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STATEMENT

OF

THE HONORABLE RODERICK M. HILLS

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES

HOUSE OF REPRESENTATIVES

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SARBANES-OXLEY

Did we need it?
Does it work?
Does it cost too much?

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

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

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

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

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

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

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

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

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

Was It Needed?

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

"What Went Wrong and Does it Need Fixing?"

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

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

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

1. It mandated that corporations construct internal controls;

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

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

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

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

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

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

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

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

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

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

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

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

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

These problems notwithstanding, I accept that the vast majority of publicly traded U.S. companies are honorably run and that they make a good faith effort to explain their financial position in a realistic fashion***. But, a substantial number of companies have used these circumstances to intentionally manipulate their numbers, and an even larger number have, perhaps in good faith, regularly presented a more optimistic financial position than a realistic appraisal would allow simply because the rules allowed them to do so.***

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

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

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

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

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

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

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

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

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

In layman's terms the Act compels the external auditor to explain to the audit committee the alternatives that were available to management in its construction of a financial statement. It compels the audit committee to look at those alternatives and decide whether, given the alternatives, management has chosen a fair way to present its financial position.

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

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

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

Will It Cost Too Much?

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

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

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

Section 404

I need not add to the complaints this Committee has received from so many companies about the cost of Section 404. A very large number of companies believe they are wasting a very large amount of money for no good reason. That some small companies are postponing a public offering because of the real or perceived cost of 404 and that others are contemplating a going private transaction are real problems. If the condition persists our capital markets will surely suffer.

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

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

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

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

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

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

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

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

The SEC will, hopefully, give careful consideration to whether existing timing requirements should be relaxed.
It may be that some companies will choose to stay private to avoid the 404 requirements. Whether that is a serious problem remains to be seen. Many of them may, after time, see the positive aspects of the Rule

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

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

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

The Burden on Directors

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

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

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

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

In particular the committees must pay far more attention to the role of internal auditors. If they do not take responsibility for the selection, retention and the compensation of the internal auditor they can hardly complain if the internal auditor is reluctant to criticize management.
Audit committees that assure themselves of the support of external and internal auditors will be alerted to the subtle problems of the audit process. Their job then is to take whatever time is necessary to deal with those problems.

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

Interference with Management

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

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

Preservation of Rules Based Accounting Standards

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

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

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

We can only rely on the continuing good judgment of the PCAOB and the SEC
to move the profession to a system that does have less rules and relies more on judgment.

APPENDIX A

Forward View: In Search of ROI for Section 404

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

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

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

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

In a recent meeting of the Audit Committee Leadership Network (ACLN), members stated their belief that small-cap companies are gaining real value from the implementation of Section 404. Many of these companies are putting in place internal controls that should always have been there. Others are finding value in what one member described as "reducing do-over work and manual routines in the finance function and controller's office." He added, "They will have made a wise investment."

Some ACLN members felt that larger companies' international subsidiaries will gain similar value. One audit committee chair commented, "The lesson for me is that some subsidiaries were not as well documented as they should have been."

That said, many audit committee chairs with whom we have spoken do not believe there can be any return from what they characterize as a costly, "check the box" compliance activity. One audit committee chair commented that there was simply no point in calculating the ROI on Section 404 "since we have to do it anyway." When asked about the value of Section 404, a chief audit executive for a Fortune 500 company replied, "In the end having the CEO and CFO able to sign the [financial] reports has to be enough."

That also seems to be the view of the regulators. The SEC's own cost/benefit analysis indicates that the ultimate benefit is "improving investor confidence in the reliability of a company's financial disclosure and system of internal control over financial reporting. These benefits are not readily quantifiable."

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

Footnote

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

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

APPENDIX B

the FUTURE of the ACCOUNTING PROFESSION

The 103rd American Assembly
November 13-15, 2003

Lansdowne Resort
Leesburg, Virginia

The American Assembly
Columbia University

The American Assembly
Columbia University

"The Future of the Accounting Profession"
American Assembly Report

103rd American Assembly

FOREWORD

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

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

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

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

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

Richard W. Fisher
Chair
The American Assembly

PREFACE

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

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

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

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

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

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

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

David H. Mortimer
The American Assembly

DISCLAIMER

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

INTRODUCTION

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

The members of the Assembly who gathered in November 2003 to discuss these challenges and the changes that must follow included representatives of all those affected by the scandals, including present and former regulators, investment analysts, money managers, investment bankers, chief executive officers of major corporations, scholars and accounting professionals. As a group, we were generally satisfied with the new regulatory trends and the moves by corporate America toward reforming its own practices. We also feel the accounting industry is moving to improve its own business, after acknowledging that auditors have far too often yielded to management pressure to paint the most favorable picture possible of a corporation's financial health.

