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ACCOUNTING UNDER SARBANES-OXLEY: ARE FINANCIAL STATEMENTS MORE RELIABLE?

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

SEPTEMBER 17, 2003

Printed for the use of the Committee on Financial Services

Serial No. 108–52

U.S. GOVERNMENT PRINTING OFFICE

92–233 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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ACCOUNTING UNDER SARBANES-OXLEY: ARE FINANCIAL STATEMENTS MORE RELIABLE?

Wednesday, September 17, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
WASHINGTON, D.C.

The Committee met, pursuant to call, at 10:07 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael Oxley [chairman of the Committee] presiding.

Present: Representatives Oxley, Baker, Bachus, Lucas of Oklahoma, Kelly, Gillmor, Ose, Biggert, Shays, Miller, Capito, Kennedy, Hensarling, Garrett, Barrett, Frank, Kanjorski, Maloney, Watt, Hooley, Sherman, Inslee, Capuano, Ford, Lucas of Kentucky, Crowley, Ross, McCarthy, Baca, Matheson, Miller, Emanuel, Scott and Davis.

The CHAIRMAN. [Presiding.] The Committee will come to order.

Members are advised that we are, again, having difficulties with the audio system. The House recording studio has provided us with their last-resort backup system. The Chair apologizes for the inconvenience, but members should share the wireless microphones we have placed throughout the room for the remainder of the hearing.

The Chair recognizes himself for 5 minutes for an opening statement. In light of the changing House schedule and after consultation with the Ranking Minority Member, the Chair asks unanimous consent that opening statements be limited to 16 minutes per side, evenly divided, and that recognition for opening statements be limited to the Chair and Ranking Minority Member of both the full Committee and the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises. All members's opening statements will be included in the record. Without objection, so ordered.

We are pleased today to welcome our distinguished witnesses. Last year, in the wake of an unprecedented erosion of investor confidence, the Congress responded by passing historic corporate reform legislation.

The centerpiece of the one-year-old law, the Public Company Accounting Oversight Board, is charged with the critical task of ensuring that audited financial statements are informative and accurate. It is well known that trust in the financial reporting system is a foundation of our capital market system.

Today we will hear from Board Chairman Bill McDonough, who assumed the reins of the PCAOB just a few months ago. I have known Chairman McDonough for some time and can say with great confidence the Board could not have a better leader. His actions to

date illustrate his dedication to rigorous and effective oversight of the accounting industry.

Thus, we should feel confident that under the leadership of Chairman McDonough and the other members of the Oversight Board, this new regulatory body has already changed the financial reporting system for the better and his work has only just begun.

We will also hear, of course, from the Securities and Exchange Commission, which must approve all of the Board's proposed rules and sanctions. Chairman Donaldson has demonstrated exemplary leadership in his first year at the Commission. To cite but one example, enforcement actions against securities law violators have increased under his supervision. I look forward to his testimony.

The Public Company Accounting Oversight Board is off to a good start. It has taken a number of important organizational steps, including hiring a first-rate staff, establishing strict ethics rules and standards of conduct for Board members and staff, and reviewing hundreds of registration applications.

There are still difficult issues remaining to be resolved, including treatment of non-U.S. auditors, establishing permanent professional standards for auditors of public companies and implementing the soon-to-be-enacted inspection and investigation rules. Some have raised concerns about the cost of compliance with the new rules for a smaller firm. While it is essential that the new regulations governing our financial reporting system not leave dangerous gaps, it is also important for regulators to conduct an appropriate cost-benefit analysis in crafting these regulations. I know the Board is working diligently on these matters and I look forward to hearing more about the Board's progress on these issues today.

The Chair would announce that I consulted with the Ranking Member. He has to be on the floor, as I speak, on a piece of legislation and will be returning shortly. In the meantime, I would like to recognize the gentlelady from New York for an introduction.

[The prepared statement of Hon. Michael G. Oxley can be found on page 44 in the appendix.]

Mrs. KELLY. Thank you very much, Mr. Chairman.

I simply want to say it gives me great pleasure to see two of my constituents sitting at the table before us. Both of them bring a great deal of knowledge and solid experience in their fields to the fore. I am so pleased that both of them have chosen to put that knowledge to the use of the United States of America.

I look forward to their testimony today. And I thank you very much for letting me introduce two men from Westchester County, New York.

The CHAIRMAN. I thank the gentlelady.

The Chair now recognizes the subcommittee chairman of the Capital Markets Subcommittee, the gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. I thought you were about to make a really important announcement there.

[Laughter.]

I want to commend the Chairman for his continued leadership on this and many other matters, particularly his good work on the Sarbanes-Oxley Act. It has been, unbelievably, a year since the President signed what was historic legislation. I believe our panel-

ists this morning are going to give us important insights into the effectiveness of that effort.

We all know that in the performance of our capital markets, investor confidence is really the singular cornerstone on which it succeeds or fails. Americans, logically, will simply not participate in a system they believe that is inherently unfair or does not disclose appropriately the information to make informed decisions.

Pursuant to Enron, WorldCom, Tyco and all the others, the average investor had a very cynical and cautious view of market performance. The Congress was called on, this Committee, and the Chairman responded with important legislation. It went a very long way to help restore investor confidence and provide a framework to ensure that markets would work in a transparent and fair manner for all participants.

The PCAOB is well on its way to helping ensure the integrity of key financial information and be readily relied on as authentic and as equally available to all participants. Sarbanes-Oxley was a first step in restoring confidence, but there is much work yet to be done.

I want to speak at the moment, even though the FDIC is not present this morning, to the importance of work they are engaged in with a pilot relative to extensible business reporting language, which is now underway for about 300 federally insured depositories. Once this technology has proven its valued, then next year the FDIC intends to extend mandatory participation to all 8,400 institutions. And I will suggest to the Chairman that at the appropriate time, after the viability and value of that system has been determined, that it be made applicable to all publicly traded corporations.

However, recent revelations with regard to another important market sector is cause for concern. Over 95 million Americans invest in mutual funds, making these funds by far the most popular choice among working families to provide for retirement or their children's education. Recent revelations provided by the SEC and other state officials have seemed to indicate significant and widespread abusive practices.

