative.

These Forums have fostered a robust dialogue that has given us valuable insights we will apply in developing our programs. I believe the Forums have also better equipped the firms that have attended with useful information to address the challenges of the new regulatory environment. So far, we have held these Forums in northern and southern California; Atlanta; Dallas; Chicago; and northern New Jersey. We will be holding additional events soon in Denver, Pittsburgh, Orlando and Boston.

In addition to conducting this outreach, we also inspected 91 small firms in 2004. For some of these firms, our inspections provided the first serious glimpse of external oversight. We have seen first-hand how some small firms distinguish themselves by performing high-quality audits. At the other end of the spectrum, we have seen some small firms that simply must do better. We identify for them the areas in which they must do better, and we use the tools specifically provided by the Act – the incentive of keeping deficiencies from being made public and, ultimately, the incentive of not having their registration revoked – to motivate them to do better. In this way we do what we can to give such firms every chance to rise to the occasion of serving and protecting the investing public. Over time, however, we expect to eliminate from the ranks of registered firms those auditors who are incapable of – or indifferent to – serving the public interest.

Finally, as I mentioned earlier, 567 non-U.S. firms have registered with the Board.[29] Although under Section 106(a) of the Act, non-U.S. firms are subject to the Act and to the rules of the Board "to the same extent as a public accounting firm that is organized and operates under the laws of the United States," oversight of the audits of U.S. public companies conducted by these firms poses unique challenges.

To craft an oversight program that addressed such challenges, we have developed a framework under which the Board may conduct its oversight in cooperation with local regulators of our registered non-U.S. firms, by relying, to an appropriate

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[29] Title I of the Act is directed toward the auditors of public companies that seek to raise capital in U.S. markets. In the United States, the Act directly affects as many as 15,000 U.S. public companies. Those companies are headquartered in the United States, but they often have significant operations in other countries as well. The securities of about 1,200 non-U.S. public companies trade in U.S. securities markets, and so those companies must also follow many of the requirements of the Act, including the requirement to file with the SEC financial statements audited by a registered firm.

degree, on the inspection work of those local regulators.[30] Over the past 18 months, we have engaged in a constructive dialogue with relevant regulators in certain key non-U.S. jurisdictions. As we speak, PCAOB inspectors are sitting side-by-side with inspectors from the Canadian Public Accountability Board, reviewing the audits of the Canadian registered public accounting firms that we will inspect together in this first year of our international program. We are also far along in working out similar arrangements with authorities in the United Kingdom, Australia, France and Japan. This dialogue has demonstrated that the Board and its non-U.S. counterparts share many of the same objectives, including to protect investors from inaccurate financial reporting, to improve audit quality, to ensure effective and efficient oversight of accounting firms, and to help to restore public trust in the reliability of audit reports. Underlying this convergence of views is the global nature of the capital markets – the effects of a corporate failure in one country tend to ripple through the financial markets of another, potentially causing substantial economic damage. Together with our counterparts, we hope to do what we can to reduce overall risk to investors in securities markets throughout the world that have devoted resources to investor protection.

IV. Building a Strong Foundation

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[30] See Briefing Paper on the Oversight of Non-U.S. Public Accounting Firms, PCAOB Release No. 2003-020 (Oct. 28, 2003). The Briefing Paper was followed by the proposal and adoption of rules by the Board which generally articulated the Briefing Paper's framework. See PCAOB Release No. 2004-005 (June 9, 2005). Under these rules, the degree of reliance to be placed on a non-U.S. system will be based on a "sliding scale" and will depend on the Board's assessment of the independence and rigor of the non-U.S. oversight system. The more independent and rigorous the non-U.S. system, the higher the Board's reliance on that system. Conversely, the less independent and rigorous, the lower Board's reliance on that system. These rules were approved by the Securities and Exchange Commission on August 30, 2004.

While our vision and form as an organization have significantly matured since I was last before this Committee, we will still spend much of 2005 building the key programs that underlie our ability to protect the investing public. The PCAOB began operations in 2003 with four Board members and a handful of staff members in a single suite of offices; it began 2004 with five Board members and a staff of 116 in five cities. At the end of 2004, the PCAOB staff numbered 260 in eight cities. By the end of 2005, we expect to have approximately 450 staff. Our main growth area will continue to be the ranks of our experienced accountants who serve as inspectors, as well as enforcement investigators.

We also plan to develop our Office of Financial Analysis and Risk Assessment, which collects, analyzes and assimilates information from multiple sources to provide us with assessments of risks related to the financial reporting process. For example, our risk specialists – who combine backgrounds in financial and statistical analysis, forensic accounting, and economics, among other disciplines – may start with a known accounting problem at one company and comb through SEC filings, other public information, and our own internal data sources, to ascertain whether other companies are applying the same accounting treatment. Working closely with our inspectors, these specialists also help to select other audits to review. In addition, they provide crucial insights to our standards-setters and enforcement investigators – as well as to the Board itself – about potentially dangerous trends in financial reporting.

Our standards-setting initiatives rely heavily on information about such trends, in addition to trends in auditing practices that need improvement. This year, we expect to develop several standards designed to improve audit quality. First, we will soon consider adopting rules on auditor independence and tax services, based on a proposal we issued for public comment in December 2004. That proposal garnered support from a variety of corners, including investors, auditors, and issuers. The public comments have helped us see certain specific areas in which the proposal could be improved and we are working now to fashion those improvements.

In addition, in the coming months we will likely propose for public comment a new auditing standard on engagement quality reviews. Such a standard is required under the Act.[31/] In developing this standard, we are using the full panoply of tools available to us. The proposed standard will therefore draw upon information we gather in our inspections about weaknesses in reviews by "concurring partners" under the existing professional standards, examples of improvements developed by other standards-setters, and advice from our Standing Advisory Group of experts with experience as investors, auditors, financial statement preparers, academics, and others. Our staff also is evaluating the communications that should take place between the auditor and the audit committee and developing a related standard that would reflect the post-Sarbanes-Oxley relationship between auditors and public companies.

Finally, we will also continue to work toward our mandate of inspecting registered public accounting firms. We will inspect the largest eight U.S. firms again this year, as

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31/ Sarbanes-Oxley Act, Section 103(a)(2)(A)(ii).

well as the single non-U.S. firm that has more than 100 public company audit clients, KPMG's affiliate in Canada.

Conclusion

During the last two years, we have established a strong operational foundation for our statutory programs, but we still have many challenges ahead. Some of our most significant challenges in the next year will be to hire the 80 or so additional inspectors we need to help us examine close to 300 registered public accounting firms; to continue to oversee appropriate implementation of Section 404 of the Act in the second year of internal control audits for accelerated filers, as well as in first year of such audits of small public companies and foreign private issuers; and to establish cooperative oversight programs with our counterparts in other countries. We work hard to push toward the realization of the objectives the Congress set for us, with passage of the Act, and using this framework we hope to do our part to reduce overall risk to investors in U.S. securities markets. We have an aggressive agenda ahead, and we are pleased that the Congress entrusted the PCAOB to confront these challenges.

Thank you.

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SAMUEL ZELL
Chairman of the Board

March 28, 2005

Congressman Barney Frank
2252 Rayburn H.O.B.
Washington, D.C. 20515

Dear Congressman Frank:

The intent of my visit was to share with you my concern that the above mentioned legislation, although well meaning and objective, has produced a significant amount of unintended consequences. An example of same, although no way intended to be all inclusive, would be the following issues:

1. Excessive cost: The addition of the $1 million to $2 million per year of accounting costs on small companies can only limit capital raising activities in the hurdle to profitability.
2. Employee morale: Mind numbing exercises in order to comply with section 404 has resulted in morale issues at many companies in a common theme that it is busy work with no apparent use or need.
3. The atmosphere: The implementation of this legislation and its unknown interpretations has led the accounting firms to become fearful of their own shadow. Decisions are deferred, interpretations are reinterpreted and chaos is common. The whole concept of what is a "major deficiency," and therefore requiring disclosure, is so undefined that the number of such disclosures will make them meaningless.
4. Criminal penalties: The requirement for the CEO and CFO to certify results is something I would have no dispute with, and accountability and responsibility should go with such positions of trust. But to impose a criminal liability when the standard of knowledge is ill-defined will dramatically limit risk taking and in the long run, will be a negative on the United States' growth patterns. There are more than sufficient means to deal with fraud than to impose a criminal standard that

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could be, and likely would be, misinterpreted in the future. (The Ebbers case is the most recent example of people being held responsible).

5. The imposition of this legislation has a direct impact on the capital markets: To the extent that this legislation is not modified, it will discourage financing activities in our capital markets. I can't imagine that there is anything beneficial about discouraging participation in our capital markets.

Very truly yours,

Samuel Zell

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April 20, 2005

The Honorable Michael Oxley
Chairman
House Financial Services Committee
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Re: Hearing on the Implementation of the Sarbanes-Oxley Act Of 2002

Dear Chairman Oxley:

Thank you for scheduling a hearing tomorrow on the implementation of the Sarbanes-Oxley Act of 2002 (the Act) and for your endorsement of the efforts by the SEC and the PCAOB to refine the implementation of the Act. There has been an enormous amount of discussion and press about the Act, and we thought it would be useful to formally provide our views to you.

The most difficult part of implementation, thus far, relates to Section 404 of the Act (management reporting on internal controls and auditor attestations relating to management's assertions). This view is especially interesting to note, coming from the banking industry, where the requirements for management reporting and auditor attestations have been in place for many years (as required by the FDIC Improvement Act of 1991). One would imagine that other parts of the Act should have been more difficult than Section 404; however, this has not been the case.

For the banking industry, the problems with Section 404 are not chiefly because of the requirements of the Act or the Securities and Exchange Commission's (SEC) rules that implement the Act; instead, the primary problem has been the ***interpretation*** of the Act. Further, we believe that the major problems relating to Section 404 can be resolved by the Public Company Accounting Oversight Board (PCAOB) and the SEC with your support.

SEC Chairman Donaldson and the SEC Commissioners should be commended for hosting their recent roundtable on Section 404. The roundtable was successful, providing various industry representatives with the opportunity to vent their frustrations and offer productive feedback, which was evidenced by the commitment during PCAOB Chairman McDonough's closing remarks to provide immediate guidance. It was very clear to our participants at the roundtable and from discussions with SEC representatives that both the SEC and the PCAOB are committed to identifying and issuing meaningful clarifying guidance so that the Section 404 process will be more efficient. We applaud their dedication to this effort.

Several themes surfaced from the witnesses at the SEC roundtable, and it appeared to us that the two consistent messages were:

- Section 404 is positive and has resulted in an improved focus on internal controls at all levels. However, it is taking away from other important issues, and the process needs to be more reasonable. The primary problem is the interpretation of the PCAOB's rules (Auditing Standard No. 2) rather than the rules themselves. Further guidance is needed, with utmost speed, focusing on: (1) reducing the level of detail (by shifting from transactions-based to risk-based audits), (2) eliminating unnecessary duplication of work, and (3) considering the impact that the upcoming inspections of the accounting firms will have on future audits.
- Further work is needed to reduce the burden of Section 404 on small companies.

With one exception, the above themes are consistent with the ABA's views, as outlined in our attached letter to the SEC. The exception is that, although we agree that most of the problems relating to Section 404 implementation are not because of the PCAOB's rules, there is one part of the rules that we believe has resulted in significant costs that were not anticipated by the Congress, the SEC, or industry. That is, the PCAOB requires attestations *plus audits* of internal controls, while the Act and the SEC's rules require only attestations (as does FDICIA). We believe that this and the other points relating to a more efficient process can be resolved by the PCAOB.

