

Testimony Concerning  
the  
Public Company Accounting Oversight Board



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Before the  
Committee on Finance  
United States Senate

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**TESTIMONY**

Chairman Grassley, Ranking Member Baucus and Members of the Committee –

I am pleased to appear before you today on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board"). I would like to begin by commending the Committee's thoughtful and deliberative review of the Enron debacle, resulting in the Joint Tax Committee's report exposing Enron's abusive tax shelters and Enron's use of executive compensation arrangements to the excessive advantage of senior managers and the devastating disadvantage of rank-and-file employees. Indeed, the evidence you and the Joint Committee on Taxation have accumulated has served as a wake-up call that we all – whether corporate leader, legislator, or regulator – must heed.

The Senate Finance Committee was quick to see the wide-ranging ramifications of the financial scandals at Enron, Adelphia, WorldCom, HealthSouth and other companies. Those corporate collapses left the impression – not just with investors, but with ordinary Americans, and even with the world community – that public company financial reporting is not to be trusted, and that professional advisors, including investment bankers, lawyers, and even a company's outside accountants, will help unscrupulous executives cook the books. When their trust was broken, the people did what they ought to – they asked their elected representatives to fix it. Congress responded by enacting the Sarbanes-Oxley Act of 2002, which, among other things, created the PCAOB. In addition, through the Senate Finance Committee's series of hearings on Enron's tax shelters – shelters that were designed to create the appearance of financial statement earnings – and on excessive executive compensation, you continue to respond to the public's concerns regarding corporate integrity and financial reporting reliability.

I am both proud and humbled to appear before you today as Chairman of the PCAOB. Among the many reasons I took on this job were my own strong convictions about the need for an aggressive response to the corporate scandals and the lack of leadership in the private sector. It is a privilege to have the opportunity to act on those convictions by helping to build an organization, in the form envisioned by Congress, to restore the linchpin of the American financial system – trust in the integrity of financial reporting.

## TESTIMONY

### Introduction

A little over a year ago, the Congress passed and the President signed the Sarbanes-Oxley Act of 2002 (the "Act").<sup>1/</sup> The Act established the PCAOB and charged it with "oversee[ing] the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the 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."<sup>2/</sup> To carry out this charge, the Act gives the Board significant powers. Specifically, the Board's powers include authority –

- to register public accounting firms that prepare audit reports for issuers;
- to conduct inspections of registered public accounting firms;
- to conduct investigations and disciplinary proceedings concerning, and to impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms;
- to enforce compliance by registered public accounting firms and their associated persons with the Act, the Board's rules, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants; and
- to establish auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers.<sup>3/</sup>

### Overview of the Board's Organization

Since the initial Board members took office in January, the Board has taken a number of steps to position it to carry out its core programs. Starting from scratch in January 2003, the Board has grown to over 90 full-time professional staff. Earlier this year, the Board opened offices in Washington, D.C. and New York City, as well as an information technology center in Northern Virginia. The Board will be opening regional

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<sup>1/</sup> P.L. No. 107-204 (2002).

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

<sup>3/</sup> Sarbanes-Oxley Act, Section 101(c).

## TESTIMONY

offices in Atlanta, Dallas and San Francisco in the near future. The Board also adopted bylaws and established ethics rules and standards of conduct for Board members and staff and developed a budget of approximately \$68 million for its first fiscal year (calendar year 2003). The SEC approved that budget in April, and we have sent invoices to public companies and other issuers of securities – based on their relative equity market capitalizations, in accordance with the Act – to cover it.

### Registration

The Act and the Board's rules require that as of tomorrow, October 22nd, all U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must be registered with the PCAOB.<sup>4/</sup>

Registration is critical to the Board's regulatory oversight of public accounting firms. As a legal matter, registration is the predicate for the Board's other oversight programs – compliance with auditing and related professional practice standards, inspections, investigations, and discipline. In addition, registration provides the Board with valuable information about the firms that apply for registration.