On July 23, this Committee reported out, by unanimous vote, I would add, in response to many of these concerns, legislation which would enhance transparency and the fairness of disclosure in mutual fund fees. During the debate, concern was expressed by members that the legislation may have gone too far. After all, at that time of consideration there was no "scandal" in the mutual fund industry.

However, as we meet here today, the SEC and the New York attorneys general are taking civil and criminal actions against market participants. These funds manage literally hundreds of billions of dollars of investor money. I do not now think anyone can or should say that there is not a problem worthy of correction.

H.R. 2420, the Mutual Fund Integrity and Fee Transparency Act, was drafted to provide investors with an accurate picture of what was going on. And frankly, when drafted I thought it perhaps went as far as one could logically go. In light of the revelations recently disclosed by the SEC, I am not sure we have, frankly, gone far enough.

As we look around today, my fear is that the bill may need dramatic additional work. I hope, time permitting, to look at another hearing later in the year, perhaps early next, and to receive the agency's comments and recommendations on whatever public policy modifications may be justifiable.

I thank each of our panelists and certainly the Chairman for his continued leadership.

The CHAIRMAN. The gentleman's time has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Ranking Member Frank had to go to the floor to control time on the first suspension bill that is on the calendar today, and asked me to say a few words in his stead. He didn't tell me what to say, so from this point on, I am kind of on my own.

[Laughter.]

But I am sure that he would want to first thank Chairman Oxley for convening this important hearing. Reflecting back on when we debated Sarbanes-Oxley in the Committee, there was a tremendous tension between those who wanted to put more content and standards into the law itself, versus those who thought that, yes, we needed to do something to restore public confidence, yet we should not be rushing into micro-managing and writing in this Committee what the standards should be, and we should be delegating that instead to a more thoughtful process and body to develop those standards.

That did not mean for those members who lost that debate, and the debate was lost to the delegating side, it certainly didn't mean that the members who wanted to control the process more and write the standards into the law should be left out of the process. I think the way members will feel more at ease about what we have done in setting up the process we have and delegating to them the authority to write the standards is for the Committee to continue to exercise aggressive oversight.

I think that is the importance of this hearing because this is the first one on this particular topic. I think a number of people feel that the jury is still out, as it should be, and the standards are evolving, as they should be, in response to what the market needs and what standards need to be developed in response to potential problems that may develop in the market.

So I think the importance of this hearing is to get feedback from the agencies to which we have delegated authority and said, "You go, think about this, talk to the industry, talk to the public and decide what the appropriate new guideline should be and report back to us. And let's keep talking to each other and keep Congress in the loop through this process."

So this is an important hearing to hear what these bodies have been doing and to keep Congress involved. I applaud the Chairman for convening the hearing to give us an oversight role to set the people at ease who were advocating more for more aggressive standard-setting in the law itself as opposed to the delegation.

I am looking forward to hearing what has been done with the delegation of authority to move us toward a more secure and safe

set of standards in the accounting field and financial reporting field and financial statement field, in particular, today.

I thank the witnesses who will be testifying today and thank Mr. Frank for giving me the opportunity to frame the issue in this way. I thank the Chairman for convening the hearing, so that we can continue our involvement constructively in this process.

I yield back the balance of my time.

The CHAIRMAN. The gentleman yields back.

The gentlelady from New York is recognized.

Mrs. MALONEY. Thank you very much, Mr. Chairman. And I thank the two panelists for being here today and they both have served and lived in New York.

Passage of the Sarbanes-Oxley legislation last year was an achievement. From what I have read and, based on interactions with business men and women, I believe it is making a positive impact on returning trust to our financial markets.

Many people think that our financial markets run on capital. I think it really runs more on trust. While the law is working, it was drafted in a rushed response to some tremendous scandals. I believe it is very appropriate for this Committee to revisit this work and recognize that it may need to be improved in the future.

Today I am very, very pleased to have Chairman Donaldson and Chairman McDonough before the Committee to report on the law's impact thus far. Chairman Donaldson and his staff have worked exceptionally hard to implement the law. I thank them for all that they have done.

I also want to thank Chairman McDonough for his appearance today and for his decision to take this important job. He served with great distinction, they both did, in New York and have taken on really tremendous challenges for the whole country.

As a new entity, the Board truly benefits from having someone with your distinguished background as its chairman. I thank you for all that you did in New York at the Fed and for your willingness to take on another public service assignment.

So I thank both distinguished former New Yorkers for the work that they have done at the stock exchange, at the Fed, in private business and for deciding to serve their country. I look forward to your testimony. New Yorkers are very proud of you.

The CHAIRMAN. Does the gentlelady yield back?

Mrs. MALONEY. Yes.

The CHAIRMAN. Actually, Ms. Kelly indicates they are still New Yorkers. They may not be in New York City or even the East Side, but They are still New Yorkers.

Let us turn now to our distinguished panel. The Chair is pleased to recognize first the Chairman of the Securities and Exchange Commission, the Honorable Bill Donaldson.

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

Mr. DONALDSON. Chairman Oxley, Ranking Member Frank and members of the Committee, thanks very much for inviting me to testify today.

Seven weeks ago, I had the pleasure of standing next to you, Chairman Oxley, and other leaders in Congress, as we marked the

1-year anniversary of the Sarbanes-Oxley Act. I want to compliment the Members of Congress again for your leadership in passing critical reforms at a time when we faced a growing crisis in investor confidence in our securities markets.

Since the passage of Sarbanes-Oxley, the SEC has been hard at work implementing this vital legislation. Today you have asked me to testify on one element of the new law, the accounting profession and what the SEC is doing to strengthen it. The centerpiece of our efforts is the Public Company Accounting Oversight Board or PCAOB, if I may refer to it as such, and I will focus my comments on this important entity.

I am pleased to have this opportunity to appear with Bill McDonough and to report to you on the Board's significant progress. I also want to assure you that the Commission is dedicated to working with the PCAOB to accomplish its mission, including restoring the confidence of investors in the integrity of the audit process and in the reliability of financial information that fuels our nation's securities markets.