The issue relating to reducing the burden of Section 404 on small companies can be resolved by the SEC, with your support. One important way to achieve this is to update the number of shareholders that currently triggers SEC registration requirements, which is a regulatory burden reduction idea that our community bankers began discussing prior to any discussions relating to the establishment of the Act. That is, the regulatory burdens for community banks that are SEC registrants, *prior to the Act*, were of such significance that our community bank members were at that time beginning to request relief. Thus, the reason for updating the threshold is not the Act itself; it was only made clearer by the requirements of the Act. Since the 500 shareholder threshold for registration and the 300 shareholder threshold for de-registration have not been adjusted since 1964, we propose updating the registration threshold to a level between 1,500 and 3,000 shareholders and the corresponding threshold for de-registration from 300 to a number of shareholders consistent with a new threshold registration number, somewhere in a range between 900 and 1,800 shareholders.

Again, thank you for holding the hearing and for your support for making the Section 404 process more efficient. If you would like to discuss this letter in more detail, please contact me at 202-663-5328.

Sincerely,

Edward L. Yingling
Executive Vice President, ABA

cc: Mr. William H. Donaldson, Chairman, SEC
Mr. William McDonough, Chairman, PCAOB

Attachment

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April 1, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File Number 4-497, Roundtable on Implementation of Internal Control Reporting Provisions

Dear Mr. Katz,

The American Bankers Association (ABA) appreciates the willingness of the Securities and Exchange Commission (SEC) to hold a roundtable discussion on the implementation of Section 404 of the Sarbanes-Oxley Act of 2002 (the Act). The Chairman of the ABA's Accounting Committee, William J. Brunner, Chief Financial Officer of First Indiana Corporation, looks forward to representing the ABA at the April 13 roundtable. The ABA, on behalf of the more than 2 million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership — which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks — makes ABA the largest banking trade association in the country.

The ABA fully supports the establishment and use of strong internal controls, which are critical not only to provide users of financial statements with reasonable assurance about the integrity of financial statements, but also to provide management with a foundation for appropriately managing a company's risks. However, we are very concerned about the huge time and cost burdens associated with compliance, as well as business opportunity costs. The purpose of this letter is to share our concerns and to provide some solutions for your consideration.

The banking industry has had a significant amount of experience with management reporting on internal controls and auditor attestations, because the FDIC Improvement Act of 1991 (FDICIA) and the corresponding banking regulations have required similar reporting for banks with total assets of $500 million or more. Although representatives from the banking agencies have indicated that some individual institutions needed to improve their FDICIA processes during the Section 404 implementation, the banking industry has quality internal control processes and was well equipped to implement Section 404. Because of our industry's prior experience with management reporting, we believe we are also qualified to provide useful feedback regarding the Section 404 process for your consideration. Many recommendations are provided in this letter; however, we strongly encourage the SEC to focus on the most important recommendations, which relate to: the impact on small companies, the unnecessary duplication of work, and the overly strict interpretations of the rules by the accounting firms.

ABA Concerns about Section 404

Our two main concerns are the costs of implementation for all banking institutions and the impact on community banks.

Costs of Implementation for All Banking Institutions

Many of our members believe that the Section 404 process has improved the awareness of internal controls, improved some employees' understanding of the important interplay between internal controls and risk management, and strengthened the audit process through more thorough audit procedures. At the same time, there is broad agreement among bankers that the Section 404 implementation process has gone too far with respect to costs and the level of detail required by the accounting firms when compared with these benefits. Too much management time and too many shareholder dollars are being consumed with a high level of detailed testing rather than spending the time and dollars providing products and services to customers.

Several recent surveys have confirmed that compliance with Section 404 is extremely costly for companies of all sizes. We will not re-hash all of the cost information in this letter, because it has been well publicized. However, we would like to provide two specific examples, because they clearly demonstrate the costs that bankers are facing.

Example 1

The fees for a bank with approximately $2 billion in total assets are as follows:

2003 audit fees for financial audit and FDICIA reporting:	$255,000
2004 engagement letter for financial audit and Section 404: (Note: There was agreement that this would likely be revised later in the year to reflect PCAOB's final rules.)	$258,000
2004 audit fees for financial audit, FDICIA, and Section 404	$433,000

As can be seen from the above, the final fee for 2004 was 70% more than the 2003 fee.

Example 2

The fees for a bank with approximately $1.5 billion in total assets are as follows:

2003 audit fees for financial audit and FDICIA reporting:	$193,000
2004 audit fees for financial audit, FDICIA, and Section 404:	$600,000
2005 expected fees for financial audit, FDICIA, and Section 404:	$700,000

For this bank, the 2004 fee was 211% more than its 2003 fee.

It should be noted that these costs exclude the internal costs related to the implementation and compliance with Section 404, and these banks had no material weaknesses to report in their SEC filings. Both banks prepared management reports and attestations under FDICIA (prior to the Sarbanes-Oxley Act of 2002); therefore, one could assume that the fee would have been higher if the bank had not been subject to FDICIA. These examples are consistent with information being reported to the ABA staff by ABA members and are not isolated instances.

Section 404 clearly expanded the focus on internal controls, driving into companies a fuller awareness of the culture of internal controls. However, for the banking industry, which has been reporting on internal controls under FDICIA, those incremental benefits generally do not outweigh the incremental costs. The incremental costs appear to be truly excessive, particularly when one considers the close relationship between the requirements of the Act (and the SEC regulations relating to Section 404) and FDICIA.

Impact on Community Banks

Community banks are simply being buried by the enormous volume of unnecessary paperwork and procedures being required in the Section 404 process. Many community banks are SEC registrants, and the "one size fits all" nature of the Section 404 process is so overwhelming that some have either de-listed or are considering de-listing. This is because their boards believe the costs of being an SEC registrant are outweighing the benefits (primarily due to current interpretations of Section 404). Community banks already spend much of their time on regulatory compliance required from banking regulators, and the additional time and cost of Section 404 is often difficult to justify to shareholders.

The ABA was contacted by the Government Accountability Office (GAO), as part of its due diligence, for its study of the impact of the Act on small businesses. We met with GAO and provided the staff with our views regarding the impact of Section 404 on community banks. One of the points we made was that many small banks are being force to change accounting firms for their annual audits because of overpricing. Some community banks prefer using a particular firm because of its banking expertise or other factors, but the costs have become prohibitive. This is likely an unintended consequence of Section 404, which could, in fact, result in the use of a firm with less banking experience and a lower quality audit.

We believe the following comments from a community banker (approximately $140 million in total assets) frames the small banks' concerns very well: "For a bank this size, the SOX [Section] 404 documentation will require such excessive amounts of time of management and accounting staff that we will be very hard pressed to complete the regular work including year-end close, call reporting, regular SEC reporting, and working with independent auditors. As CFO of a bank this small, I am required to be very hands-on in accounting as well wearing many different hats...Our biggest problem now is manpower with expertise to do the job. We do not have the option to outsource due to the cost of doing so. But, the amount of work for us is as much as for a bank ten times our size."

ABA Suggested Solutions

We propose improving the efficiencies of Section 404 implementation by:

- Improving the rules – The ABA would like to work with the SEC and the Public Company Accounting Oversight Board (PCAOB) to streamline rules relating to Section 404 to eliminate processes that are unnecessary or duplicative.
- Improving the accounting firms' interpretations of the rules – The ABA would like to work with the SEC, PCAOB, and the accounting firms to achieve a more meaningful and targeted approach in the interpretation and application of the PCAOB's rules relating to Section 404.

We believe that guidance will be needed to achieve efficiency opportunities, and we strongly encourage the SEC and the PCAOB to use a public forum for providing further guidance. We request that the guidance not be delivered in speeches various conferences, because those events are not attended by all registrants, and speeches often include information on a variety of topics. Instead, providing information on the official websites of the SEC and PCAOB, with the information clearly labeled, would be very useful.

Improving the Rules

SEC

The ABA recommends that the SEC:

- Evaluate whether Section 404 as currently applied is fulfilling the purpose for which it was intended and consider whether the costs are excessive in light of the benefits achieved for certain types of industries and sizes of companies.
- Consider differentiating the rules for small businesses by making the rules less burdensome.
- Update the number of shareholders that currently trigger SEC registration requirements. A company is be deemed public if it is listed on a national securities exchange, traded on the NASDAQ or the OTC Bulletin Board, or has $10 million in assets and 500 shareholders. Since the 500 shareholder threshold has not been adjusted since its initial enactment in 1964, we propose updating this threshold to a level between 1,500 and 3,000 shareholders. Additionally, a company cannot seek to de-register until the number of outstanding shareholders drops below 300. We propose a corresponding update in the threshold for de-registration to a number of shareholders consistent with a new threshold registration number, somewhere in a range between 900 and 1,800 shareholders.
- Freeze the accelerated filing dates until the Section 404 procedures are more streamlined.
  - 10-K reporting: For this first year of Section 404 reporting, the SEC provided some relief to accelerated filers by freezing the existing 75-day deadline rather than requiring the new 60-day deadline. The 60-day deadline is too short, and companies should be given the full 75-day time frame to help ensure quality reporting.
  - 10-Q reporting: The SEC also provided some relief for quarterly reporting by requiring reporting within 40 days rather than the accelerated 30-day filing date. Although the requirements for Section 404 at quarter-end are not as in-depth as year-end (unless there are changes in controls), companies and their auditors must go through similar processes at quarter-end and year-end. The 30-day time frame will be too short for some companies, and we suggest that the SEC continue to use the 40-day window at this time.
- Consider a 90-day window (prior to a company's fiscal year-end) during which a company could establish its "as of" assessment date. Closing procedures are generally the same for third quarter and fourth quarter, and this could ease some of the overload for staffing by the accounting firms and for year-end work by banks. We recognize that the law specifies the "as of" date; however, additional rollforward procedures relating to significant changes could be required in order to continue to ensure compliance with the law. This could be extremely useful to companies, which are extremely busy at year-end, and to audit firms, which seem to be thinly staffed at year-end.

PCAOB

For the purpose of reporting on internal controls by management and the related attestations by auditors, the requirements of FDICIA and the Sarbanes-Oxley Act are virtually identical. Similarly, the regulations that implement those laws (FDIC 12 CFR Part 363 and SEC Release No. 33-2838) are also virtually identical (the most significant differences are: the definition of the reporting entity, the requirements relating to material weaknesses, and certain quarterly procedures). These similarities were not included in these laws and regulations by mistake. As noted in the SEC's final regulations, the SEC and banking regulators coordinated "to eliminate, to the extent possible, any unnecessary duplication..."

The similarities between FDICIA implementation and Section 404 implementation (aside from the definition of the reporting entity) diverge under the rules issued by the PCAOB. When the PCAOB developed its new auditing standard, Auditing Standard No. 2 - "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements" (AS 2), for use by auditors in providing the attestations required by Section 404, it expanded certain requirements.

ABA's suggestions for the PCAOB are as follows:

- PCAOB should focus on how to reduce unnecessary duplication.
  - Attestations should be required rather than attestations plus audits of internal controls. Section 404 requires an attestation by external auditors on management's assessment of internal controls, but AS 2 requires an additional stand-alone opinion by auditors on internal controls. The PCAOB appears to have based its decision to require audits (AS 2, paragraphs E15-E16) on Section 103(a) of the Act, which is a section that describes rules to be established by the PCAOB. However, we do not believe that Section 103(a) requires audits; instead, Section 404 clearly states that attestations—not audits of internal controls—are required in the reporting process. We agree with the definition of an attestation in the introduction to the proposed version of AS 2, which states that: "An attestation, in a general sense, is an expert's communication of a conclusion about the reliability of someone else's assertion." This is what we believe is required by the Act and FDICIA, and we believe that the PCAOB should require attestations rather than attestations and audits. The requirement for attestations plus audits of internal controls results in auditors' re-testing management's testing of internal controls (for the attestations) and then performing new tests of those same areas (for the audits of internal controls). This results in unnecessary duplication of effort and cost with little corresponding benefit.
  - The ABA recommends that the PCAOB leverage, to the greatest extent appropriate, the work of internal auditors and others in order to reduce duplicate testing. The ABA would like to work with the PCAOB to consider how to best make use of the work of internal auditors by external

auditors under the existing rules. We believe that increased communication between the PCAOB and the accounting firms, possibly through further use of authoritative questions and answers, could resolve some of the problems. It appears that at least two areas need attention: (1) clarifying the appropriate degree of reliance on the work of internal auditors; and, (2) clearer guidance as to what is meant by the requirement that auditors use principal evidence.

