WRITTEN TESTIMONY OF

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BEFORE THE
CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE
HOUSE FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

HEARING TO EXAMINE THE BURDENS AND BENEFITS OF THE SARBANES-OXLEY ACT

JULY 26, 2012

Introduction

Mr. Chairman and Members of the Subcommittee, my name is Michael Gallagher and I am pleased to testify today on behalf of the U.S. auditing profession regarding the Sarbanes-Oxley Act of 2002 (the Act). I have more than 26 years of experience in public accounting, and am currently Chairman of the Professional Practice Executive Committee (PPEC) of the Center for Audit Quality (CAQ). I am also the Managing Partner of PricewaterhouseCoopers LLP's audit quality functions.

I am here today on behalf of the CAQ and PPEC. The CAQ was formed in 2007 to serve investors, public accounting firms that audit public companies, and the capital markets by enhancing the role and performance of public company auditors. It is a membership organization with nearly 600 public company audit firms as members. The firms are registered with the Public Company Accounting Oversight Board (PCAOB). The member firms are committed to fulfilling the public interest role that auditors play in our capital markets.

The PPEC supports the CAQ's objectives by providing a forum for public accounting firms to express their views on technical and regulatory matters involving practice before the Securities and Exchange Commission (SEC) and the PCAOB. It also liaises with the SEC, PCAOB, Financial Accounting Standards Board, and others on technical and regulatory matters, including those related to financial reporting and audit quality.

My comments represent the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Overview

Let me begin by providing a brief summary of the objectives, benefits, and costs of the Act, each of which I will explore in greater detail in my testimony.

The Act was passed to restore investor confidence in public companies and enhance investor protection by improving corporate governance and increasing the accuracy and transparency of financial reporting. This subcommittee played an important role in crafting the Act 10 years ago, at a time when the financial markets had been roiled by a series of significant financial reporting frauds, and one of the largest audit firms had gone out of business. Investor confidence had been shaken, and Congress responded in a near unanimous and bi-partisan fashion to improve the accuracy of public company financial reporting, and the quality of public company audits.

We believe the benefits of the Act to investors and the capital markets more broadly have been substantial. In passing the Act, Congress explicitly recognized the interrelated roles that companies, audit committees, and auditors have in assuring the integrity of financial reports. Benefits of the Act include: (i) strengthened audit committees and corporate governance; (ii) enhanced auditor independence; (iii) improved transparency and accountability for financial reporting, in part through new requirements for public companies and their auditors focused on internal

control over financial reporting; and (iv) independent oversight of the audit profession by the PCAOB.

These benefits came with certain compliance costs -- costs which are ultimately borne by investors whose confidence had been upset by a series of financial reporting failures. The compliance costs have declined significantly since the Act was first implemented, but nonetheless we understand they need to be considered in the appropriate context when examining the Act.

We believe the Act has been successful in achieving its objectives. In many ways, it has also set new standards for corporate governance and auditor oversight that many other jurisdictions around the world have embraced. Also, we continue to examine ways to build upon the successful reforms of the Act to enhance financial reporting and audit quality and promote greater investor protection. I'll touch upon some of these areas later.

Strengthened audit committees and corporate governance

The Act placed the responsibility for overseeing a public company's financial reporting process and the appointment, compensation, and oversight of its external auditor, with the audit committee rather than management. It requires audit committee members to be independent of management. The audit committee therefore has a responsibility to protect the interests of investors, and auditors report directly to them in their oversight role. This change, which is one of the most important reforms for investors and the capital markets, increased the depth,

breadth, and candor of dialogue between auditors and audit committees, improving financial reporting and audit quality.

The Act strengthened audit committees by encouraging them to have at least one member who is a financial expert to serve as a resource to help the audit committee execute its responsibilities. Companies that do not have a financial expert must disclose this in their proxy statement and explain the rationale.

Required communications between auditors and audit committees were enhanced by the Act. They included critical accounting policies and practices and alternative accounting treatments. Audit committees were required to establish procedures for receiving whistleblower complaints, providing another means to identify potential accounting, reporting, and internal control issues and promote improved financial reporting.