In a matter of months, the joint efforts of the commission and the PCAOB have turned what was an outline on paper into an energetic organization that is guided by a hardworking and entrepreneurial staff. The Board is absolutely vital to our markets going forward, and it has already launched a number of important measures, such as accepting accounting firm registrations, collecting the funds authorized by Sarbanes-Oxley, initiating inspections of accounting firms, developing rules for its disciplinary programs and writing new auditing standards.

We at the Commission were extremely pleased when Bill McDonough assumed the chairmanship of the PCAOB in June. He is exceptionally qualified to lead this important organization. We are fortunate that he agreed to accept the challenge.

Prior to Bill's arrival, the other four board members, Kayla J. Gillan, Dan Goelzer, Bill Gradison and the Acting Chairman Charley Niemeier worked hard and effectively to make significant progress in developing the Board's operational infrastructure. As a result of their efforts, the Commission certified in April, as required by law, that the PCAOB possessed the capacity to meet the requirements of the Sarbanes-Oxley act. Under Mr. McDonough's leadership, we expect the Board to implement reforms that will restore confidence in the integrity of the financial information investors use every day to make investment decisions.

While the PCAOB operates separate and distinct from the Commission, the Act vests the Commission with oversight authority and responsibility over PCAOB. In addition to appointing Board members, the Commission approves all of the Board's rules and professional standards before they may become effective, approves the Board's annual budget, acts as an appellate authority for PCAOB disciplinary actions and disputes relating to PCAOB inspection reports, and may assign additional tasks to the Board as appropriate.

As part of its oversight, the Commission also has the authority to inspect the PCAOB in much the same way it inspects the securities exchanges and the National Association of Securities Dealers.

I am pleased to report on the Commission's active role in helping the PCAOB meet its mandate. To date, the Commission has published three notices of PCAOB rulemaking, promulgated six orders related to the Board's financial matters and rules, published a Commission notice regarding auditors of broker-dealers's financial statements registering with PCAOB, and provided the Board with three advances to fund its initial operations. There is a full explanation of these activities and a chronology in my written statement.

The Commission and the PCAOB staffs have worked closely together during the past months on all of these efforts. In the startup days of the PCAOB, before the Commission recognized it as fully operational, Commission staff formally met in weekly meetings with the Board and its staff. The two staffs were in daily contact on matters related to the Board's organization, staffing, rulemaking and budget.

Now that this critical infrastructure is in place, the Board can focus more on increasing its consideration of new and improved professional standards, on implementing its inspection process and beginning its disciplinary program.

Joint consultations with the Commission continue on the Board's numerous projects, and we expect to maintain a close working relationship with the Board. As the Board expands its capability to carry out its mission on its own, the Commission will look increasingly to its expertise in setting and revising auditing standards and regulating the auditing profession, while continuing in our primary role to provide guidance and oversight.

In conclusion, I can assure you that the PCAOB is off to a very strong start and is developing strong internal processes, policies and expert personnel that will enable us to beat the expectations that you set forth in the Sarbanes-Oxley Act.

A strong PCAOB is absolutely vital to the integrity of our nation's security markets, but it alone cannot restore investor confidence in the integrity of the accounting profession. There must also be a willingness on the part of everyone in the industry to place the interests of investors above all else. Remaining independent and telling it like it is, is fundamental. The PCAOB can help install this culture, particularly with the leadership and integrity of a respected figure like Bill McDonough at its head.

We are all fortunate to have him leading the Board's efforts, and I will leave it to him to describe the details of the Board's infrastructure and its other major initiatives.

Thanks again for inviting me to testify.

[The prepared statement of Hon. William H. Donaldson can be found on page 48 in the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman.

And now we are pleased to turn to the Chairman of the Public Company Accounting Oversight Board, Mr. William McDonough.

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

Mr. MCDONOUGH. Chairman Oxley, Ranking Member Frank and members of the Committee, I am pleased to appear before you

today on behalf of the Public Company Accounting Oversight Board.

This is the first appearance of a PCAOB member before this Committee. On behalf of the Board, I would like to begin by commending the leadership shown by the members of this Committee as you addressed the crisis in public confidence brought on by the corporate failures of the last 2 years. The legislation, now law, that you worked so hard on, is a landmark reform of corporate governance and oversight and you should be proud.

I am both proud and humbled to appear before you today as Chairman of one of the products of your hard work, the Public Company Accounting Oversight Board. There are many reasons I was willing to take on this job. Among them were my own strong feelings about the corporate scandals and the lack of leadership in the private sector. The mission of the PCAOB, as spelled out in the Act, gave me an opportunity to act on those strong feelings.

When I joined the PCAOB on June 11, the day after I left the Federal Reserve Bank of New York, I found four fabulous colleagues, all as dedicated as I to the Board's mission. Those colleagues, Charley Niemeier, Bill Gradison, Kayla Gillan and Dan Goelzer, had already made tremendous strides in writing the unprecedented new rules that are required by the Act.

We have a rapport and a collective will to maintain that momentum and fulfill the mandate you gave the PCAOB to protect the interests of investors and the public in the preparation of informative, accurate and independent audit reports for public companies.

The Board started from scratch in January of this year and has grown to a talented and dedicated band of about 85 full-time professional staff. We hope to be a force of 200 by year-end, as we perform the four primary functions that Sarbanes-Oxley set out for us: registration, inspection, enforcement and standard-setting.

Let me start with registration. Under the Act, any accounting firm that audits a company whose securities trade in U.S. markets and any firm that plays a substantial role in those audits must be registered with the Board in order to continue that work. Under the law, U.S. firms must be registered with us by October 22nd. We have received more than 450 registration applications from U.S. accounting firms and the Board will review each of those applications.

The Board also voted to require non-U.S. accounting firms to register if they audit companies whose securities trade in U.S. markets. We recognize the special issues that arise with that requirement, so the deadline for non-U.S. firms to register is well into next year. In addition, we have begun a dialogue with our counterparts in other jurisdictions in order to find ways to coordinate in areas where there is a common programmatic interest.

Registration is a prerequisite for accounting firms to continue their work as auditors of public companies. It is also the foundation established in the Act for the PCAOB to perform its important functions of inspection and enforcement.