- Reliance on internal auditors. Much of the work done by internal audit is routine, based on routine transactions, and the current interpretation of AS 2 is resulting in unnecessary duplication. One result of the Act is the enhancement of the quality, independence, and reporting relationship of the internal audit function. If the quality of the internal audit function within a company is deemed to be reliable, there is little reason why the external auditor must duplicate so much work.
- Principal evidence. The use of the term "principal evidence" (AS 2, paragraphs 108-111 and 116) may be the source of a significant amount of the unnecessary duplication that is being done. Paragraph 108 states that: "the auditor must perform enough of the work himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion." Even though AS 2 describes this within the section of the rule that permits a certain degree of reliance on the work of internal auditors, it is being translated by some auditors as requiring that nearly the entire amount of work be original work performed by the auditor. This is effectively requiring a higher level of audit certainty than financial statement audits, and is not what is intended by the Act. It is a primary contributing factor to the escalation of costs. Within a context of adequate verification, there can be more reliance on management's assessment and internal audit work.

- PCAOB should re-examine other restrictions on information that independent accountants can use to assess the internal control structure.
  - The detail level of testing is extensive and redundant. PCAOB should evaluate and provide public guidance on how much testing the external auditors must perform.
  - Auditors should be able to consider other compensating controls that are not included in the internal controls flowcharts, including risk management practices. The PCAOB rules are being implemented on an excessively detailed level, described as: check the checker to check the checker to check the checker to make sure financial statements are being typed correctly. A very prescriptive approach is being used, focusing, for example, on the mechanical process of locating a signature or a set of initials (indicating a manager's review of a control) and ignoring some of the broader and more important company practices. Risk management practices, many hours of internal audit testing, many dollars spent on banking regulatory examinations, etc., are not being considered. Auditors should be able

there is no presumption that a control does not exist simply because it is not documented.

- Auditors should be able to rely on analytics as opposed to relying only on a demonstration of a control. For example, if delinquency levels and loan charge-offs are acceptable, the auditor could reduce or eliminate detail testing of collection histories, etc. In many cases, analytical reviews provide more information about how risk is controlled than does sample testing.

- Materiality needs to be defined better, possibly as an amount that would result in the need to restate earnings. We recognize that this is a difficult task; however, more consistency is needed.
  - Accounting firms are using ranges that may or may not be material. In some cases, the percentage appears to be low for reporting to the audit committee, especially if it relates to a small line item.
  - Materiality with respect to deficiencies generally appears to be within a 3-5% range (3-5% percent of pre-tax earnings for income statement purposes; 3-5% of total assets for balance sheet purposes). However, this range is not being consistently applied. The definition may need to include other issues, such as whether the amount in question places the company in an inappropriate capital position, whether it would have an impact on debt covenants, etc.
  - PCAOB should reconsider how or whether the SEC's Staff Accounting Bulleting No. 99 applies with respect to materiality (AS 2, paragraphs 22-23 state that "the same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting…"). It is our understanding that an internal control deficiency that results in as little as a one to two cent change in the earnings per share for a large company (with a high per share value) is being considered as a significant deficiency.
- The definitions of control deficiencies (significant deficiencies and material weaknesses) need to be revised. For example, evaluating the significance of a deficiency is initially evaluated by determining: "The likelihood that a deficiency, or a combination of deficiencies, *could* result in a misstatement of an account balance or disclosure…" (AS 2, paragraph 131; emphasis added). The definitions lack meaning because "could" is very broad, and too much energy is expended on deficiencies that do not have a true financial impact on investors.
- The extent of documentary evidence should be reviewed and revised. Relying solely on signatures/signoffs as the only evidence that a control is in place (the notion that if the control is not documented, it is not in place) is inadequate. Oversight or failure to document a signature on a report to support management's review happens and does not directly correlate to invalid financials. The signoff focus also leads to expending too much energy on form over substantive control work. It should be noted that AS 2 (paragraph 97) describes the reverse situation: when a signature exists, the auditor still may need to check perform additional procedures. We believe that the reverse should also be true: if a signature does not exist, this does not necessarily mean the control is not in place.

- SAS 70 report "as of" dates should be reconsidered. External auditors require financial institutions to obtain SAS 70 reports from their service providers that extend to December 31 of the current year. Obviously, the service providers cannot provide these reports until after year-end, as their own external auditors cannot produce them until February or later. It would be preferable for external auditors to require that service provider controls be monitored annually without mandating the December 31 date. This issue is even more onerous for a company whose fiscal year-end is prior to December 31, because the SAS 70 reports were not available until December and auditors would not release their signed opinion and consents until after the SAS 70 reports were received and reviewed by them. It should be noted that AS 2 (paragraphs B25-B28 and PCAOB Staff Q&A No. 25) describe the procedures required if a significant period of time has elapsed between the "as of" date in the SAS 70 report and a company's year-end. However, this may not be operating effectively in practice.
- There should be an assessment of whether current body of talent in the audit firms can keep pace with the new workload. Due to the focus on controls as of year-end, along with the financial statement audit staffing required at year-end, the work force availability has been reduced.
- The PCAOB should consider establishing a reasonable scope of financial statement and disclosure coverage. Some accounting firms expect coverage in excess of 80 percent of the balance sheet and income statement and financial disclosures, which seems excessive.

Improving the Accounting Firms' Interpretations of the Rules

We believe that a major component of the costs relating to Section 404 is the accounting firms' interpretations of the rules.

ABA's suggestions are as follows:

- The accounting firms' terror of the PCAOB must be replaced. Aside from the duplication of work as described in an earlier section of this letter, this appears to be the most significant cost relating to the application of Section 404. Although a high level of respect is healthy, the ABA believes the pendulum has swung too far and may well be counterproductive. While it is clear the PCAOB needed to establish tough, yet reasonable, standards for accounting firms to follow, ABA is concerned that the PCAOB may have underestimated the reaction by the accounting firms. This must be addressed in order to bring reasonableness back to the process.
- In situations where the PCAOB's rules provide a certain level of flexibility, which we believe is appropriate, the accounting firms appear to be ignoring the flexible nature of the rules and applying only the most stringent interpretations. Many companies believe that these decisions are being made by the risk managers within the firms rather than audit practice staff, and those risk managers are aiming for absolute assurance rather than reasonable assurance (reasonable assurance that is required under AS 2). In a November 24, 2004 Wall Street Journal article, Holman W. Jenkins Jr. wrote: "...each

of the Big Four is free pretty much to interpret Section 404 by its own whimsical lights, acting as judge and jury, with the accountants' dominant incentive being to protect their own posteriors with paperwork lest they be targeted in a shareholder lawsuit next time one of their clients goes bust." This is obviously strong language, but we believe that it reflects the perception in the marketplace and represents a major component of the costs. We believe it would be useful for the firms to reconsider their approaches and to develop a more reasoned application of the rules.

- The accounting firms appear to be testing for attestation purposes and then re-testing the same work for the audit of internal controls. We believe that this is not necessary, according to the PCAOB's release relating to AS 2 (PCAOB Release No. 2004-001, March 9, 2004, page 11):

  "The natural starting place for the audit of a company's internal control over financial reporting is management's assessment. By evaluating management's assessment, an auditor can have confidence that management has a basis for expressing its conclusion on the effectiveness of internal control. Such an evaluation also provides information that will help the auditor understand the company's internal control, helps the auditor plan the work necessary to complete the audit, and provides some of the evidence the auditor will use to support his or her opinion.

  The work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work the independent auditor will need to perform. Auditing Standard No. 2 allows the auditor to use, to a reasonable degree, the work performed by others. The more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.

  Also, the more clearly management documents its internal control over financial reporting, the process used to assess the effectiveness of the internal control, and the results of that process, the easier it will be for the auditor to understand the internal control, confirm that understanding, evaluate management's assessment, and plan and perform the audit of internal control over financial reporting. This too should translate into reduced professional fees for the audit of internal control over financial reporting."

- The role of external auditors needs to be returned to a trusted – albeit arms-length – advisor role. Although the Act clearly increases the tension between an auditor's role as both an advisor and independent examiner, it appears that the role of external auditors may have shifted too far with respect to independence from management. We believe there are at least two reasons for this: (1) the new reporting relationship between the auditor and the audit committee, and (2) the rules relating to auditor independence. In the past, auditors have been a good source of recommendations for improvements to management. However, in the current environment, this appears to have shifted heavily toward enforcement, with the almost complete loss of the auditor as a valued advisor to management. Further, some audit firms continue to believe that: (1) if the company asks the external auditors a question about the accounting for a particular transaction, it may be viewed as a significant deficiency and a strong indicator of a material weakness (even though this does not seem to be required under PCAOB Staff Q&A No. Q.7.); and, (2) draft financial statements should not be shared with external auditors, because if early drafting errors are identified by the auditors (even if purely mechanical), such errors can be cited as control deficiencies. We recognize that the PCAOB has attempted to address some of these concerns; however, it does not seem to be clear to some auditors.

- External auditors should re-evaluate the frequency of contact with audit committees, and should consider whether the issues being presented to the audit committees are significant enough to require their attention. For example, it is our understanding that: (1) minor disagreements between audit firm and company are being reported to the audit committee, (2) insignificant errors are being reported, (3) payments of relatively small fees are being required to be pre-approved, and (4) minor issues are being discussed with audit committees. This is not a wise use of the audit committee's time and distracts the committee from more important issues. It also slows the business processes for the company, due to preparation and explanation of the issues with the audit committee.
- The information technology (IT) emphasis has been interpreted too broadly by external auditors. Specifically, it appears that auditors are struggling to clearly define for their clients the appropriate level of IT controls documentation to achieve the intended scope and focus of Section 404 (i.e., financial reporting and disclosure). A company's IT approach should, for Section 404 purposes, remain focused on significant applications truly critical to the accurate reporting and presentation of financial data. The accounting firms also appear to have a significant staffing shortage in this area.
- SAS 70 Reports. Some auditors believe that a company cannot rely on a SAS 70 report if that report is prepared by the company's audit firm. However, SEC's Q&A Question 14 permits reliance.
- Accounting firms need further staffing and education on the Section 404 process, with particular emphasis on IT. In some cases, a significant amount of time was wasted during the Section 404 process due to disjointed approaches by the audit firm, poor timing, lack of knowledge, and having to check with their national offices before making even minor decisions. (It should be noted that the NASDAQ survey, March 2, 2005, found that 70% of respondents said the accounting industry does not have sufficient adequately trained audit staff to work on Sarbanes-Oxley.) We recommend that the accounting firms evaluate whether this is simply a problem relating to the initial implementation of Section 404 or whether it will be a problem next year as well.

Thank you for your consideration of our views. If you would like to discuss this letter in more detail, please contact me at 202-663-5318.

Sincerely,

Donna J. Fisher

cc: Mr. William McDonough, Chairman, PCAOB

Questions for the Record
Congressman Vito J. Fossella
Financial Services Committee

The Impact of Sarbanes-Oxley
April 21st, 2005

The SEC and the Public Accountability Oversight Board (PCAOB), established under Sarbanes-Oxley, work to protect individual investors and the integrity of our financial markets. The PCAOB is in the process of establishing arrangements with foreign entities for the purpose of vetting the auditors of non-US publicly traded companies listed on US stock exchanges.

1. Would the PCAOB please update me as to the status of the discussions between the PCAOB and entities in Canada, the US and Japan with regards to establishing working arrangements with them? What exactly is the goal that these arrangements will entail in both the short term and in the long term or permanent basis?