Collectively, these changes enhanced the role of the audit committee, empowered it to effectively carry out its responsibilities, and significantly contributed to improved financial reporting and audit quality. Today, proxy filings indicate that audit committees meet with greater frequency than a decade ago, and almost half of all audit committee members are financial experts. This compares to only a small number in 2003[1]. The increase in audit committees' skill sets, coupled with enhanced communications requirements, better enables them to understand and challenge the adequacy and appropriateness of a public company's accounting and

[1] *The Sarbanes-Oxley Act at 10: Enhancing the reliability of financial reporting and audit quality*, Ernst & Young.

financial reporting processes. They also help the audit committee better assess if the auditor has been objective and appropriately skeptical, and whether he or she has performed an effective audit.

Enhanced auditor independence

The Act introduced a number of changes to enhance the independence of public company auditors. We believe these changes were balanced and very effective, and have described them below.

The Act prohibits audit firms from providing certain non-audit services to companies they audit that might compromise their independence. Examples of prohibited services include financial information systems design and implementation, and internal audit outsourcing services. In addition, it requires audit committees to pre-approve all services to be provided by a public company's auditor, including any permissible non-audit services, such as financial due diligence and tax compliance services. Thus, audit committees were empowered to determine which, if any, permissible non-audit services could be performed by the auditor. Transparency also was increased through new proxy statement disclosure requirements that enable investors to see the amount of fees paid by public companies to their auditors for audit and non-audit services.

The Act requires the lead engagement partner to rotate off the audit engagement every five years, rather than seven as had been the case previously under the rules of the profession. It lengthened the "cooling off" period, the period before the partner

can return to the engagement, from two years to five years. These requirements were extended to the engagement quality review partner as well, whose role is to perform an objective review of the significant judgments and conclusions of the engagement team.

Conflict of interest rules restricting employment by public companies of former employees of its audit firm's engagement team were also expanded by the Act. In effect, the SEC's rules prohibit a former partner or professional employee of the audit firm who was a member of the audit engagement team from being employed by the public company in a financial reporting oversight role[2] until the audit firm has completed an annual audit without the individual. If the individual is a former partner, he or she may not have a remaining capital balance with the audit firm, and no individual can have a financial arrangement with the audit firm under which payouts would depend on the revenues or profits of the audit firm.

Improved transparency and accountability for financial reporting

Executive Officer Certifications

One of the core elements of the Act was to place clear responsibility for a public company's financial statements with its chief executive officer (CEO) and chief financial officer (CFO). CEOs and CFOs must individually certify that to their knowledge, the periodic financial reports filed with the SEC are materially correct,

[2] Defined in the SEC's final rule regarding auditor independence as a role in which an individual has direct responsibility for or oversight of those who prepare the registrant's financial statements and related information (e.g., management discussion and analysis), which will be included in a registrant's document filed with the SEC.

and that those reports “fairly present” the public company’s operations and financial condition in all material respects.

The CEO and CFO must certify that they are responsible for establishing and maintaining an effective system of internal control over financial reporting. Management must evaluate the effectiveness of internal control over financial reporting, and present its conclusion in a report that accompanies the financial statements.

The Act further enhanced executive officers' accountability for financial reporting by mandating stiff penalties -- including forfeiture of bonuses and profits, potential SEC enforcement action, and criminal penalties -- for knowingly certifying non-compliant financial reports.

Internal Control Over Financial Reporting

In addition to requiring management to evaluate and report its conclusion on the effectiveness of internal control over financial reporting, the Act requires auditors to attest to management's conclusion. This requirement has been applied to public companies whose market capitalization exceeds $75 million. We believe these requirements provide significant benefits to investors. They increase accountability of individuals involved in the financial reporting process, enhancing the quality and reliability of companies’ financial reporting.