We have proposed far-reaching rules for inspections of registered firms, but we have not waited for those rules to be final to begin our inspection work. With the cooperation of the four largest firms,

we have already begun limited inspection procedures at those firms in advance of registration.

Going forward, our inspection staff, made up of experienced, skilled audit professionals, will annually inspect each accounting firm that audits more than 100 public company clients. Smaller firms will be inspected every 3 years.

Through these inspections, we will be looking, of course, for fundamental compliance with professional standards. But our inspectors will also look closely at other things that bear on the quality of a firm's audit work.

We will look at what we call the tone at the top. We want to know the nature of the communications coming from the highest levels of the firm. We want to know that the leaders of the firm and of audit teams get the message that Sarbanes-Oxley sends about the firm's responsibilities. We want to know that the message is reaching the firm's rank and file. We want to know what kinds of work the firm rewards through its compensation system. And we want to know how a firm decides to retain or fire a client.

Registered accounting firms are subject to PCAOB inspections and they are also subject to enforcement authority. We are empowered to investigate possible violations of our rules, securities laws and professional standards. If we conclude that a firm has violated the rules, we have the authority and the responsibility to impose sanctions, even to the point of revoking a firm's registration or barring an individual from participating in audit work.

The Board has proposed rules for investigation and hearings that are intended to implement our authority in a fair way, preserving all appropriate rights for the person subject to our jurisdiction. We expect to adopt final rules later this week or early next week, hurricane deciding.

Finally, I want to outline our progress with respect to audit standards. The Act charged the Board with establishing auditing and related out-of-station standards, quality control standards, ethical standards and independent standards. The Act gave the Board the option of setting standards on its own or designating any professional group of accountants to propose new standards.

Before I joined the Board, my fellow Board members made the decision not to delegate standard-setting to the accounting profession, but to have that responsibility rest directly on the Board's own shoulders. I firmly believe this was a wise and prudent decision and I strongly support it.

The Board established an internal standard-setting division and began recruiting a talented in-house staff of professional auditors. Because of our access to information from our inspections and investigations programs, the Board and our standard-setting staff will be in a unique position to understand and head-off problems and practices. We will also tap the expertise of a standing advisory group made up of experts from a variety of fields.

The first standards to come from the Board will be those prescribed in the Sarbanes-Oxley Act relating to auditors out of station, to management's assessment of internal controls. We held an excellent public roundtable discussion on internal controls in late July and we intend to have final rules in place by early 2004. We

will hold another roundtable later this month to discuss audit documentation as we prepare to set standards in that area.

But standard-setting registration, inspection and enforcement, the responsibilities you gave the PCAOB through the Sarbanes-Oxley Act, are tremendous. I have faith in our staff that my fellow Board members and they and I will live up to your expectations.

I have not been shy about telling members of the accounting profession that we expect a lot from them, and that they will have to work harder than they could have imagined before Sarbanes-Oxley.

Through a succession of scandals, the entire profession came to be judged harshly. But you and your colleagues, through the Act, did not merely judge them, but you gave them a meaningful shot at redemption. In my mind, facilitating that redemption and not just punishing miscreants is a key objective, one that the Board must not lose sight of even when we are, as we will need to be, tough on the profession.

As we work toward that objective, my fellow Board members and I look forward to a long and constructive relationship with this Committee and with the Securities and Exchange Commission.

Thank you.

[The prepared statement of William J. McDonough can be found on page 59 in the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman.

And thanks to both of you for your excellent testimony.

Let me begin by asking Chairman Donaldson the issue that has been brought up a number of times to me, and I am sure to you, and that is the extraterritoriality issue as it relates to foreign firms that are listed in the United States. It is also that issue that would come before the Board.

The number of contacts that I have had since the passage of the Act have been even to cause some concern within the European Union and European Commission as it relates to regulation on both sides of the Atlantic. I know that we tried in the legislation to provide as much flexibility to the SEC and to the Public Company Accounting Oversight Board regarding the registration of accounting firms.

Where are we now? What has happened since the regulations were promulgated to you, Chairman Donaldson? And what else needs to be done to assure that we will provide the highest level of regulation, but at the same time recognize the inherent differences sometimes in various countries's attitudes toward the board make-up and corporate governance?

Mr. DONALDSON. The Commission approved the PCAOB rules requiring foreign auditors to register with the PCAOB. The PCAOB made significant accommodations in its registration system for foreign accounting firms, however, including eliminating the potential for compliance with the PCAOB registration provisions' resulting in a violation of the laws in an accounting firm's home country. They narrowed the scope of the information provided. They extended a deadline for foreign firms to register.

If I can characterize this, I think there has been a correct insistence that the foreign firms will register. I think under Chairman McDonough's guidance now the PCAOB is working to, (A), understand and, (B), accommodate the particular circumstances that

exist in certain foreign countries. They are also trying to accommodate foreign firms by utilizing some of their own domestic methodology, if you will, to achieve our purpose, which is the oversight of those firms that are working for U.S.-registered companies.

Bill, I don't know if you want to add anything.

The CHAIRMAN. What kind of feedback have you gotten so far regarding your ability to round off some of the sharp edges of the law and to accommodate it to those firms?

Mr. DONALDSON. Right. Going back to the beginning, and really prior to Bill McDonough's arrival, the PCAOB Board held a roundtable, if you will, an open discussion with representatives from countries throughout the world, and all of the members of the SEC were there to listen to those comments. I think it was a tremendously educational experience for all of us to focus in on particular problems each country had.

I think since that time the understanding that we gathered, and now with the arrival of the Chairman, the feedback that I am getting is very good from Europe. I think that there is a feeling there that we want to work with them and that we are not going to simply impose in a regimented way without taking into consideration the particular problems that they have.

The CHAIRMAN. At that point, you are referring specifically to the accounting firms, correct?

Mr. DONALDSON. Right.

The CHAIRMAN. What about in a general sense with the initial law covering foreign companies listed on the exchanges here? What kind of feedback were we receiving after the regs came out regarding them?

Mr. DONALDSON. Are you referring to overseas or domestically?