2. What sort of time frame does the PCAOB intends to establish such arrangements and for what length of time will they be in place? In addition, what review mechanism will be in place to protect the American investor?

3. What would be the resource implications for the PCAOB if it did not have an arrangement with entities in Canada, the UK, and Japan and instead did the work itself?

Answer:

Pursuant to Section 106(a) of the Sarbanes-Oxley Act of 2002, non-U.S. public accounting firms that participate in audits of companies with securities registered with the Securities and Exchange Commission ("SEC") are subject to the Act and the rules of the Public Company Accounting Oversight Board ("PCAOB" or "the Board") and of the SEC in the same manner and to the same extent as U.S. accounting firms. Early in its history, the Board recognized that certain aspects of the registration, inspection, investigation and adjudication provisions of the Act and the Board's rules raise special concerns for non-U.S. firms. In an effort to address such concerns, the Board developed a framework under which, with respect to non-U.S. firms, the Board could implement the Act's provisions by relying, to an appropriate degree, on a non-U.S. system. The Board outlined the broad parameters of this cooperative framework in its Briefing Paper on Oversight of Non-U.S. Public Accounting Firms. Briefing Paper on the Oversight of Non-U.S. Public Accounting Firms, PCAOB Release No. 2003-020 (October 20, 2003). The Board subsequently adopted rules consistent with the Briefing Paper's framework. See Final Rules Relating to the Oversight of Non-

U.S. Public Accounting Firms, PCAOB Release No. 2004-005 (June 9, 2004). These rules were approved by the SEC August 30, 2004. (Note: PCAOB documents available at www.pcaobus.org)

During the past 18 months, the PCAOB has engaged in a constructive dialogue with relevant regulators in certain key non-U.S. jurisdictions, including Canada, the United Kingdom and Japan. This dialogue has demonstrated that the Board and its foreign counterparts share many of the same objectives. Underlying this convergence of views is the global nature of the capital markets – the effects of a corporate failure in one country tend to ripple through the financial markets of another, potentially causing substantial economic damage. The Board has stated it believes the best way to fulfill its mission – to protect investors in the U.S. markets – is to participate in global efforts to protect investors in all markets.

To that end, the Board has said it believes it is in the interests of the public, investors and the Board's non-U.S. counterparts to develop efficient and effective cooperative arrangements where reliance may be placed on the home-country system to the extent appropriate. This approach also has the added benefits of allowing auditing oversight bodies to allocate their resources in the most cost effective manner, while addressing some practical problems, such as the use of non-native languages, that would otherwise hamper efforts to oversee non-U.S. firms. With 584 non-US firms from 77 countries registered with the PCAOB, inspecting these firms without the benefit of such cooperative arrangements would require substantially more resources.

PCAOB Rule 4012, one element of the Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms, mentioned above, facilitates such arrangements. Pursuant to this rule, the degree of reliance that the Board places on a non-U.S. system will be based on a "sliding scale" and will depend on the Board's assessment of the independence and rigor of the non-U.S. oversight system. The more independent and rigorous the non-U.S. system, the higher the Board's reliance on that system. Conversely, the less independent and rigorous, the lower the Board's reliance on that system. Regardless of the independence and rigor of the non-U.S. system, however, the Board will not relinquish or otherwise agree to limit its authority under the Act to oversee registered non-U.S. public accounting firms.

While the procedures surrounding such arrangements may be reflected in an exchange of letters, the substance will be informal, allowing for maximum flexibility. To date, we have exchanged procedural letters with the Canadian Public Accountability Board. We have made substantial progress in discussions with Australia, France, Japan and the United Kingdom. In order to ensure that any agreed upon working arrangements with a non-U.S. regulator continue to serve the public interest and protect investors, the PCAOB intends to review the arrangements with the regulator in a given country each year that a registered firm in that country is selected for inspection.

Congressman Nydia M. Velazquez
Questions for the Record
"The Impact of the Sarbanes-Oxley Act"
April 21, 2005

2. Chairman McDonough, it is my understanding that Auditing Standard No. 2 was not intended to create a wall between auditors and clients, and that, within reason, the line of communication between management and auditors should remain open on issues relating to financial reporting and internal controls. What is your opinion on whether or not external auditors can provide company management with accounting advice on complex issues?

   Do you believe that external auditors believe they have received reasonable assurances that they may provide companies with advice on accounting issues?

   If not, does the PCAOB plan on taking any additional action so that companies do not incur significant costs in the future because current practice

Answer:

You are correct that the Board does not intend Auditing Standard No. 2 to create a wall between auditors and clients. Auditing Standard No. 2 should not be misunderstood to preclude audit clients from looking to their auditors for advice on difficult accounting and internal control issues. On May 16, 2005, the Board issued a Policy Statement that addressed this issue, as well as others that have arisen in the course of the initial implementation of Auditing Standard No. 2. See Policy Statement Regarding the Implementation of Auditing Standard No. 2, an Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, Release 2005-009 (May 16, 2005), available at www.pcaobus.org. In the Policy Statement, the Board reaffirmed that auditors should engage in direct and timely communication with audit clients when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports.

Congressman Nydia M. Velazquez
Questions for the Record
"The Impact of the Sarbanes-Oxley Act"
April 21, 2005

3. Chairman McDonough, large firms can require substantial resources for an engagement – potentially squeezing the firms' ability to service mid-market or smaller companies. And, given the momentous change to the audit environment in recent years, the ability to hire and train new audit staff sufficiently may be challenging – raising concerns that smaller companies may not be receiving the audit expertise that they need. What is your perspective on this issue?

Answer:

The improvements in audit practice since Sarbanes-Oxley's enactment, as well as the implementation of Auditing Standard No. 2, have no doubt created resource challenges for the public accounting firms involved. The decision of the Securities and Exchange Commission ("SEC") to implement the internal control requirements of Sarbanes-Oxley in two stages has relieved some of this pressure.[1] Nonetheless, we understand that these resource challenges still exist.

To promote quality audits, our inspections will seek to ensure sufficient audit expertise is brought to bear on all public company audits a registered firm undertakes. To the extent a registered firm does not have sufficient resources to undertake an engagement, the auditor's professional responsibilities under PCAOB standards preclude the firm from accepting that engagement. Any public company, regardless of size, that believes it is not receiving adequate resources and expertise from its auditor should seriously consider finding an auditing firm that is able to assign sufficiently experienced and qualified personnel to its audit.

In fact, there appears to be some restructuring in the client base of the major accounting firms that may address the concerns you identify. As noted in the Board's written testimony, over the past two years, the "Big Four" accounting firms have reduced their public company audit client rosters. At the same time, the next four and even smaller firms have increased the number of public companies that they audit. We expect to continue to see smaller firms seizing

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[1] For large, established companies – which the SEC calls accelerated filers – the initial assessments and attestations were required by SEC regulations to be included in their annual Form 10-K filings for fiscal years ending after November 14, 2004. Calendar-year companies were thus required to file their reports on or before March 16 of this year. The SEC has allowed accelerated filers with market capitalizations below $700 million an additional 45 days to file their internal control reports. For non-accelerated filers – which are essentially the smallest public companies – and foreign companies with securities traded in the U.S., Section 404 internal control reporting will begin in 2006.

opportunities to expand their business by taking on new clients appropriate to the size and sophistication of the firms' practices.

Congressman Nydia M. Velazquez
Questions for the Record
"The Impact of the Sarbanes-Oxley Act"
April 21, 2005

4. Chairman McDonough, given the effect of Sarbanes-Oxley on the public accounting industry, there was speculation that some smaller CPA firms would drop their public clients. There was concern that this would lead to fewer companies in an industry already marked by significant consolidation. While GAO addressed this issue in a study last year, could you please provide your perspective on what role smaller CPA firms are playing in the market for PCAOB compliant audit services?

Do you believe that the barriers for entry into this market are so substantial that it is unlikely any new firms will enter in the near-term?

Answer:

As you note, early after the enactment of the Sarbanes-Oxley Act some expressed concerns that the Act's oversight requirements might inhibit small accounting firms from competing for public company audit clients. In fact, however, a number of these smaller firms have actually increased the size of their public company audit practices, while the larger firms have reduced the number of smaller public companies they audit. According to one study:

> Small accounting firms were the winners of market share in 2004. While small accounting firms in general vehemently opposed the passage of SOX, it appears that in reality, they may be one of the largest beneficiaries of the Act. The larger firms appear to be more selective these days in accepting smaller companies to audit, perhaps as they typically involve much lower revenue and profit potential.

See Yellow Card Trend Alert, Glass, Lewis & Co., at 17 (Feb. 15, 2005).

Moreover, as of April 21, 2005, 1,488 firms had registered with the PCAOB. This total includes the eight largest firms, 913 small U.S. audit firms, and 567 non-U.S. firms. Of the 913 small U.S. firms, 715 audit the financial statements of fewer than five public companies, and 313 audit no public companies (but presumably have registered in order to be able to compete for such business). These numbers suggest that PCAOB registration is not a barrier to entry into the public company auditing market.

Congressman Nydia M. Velazquez

Questions for the Record
"The Impact of the Sarbanes-Oxley Act"
April 21, 2005

5. Chairman McDonough, with the PCAOB now inspecting audit firms, the peer review process will undoubtedly be less of a focus. I understand, however, that a majority of states still require a triennial peer review, but this may lessen in the future. While not providing the level of inspection that PCAOB will provide, the peer review process did provide audit firms with a means to improve many of their practices. If the peer review process becomes a thing of the past, what sort of affect will this have on the industry?

Answer:

As your question notes, it is our understanding that most states continue to require that firms licensed in that state undergo a peer review. As these peer review programs are being administered, however, we understand that they focus on accounting firms' audits of private companies. In contrast, PCAOB inspections focus on the portion of registered firms' practices that relates to auditing public companies. The peer review process therefore does not duplicate the PCAOB inspection program.

Congressman Nydia M. Velazquez
Questions for the Record
"The Impact of the Sarbanes-Oxley Act"
April 21, 2005

6. Chairman McDonough, of the almost 1,000 registered public accounting firms, the Big Four audits nearly 80 percent of public companies. While I understand that the Big Four and their legacy firms have traditionally audited the majority of public companies, I am interested in what affect you believe greater competition would have on the public accounting industry – for instance, would it yield higher quality audits or bring down the prices of audit services?

Answer:

As noted in response to your fourth question, since the enactment of the Sarbanes-Oxley Act, we are seeing some evidence of increased competition for smaller public company audit clients. Competition generally holds the promise of increased efficiency in auditing and a greater range of choices for public companies.

In order for smaller registered public accounting firms to take advantage of these opportunities, these firms need access to information concerning the requirements of the Sarbanes-Oxley Act and concerning the PCAOB's regulatory framework. We recognize that, for smaller firms, obtaining this type of information is often more difficult than it is for large accounting firms that have the resources to maintain staffs dedicated to monitoring regulatory developments. In an effort to help level the playing field, the Board embarked in late 2004 on an outreach effort directed toward small registered public accounting firms. Since November 2004, we have conducted seven two-day discussion sessions with small firms and their audit clients, focusing on the topic "Auditing in the Small Business Environment," in southern California, Dallas, northern California, Atlanta, Chicago, northern New Jersey, and Denver. Each of these sessions have been hosted by me or one or more of my fellow Board members and include presentations and question and answer sessions with the hosting member and senior PCAOB staff on our inspection process, on implementation of new auditing and professional practice standards, and on auditor independence issues faced by small firms.

**QUESTIONS OF THE HONORABLE RUBEN HINOJOSA
TO BE ASKED OF SEC CHAIRMAN DONALDSON
AND
PCAOB CHAIRMAN MCDONOUGH
COMMITTEE ON FINANCIAL SERVICES
"THE IMPACT OF THE SARBANES-OXLEY ACT"
APRIL 21, 2005**

1. Companies are concerned about what they deem to be inconsistent, and sometimes arbitrary, application of the PCAOB audit standard by accounting firms or even teams within firms. In particular, they contend that there appear to be variances among firms about what constitutes a "material weakness" or "significant deficiency." Predictably, their views on internal controls sometimes differ from what the external auditors demand, thus resulting in a lack of clarity leading to uncertainty and disputes. How can the Commission, the Board and the private sector work together to get more consistency, more clarity, and fewer disputes? Furthermore, is it possible, and appropriate, to provide more flexibility to allow external auditors to rely more on the work of internal audit staff?