Registration of a public accounting firm is not automatic upon application. In order to approve an application, the Board must determine that registration of the applicant is consistent with the Board's responsibilities under the Act to protect investors and to further the public interest in the preparation of informative, fair and independent audit reports for public companies. To make that determination, the Board has been and remains committed to a careful and fair review of all applications. The Board received its first registration application on August 7, 2003, and, as of October 16, 2003, the Board has received 619 applications.

### Inspections

The Act requires the Board to conduct a continuing program of inspections of registered public accounting firms. The purpose of these inspections is to assess the degree of compliance of each registered public accounting firm, and associated persons of that firm, with the Act, the rules of the Board, the rules of the Commission, and professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.

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<sup>4/</sup> Non-U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must register with the PCAOB next year.

## TESTIMONY

Through the Board's inspection program, we will have extensive contact with registered firms and their personnel. It is the tool we will use to assess the quality of the audits that have been conducted and, when necessary, to exert pressure to change auditor behavior. It will provide us with a view – at times through a microscope, and at other times from a bird's eye – into the registered firms to see how they are implementing applicable auditing and related professional practice standards, how they are complying with applicable laws and rules, where they are doing well, and where improvements are needed. Our inspections program will provide a unique new source of evidence relating to audit quality and to the symptoms of any weaknesses in audit quality, ranging from competence and methodology to judgment and integrity.

Our inspections will focus on a number of areas that have not been the traditional focus of the profession's own peer review process. These include –

- the "tone at the top" of registered firms – we want to know the nature of the messages that are coming from the highest levels of the firms and their frequency, and whether the messages are received and acted on;
- partner compensation and promotion – we are going to look into what behaviors are rewarded and reinforced through compensation and promotions; and
- the firms' overall communication and training practices with regard to all firm professionals.

On October 7, 2003, the Board adopted final rules relating to inspections. Under the final rules –

- regular inspections are to take place annually for those firms that issue audit reports for more than 100 U.S. public companies;
- other firms are subject to regular inspections every three years; and
- special inspections may be authorized by the Board at any time.

Earlier this year, we began conducting limited inspection procedures on the four largest accounting firms, which agreed to cooperate with the Board's inspectors even before they were registered. Those inspections are well underway now. Beginning in 2004, we will conduct annual regular inspections of all firms with more than 100 issuer

## TESTIMONY

audit clients, as required by the Act, and we will conduct triennial regular inspections of registered firms with 100 or fewer issuer audit clients.

Of particular importance, given the Joint Committee on Taxation's findings on the non-audit services Arthur Andersen provided to Enron, our work programs for this year's limited procedures include a focus on evaluating the independence implications of non-audit services that firms have provided to audit clients. Based on this work, we will not only assess whether the firms comply with existing independence requirements, but we will also assess whether there are any factors present that have adversely affected audit quality. Because we are inspecting the Big Four large firms, and a variety of selected audit engagements, we expect to gain an understanding of the firms' practices on an overall basis, which will help us to determine whether further action is needed.

### Investigations and Discipline

The Act authorizes the Board to conduct investigations when there are indications that a registered firm or an associated person may have violated the Act, the Board's rules, provisions of the securities laws and the Commission's rules related to financial reporting and auditing, or professional standards. The Act further authorizes the Board to use the results of those investigations as the bases for disciplinary proceedings. If a violation is established in those proceedings, the Act authorizes the Board to impose a range of sanctions on the firm or associated person who committed the violation.

On September 29, 2003, the Board adopted an extensive set of rules relating to investigations and disciplinary hearings. The PCAOB is also in the process of staffing a Division of Enforcement and Investigations, which will have responsibility for carrying out the Board's investigative work and conducting its disciplinary proceedings.