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

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

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

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

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

THE CURRENT STATE OF THE ACCOUNTING PROFESSION

What Went Wrong?

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

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

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

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

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

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

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

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

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

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

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

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

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

Regulation and Oversight in Flux

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

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

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

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

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

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

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

The Value of the Audit

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

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

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

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

Many of our recent accounting scandals can be traced to auditors' failure to resist management pressure to accept misleading financial statements. Others, however, appear to have been the result of fraud and collusion. While auditing depends on verifying data by checking it with a number of independent sources, it is possible for company personnel bent on deceit (and sometimes with the assistance of individuals outside the company) to defeat the auditing function. Not even the best of audits and the most honorable of auditors will be able to protect investors from such conduct in all cases.

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

Structural Challenges Facing the Accounting Profession

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

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

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

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

For the profession to regain its luster, more experience and expertise must be devoted to the 'field work' of an audit. For example, the process of ascribing a value to exotic assets and comprehending how unique derivative securities and hedging strategies are used are beyond the skills of even some of the most sophisticated and experienced certified public accountants (CPAs), much less the recently graduated auditors most often dispatched to the field. Participants noted that the auditors in the field are in the best position to see the red flags of fraud and other problems but too often they are the least trained to recognize those flags. The fact that experienced auditors who could recognize warning signals are too seldom on the spot is a sign that auditing firms may not be deploying their resources as effectively as they might.

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

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

SETTING ACHIEVABLE GOALS

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

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

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

What Should Financial Reporting Look Like in the Future?

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

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

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

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

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

A new and more flexible approach to preparing financial statements, such as that suggested at the Assembly, would allow corporations and their auditors to fairly present this inherent uncertainty. In cases where an item has a relevant historical cost (such as depreciable fixed assets), or where the item has a real market value (such as securities for which there is a trading market capable of absorbing a position of the size held) it is reasonably straight forward. But for those line items for which historical cost is irrelevant, and for which no ready market exists, there needs to be a different notation. The premise is simple: give preparers and auditors of financial statements the freedom and flexibility they need to inform the users of those balance sheets and income statements when the information contained in them is, by definition, uncertain.

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

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

Improving Auditing and Financial Reporting Standards

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

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

Ideally, auditors would use the current wording to vouch for the most concrete, non-speculative aspects of future financial statements, such as those items for which historical cost is an adequate accounting metric. For information that is more subject to individual judgments by managers and auditors, those auditors would give a significantly more limited attestation, perhaps nothing more than a procedural attestation. In these instances, the audit function could be structured in such a way as to verify that a company has reached these judgments with respect to estimated fair value using a clear and seemingly reasonable process. The auditor would not, however, have to attest to the estimate itself. It may be that some of these values are better presented as a range of numbers rather than as a single number. This approach is one auditors currently use to deal with management forecasts.

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

A recent report released by the SEC staff, entitled “Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System” and released in July 2003, is another good starting point for discussion of the merits of both principles and rules within the accounting profession. It contains the interesting suggestion that new standards should be developed with an eye to the objectives being sought. We believe these recommendations, which include the consistent application of these standards and a shift away from bright-line rules permitting technical compliance while violating the spirit of the standard, are a step in the right direction.

Licensing Issues: More Firms, More Depth

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

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

The Big Four’s dominance, however, significantly limits an audit committee’s freedom of action when it comes to changing accounting firms and thus to ensuring directors’ oversight of the audit process. For example, the Sarbanes-Oxley Act prohibits accounting firms from providing many non-audit services to their audit clients. As a result, multinational companies typically engage two of the Big Four--one to provide audit services and the second for non-audit assignments. That means if directors later wish to change auditors, it has only two firms available from which it may pick. If one of those audits a direct competitor and the second of those lacks sufficient expertise, management and directors are left with few options, other than taking the drastic step of switching *both* its audit and non-audit engagements – a move which may put the former advisory firm in the uncomfortable position of auditing its own work. Assembly participants found no ready answer to this quandary, despite extensive discussion and a significant degree of concern.