Answer:

The PCAOB's Auditing Standard No. 2 defines the terms "material weakness" and "significant deficiency." These definitions, which utilize concepts drawn from the pre-existing accounting and auditing literature, are key in the evaluation of deficiencies in company's internal controls. Evaluating deficiencies requires the exercise of sophisticated professional judgment and it is inevitable that, in some cases, management and the external auditors will have differing opinions regarding a particular deficiency.

At the same time, we are aware that some have raised concerns about the application of these definitions in the initial round of internal control audits. Accordingly, the Board has identified this issue as a discussion topic for the next meeting of its Standing Advisory Group ("SAG"). The SAG, whose members have a variety of experience, including in preparing financial statements at public companies, in auditing, and in using financial statements and evaluating investments, will meet publicly with the Board on June 8-9, 2005. This SAG meeting will be devoted exclusively to discussion of the implementation of Auditing Standard No. 2, with particular focus on the types of issues raised in your question. Specifically, the SAG will discuss how the definitions were applied in the first round of implementation of Auditing Standard No. 2, whether using the definitions helped identify matters that should be disclosed to the audit committee and the public, and what challenges were encountered in evaluating deficiencies using these definitions.

With respect to the external auditor's ability to rely on the work of the company's internal audit staff, the Board on May 16, 2005, issued a Policy Statement that addressed this issue, as well as others that have arisen in the course of the initial implementation of Auditing Standard No. 2. See Policy Statement Regarding the Implementation of Auditing Standard No. 2, an Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, Release 2005-009 (May 16, 2005), available at www.pcaobus.org. In the Policy Statement, the Board reaffirmed that auditors should take advantage of the significant flexibility that Auditing Standard No. 2 allows to use the work of others, including internal audit staff, and specifically should "seek to use the work of others in areas of lesser risk."

QUESTIONS OF THE HONORABLE RUBEN HINOJOSA
TO BE ASKED OF SEC CHAIRMAN DONALDSON
AND
PCAOB CHAIRMAN MCDONOUGH
COMMITTEE ON FINANCIAL SERVICES
"THE IMPACT OF THE SARBANES-OXLEY ACT"
APRIL 21, 2005

2. Some of my constituents have expressed concern with what they describe as the "varying degrees of implementation, and the 'control' the accounting firms are exerting as a result of Sarbanes-Oxley." They argue that the accounting firms are performing testing and requiring documentation that is unnecessary out of fear that they will not be deemed in compliance with certain sections of Sarbanes-Oxley, and, consequently, will suffer substantial penalties and increase liability for failing to report financials accurately. What can be done to reverse this apparent trend?

Answer:

As noted in response to your first question, on May 16, 2005, the Board published additional guidance to auditors on how to implement the PCAOB's Auditing Standard No. 2. The guidance consists of a Board Policy Statement and a series of staff questions and answers.

Both the Board Policy Statement and the staff questions and answers focus primarily on the scope of the internal control audit and how much testing of a company's internal control over financial reporting is required. The PCAOB identified these as the issues that primarily drive cost and therefore needed to be addressed most urgently in order to affect the 2005 audit process. In particular, the staff questions and answers seek to correct the misimpression that certain provisions of Auditing Standard No. 2 need to be applied in a rigid manner that discourages auditors from exercising appropriate judgment.

In addition, the Policy Statement articulates the Board's approach to reviewing internal control audits as part of its inspections. The goal of this discussion, like the rest of the guidance in the Policy Statement and the staff questions and answers, was to ensure that internal control audits are carried out in a manner that is both effective and cost-efficient, rather than being driven by fear of being second-guessed.

**QUESTIONS OF THE HONORABLE RUBEN HINOJOSA
TO BE ASKED OF SEC CHAIRMAN DONALDSON
AND
PCAOB CHAIRMAN MCDONOUGH
COMMITTEE ON FINANCIAL SERVICES
"THE IMPACT OF THE SARBANES-OXLEY ACT"
APRIL 21, 2005**

Sarbanes-Oxley Questions

3. Some of my constituents have also contended that the accounting profession is no longer "principles – based" but it is now "rules based" due to Sarbanes-Oxley. They argue that the recent and numerous restatements serve absolutely no purpose for an investor, particularly a debt investor as there is generally no impact on cash flows. If this is the case, how do we get back to a principles – based approach? Even if you do not believe this is the case, please address their concerns, and mine, on this issue?

Answer:

I believe that auditing standards should be principles-based. The Board's Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, is a principles-based standard.

As your question relates to accounting standards, on July 25, 2003 the Securities and Exchange Commission ("SEC"), as required by Section 108(d) of the Sarbanes-Oxley Act, released a staff study on the adoption of a principles-based accounting system. The SEC staff concluded in the study that an objectives-oriented approach should ultimately result in more meaningful and informative financial reporting to investors and also would hold management and auditors responsible for ensuring that financial reporting complies with the objectives of the standards. The report also identifies the following steps to achieving an objectives-oriented approach to accounting standard setting in the U.S.:

- Ensure that newly-developed standards articulate the accounting objectives and avoid scope exceptions, bright-lines and excessive detail;
- Address deficiencies and inconsistencies in the conceptual framework;

- When developing new standards, ensure that they are aligned with an improved conceptual framework;
- Address current standards that are more rules-based;
- Redefine the GAAP hierarchy; and
- Continue efforts on convergence of U.S., foreign, and international accounting standards.

The report also acknowledged that the Financial Accounting Standards Board ("FASB"), the entity designated by the SEC under Section 108 of the Sarbanes-Oxley Act as the authoritative accounting standards-setter, had begun the shift to objectives-oriented standard setting and was doing so on a prospective, project-by-project basis. It is our understanding that FASB has continued to move towards objectives-oriented standard setting.

**QUESTIONS OF THE HONORABLE RUBEN HINOJOSA
TO BE ASKED OF SEC CHAIRMAN DONALDSON
AND
PCAOB CHAIRMAN MCDONOUGH
COMMITTEE ON FINANCIAL SERVICES
"THE IMPACT OF THE SARBANES-OXLEY ACT"
APRIL 21, 2005**

4. Is there a way regulators can provide additional relief for depository institutions that are struggling with redundant compliance burdens as a result of the Sarbanes-Oxley Act?

Answer:

It is my understanding that depository institutions that are public companies are chiefly concerned with the impact of Section 404 of the Sarbanes-Oxley Act. Section 404 requires all public companies, regardless of the business in which they engage, to file annually with the Securities and Exchange Commission a management report on the company's internal control over financial reporting and an auditor's opinion on management's report and on the controls. Depository institutions, regardless of whether or not they are public companies, are also subject to internal control reporting requirements under the banking laws.

Regulators, including the PCAOB, are taking several steps to address depository institutions' concerns about the relationship between these two sets of internal control requirements.

- First, as noted above, Section 404 does not apply to depository institutions that are not "issuers," and the Board does not apply its standards to audits of those companies. The requirements under FDICIA for these banks are set by the banking regulators. I understand that the FDIC has recently announced that it will relieve certain smaller institutions subject to its jurisdiction from FDICIA's internal control assessment requirements.

- Second, to aid the auditors of depository institutions that are subject to both Section 404 of the Sarbanes-Oxley Act and to the internal control requirements of FDICIA, the PCAOB issued guidance last Fall explaining how the auditor may comply with both laws in one audit and issue one report on the bank's internal controls. PCAOB Staff Questions and Answers, Auditing Internal Control Over Financial Reporting, Question No. 31 (November 22, 2004), available at www.pcaobus.org.

- Third, as noted in response to your prior question, the Board's May 16, 2005 guidance seeks to promote an internal control audit process that is both effective and cost-efficient. Because of the interplay between Section 404 and FDICIA, I believe this guidance will be particularly beneficial to publicly-traded depository institutions.

- Fourth, we know that Section 404 compliance raises special concerns for small public companies and are working to address these issues, along with the SEC, through the SEC's Advisory Committee, on which the Board is an official observer. Since the concerns raised in your question arise primarily from smaller depository institutions, the work of this advisory committee should be of special importance in addressing the concerns you raise. The advisory committee has appointed a working group to focus specifically on Section 404.

- Finally, the Committee of Sponsoring Organizations ("COSO"), the body that promulgated the framework under which most companies, including depository institutions, review their internal controls, has undertaken to issue guidance concerning the application of the framework to smaller public companies. The Board also has observer status on COSO's project. Again, this initiative should be of special interest and benefit to smaller depository institutions.

QUESTIONS OF THE HONORABLE RUBEN HINOJOSA
TO BE ASKED OF SEC CHAIRMAN DONALDSON
AND
PCAOB CHAIRMAN MCDONOUGH
COMMITTEE ON FINANCIAL SERVICES
"THE IMPACT OF THE SARBANES-OXLEY ACT"
APRIL 21, 2005

5. It is difficult to generalize, but in many cases where companies report material weaknesses, those weaknesses involved one-time problems with specific controls rather than systematic weakness. In most cases these weaknesses are remediable. Is there a way to provide additional flexibility to correct these problems prior to reporting?

Answer:

Under Section 404 of the Sarbanes-Oxley Act, management's assessment of internal control over financial reporting must be as of the end of the company's fiscal year. This means that management may correct any material weakness found up to December 31 of the year being audited (in the case of a company with the calendar year as its fiscal year) without having to report that weakness as a material weakness. Conversely, however, if a material weakness exists on the measurement date – e.g., December 31 – the material weakness must be reported, even if the material weakness is remediated early the following year.

Several avenues exist, however, for a company to disclose to investors its actual remediation, or planned remediation, of the material weakness, including disclosure in the SEC filing that originally identified the material weakness or in the company's quarterly certifications. In addition, the Securities and Exchange Commission staff recently encouraged companies to distinguish between weaknesses that are pervasive and those that are limited in nature. Specifically, on May 16, 2005, the SEC staff issued guidance, complementing the PCAOB's policy statement and staff questions and answers of the same date, advising that "disclosure will likely be more useful to investors if management differentiates the potential impact and importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have a pervasive impact on internal control over financial reporting from those material weaknesses that do not." See Staff Statement on Management's Report on Internal Control over Financial Reporting (May 16, 2005)(available at http://www.sec.gov/info/accountants/stafficreporting.htm).

Finally, the Board has proposed a new, voluntary auditing standard, which would allow management the opportunity to have an auditor opine and publicly report on the elimination of the material weakness before the next required management assessment.

Chairman Deborah Pryce
Subcommittee on Domestic and International Monetary Policy, Trade and Technology
B-304 RHOB

Questions for Chairman Donaldson and Chairman McDonough
Hearing on Sarbanes-Oxley
April 21, 2005

I understand the importance of restrictions on external auditors providing internal audit service. External auditors who are supposed to verify the accuracy of a company's financial statements ought not to have financial inducements to disregard or gloss over serious deficiencies. However, I have heard from some SEC registrants that the constraints applied to the independent auditors regarding guidance/interpretation of the application of accounting standards to complex business transactions has had a chilling effect on the auditor/client relationship. They have voiced concern that there is no way for internal and external auditors to make sure they are on the same page prior to a company accounting for an item in a particular way, and differences in interpretation might result in a company having to revise a financial report, which could lead to the appearance of underhanded accounting and potentially bad publicity.

Was this an intended result of that requirement? If not, are you considering addressing this complaint in future guidance?