### Professional Standards

Title I of the Act also gives the Board the authority to establish auditing and related professional practice standards to be followed by registered public accounting firms, and persons associated with such firms, when they audit and issue opinions on the financial statements of public companies.<sup>5/</sup> In addition to auditing standards, those standards include related attestation work, standards for quality controls, ethics standards, and independence standards. Early on, the Board decided to establish professional standards by creating within the PCAOB a standard-setting office, made up of highly-skilled experts, rather than by delegating the standard-setting function to a

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<sup>5/</sup> See Sarbanes-Oxley Act, Section 103.

## TESTIMONY

professional organization of accountants, such as the AICPA's Auditing Standards Board.

In addition to this general standards-setting authority that Title I of the Act confers on the Board, Section 201 of the Act expressly authorizes the Board to adopt regulations specifying non-audit services – in addition to those specified in the Act – that may not be provided to audit clients.<sup>6/</sup> Section 201 also permits the Board, on a case-by-case basis, to grant exemptions from the Act's prohibitions on providing certain non-audit services to audit clients, but only to the extent necessary or appropriate in the public interest and consistent with the protection of investors.

The Act required the Board to adopt initial or transitional standards as part of the process leading up to the SEC's determination, pursuant to the Act, that the PCAOB was capable of carrying out its responsibilities under the Act.<sup>7/</sup> Accordingly, on April 16, 2003, the PCAOB announced the adoption of certain interim standards to be used by registered public accounting firms and associated persons in the issuance of public company audit reports, and the SEC approved those standards as part of its April 25, 2003 determination. The interim standards include the accounting profession's existing standards on auditing, attestation, quality control, ethics and independence. Further, where the SEC's rules on independence are more restrictive, the interim standards note that registered public accounting firms and their associated persons must comply with the SEC's more restrictive requirements.

When the Board announced these interim standards, we also announced the process we intend to use to establish permanent auditing and other professional standards. The process will include soliciting comment from the public, in addition to the views of an advisory group formed pursuant to the Act. Under the Board's rules, that advisory group will be composed of individuals with a variety of expertise, including accountants, issuers, investors, regulators and others. We also plan to use other

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<sup>6/</sup> Section 201 of the Act specifies the following non-audit services that may not be provided to an audit client: (1) bookkeeping or other services related to the accounting records or financial statements of the issuer; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker, dealer, investment adviser, or investment banking services; and (8) legal services and expert services unrelated to the audit.

<sup>7/</sup> Sarbanes-Oxley Act, Section 103(a)(3)(B).

## TESTIMONY

means to obtain expert advice, such as *ad hoc* task forces, roundtable discussions (which we have already held on certain issues), and other public hearings.

### **Statutorily Established Standards-Setting Priorities**

The Act itself sets forth the PCAOB's initial standards-setting agenda. First and foremost on this agenda is a standard for the auditor's attestation on management's assessment of internal control over financial reporting, as required by Section 404 of the Act. This provision required both the SEC and the PCAOB to promulgate rules. Section 404(a) required the SEC to promulgate rules requiring management to assess and report on the effectiveness of internal control. The SEC did so in June 2003, and its rules now require public companies to file such reports, with annual reports for fiscal years ending on or after June 15, 2004. Section 404(b) requires registered public accounting firms to attest to management's report on its assessment of internal control, consistent with attestation standards established by the PCAOB. In order to have a permanent standard in place in time for auditors to use in audits completed in June 2004, the PCAOB has already begun developing the standard, by holding a public roundtable discussion on internal control in July 2003 and issuing a proposed standard at a public meeting held earlier this month.

Good internal control over financial reporting is essential for a public company to function and to meet its obligations to protect its investors. Thus, the professional standards that the PCAOB is setting in this area are central to the mandate to protect investors and vital to furthering the public interest in the preparation of informative, fair, and independent audit reports.

While addressing Section 404 is the PCAOB's most pressing standards-setting assignment, it is far from the only one. The Act also mandates that we establish requirements for audit documentation, for second-partner reviews, and for quality control standards for audit firms, and we are diligently and rapidly working on those subjects.