The CHAIRMAN. Overseas.

Mr. DONALDSON. Overseas. Yes, I think that, again, the reaction is not dissimilar to the reaction we have had domestically as we push ahead to implement the Sarbanes-Oxley laws. I think there is an initial reaction of reaching out to lawyers and advisers and thinking about the costs of implementing these regulations. I think as time has gone on, people are beginning to realize that the impact of the law is going to help them in their own internal governance.

Truly there will be a cost, but I think the benefit that will be received and is being received is gradually being recognized. That is not universal. There are still some that are concerned only with the cost side, and I hope that the benefit side will soon appear.

The CHAIRMAN. Thank you.

One last question, if I may, ask of you, Chairman McDonough. The SEC recently approved a $68 million annual budget for you by assessing fees on public companies's mutual funds based on their relative market capitalizations. For a start-up, your Board needed a federal loan to pay for the initial cost with setting up your organization. Does the Board intend to reimburse the federal government for that $68 million loan?

Mr. MCDONOUGH. Mr. Chairman, I am very happy to inform you that we have drawn, in three draws approved by the Securities and Exchange Commission, something in excess of $20.3 million from

the Treasury of the United States and it will be repaid in full next Monday.

The CHAIRMAN. Very good.

With that positive note, I will now recognize the gentleman from Pennsylvania, Mr. Kanjorski.

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

Two question areas that I really have. Prior to the enactment of the law, there were 850 firms that were doing accounting for public corporations and I noticed from the Web site of the Board only 450 firms have applied for registration. Some of the management consultant people are predicting that in a not too distant period of time less than 100 firms will be doing corporate public accounting. Do you see any risk in this in limiting competition? And is there something we should do to encourage smaller firms to remain and to get involved in public auditing?

Mr. MCDONOUGH. Congressman, we are hopeful that more than the 450 firms approximately which have applied for registration thus far will continue to apply. The registrations continue to come in.

It would appear to me that there should be some additional number that are in the business, I think would like to stay in the business, and perhaps were looking at the October 22 deadline, rather than noticing that we are supposed to have 45 days to look at their applications. I can assure you that we will jump through every hoop possible to look at their applications on an accelerated basis and to register them by 22 October.

One does hear stories about certain small auditing firms that perhaps had one or two public companies that they were auditing, wondering if this is a business that they want to stay in. I very much hope that they do, because very large companies are typically audited by very large accounting firms. The smaller accounting firms audit small-and medium-size companies. And it is small-and medium-sized companies that create economic growth in the United States. That is where new jobs are created.

So we want to do everything possible in everything the PCAOB does, to encourage small-and medium-size companies to stay in business. It would be tragic if a company that is relatively small that has gone public and really should have gone public and should stay public, should decide to go private just because of the Sarbanes-Oxley Act. I think we would all want to discourage that, I Assume, particularly the members of Congress who passed the Act.

I can assure you that at the PCAOB, we will do everything we can. We have been reaching out to the small-and medium-sized accounting firms, reminding them, "Hey, it's time to apply; please do so." And in talking with the accounting profession, we have encouraged them to use a concept that Chairman Oxley did in his opening remarks, and that is to apply a cost-benefit analysis. How much work did they really need to do in audit of a small-or medium-size company? It should be thorough and it should protect investors, but it doesn't have to do every bell and whistle that would be needed for General Electric.

Mr. KANJORSKI. I appreciate that, Mr. Chairman. I hope you keep us apprised if there is anything we have to do technically to help that out to keep the competition firm.

Now I want to move to an area that I have discussed with Chairman Donaldson. I think this may be a good idea to throw up the issue. I notice that you would have authority to go in examining an auditing firm as to whether they acted properly or to their client to see whether they acted properly. And more than likely, in your investigative authority, you could ask for anything within that firm, including the e-mails.

As you may recall, most recently the New York Stock Exchange engaged in an investigation of some of the specialty firms. It became a dispute between what is considered business e-mails and what are considered private e-mails, and it went to loggerheads. I think it has now been resolved by these specialty firms turning over what they considered private e-mails.

It goes to the issue of privacy. I am a little disturbed insofar as we have not thought-out a mechanism to protect communications between employees in firms of their private e-mails, when they are caught up in an investigative process.

Now, I have no problem with the Board or the SEC having that Authority, but we haven't put together any rules for nongovernmental entities that are doing this type of regulatory process. I was just wondering whether or not, if there is a dispute as to what is germane to the issue being examined by nonprofit organizations, that perhaps the Board would not be the proper arbiter of what is considered a germane e-mail to be considered and what can be held in camera, if you will, after the protest is filed.

Mr. Donaldson, maybe I will direct that to you because you are aware of what I am talking about.

Mr. DONALDSON. I think the issue of confidentiality is one that the SEC wrestles with all the time. I think that, in the consultations with the PCAOB, we will attempt to work out those problems if there are problems.

Mr. KANJORSKI. I don't know if you had anything to do with the result of the issue on the New York Stock Exchange, but when regulators or quasi-regulators are involved with private entities and there is a question of private or business e-mail, do you think it would be appropriate for us perhaps to take some action to authorize or put the jurisdiction of the arbitration of that dispute within the hands of the SEC or the Board, and that they may be the properly constituted bodies to resolve that dispute so we don't have the invasion of privacy that obviously can occur in a very gross way?

We don't seem to have any protection here, obviously because we have not been dealing with e-mails until most recently. But now we have seen a very flagrant example of how investigative authority even by a nongovernmental entity can be very invasive of privacy of employees within a firm. And there doesn't seem to be any resolve that we have structured to handle this. Perhaps this is a jurisdiction that we could give in public corporations to the SEC or to the Board. What is your thought on that?

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Louisiana, Mr. Baker.

Mr. KANJORSKI. Can I have the answer on that?

The CHAIRMAN. Oh, I am sorry.

Did either gentleman wish to respond?

Mr. MCDONOUGH. I think it might be indicative, Congressman, as to what the PCAOB's own role is regarding discretion.

The Board has discretion to exercise its inspection authority in a manner appropriate to respect and protect individual rights. That is in the Act. I think what you are suggesting is, should there be something that would make the SROs have the same responsibility to protect rights.