Answer:

You are correct that the Board does not intend Auditing Standard No. 2 to create a wall between auditors and clients. Auditing Standard No. 2 should not be misunderstood to preclude audit clients from looking to their auditors for advice on difficult accounting and internal control issues. On May 16, 2005, the Board issued a Policy Statement that addressed this issue, as well as others that have arisen in the course of the initial implementation of Auditing Standard No. 2. See Policy Statement Regarding the Implementation of Auditing Standard No. 2, an Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, Release 2005-009 (May 16, 2005), available at www.pcaobus.org. In the Policy Statement, the Board reaffirmed that auditors should engage in direct and timely communication with audit clients when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports. In particular, the Policy Statement reaffirms that "management may provide and discuss with the auditor preliminary drafts of accounting research memos, spreadsheets, and other working papers in order to obtain the auditor's views on the assumptions and methods selected by management."

Questions for the Record by Rep Joseph Crowley
Hearing "The Impact of the Sarbanes-Oxley Act."
Thursday, April 21, 2005

Section 404 Question
To: SEC and PCAOB

3. As a follow up to the question by Chairman Oxley, at the SEC roundtable last week on accounting issues, there was a general agreement that the application of SOX 404 and auditing Standard No. 2 should be principles-based rather than rules-based.

Along those same lines, there was some discussion that a move to a principles-based standard must be coupled with protection for auditors that provide room for reasonable business judgment to protect against second-guessing earlier judgment with perfect 20-20 hindsight.

Chairman McDonough stated his support for some sort of liability protections for auditors. On that note, what guidelines could you provide this Committee on this issue? What can the PCAOB and SEC do to assure auditors that their appropriate exercise of judgment will be afforded respect – not just by you as regulators – but by the legal system? And should additional steps be taken to shield the liability of smaller accounting firms to provide them greater strength to compete in the market?

Answer:

We understand and share your concern that auditors' fears of being second-guessed can drive excessive amounts of work. To address that concern, the Board stated in its May 16, 2005 Policy Statement on the implementation of Auditing Standard No. 2 that, in reviewing internal control audits as part of its inspections, it does "not intend to second-guess good faith audit judgments."

A limitation on liability in private civil actions would require legislation. The PCAOB has not taken a position on this issue, and I believe it would require carefully balancing competing policy considerations. On the one hand, there is an important public interest in the financial integrity and viability of the nation's auditing firms. These firms play a key role in our capital markets, which depend on accurate, reliable financial reporting by the users of capital to the suppliers of capital. If the standards for, and scope of, liability jeopardize the ability of accountants to play that key role, the ability of the markets to sustain our free enterprise system could be compromised.

On the other hand, protection of investors – the suppliers of capital in our financial system – is the paramount goal of our securities laws. It is clear that exposure to liability in the case of deviations from legal and professional standards is a major compliance incentive for all participants, including auditors, in our capital-raising system. Further, the willingness of investors to commit resources to the securities markets could be severely impaired if the ability to recover losses that result, not from market forces but from illegal conduct, were unduly restricted.

As I stated during the hearing, if and when Congress and the President decide to limit accountants' liability, the PCAOB would, of course, support and carry out this decision. Regardless of whether or not accountants' liability is legislatively limited, the Board will continue to carry out our statutory responsibilities to see that accountants comply with their existing legal and professional responsibilities.

Questions for the Record by Rep Joseph Crowley
Hearing "The Impact of the Sarbanes-Oxley Act."
Thursday, April 21, 2005

PCAOB – Section 109
To: PCAOB

4. I understand that Section 109 of the Sarbanes-Oxley act requires that the fee for payment to PCAOB for services be based on market capitalization. My concern is that this seems to have the unintended consequences of adversely affecting high tech and start up firms with high market cap. What do you think about the current fee structure, should it be changed and if so what would you suggest?

Answer:

Section 109(g) of the Sarbanes-Oxley Act of 2002 established the requirement that the accounting support fee be allocated among issuers based on their relative "equity market capitalizations." In basing the allocation formula on market capitalization, Congress chose a method that takes into account the market's overall valuation of companies across many industries. The method also allows the accounting support fee to be assessed equitably across the universe of companies that qualify as "issuers" under the Sarbanes-Oxley Act and that therefore benefit from the PCAOB's work. Other measures, such as revenue or net profits, could not be readily applied to mutual funds and other types of companies that fall within the issuer definition. To be sure, as your question notes, there are companies with relatively high market capitalization and low or non-existent revenues. At the same time, there are also companies -- for example, in industries with thinner margins -- that have high revenue relative to their market capitalization. By basing the allocation of the accounting support fee on market capitalization, we believe that Congress chose a metric that best approximates companies' relative size across the universe of issuers. Of the 9,593 companies assessed a share of the PCAOB's 2005 accounting support fee, the average fee was $14,200 and 7,157 of these companies were assessed a fee of $5000 or less.

Congresswoman Deborah Pryce

Q. I understand the importance of restrictions on external auditors providing internal audit service. External auditors who are supposed to verify the accuracy of a company's financial statements ought not to have financial inducements to disregard or gloss over serious deficiencies. However, I have heard from some SEC registrants that the constraints applied to the independent auditors regarding guidance/interpretation of the application of accounting standards to complex business transactions has had a chilling effect on the auditor/client relationship. They have voiced concern that there is no way for internal and external auditors to make sure they are on the same page prior to a company accounting for an item in a particular way, and differences in interpretation might result in a company having to revise a financial report, which could lead to the appearance of underhanded accounting and potentially bad publicity.

Was this an intended result of that requirement? If not, are you considering addressing this complaint in future guidance?

A. *The Commission shares these concerns and in public statements issued on May 16th both the Commission and its staff addressed the need for effective communications among members of management and auditors. Both common sense and sound policy dictate that communications must be ongoing and open in order to create the best environment for high quality financial reporting and auditing. The Commission and staff statements are available on the Commission's web site at www.sec.gov.*

Congressman Patrick Tiberi

Q. I have heard from public companies who have multiple subsidiaries that are Sec registrants that are facing some special problems under the Act as it is being implemented.

For example, the parent company may use the same process for sending bills or depositing checks for each subsidiary, yet it must be reviewed separately for each one, as well as for the parent company.

If one of the subsidiaries makes an accounting mistake that would constitute a material weakness based on the subsidiary's capitalization, the parent company has to report it, even if the amount is very small in relation to the parent's finances. For example, someone told me of a situation that equated to an $80 mistake by a subsidiary for a parent with $1 million in assets constituting a material breach. That simply should not be a material weakness.

What purpose is served by having to perform separate Sarbanes-Oxley audits on subsidiary companies who are registrants if they don't have separate stockholders and they are audited in the review of the parent's finances? Why should we be duplicating this effort?

A. *The extent that an auditor examines the internal controls of a non-public subsidiary of a public company generally would depend on the significance of that subsidiary to the financial statements of the parent. In determining the scope of the internal control work to be performed, management and the auditor should use a "top down" and risk based approach, as described in the statements released by the Commission and its staff, and the Public Company Accounting Oversight Board and its staff, on May 16th. Those statements are available on the Commission's web site at www.sec.gov.*

Q. Couldn't we at a minimum have a allow that when the same financial process is used by multiple entities within the same company, it only needs to be internally reviewed once?

A. *As discussed in the statements referenced above, management and auditors may use the information and knowledge obtained in performing one aspect of an examination of a company's internal controls in determining whether or how to examine other controls. Accordingly, depending on the degree of risk associated with the control, it might not be necessary to repeat the same audit work.*

Q. When there are no "subsidiary" shareholders at risk, shouldn't the threshold of a material weakness be what is material for the parent, rather than what is material for a subsidiary?

A. *There may be instances where weaknesses in the internal controls of a subsidiary would be important to shareholders of the parent, such as when the subsidiary contains significant assets or operations of the consolidated entity. Auditors and managements would take such matters into consideration in deciding whether the weakness at a subsidiary level should be disclosed.*

Congresswoman Ginny Brown-Waite

Q. Thank you Mr. Chairman. And thank you Chairman Donaldson for being here today.

Chairman Donaldson, an article recently published in the Wall Street Journal highlighted a disturbing trend of labor unions in the United States.

Mr. Chairman, I'd like to submit a copy of this article for the record.

This article in the Wall Street Journal highlighted several instances where labor unions were using their control over billion dollar pension funds to bully corporations into agreeing with their partisan political agenda.

- New York State's Democrat Comptroller Alan Hevesi sent a threatening letter to Sinclair Broadcasting Group, on behalf of the state pension fund, after the network decided to air a documentary questioning then Presidential candidate John Kerry's post-Vietnam activities.
- Referring to financial services funds backing the President's personal retirement account proposals, Gerald Shea, a top AFL-CFO lobbyist, was quoted as saying, "We have no intention of letting any of these companies get away with this while they manage our workers' funds."
- Three trustees representing the New York City Employees' Retirement System recently sent a letter to a half-dozen investment banking companies demanding to know their Social Security stance.

These union boards are supposed to ensure that their members' pensions are invested wisely. The board members should be ensuring the companies they are using are qualified, ethical, and capable. How can we say that Sarbanes-Oxley has strengthened corporate responsibility and has increased investor confidence if labor unions are investing in and managing boards based on their political interests, rather than their fiduciary responsibility to their members? This is a clearly a huge loophole that is being exploited by labor unions.

Under Sarbanes-Oxley, corporate boards are supposed to be independent of the funds they manage. How can we call these union boards "independent" if they're using these type of tactics?

This is clearly an SEC issue. Isn't the SEC tasked with ensuring workers in America have their money invested wisely and fairly, not based on the political opinions of those governing their pensions? How are these labor unions not taking advantage of their "shareholder rights"?

A. *These questions raise important public policy issues that Congress may wish to address as to how state and corporate pension plans exercise rights as security holders. Where pension trustees hold legal title to the plan's assets, they are entitled to act on that ownership with respect to various matters including, for example, the voting of proxies. Whether pension boards act in the best interests of workers, and what factors they consider in making their decisions, do not raise issues under the federal securities laws, but clearly are a matter of concern for America's workers.*

Wall
Street
Journal
*Pension
Fund
Blackmail*
March 31,
2005

A notable sidelight to the Social Security debate has been Big Labor's battle to keep business from supporting reform. The specifics of that attack are worth examining in their own right (see below), but the bigger story here is the way the AFL-CIO and its friends are now using pension funds to advance their political agenda.

With their membership falling, union leaders are finding it harder to influence companies or politics from the factory floor. Their new approach is to use their control over large employee pension plans to insert themselves directly into the boardroom. The result is what one observer has termed "the new politics of capital," in which liberal activists attempt to turn entire corporations into lobbyists for their social and political goals, their campaigns all neatly disguised as "shareholder activism."

Last year Calpers, the pension fund managing some $180 billion in assets for California workers, used its investment in Safeway to advance a labor agenda. When the grocer took a tough stance against its union during a strike, several Calpers board members demanded that it capitulate. Yet even as then-Calpers Chairman Sean Harrigan put the screws to Safeway, he was serving as the executive director of the very food workers' union striking against the grocer. Eleven of the 13 Calpers board members had union ties, including Democratic State Treasurer Phil Angelides, who will undoubtedly point to his anti-Safeway bona fides while hustling labor endorsements for his 2006 gubernatorial run.

Meanwhile on the East Coast, New York State's Democratic Comptroller Alan Hevesi was using his clout to aid John Kerry. When Sinclair Broadcast Group decided to air "Stolen Honor," a documentary on Mr. Kerry's post-Vietnam antiwar activities, Mr. Hevesi fired off a letter to the company in his capacity as trustee of the state pension fund (which owned shares of Sinclair) suggesting the broadcast could hurt "shareholder value." Recognizing a not-so subtle-threat when it saw one, Sinclair pulled the show.

Now comes the AFL-CIO's campaign against private Social Security accounts. In addition to its usual grassroots and Congressional lobbying, it is threatening to pull its $400 billion pension fund business from any financial services firms backing personal accounts. "We have no intention of letting any of these companies get away with this while they manage our workers' funds," stated Gerald Shea, a top AFL-CIO lobbyist.