For example, a study released by the SEC in 2009[3] found that the auditor attestation requirement caused management to devote more resources to a disciplined financial reporting process in order to better understand financial reporting risks, implement controls to address those risks, and address control issues in a more timely fashion. That study also noted that an auditor's professional expertise in evaluating internal control over financial reporting provides incremental benefit to management's assessment, and ultimately a benefit to investors, similar to the audit of the financial statements. Other studies have also found that restatements of financial information, an important area of concern to investors, are less frequent for companies subject to the auditor attestation requirement than those that are not[4]. For these reasons, we believe that the discipline and accountability that the auditor attestation requirement provides is very important in today's complex and ever evolving business and financial reporting environment.

The above changes have also led to improvements in the audit committee's role in corporate governance. For example, auditors are required to communicate to the audit committee all significant deficiencies and material weaknesses in internal control over financial reporting that have been identified during the audit. This communication promotes important discussions about internal control over financial reporting among management, the audit committee, and the auditor -- helping improve the audit committee's oversight and the quality of companies' controls and financial reporting.

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[3] Section V of the SEC's Office of Economic Analysis *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control Over Financial Reporting Requirements* found at http://www.sec.gov/news/studies/2009/sox-404_study.pdf.
[4] See http://www.thecaq.org/newsroom/pdfs/CAQCommentLetter-SOX404(b)Study.pdf (page 3).

Independent oversight of public company audits and auditors

The Act established the PCAOB to oversee public company audits and auditors. We believe its activities, and in particular its inspections and standard-setting roles, which were conducted by the auditing profession under a self-regulation model prior to the Act, have been a significant factor in the improvement of audit and financial reporting quality over the past decade.

The largest audit firms are inspected by the PCAOB on an annual basis, while others are inspected at least every third year. The inspection process provides the PCAOB a basis for assessing the degree of compliance by an audit firm with applicable requirements related to auditing public companies. It includes reviews of components of selected public company audits completed by audit firms and the policies and procedures related to certain quality control processes of audit firms, such as those used to monitor audit performance and risks in accepting and retaining clients.

The PCAOB's inspections promote audit quality a number of ways. For example, they reinforce accountability for audit quality at all levels of an audit firm, including leadership. The inspections also highlight opportunities for audit firms to improve. This might include identifying areas on an engagement where more or different audit procedures should be performed. The inspections also help identify areas in which additional training, audit guidance, skills, or communications may be needed.

It is also important to note that the PCAOB's inspection activities are not limited to the U.S. The PCAOB has made significant progress over the past several years reaching inspection agreements with audit regulators in other territories. These efforts are ongoing, and US regulators are seeking to obtain better alignment in those cases where US and local territory laws conflict. Thus, international inspections also promote investor protection, particularly in light of the ever increasing complexity and global scale of business. Many jurisdictions have adopted similar independent auditor oversight models.

Standard-setting can also have a significant impact on audit quality. The PCAOB publishes its standard setting agenda, and solicits feedback, in part, through its Standing Advisory Group (SAG). The SAG comprises investors, public company executives, audit committee members, auditors, and other stakeholders. I am a member of the SAG, as are several other individuals in the member firms of the CAQ. Also, the CAQ, including the PPEC, works closely with the PCAOB and its Staff on new and emerging auditing issues, with a focus on promoting standards that enhance financial reporting and audit quality.

Costs of the benefits

We recognize the aforementioned benefits associated with the Act came with certain costs of compliance, costs which have generally declined over the last ten years[5]. In fact, a July 2012 report by Audit Analytics found that in 2011, audit fees, as a

[5] Protiviti's *2010 Sarbanes Oxley Compliance Survey* can be found at http://www.auditnet.org/articles/KL201010.pdf.

percentage of public company revenues, were at the lowest level since 2004, the first year of the Act[6].

In order to put the above in context, it is helpful to consider how the Act's implementation has evolved over time. The PCAOB's original auditing standard on internal control, issued in 2004, was widely viewed as being too rules-based and costly, as audit hours, audit fees, and companies' associated internal costs increased significantly. The PCAOB recognized these concerns and responded by issuing a revised standard in 2007 that was intended to promote a more risk-based audit and was less prescriptive, thereby allowing the use of more auditor judgment. While focused on maintaining audit quality, that standard generally resulted in reductions to the nature and extent of audit procedures, and a corresponding reduction in audit hours and fees[7].