I think it will come up in every examination we do, especially as we get in, as part of the inspection of an audit firm, into their work on the audit of a particular client. But we take enormously seriously the respect of confidentiality, and our ethics code, which is awaiting approval by the SEC, is absolutely draconian on the issue not only when the person is an employee of the PCAOB, but for the rest of his or her life.

Mr. DONALDSON. Let me come back to your question. I was having a little trouble with your microphone there. I apologize.

I think, part and parcel with our historical oversight of the SROs and stock exchanges and so forth has been the oversight of the enforcement aspects of those organizations, and in a way the procedures that they have to protect confidentiality.

If you take a registered exchange, they all have constitutions. They all have constitutional rights, particularly on an investigative side, to investigate, to get data. We are very conscious, and I know many of them are very conscious, of the protection of that information that they get in a confidential investigative setting.

The CHAIRMAN. The gentleman from Louisiana?

Mr. BAKER. Thank you, Mr. Chairman.

I do believe that the consequences of Sarbanes-Oxley is to incentivize professional conduct and to bring about accountability where it does not occur. But in my judgment there is another pervasive incentive still within the context of the business world, the earnings report. Every 90 days, the CEO, the CFO begin from minute one of day one to figure out how to represent corporate performance in the most favorable light within the rules that currently constrain them, whether it be Sarbanes-Oxley or what may follow.

It provides the investor with information which is a retrospective analysis of dated analytics that gives little indication about where the company may actually be going forward in risk-taking, new product development, customer satisfaction, any of those relevant pieces of information.

What is more disturbing to me is that you may comply with the rules and do everything legally in conformity with expectations, but yet not provide an accurate portrayal of corporate financial conditions. It would seem to me that in the work going forward, and it would be a much larger task, that we really ought to evaluate the perspective of a more forward-looking transparent disclosure regime that requires the disclosure of material facts that affect shareholder value when you, as a corporate official, become aware of that information. Not later, not take 29, 30, 45, 60 days to try to manage your way out before you disclose it, but to have almost mark-to-market real-time disclosure as I believe would be provided by the XBRL pilot that the FDIC is now engaged in.

I don't expect either of you to comment with regard to that technology today, but really want it on the record for both of your per-

spectives that I find the potential for that real-time disclosure regime to bring about real accountability, where you have the capacity to evaluate individual corporate performance against a relevant sector of the economy against the broader market. You can see the good guys from the bad guys.

I think more information is always better than less. Some argue that this may add additional volatility. I can't see how. With what I see occurring with the whisper numbers on CNN or CNBC before the earnings reports come out the next morning, it is not very helpful to a stable functioning of the capital market. So I just wanted to bring that up for whatever it is worth in your future deliberations.

Chairman Donaldson, I read with great interest the joint announcement by the Commission and NASD regarding formation of a working group to look at securities law enforcement. I want to commend you for taking this initiative. As you are aware, I have had great interest in this matter. H.R. 2179, which was reported from subcommittee, includes an amendment which was authored by Mr. Scott and myself that would reestablish SEC supremacy with regard to state remedies that impose new national market regulations.

Would it be your intention that this working group will examine that particular issue?

Mr. DONALDSON. Congressman Baker, first I want to commend you for raising these important issues and encouraging us to focus our attention on a constructive approach to this important relationship. Your subcommittee sent a very strong message to both the Commission and the states regarding the need for communication, cooperation, and coordination on enforcement matters, particularly those that could result in new requirements affecting the operation of our national market system.

The formation of this working group which you refer to, which will focus us on developing a sound protocol for our enforcement efforts at the State and federal level, is in large part intended to address these issues.

I do want to be clear, however, that I know we both agreed that the states have played and must continue to play a vital role in security law enforcement, as the local cops on the beat. We should do nothing to diminish the enforcement vigor they bring to their work.

Mr. BAKER. Mr. Chairman, I agree with that view. In my opinion, H.R. 2179 did nothing to preclude such state action.

But I understand the working group is now in its early stages. Do you have now an ability to give me an estimate of when those individuals on the Committee who were concerned with these issues can expect to see some working group recommendation?

Mr. DONALDSON. The working group is in its formative stages. As it comes together, it is going to develop an agenda. We expect them to submit a timetable for action on the agenda items. We will be encouraging members of the group to complete their work as soon as possible, and I would be happy to keep you apprised of the group's progress as we move along.

Mr. BAKER. Again, I want to thank you, Chairman, for this joint effort. I am inclined at this point to yield to the working group and

give you the opportunity to resolve many of these issues. I would like to get your technical opinion on the revised language of Section 8B of H.R. 2179. The language would not, in my view, preempt by force of law anything the New York State Attorney General has done.

As a matter of fact, I have even commended Mr. Spitzer, some days with more enthusiasm than others, I might add, for his efforts on behalf of mutual fund shareholders and for returning $30 million to injured investors. While it does not match the efforts of the SEC through the FAIR fund amounting to $1.4 billion, it is a very good start.

In the Commission's opinion, would the language in H.R. 2179 in any way, preempt states from carrying on such investigations?

Mr. DONALDSON. Chairman Baker, I appreciate your support in this effort, which I believe will help us to strike the balance necessary for effective and efficient enforcement of our securities law. I also appreciate your willingness to let us take some time to see where this process will take us.

As to whether your proposed amendment would have impeded the New York Attorney General's efforts in the mutual fund area, let me start by saying that I am not qualified personally to give legal opinions, since I am not a lawyer. However, our legal staff has advised me that they do not believe your legislation would have come into play here. It is my hope that the working group will take a comprehensive look at all the federal-state efforts with respect to security law enforcement and that the end result would be one of more effective cooperation and coordination to the benefit of investors.

Mr. BAKER. I very much appreciate that perspective and look forward to working with you going forward.

Finally, I am concerned about a related issue stemming from recent actions of West Virginia's Attorney General. Would you agree with the general principle that once an official has acted in an official capacity with respect to a state securities violation, a second official from the same state should not be allowed to double-dip or, in other words, that there should not be double jeopardy at the State level? Will the working group be examining this issue as well?