The PCAOB has also announced plans to review systematically all of the interim professional standards and to determine whether they should be modified, repealed, or made permanent. We plan to consider and establish priorities for conducting this review once we have formed a standing advisory group, in order to obtain the benefit of the group's advice.

### **Current Rules on Auditors' Provision of Tax Services**

As directed by the Act, the SEC adopted new independence rules in order to implement Title II of the Act. These rules, which became effective in May 2003, address

## TESTIMONY

key aspects of auditor independence with special emphasis on the provision of non-audit services. Consistent with Section 201 of the Act, the rules expressly prohibit eight categories of non-audit services.<sup>8/</sup> The SEC's rules also implement the Act's requirement, in Section 202, that all auditing services, and those non-audit services that do not satisfy a *de minimis* threshold, be preapproved by the company's audit committee.

Neither the Act nor the SEC's rules prohibit tax services that are preapproved by the company's audit committee (unless, of course, those services also fall into one of the categories of expressly prohibited services). Rather, the Act expressly recognized that accountants "may engage in any non-audit services, including tax services," that do not fall into one of the prohibited categories, provided that each service is approved in advance by the audit committee.<sup>9/</sup> The SEC's adopting release on its new rules noted that there had been considerable debate regarding whether an accountant's provision of tax services for an audit client could impair the auditor's independence. The SEC determined not to prohibit tax services, however, in part because audit firms – both large and small – have long played a part in return preparation and have advised their clients on the complexities of the tax code and how it affects the client's tax liabilities. Thus, the SEC "reiterated its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence \* \* \* [and] may continue to provide tax services such as tax compliance, tax planning, and tax advice, to audit clients, subject to normal audit committee pre-approval requirements \* \* \*."<sup>10/</sup>

While the SEC made clear that it did not consider conventional tax compliance and planning to be a threat to auditor independence, it distinguished such traditional services from the marketing of novel, tax-driven, financial products, which the SEC noted raise some serious issues. The SEC's release thus cautioned that audit committees should "scrutinize carefully" the retention of the auditor in a transaction initially recommended by the auditor. Moreover, the release referred to the recommendation of the Conference Board's Commission on Public Trust and Private Enterprise that, as a "best practice," auditors not provide advice on "novel and debatable" tax strategies and products.<sup>11/</sup> Further, since the SEC's release, the AICPA has also suggested that "advice on tax strategies having no business purpose other

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<sup>8/</sup> See supra note 6.

<sup>9/</sup> See Sarbanes-Oxley Act, Section 201(a).

<sup>10/</sup> Securities Act Release No. 8183 at § II.B.11 (January 28, 2003).

<sup>11/</sup> Id. at note 112.

## TESTIMONY

than tax avoidance is an appropriate dividing line for activities that should be prohibited to auditing firms registered under the Sarbanes-Oxley Act."<sup>12/</sup> Thus, there appears to be consensus that auditors ought not to be selling abusive tax shelters to audit clients.

### **The PCAOB's Tools to Evaluate and Address the Use of Abusive Tax Shelters to Manipulate Financial Statement Earnings**

The PCAOB has a variety of tools to help address problems caused by the use of complex structured transactions designed to inflate financial statement earnings. First, as part of the Board's inspections of registered firms' audits of public companies' financial statements, we will identify, and examine how firms audit, questionable, tax-oriented transactions. We will also look for auditors' involvement in structuring such transactions. The Joint Committee on Taxation found that Enron's auditor, Arthur Andersen, had promoted and provided an opinion on two of the 12 structured transactions that the Joint Committee examined and challenged. Given Arthur Andersen's involvement in the transactions, the Joint Committee also questioned the firm's ability to audit the transactions with impartiality.

Because we are only beginning to build our inspections program, we cannot today assess the current extent of promotion and use of corporate tax shelters and products. We will, however, scrutinize the accounting and presentation of transactions that we discover through our inspections program, including specifically through our reviews of selected audit engagements. In addition, by looking at compensation, promotion, and retention issues, our inspections will identify a firm's policies and practices that create incentives for firm audit personnel to promote such transactions to their clients.