The PCAOB also published staff guidance on its revised standard for audits of smaller public companies[8]. This guidance was intended to facilitate more efficient and effective audits of internal control over financial reporting for smaller, less complex public companies. The PCAOB conducted forums across the country for auditors of smaller audit firms, to help address implementation issues associated with its revised standard.

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[6] Audit Analytics' *Audit Fees and Non-Audit Fees: A Ten Year Trend*, July 2012 (page 3).
[7] http://www.sec.gov/news/studies/2011/404bfloat-study.pdf.
[8] PCAOB Staff Views *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements Guidance for Auditors of Smaller Public Companies.*

The SEC also undertook targeted reforms that resulted in more efficient and effective implementation of the internal control requirements of the Act. It released guidance in 2007 for companies to use in their assessments of internal control[9]. This guidance improved management assessments, which has contributed to an increase in auditor efficiency.

In addition, the recently passed Jump Start our Business Startups Act (JOBS Act) also provides certain relief to emerging growth companies, including a temporary exemption from the auditor attestation on internal control over financial reporting. While we believe that the auditor attestation requirement enhances investor protection, we understand the cost/benefit balance achieved by providing emerging growth companies additional time to comply with it.

Aside from actions by Congress, the PCAOB, and the SEC, other factors have contributed to the downward trend in costs related to the internal control requirements. For example, as the work of auditors and public companies in this area has evolved over the years, there continue to be efficiencies gained by both. Management's processes and activities that support a public company's required assertion about internal control over financial reporting have become more integrated with their day-to-day activities and related financial reporting, in part due to investments to update information technology systems. Further, auditors have

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[9] SEC *Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934.* http://www.sec.gov/rules/interp/2007/33-8810.pdf

made continued progress in integrating their audits of internal control over financial reporting with their financial statement audits.

Thus, the collective impact of these factors has led to a general decline in compliance costs associated with the internal control provisions of the Act.

Continuous improvement

Often the only time the investing public hears about a significant financial reporting or auditing issue tends to be when the financial reporting system has not worked as it should, whether it is a restatement of the financial statements, an audit deficiency, or other matter. We believe the accountability and transparency provided by the Act has been a significant deterrent to potential wrong doers. Also, in some respects, investors do not hear anything when the system works and delivers the value that was intended, which is the case the vast majority of the time - - issues are identified and fixed, internal controls are improved, and auditor performance and audit committee oversight are effective.

That said, the auditing profession is constantly looking for ways to make the system better, with appropriate consideration of cost/benefit. Accordingly, we are actively engaged in the dialogue with investors, audit committees, regulators and others on ways to further enhance financial reporting and audit quality. For example, the CAQ has been supportive of a number of the PCAOB's recent proposals, including making improvements to the auditor's reporting model and audit committee communications. We also support looking for ways to have more meaningful

conversations with audit committees about PCAOB inspection findings for a given engagement. Further, the CAQ is working with the audit committee community to identify what auditors can do to promote best practices for audit committees as they execute their responsibilities.

Closing

To briefly recap, we believe the Act has achieved its objectives, and that the benefits to investors and the capital markets more broadly are substantial. It (i) strengthened audit committees and corporate governance; (ii) enhanced auditor independence; (iii) improved transparency and accountability for financial reporting; and (iv) established independent oversight of the audit profession by the PCAOB.

Though the significant benefits achieved did include certain compliance costs, those costs have generally declined over the past 10 years, in part due to additional experience and process improvements by public companies and their auditors, and other actions.

Lastly, we believe that the best course looking forward is to build upon the successful reforms of the Act. We commit to fulfilling our role by engaging investors, audit committees, regulators, and others on this subject with a clear focus on enhancing investor protection.

Thank you. I would be happy to take any questions you might have.