That threat sent two Wall Street players, Edward Jones and Waddell Reed, scurrying out of a coalition supporting reform, as did the Financial Services Forum, a group of 21 chairmen of large financial concerns. Next on labor's hit list are heavyweights ranging from Morgan Stanley to Charles Schwab. Three trustees representing the New York City Employees' Retirement System recently sent a letter to a half-dozen investment banking companies demanding a review of their Social Security stance.

The problems with all this are many, starting with a rich irony: Unions are using the clout they've acquired from investing in the stock market to oppose a plan to let individuals invest their own tax money in the same market. According to a Tax Foundation paper, of nearly $2 trillion in public employee pension plan assets, 55% are invested in corporate equities. Labor leaders don't mind stock-market investing when it enhances their own political leverage, but for individual workers to build their own wealth is too "risky."

Then there's the use of the "shareholder rights" slogan to muzzle the free-speech of corporations. If any CEO who speaks up on a hot-button issue is suddenly risking "shareholder value," we are in a brave new political world. The next step will be to stop corporate execs from making political donations, or contributing to the Chamber of Commerce.

Most troubling of all is the confusion of fiduciary responsibility with partisan politics. As a matter of law, pension-fund trustees have a fiduciary duty to maximize investment returns for their beneficiaries. That certainly includes the right as shareholders to lobby for better "corporate governance," to the extent that that improves company performance or prevents fraud.

But Big Labor's new political campaigns have nothing at all to do with return on shareholder equity. They may even end up lowering returns to the extent that they prohibit certain good investments or obstruct useful government reforms. A successful union strike would have made Safeway less competitive against Wal-Mart and other companies. And Schwab and other investment companies could only benefit from the spread of an "ownership society" more knowledgeable about stock-market investing (even if companies' direct fees from managing Social Security accounts were negligible).

This fiduciary question is something that both the Labor Department and SEC ought to be looking into. The obligations of pension-fund trustees are fairly well defined, but the fiduciary duties of union leaders need to be examined now that those leaders are determining where pension money can be invested. State lawmakers will also need to put limits on the political activism of state officials who manage public assets but have their own partisan ambitions.

Meantime, the pension juggernaut is growing. Terence O'Sullivan, president of the Laborers Union, has argued that unions should consolidate their assets under one umbrella, in a kind of giant financial AFL-CIO. The idea would be to produce new profit centers for unions from credit card, mortgage and pension fund management, but more important to create an investment body large enough to dictate political terms to any company in America.

Congresswoman Nydia M. Velásquez

Q. Chairman Donaldson, complying with Sarbanes-Oxley, in particular Section 404, requires substantial resources, both in terms of personnel and cost. While large companies can more easily absorb these compliance costs through existing resources and professional staffing budgets, many of the smaller cap companies, however, do not have resources to comply with this Act and must hire outside attorneys and accountants. How significant have these compliance costs been in deterring private companies from going public and causing smaller public companies to go private?

A. *As noted in the public statements issued by the Commission and its staff, and the Public Company Accounting Oversight Board and its staff, there are valid concerns regarding the costs imposed on small issuers. For this reason, compliance with the Section 404 reporting provisions have been delayed while the appropriate private sector organization considers additional guidance on the framework for internal controls over financial reporting for smaller companies. The Commission also has established the Securities and Exchange Commission Advisory Committee on Smaller Public Companies, which will consider, among other things, the effect of Section 404 internal control provisions on smaller companies. To date, however, there is no reliable data on how many small companies have been deterred from going public or how many small public companies have gone private as a result of the Section 404 requirements.*

Q. Companies with market caps of up to $75,000,000 are not accelerated filers under Sarbanes-Oxley and have been permitted additional time to come into compliance. Do you believe that the additional time permitted for these non-accelerated filers is sufficient relief given the expense of compliance or do you believe that smaller companies need more time or greater relief?

A. *Smaller companies do not have to comply with the Section 404 reporting requirements until they file reports for fiscal years ending on or after July 15, 2006. As noted above, additional guidance on the framework for internal controls over financial reporting for smaller companies should be available before those companies file reports with the Commission. That guidance should recognize that the controls for companies vary based on the nature and size of a company's business. Smaller companies need less extensive internal controls than larger ones, and the amount of documentation and testing of those controls also may vary.*

Q. Some companies that were initially accelerated filers have now come under the threshold for non-accelerated filing. How is the SEC addressing this issue of defining the term "accelerated filer" for the purposes of complying with Section 404?

A. *The definition of "accelerated filer" has not changed. The Commission, however, granted an additional 45 day filing extension to companies with market capitalizations between $75,000,000 and $700,000,000.*

Congressman Joseph Crowley

Q. Should there be some conflict of interest clause that permits corporate titans from collecting huge bonuses during mergers if they themselves are involved in said merger.

A. *It is not the Commission's role to dictate appropriate compensation measures for corporate executives. It is the Commission's role to ensure that public companies, including companies' compensation committees, disclose completely the compensation being paid to executives and how that compensation was determined. Shareholders then may make their own judgments regarding whether those executives are being fairly compensated.*

Q. I have some real concerns about the excessive compensation packages of CEO's and heads of major publicly traded companies in the US. I know that both of you share these concerns. There is something perverse in seeing CEO's who drive their company into the ground and then earn salaries - or bonuses - totaling tens of millions of dollars,, It disgusts rank and file employees and lessons their confidence in our corporate structure.

As a capitalist, I have concerns about the government telling companies how to pay or not pay their executives. That is a job for the Board of Directors and the shareholders. But, there is growing concern that shareholders themselves do not have adequate access or information about senior executive compensation packages.

One way to allow more transparency in the compensation process is to allow all shareholders access to this pay package -- possibly through the SEC issuing new transparency regulations on shareholders direct access to management's proxy. This is an issue of growing concern not only to members of this Committee, but all members, such as Congressman Mike Michaud who has encountered similar problems with respect to shareholder access to the Proxy in his home state of Maine.

Additionally, on this issue of shareholder access to proxy, I have concerns over some recent SEC staff decisions have been inconsistent on this issue, and that such decisions do not provide appropriate guidance to either companies or their shareholders in dealing with such vital issues as corporate governance and transparency issues. Both of which are vital in ensuring the confidence of the people in our markets

Therefore, Chairman Donaldson, where is the SEC in developing this access to proxy proposal, and what efforts are being made at the SEC to either address this pay issue or find ways to restore transparency - and eliminate disgust of regular people who are sick of seeing 8' and even 9 figure compensation figures for CEO's of companies, especially bad CEO's.

A. *I agree with you that it is beyond the SEC's authority to set standards for executive and director compensation. However, I believe that the SEC can work to ensure that public companies provide full, transparent disclosure of executive compensation and their boards' policies and practices for setting this compensation. Such disclosure provides shareholders insight into company decision-making process in these areas, and increased opportunity to evaluate company policies as well as processes.*

The Commission's current executive compensation disclosure requirements regarding compensation of the company's chief executive officer and four other most highly-paid executive officers seek to elicit both the amount of their compensation and the manner in which this compensation is delivered. These disclosures are intended to assist shareholders in their voting decisions regarding such significant matters as the election of directors and approval of executive or director compensation plans.

The current executive compensation disclosure requirements have not been significantly revised since 1992. Given that compensation practices and policies have continued to evolve and our growing concern that companies construe these disclosure requirements narrowly, rather than in the spirit of disclosing all compensation as we intended, the Commission's staff is now in the process of reviewing our executive compensation disclosure requirements with a view toward possible proposed revisions of these rules. Specific disclosure requirements that the staff is reexamining include those that apply to deferred compensation, perquisites, and post-termination compensation. This project is on-going, and I expect the staff to provide their recommendations later this year.

Even while this project is pending, my fellow Commissioners and I have taken and will continue to take action to address concerns about the adequacy of disclosure regarding executive compensation and public companies' other relationships with their directors and executive officers. The Commission recently required current reporting of material agreements, including employment agreements and compensatory plans with their CEOs, their other highly compensated executives, and directors. The Commission also has recently brought enforcement actions with regard to public companies' failure to fully disclose executive compensation and related party transactions against companies such as General Electric Company, Tyson Foods, Inc. and The Walt Disney Company.

With respect to the your question regarding "proxy access," it is important to remember that the shareholder nomination proposal was the Commission's second step in addressing the control of management over critical governance issues, including the proxy process related to nominating and electing directors. The first step was our new disclosure requirements regarding the process by which nominating committees consider director candidates, including those recommended by shareholders, and the processes by which security holders could communicate directly with members of the board. I am proud to say that those requirements have elicited extensive, useful disclosure for investors during the last two proxy seasons.

The "proxy access" proposal attempts to find a middle ground between the extreme choices of forcing shareholders to give up their long-term interest in the company and sell their stock, on the one hand, and forcing them to wage a wasteful proxy fight on the other. The Commission has received more than 16,000 comment letters regarding this proposal and held a Roundtable on the topic in March 2004. Obviously, there are strongly held views on each side of this issue and we have not yet been able to find a middle ground. I am committed to continuing to work toward reaching a final resolution on this matter. We are not there yet, but I am not giving up on the effort.

I believe that the staff's recent no-action determinations in this area are not inconsistent with the shareholder nomination proposal. In this regard, the staff has consistently determined that companies may exclude proposals that seek to give shareholders access to the company proxy for the purpose of nominating directors, and the United States District Court for the Southern District of New York recently agreed with this view. The staff's position constitutes a view on shareholder proposals and is not a statement regarding the proposed shareholder nomination proposal. Indeed, the position facilitates the Commission's ability to seek a compromise rule on a broad basis, rather than having the rulemaking process proceed against the backdrop of a company-by-company debate.

Q. As a follow up to the question by Chairman Oxley, at the SEC roundtable last week on accounting issues, there was a general agreement that the application of SOX 404 and auditing Standard No. 2 should be principles-based rather than rules-based. Along those same lines, there was some discussion that a move to a principles-based standard must be coupled with protection for auditors that provide room for reasonable business judgment to protect against second-guessing earlier judgment with perfect 20-20 hindsight.

Chairman McDonough stated his support for some sort of liability protections for auditors. On that note, what guidelines could you provide this Committee on this issue? What can the PCAOB and SEC do to assure auditors that their appropriate exercise of judgment will be afforded respect -- not just by you as regulators -- but by the legal system? And should additional steps be taken to shield the liability of smaller accounting firms to provide them greater strength to compete in the market?

A. *The need for managements and auditors to exercise judgment in the application of the reporting requirements under Section 404 of the Sarbanes-Oxley Act was emphasized in public statements issued by the Commission and its staff, and by the Public Company Oversight Board and its staff, on May 16th. The Commission staff's statement also discusses the range of "reasonable" judgments that a company might make in implementing those requirements. These strong statements by the Commission and the PCAOB, the two bodies charged by the Act with the responsibility for implementing these requirements, may provide persuasive information for courts and others that, while the zone of reasonable conduct is not unlimited, it will be rare that there will be only one acceptable choice in implementing Section 404 in any given* *situation. The Commission and its staff statements are available on the Commission web site at www.sec.gov.*

Other Questions for the Record
Offered by Congressman Crowley on behalf of Congressman Michaud of Maine

Q. Section 301 of the Sarbanes-Oxley Act, *requires* that every company with securities traded on a national securities exchange or national securities association *must* have an audit committee comprised *entirely of independent directors.* The SEC was required to implement this requirement and it did so by promulgating a formal rule in 2003 requiring all national securities exchanges and national securities associations to adopt listing requirements that *require* publicly traded companies to have audit committees comprised *entirely of independent directors.*

In testimony before the Senate Committee on Banking, Housing and Urban Affairs on September 9, 2003, Chairman Donaldson, you, testified about the SEC's rules implementing the Sarbanes-Oxley Act, and stated - and I quote - "Under the new rules, listed companies must meet the following requirements:" and the *first* requirement you highlighted was that - and I'm quoting again - *"All audit committee members must be independent."*

Therefore, my question is, is it the SEC's position that publicly traded companies are capable of complying with Section 301 of the Sarbanes-Oxley Act and the SEC's rules promulgated there under by ensuring that corporate boards have a sufficient number of independent directors to permit the establishment of an audit committee comprised entirely of independent directors?