Mr. DONALDSON. As you know, this is a complex issue that has implications for both civil and criminal law enforcement. At the federal level, of course, the Justice Department and we bring parallel actions on the same underlying conduct quite frequently. Parallel civil actions by the same jurisdiction may be another story, of course.

While this subject was not one that we had contemplated would be addressed in our working group, I believe it is an issue that merits further discussion.

Mr. BAKER. Thank you, Mr. Chairman. I want to commend you and Commissioner McDonough for both of your efforts in trying to bring about a functioning of a fair and efficient market for the benefit of all investors. Thank you.

The CHAIRMAN. The gentleman's time has expired.

The gentleman, Mr. Frank.

Mr. FRANK. Mr. Chairman, I have sat through a number of scripted colloquies on the floor of the House. I believe this is the first one I have seen in Committee. I am torn between commenting on the substance and complimenting the performance. The readings were quite good.

Mr. BAKER. I take that as a compliment. Thank you.

Mr. FRANK. I guess that underlines the delicacy of the subject, when the Chairman of the subcommittee and the Chairman of the SEC want to read that very carefully. I apologize for extemporizing on this subject, but nobody sent me my part. So I apologize. Perhaps I wasn't cast for it, but there is a certain amount of self-starting that is allowed.

I must say with regard to that agreement with the regulators, et cetera, I spoke with the Secretary of State of Massachusetts, William Galvin, who has been one of the most energetic and I think constructive, State regulators here. I don't think he has done anything that in any way was disruptive of any need for uniformity where it exists.

He has been, as I said, very energetic. He was very concerned about the negative implications of the gentleman from Louisiana's legislation. He also told me that he was not himself a supporter of this agreement that is just being discussed, and that he felt that there were others in the Secretary of State and the regulatory area who didn't. So obviously individuals are free at the State level to participate in what they want.

I did want to report that, at least from my conversation with Mr. Galvin, who has been one of the most, as I said, creative and energetic users of State authority, he did not feel that he was bound by this process.

I continue to be open to any examples people want to give me where State regulators interfered with a need for uniformity where it existed. On the whole, I think that the role of the various State regulators in New York and Massachusetts, and I have talked to some of my colleagues in other States who are very proud of the work that their regulators have done, I think it's been wholly supportive. Frankly, I think we at the federal level, and I would include the Congress as well as the executive branch and the independent agencies, have under-performed in this area. All these things that have happened, I think all of us probably should have been paying more attention earlier.

There are an awful lot of private activities going on out there, the overwhelming majority, of course, of which are entirely legitimate and wholly constructive, but I do not think we are at the point of having too many regulators. So I would be glad if people would give me examples of where they thought there might be a specific conflict. Perhaps Oklahoma is one, but I haven't heard anybody officially tell me that.

I would just want to reiterate, one, that I continue to believe that legislation that would impinge on the state's ability to go forward would be a grave error. I do know that the State regulators who have been particularly active, the Attorney General of New York, the Secretary of the Commonwealth of Massachusetts, are very much opposed to the bill as it has existed because of its potential.

If, as I said, there are examples of activities that interfere with uniformity, I would be glad to know them.

So let me ask Mr. Donaldson, are there examples where State regulators have taken actions that in fact interfered with our ability to achieve what we all agree is necessary, some level of uniformity? Or uniformity, I guess by definition, if one state gets more active than other, it is not uniform.

But have they interfered with the rational scheme that we need? Have states done things that were disruptive of our ability to maintain an overall scheme? Have we subjected people to inconsistencies, et cetera? So if you have any specific examples I would be glad to hear of them.

Mr. DONALDSON. To step back a moment, I think the issue here is that the SEC needs all the help it can get at the State and local area. We simply do not have the resources, even with our increased resources, to investigate malfeasance down at the local level. I applaud, as I have said in the past, the efforts, particularly the efforts recently by the Attorney General in New York, to bring to our attention areas of malfeasance.

Where the problem arises is when the remedies, if you will, interfere with the national structure of the markets. That is our only problem.

Mr. FRANK. Has it happened? Are there examples of that? Are there examples of remedies imposed at the State level that have interfered with our ability to have a nationally structured market?

Mr. DONALDSON. I think there were potential examples of that on the global settlement had we not gotten together. This was basically before my time when that was negotiated. I think that was a perfect example.

Mr. FRANK. Okay. But in all fairness, the answer to the question of "are there examples," is no.

Mr. DONALDSON. But to get very contemporary, I think that there was an action filed in Oklahoma by the Attorney General.

Mr. FRANK. The criminal case against Enron, or against WorldCom?

Mr. DONALDSON. It was an action which had already been worked on by the U.S. Attorney in New York and by the SEC, and we brought actions. This is the WorldCom situation. I think there is a danger here as it rolls out that that sort of an investigation could interfere with the very complex issues associated with it.

Mr. FRANK. Except that your work was pretty much completed. So again, let me ask you, and I will take this in writing after this, so I will have something in writing, too, and I won't feel left out of the writing process here.

Would you send me any examples, not of potential conflicts between state regulatory actions and the need for a national structure, but any actual conflicts that have happened? If you could send me those in writing.

Mr. DONALDSON. I would be glad to give you a history from the SEC of conflicts where they have arisen. I can't give you that today.

Mr. FRANK. I am encouraged by that because I think you know a great deal. I will take the history. The later back they are, the

less relevant they are. But yes, if you could give me that list that would be very helpful. I think would also be very short.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Oklahoma, Mr. Lucas.

Mr. LUCAS OF OKLAHOMA. Thank you, Mr. Chairman.

Gentlemen on the panel, let's shift for just a moment to a little different perspective. As I read Sarbanes-Oxley and the SEC rules, no accounting firm may provide tax services to any publicly traded company for which it serves as auditor, of course, without the approval of the company's auditing Committee. This additional layer of required scrutiny applies only to tax services provided by that company's auditor.

I am concerned that in reality if at some point in time in 6 months or 6 years corporate management wanted to engage perhaps in tax practices that were, to say politely, aggressive or, perhaps more descriptive, over the edge, that under the way this is coming together they would find substantially less scrutiny if they used anybody but the auditor for those tax services.