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

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

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

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

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

REACHING OUR GOALS

Changing the Current Regime

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

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

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

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

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

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

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

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

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

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

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

Adjusting Auditing Practices

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

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

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

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

Reinvigorating Audit Committees

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

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

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

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

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

Adopting such standards need not be burdensome. Audit committees can charge their auditors with identifying the assumptions, estimates and accounting practices that have been chosen by management. Many participants in the Assembly believe that it is incumbent on audit committees to engage in meaningful discussions with both management and auditors in order to ensure the financial positions of their companies are presented fairly.

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

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

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

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

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

Preparing the Next Generation of Professionals

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

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

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

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

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

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

Development of Directors

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

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

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

CONCLUSION

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

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

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

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

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

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

American Assembly Steering Committee

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- James R. Doty, Managing Partner, Baker Botts, LLP; Former General Counsel, Securities Exchange Commission
- Gary P. Fayard, CFO and Executive Vice President, The Coca-Cola Company
- Ralph C. Ferrara, Managing Partner, Debevoise & Plimpton; Former General Counsel, Securities Exchange Commission
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- Judy C. Lewent, Executive Vice President & CFO, Merck & Co., Inc.
- Simon M. Lorne, Munger, Tolles & Olson; Former General Counsel, Securities Exchange Commission
- David H. Mortimer, Chief Operating Officer, The American Assembly
- Russell E. Palmer, The Palmer Group; Former Dean, Wharton School
- Katherine Schipper, Member Financial Accounting Standards Board; Former L. Palmer Fox Professor of Business Administration, Fuqua School of Business, Duke University
- Washington SyCip, Founder, SGV & Company
- Sir David Tweedie, Chairman, International Accounting Standards Board
- Paul A. Volcker, Trustee, The American Assembly; Former Chairman, Board of Governors, Federal Reserve Board; Former Chairman & CEO, Wolfensohn & Co., Inc.
- Roman L. Weil, Professor of Accounting, Graduate School of Business, University of Chicago
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ABOUT THE AMERICAN ASSEMBLY

The American Assembly was established by Dwight D. Eisenhower at Columbia University in 1950. It holds nonpartisan meetings and publishes authoritative books to illuminate issues of United States policy. The Assembly seeks to provide information, stimulate discussion, and evoke independent conclusions on matters of vital public interest.

An affiliate of Columbia, The Assembly is a national, educational institution incorporated in the State of New York.

American Assembly Sessions

At least two national programs are initiated each year. Authorities are retained to write background papers presenting essential data and defining the main issues of each subject.

A group of men and women representing a broad range of experience, competence, and American leadership meet for several days to discuss the Assembly topic and consider alternatives for national policy.

Most Assemblies follow the same procedure. The background papers are sent to participants in advance of the Assembly. The Assembly meets in small groups generally in four lengthy periods. All groups use the same agenda. At the close of these informal sessions participants adopt in plenary session a final report of findings and recommendations.

Regional, state, and local Assemblies are held following the national session at Arden House. Assemblies have also been held in England, Switzerland, Malaysia, Canada, the Caribbean, South America, Central America, the Philippines, China and Taiwan. Over one hundred sixty institutions have cosponsored one or more Assemblies.

Arden House

The home of The American Assembly and the scene of the national sessions is Arden House, which was given to Columbia University in 1950 by W. Averell Harriman. E. Roland Harriman joined his brother in contributing toward adaptation of the property for conference purposes. The buildings and surrounding land, known as the Harriman Campus of Columbia University, are fifty miles north of New York City.

Arden House is a distinguished conference center. It is self-supporting and operates throughout the year for use by organizations with educational objectives. The American Assembly is a tenant of this Columbia University facility only during Assembly sessions.

AMERICAN ASSEMBLY PUBLICATIONS

1951–-U.S.-Western Europe Relationships

1952–-Inflation

1953–-Economic Security for Americans

1954–-The U.S. Stake in the U.N. • The Federal Government Service (revised 1965)

1955–-United States Agriculture • The Forty-eight States (State Government)

1956–-The Representation of the United States Abroad (revised 1964) • The United States and the Far East (revised 1962)

1957–-International Stability and Progress • Atoms for Power

1958–-The United States and Africa (revised 1963) • United States Monetary Policy (revised 1964)

1959–-Wages, Prices, Profits, and Productivity • The United States and Latin America (revised 1963)