Therefore, while existing laws and regulations may not ban auditors from promoting and giving tax opinions on all such transactions to their audit clients, both auditors and companies should expect heightened scrutiny of such transactions. The prospect of that scrutiny may help to influence the relevant parties – corporate managements that are attracted to the transactions, audit committees that must approve auditors' work on the transactions, and auditors that must attest to the propriety of the accounting treatment of the transactions – not to engage in questionable transactions. Indeed, some firms have already announced that they will no longer promote or give tax opinions on certain types of structured transactions to their audit clients.

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<sup>12/</sup> "SEC Proposals on Auditor Independence, Non-Audit Services Affect Tax Practitioners," 83 The CPA Letter at 1, 4 (February/March 2003).

## **TESTIMONY**

Second, through our authority to discipline registered firms and associated persons, we may impose stiff penalties for failing to audit such transactions adequately and impartially. These penalties include revoking a firm's registration and banning individual accountants from working on audits of public companies. We also have lesser sanctions in our arsenal, such as imposition of an independent monitor to review the firm or person's work and of tailored quality control measures.

Finally, the Board has the authority to commence a standards-setting project to address the problem, including, for example, by adopting new auditing, ethics or independence standards. The Board's authority to prohibit a registered firm from providing certain non-audit services is restricted, however, to limiting the services that a registered firm may provide to an audit client, and the Board cannot directly prohibit a registered firm from selling tax shelters to non-audit clients. Therefore, even adding to the list of prohibited services may not ensure that an auditor who has sold such a strategy to a non-audit client is any more impartial when he or she audits a similar transaction purchased by an audit client from another promoter.

The Board also has the authority, however, to develop and impose additional auditing procedures. If registered public accounting firms and their associated persons conduct audits properly and impartially, then the financial statement effects of aggressive – even if arguably legitimate – tax shelters should be transparent, which would essentially defeat the purpose of transactions whose only purpose is to make the financial statements look better. The Internal Revenue Service's list of punishable abusive tax shelter devices may, by necessity, lag practice (such that by the time a transaction joins the list, the field has already moved onto another type of transaction), but outside accountants audit the financial statements of companies who choose to engage in these transactions on a current basis. Just as Arthur Andersen had year-round offices at Enron's headquarters, the auditors of the largest companies are often "in the field" auditing much of the year. In addition, companies that engage in complex transactions typically ask their auditors to bless such transactions before completion, in order to be sure of the transaction's financial accounting treatment.

Abusive, or even very aggressive, tax strategies undertaken primarily to have an effect on a company's financial statements may be difficult for regulators and other investigators to find, but auditors are in a unique position to identify them. If the accounting profession chooses to rise to this challenge, then it will reap the benefits of renewed confidence in the integrity of its professionals. If the accounting profession shrinks from the challenge, then we will address it for them.

## **TESTIMONY**

### **Conclusion**

With the Congress's vision in establishing authority for independent standards-setting, registration, inspection, investigations and discipline, you have given the PCAOB the responsibility and the tools to build a new future for auditing public companies. I have faith that my fellow Board members and our staff will live up to your expectations.

I have not been shy about telling members of the accounting profession that we expect a lot from them, and that they will have to work harder than they could have imagined before enactment of the Sarbanes-Oxley Act. We will scrutinize accounting records, accountants' practices, and we will adjust the rules as necessary. In the wake of Enron and Arthur Andersen, the accounting profession was weighed and found wanting, but it was given a meaningful shot at redemption. In my mind, facilitating that redemption, and not just punishing miscreants, is a key objective – one that the Board must not lose sight of even when we are, as we will need to be, tough on the profession.

What's at stake for all of us is the trust of the American people in our markets and the companies that drive our economy. We have an opportunity to reclaim that trust. As we work toward that objective, my fellow Board members and I look forward to a long and constructive relationship with this Committee.

Thank you.