(And NYSE listing requirements that were approved by the SEC, for example, set the minimum number of directors to serve on the audit committee at three.)

If they are capable of meeting this Section 301, is it the SEC's position that publicly traded companies are capable of ensuring that there are a sufficient number of independent directors on the board who can serve on the corporation's audit committee, why has the staff of the SEC's Division of Corporation Finance several times within the last year *rejected* shareholder proposals advocating the appointment of independent directors as Chairman on the grounds that corporate boards supposedly "lack[] the power and authority to implement the proposal" under SEC Rule 14a-8(i)(6) because corporations somehow cannot ensure the election of even a single independent director? (***Exxon Mobil*** *Corporation,* SEC No-Action Letter, 2005 WL 589923 - March 13, 2005).

Or if you believe publicly traded companies do not have the capacity of ensuring that an independent director will be elected to a corporate board, then does the SEC not intend to enforce Section 301 of the Sarbanes-Oxley Act? Are there any other provisions of the Sarbanes-Oxley Act that the SEC deems extraneous and which the SEC has determined that it will not try to enforce? Nowhere in your previous testimony did you advise Congress that the SEC believed that Section 301 of the Sarbanes-Oxley Act was extraneous or that companies, somehow, lack the ability to appoint independent directors to serve on the audit committee.

Instead, you *highlighted* this independence requirement in your previous testimony to the Senate on this very issue. Please explain.

Or do you believe the independence requirement for corporate audit committees is effected through listing requirements that provide for opportunities to "cure" in the event that independent directors, due to subsequent events, cease to be independent then wouldn't it be the case that you are arguing that companies are capable of ensuring that at least one independent director serves on the Board, even if circumstances somehow change and that director loses his or her independence, right?

So then this ability to "cure" the lack of independence of a Chairman, may be found in state law - such as in an ability of a corporate board to amend a corporation's bylaws to cure any such defects, right?

So therefore if a corporate board is given the opportunity through state law to "cure" any problem that may be encountered in the event, however unlikely, that an independent Chairman somehow loses his or her independence, it cannot be said that a corporation "lacks the authority" to adopt a policy or bylaw that would require that an independent director serve as Chairman, right?

So then, Mr. Donaldson, do you agree with the opinion of the staff of the Division of Corporation Finance that corporations necessarily "lack the power" to implement a shareholder proposal advocating an amendment to corporate bylaws to require that an independent director serve as Chairman, even if the particular corporation's board is empowered under state law appoint a new director as Chairman or to amend the bylaws in the unlikely event that the Chairman's independence is ever compromised?

A. *I believe that publicly traded companies are capable of complying with Section 301 of the Sarbanes-Oxley Act and the SEC's rules promulgated there under, and that the staff's position in Exxon Mobil Corporation, dated March 13, 2005, is consistent with those provisions and prior staff positions. Specifically, the staff's response in that matter makes clear that its determination in Exxon Mobil was not based on the view that companies cannot ensure the election of independent directors. The staff's response states "it does not appear to be within the power of the board of directors to ensure that its chairman retains his or her independence at all times and the proposal does not provide the board with an opportunity or mechanism to cure such a violation of the standard requested in the proposal." I believe this position is entirely consistent with Section 301 of the Act, which added Section 10A(m) to the Securities Exchange Act. In this regard, Section 10A(m) mandates that a cure mechanism exist for situations in which the independence of the company's directors is lost. Section*

10A(m) states that "[t]he rules of the Commission . . . shall provide for appropriate procedures for an issuer to cure any defects that would be the basis for a prohibition [of the listing of an issuer's securities, such as a board member's lack of independence] before the imposition of such prohibition." As such, the Commission adopted Exchange Act rule 10A-3, which provides such an opportunity and states that "if a member of an audit committee ceases to be independent in accordance with the requirements of this section for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable national securities exchange or national securities association, may remain an audit committee member of the listed issuer until the earlier of the next annual shareholders meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent."

The staff's no-action determinations are not based solely on the subject matter of a proposal. Rather, the staff analyzes the specific wording of each proposal and differing language may result in different responses. In this regard, it is noteworthy that during the past proxy season, the staff denied numerous requests from companies to exclude director independence proposals that contained language permitting the companies to cure losses of independence. However, when a proposal such as the one in Exxon Mobil is drafted in a manner that requires a director to maintain his or her independence at all times, the staff will, consistent with Section 10A(m), Exchange Act rule 10A-3 and prior staff determinations under Exchange Act rule 14a-8, permit the company to exclude the proposal on the basis that the proposal does not provide the board with an opportunity or mechanism to cure a violation of the standard requested in the proposal. The staff has advised me that it is not necessary to analyze state law in reaching this determination; rather, even if a company's bylaws permit the company to replace its chairman, the company still cannot ensure that its chairman remains independent at all times.

Congressman Ruben Hinojosa

Q. Companies are concerned about what they deem to be inconsistent, and sometimes arbitrary, application of the PCAOB audit standard by accounting firms or even teams within firms. In particular, they contend that there appear to be variances among firms about what constitutes a "material weakness" or "significant deficiency." Predictably, their views on internal controls sometimes differ from what the external auditors demand, thus resulting in a lack of clarity leading to uncertainty and disputes. How can the Commission, the Board and the private sector work together to get more consistency, more clarity, and fewer disputes? Furthermore, is it possible, and appropriate, to provide more flexibility to allow external auditors to rely more on the work of internal audit staff?

A. *On April 13, 2005, the Commission and PCAOB heard similar concerns during an SEC sponsored roundtable on the implementation of Section 404. The Commission staff, in a public statement issued on May 16th, emphasized the need for reasonable judgment in the evaluation of internal control deficiencies. The staff indicated that consideration should be given to, among other things, the nature of the deficiency, its cause, the relevant financial statement assertion the control was designed to support, its effect on the broader control environment, and whether compensating controls are effective. The Commission staff statement and a separate Commission statement are available on the Commission web site at www.sec.gov.*

The Commission staff statement, as well as statements from the PCAOB and its staff, emphasized that an auditor may rely on competent and objective internal auditors in certain instances, particularly regarding internal controls that have a low risk of contributing to a material misstatement in the company's financial statements.

Q. Some of my constituents have expressed concern with what they describe as the "varying degrees of implementation, and the `control' the accounting firms are exerting as a result of Sarbanes-Oxley." They argue that the accounting firms are performing testing and requiring documentation that is unnecessary out of fear that they will not be deemed in compliance with certain sections of Sarbanes-Oxley, and, consequently, will suffer substantial penalties and increased liability for failing to report financials accurately. What can be done to reverse this apparent trend?

A. *In response to such concerns, the Commission and its staff and the PCAOB and its staff recently issued statements emphasizing the need for reasoned professional judgment in the application of the Section 404 internal control reporting requirements. The Commission staff's statement also discusses the range of "reasonable" judgments in implementing those requirements. These strong statements by the Commission and the PCAOB, the two bodies charged by the Act with the responsibility for implementing these requirements, should provide persuasive information for court and others that, while the zone of reasonable conduct is not unlimited, it will be rare that there will be only one acceptable choice in implementing Section 404 in any given situation.*

Q. Some of my constituents have also contended that the accounting profession is no longer "principles - based" but it is now "rules based" due to Sarbanes-Oxley. They argue that the recent and numerous restatements serve absolutely no purpose for an investor, particularly a debt investor as there is generally no impact on cash flows. If this is the case, how do we get back to a principles - based approach? Even if you do not believe this is the case, please address their concerns, and mine, on this issue.

A. *The Commission staff has issued a report under Section 108(d) of the Sarbanes-Oxley Act discussing the benefits of an objectives-based approach to setting accounting standards. Under such an approach, the guiding principals for a new standard would be minimized, and sufficient guidance would be provided to assure consistent application of the standard. The standard would not be so detailed, however, as to encourage accounting that complies with the letter but not the spirit of the standard. This approach requires the use of professional judgment in achieving the goals of a standard as opposed to a "check the box" method of accounting. Full implementation of this approach will take time; however, both the Commission and the Financial Accounting Standards Board have indicated a commitment to following an objectives-based approach in future standard-setting projects.*

Q. Is there a way regulators can provide additional relief for depository institutions that are struggling with redundant compliance burdens as a result of the Sarbanes-Oxley Act?

A. *The FDIC Improvements Act of 1991 required depository institutions to prepare internal control reports similar to those required under Section 404 of the Sarbanes-Oxley Act. The staff of the Public Company Accounting Oversight Board has issued guidance indicating that compliance with the PCAOB standard should satisfy the internal control reporting requirements under FDICIA.*

Q. It is difficult to generalize, but in many cases where companies report material weaknesses, those weaknesses involved one-time problems with specific controls rather than systemic weakness. In most cases these weaknesses are remediable. Is there a way to provide additional flexibility to correct these problems prior to reporting?

A. *Under Section 404, companies are required to report material weaknesses that exist as of the end of its fiscal year. Accordingly, a weakness that is identified and corrected before year-end would not need to be reported. If a company discloses a weakness that exists at the end of its fiscal year, but subsequently corrects that weakness, the company may disclose its corrective actions. The Public Company Accounting Oversight Board has proposed a standard that would provide guidance for auditors engaged to attest to the effectiveness of those actions and whether, in the auditor's view, the material weakness has been remediated.*

Congressman Dennis Moore

Q. Chairman Donaldson, as you are aware, over the last several months there have been significant activities and developments related to lease accounting issues that have affected hundreds of public companies.

As I am sure you have heard, many businesses have concerns about these lease accounting issues and have asserted that they have been dealt with in an inconsistent manner, resulting in significant confusion and added costs.

In particular, many public companies have argued that there has been inconsistent application of the standards that the public accounting firms apply to determine whether lease accounting issues led to a material weakness determination under the internal control assessment required by Section 404 of the Sarbanes-Oxley Act.

I hope you would agree that consistent application of Section 404 is in the best interests of the investing public and the capital markets.

Chairman Donaldson, would you and the SEC be willing to work with the accounting industry and public companies affected by changes to lease accounting standards in a way that will help businesses understand their responsibilities in this area?

A. *On April 13th, the Commission hosted a Roundtable on Implementation of Internal Control Reporting Provisions, at which this issue and many others were discussed by panels of investors, auditors and members of management and audit committees. On May 16th the Commission and its staff issued statements on issues that arose during the first year of experience with the implementation of Section 404. The Commission and its staff statements are available on the Commission web site at www.sec.gov. The Commission is committed to working with all interested parties to assist in the understanding and efficient implementation of their reporting responsibilities under Section 404.*

The Commission staff's statement notes that neither Section 404 nor the Commission's rules require that a material weakness in internal control over financial reporting must be found to exist in every case of restatement resulting from an error. Such a determination should be based on the judgment of management and the company's external auditor in assessing the reasons why a restatement was necessary and whether the need for restatement resulted from a material weakness in controls.

As for the lease accounting issues that you mention, as you may be aware, on February 7th the Commission's Office of the Chief Accountant issued a letter outlining the current GAAP literature that should be looked to in determining the appropriate accounting for certain leasing situations or transactions. This letter is available on the Commission's web site at www.sec.gov. To the extent that SEC registrants have *deviated from the lease accounting standards and related interpretations set forth by the FASB, those registrants, in consultation with their independent auditors, should assess the impact of the resulting errors on their financial statements to determine whether restatement is required. The Commission's staff continues to answer questions that arise on accounting for leases and will assess whether additional guidance, either by the Commission or the standard-setters, is needed to address any areas not currently covered in GAAP.*

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