1960–-The Federal Government and Higher Education • The Secretary of State

1961–-Arms Control: Issues for the Public • Outer Space: Prospects for Man and Society (revised 1968)

1962–-Automation and Technological Change • Cultural Affairs and Foreign Relations (revised 1968)

1963–-The Population Dilemma (revised 1969) • The United States and the Middle East

1964–-The United States and Canada • The Congress and America's Future (rev. 1973)

1965–-The Courts, the Public, and the Law Explosion • The United States and Japan (revised 1975)

1966–-The United States and the Philippines • State Legislatures in American Politics • A World of Nuclear Powers? • Challenges to Collective Bargaining

1967–-The United States and Eastern Europe • Ombudsmen for American Government?

1968–-Law in a Changing America • Uses of the Seas • Overcoming World Hunger

1969–-Black Economic Development • The States and the Urban Crisis

1970–-The Health of Americans • The United States and the Caribbean

1971–-The Future of American Transportation • Public Workers and Public Unions

1972–-The Future of Foundations • Prisoners in America

1973–-The Worker and the Job • Choosing the President

1974–-The Good Earth of America • On Understanding Art Museums • Global Companies

1975–-Law and the American Future • Women and the American Economy

1976–-The Nuclear Power Controversy • Jobs for Americans • Capital for Productivity and Jobs

1977–-Ethics of Corporate Conduct • The Performing Arts and American Society

1978–-Running the American Corporation • Race for the Presidency

1979–-Energy Conservation and Public Policy • Disorders in Higher Education

1980–-Youth Employment and Public Policy • The Economy and the President • The Farm and the City • Mexico and the United States

1981–-The China Factor • Military Service in the United States • Ethnic Relations in America

1982–-The Future of American Political Parties • Regrowing the American Economy

1983–-Financial Services • Technological Innovation in the ’80s

1984–-Alcoholism and Related Problems • The Arts and Public Policy in the United States

1985–-Canada and the United States • The Promise of Tax Reform

1986–-East-West Tensions in the Third World • World Population and U.S. Policy

1987–-Health Care and Its Costs • A Workable Government? The U.S. Constitution

1988–-Global Competitiveness

1989–-America’s Global Interests

1990–-The Global Economy

1991–-Preserving The Global Environment • Tort Law and the Public Interest • Public Money & the Muse

1992–-Rethinking America’s Security • From Occupation to Cooperation: The United States & United Germany • After the Soviet Union

1993–-Interwoven Destinies: Cities and the Nation • Beyond the Beltway: Engaging the Public in U.S. Foreign Policy

1994–-The United States, Japan, and Asia: Challenges for U.S. Policy • U.S. Intervention Policy for the Post-Cold War World

1995–-Threatened Peoples, Threatened Borders: World Migration and U.S. Policy-U.S. Foreign Policy and the United Nations System

1997–-Living with China: U.S./China Relations in the Twenty-First Century

1998–-The United States and Africa: A Post-Cold War Perspective

1999–-Philanthropy and the Nonprofit Sector in a Changing America• The United States and the Americas: A Twenty-First Century View

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2001–-Matters of Faith: Religion in American Public Life

2001–-Strengthening American Families: Reweaving the Social Tapestry

2001–-Racial Equality: Public Policies for the Twenty-First Century

2001–-Collaborating to Make Democracy Work

2002–-Building a More United America

2002–-Art, Technology, and Intellectual Property

2003–-Keeping America in Business: Advancing Workers, Businesses, and Economic Growth•Workforce Intermediaries for the 21st Century

The American Assembly

COLUMBIA UNIVERSITY

APPENDIX C

RODERICK M. HILLS

GOVERNMENT

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

BOARD OF DIRECTORS (PRESENT & FORMER)

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

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

PREVIOUS PRIVATE EMPLOYMENT

Partner, Munger, Tolles & Hills, 1962-75;
Chairman, Republic Corporation (NYSE) 1971-75, Chief Executive Officer, 1974-75;
Chairman and Chief Executive Officer, Peabody Coal Company, 1977-78;
Partner, Latham, Watkins & Hills, 1978-82, Of Counsel, 1982-84;
Chairman, Hills Enterprises, Ltd. (formerly The Manchester Group, Ltd.), 1984-.
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Stanford University, B.A. 1952, LL.B. 1955; Order of the Coif, Comment Editor, *Stanford Law Review*, 1953-55.