I have dredged up a quote here from back in the year 2000 from the SEC, that tax services generally do not create the same independence risks as other non-audit services, which I guess brings me back to my real point about aggressive tax planning.

None of us want any companies to skirt the tax laws and to go beyond the pale, and if we should stop and recognize in that regard that the audit Committee approval process is our friend, do we potentially create the unintended consequence where basically anyone will secure their tax services from everybody but an auditing firm? Are we going to drive people over to the tax attorneys or other areas of advice? Will we ultimately not achieve what we want to do by this effort, gentlemen? I guess that is my curious question to you.

Mr. MCDONOUGH. Which one of us do you want?

Mr. LUCAS OF OKLAHOMA. I have great confidence in both. I would like insights from either.

Mr. MCDONOUGH. Let me try my hand at it and then I will turn it over to Bill.

I think there has been a sea change in the escalation of the responsibility of the audit Committee, in terms of just exactly who are the accountants working for. It is within that context that we have heightened the awareness of audit Committees to really delve into the potential conflicts of interest vis-a-vis accounting, auditing and other services. I think that it is very difficult to legislate that by rules. It is the on-the-scene oversight that comes from an awake and alert audit Committee.

Mr. DONALDSON. I think the key is the role of the audit Committee, When one is looking at how much the accounting firm that actually does the audit of a public company can do, the key that you are looking for is that they don't lose their independence.

Now, there are those who say that they shouldn't be able to do any tax work at all. The SEC decided that they didn't agree with that, that the audit firm could do a considerable amount of tax work and actually there is a lot of basic stuff that the audit firm learns more about than anybody else except the management, simply in the course of doing the audit.

So I think that there is not a question that it can be done and stay within the bounds of independence. Since it is a tricky area, it clearly should be approved beforehand and in considerable detail by the audit Committee.

Now when we get to the area of very creative tax recommendations, I think that it would be impossible for the audit firm to provide that service and not lose independence because it would be in the position of auditing its own creative work. I think by definition it would lose independence.

I do remember, though, that if the management went out and hired a consultant who would be immensely creative, the auditor and the auditing Committee have to look at that very creative recommendation and decide whether it is legal. I have the view that it should also decide whether it is moral. If it isn't, then the auditor should jump on it and the audit Committee should jump on it and that degree of creativity should be removed because it is not a good thing for investors or the American people.

Mr. LUCAS OF OKLAHOMA. Exactly, and I share that perspective. I certainly am not a proponent of any concept of what my constituents would define as creative tax work. I just don't want us to create a situation by unintended consequences where in an effort to do the right thing, and I believe that is what this is well-versed on, we cause a shift of resources and we cause future management perhaps to look for alternatives to work their around against the existing rules, and we unfairly impede who are doing good honest efforts.

I appreciate your response, gentlemen.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from North Carolina, Mr. Miller.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

I suppose my question is for Mr. Donaldson.

Among the provisions in the legislation enacted, Sarbanes-Oxley, were attorney conduct standards. I know that the rules promulgated by the SEC pursuant to that legislation required attorneys to report up the line to the CEO any violations, and to the counsel and then the audit Committee if there is not appropriate remedial action. And then there would also be provision for a noisy withdrawal, for the attorney to say essentially, "I am withdrawing; there is something wrong here; I can't say what it is, but there is something wrong here."

First of all, the rules that have been promulgated by the SEC, is there any evidence of how that is working? Are violations being reported and corrective action taken? And what evidence, if any, is there of what effect there might be on the candor of the relationship between issuers and their attorneys?

Mr. DONALDSON. Obviously this area of attorney responsibility is a complex one, given the long tradition of confidentiality associated with the legal profession. I think we have worked out now the issue of reporting up in the organization, the responsibility for the lawyers to report suspected malfeasance up to a recognized Committee, whether it be the audit Committee or some other point of contact.

The issue of noisy withdrawal, if you will, and reporting out, I think that this has been a complex issue to work out. We have not written a rule on this yet. We have it under consideration. We have

taken great encouragement from the changes in ethics responsibilities brought forth by the American Bar Association in August, basically in terms of their interpretation of lawyer responsibility. So I think we are moving toward a better understanding of how a rule might be written, though we haven't written it yet.

Mr. MILLER OF NORTH CAROLINA. With respect to the rules that you do have, do you have any evidence yet of whether top corporate management and CEOs, the audit Committees, the counsel, is learning about conduct they weren't learning about before and acting appropriately to correct it?

Or the downside in that balance, the other side of that balance is the effect on the candor of the relationship between issuers and their attorneys. Do you have anything to go on yet? How is it working? I understood already that it was a complex issue, but how is it working, what we have done so far, or what you have done so far?

Mr. DONALDSON. I really think that it is too early to give you a definitive answer on that. It really is only fairly recently that the final year-long implementation of Sarbanes-Oxley rules was accomplished. I can assure you that we will be monitoring as best we can how it is working. But I think it is too early to give you anything, except possibly anecdotal, but a meaningless reaction.

Mr. MILLER OF NORTH CAROLINA. One last question along the lines that Mr. Frank raised, with respect to litigation by State regulators or others and the orders that may result from that. My understanding of injunctive action where there has been a showing of wrongdoing is that frequently it is tailored specifically to the conduct specifically to the violations and tailored to try to make sure that the sinner go forth and sin no more.

Why would you not want courts to have the flexibility to impose that kind of requirement where there has been a showing of a violation of law?

Mr. DONALDSON. The issue of State regulators and their ability to do what their mandate requires is something that our new Committee, between the State Regulator Association and ourselves, is trying to work out. I personally believe that this communication as quickly as possible is going to resolve a lot of the differences.

I just want to emphasize that the thing we are concerned about is where the enforcement on the local level leads to structural changes in the way the markets are organized, and that is where the problem lies.

The CHAIRMAN. The gentleman's time has expired.

The Chair is pleased to recognize the gentlelady from New York, Ms. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman.

One of the most important things that we tried to do with Sarbanes-Oxley was make sure that the people who had been defrauded of their monetary goods got that money returned. We established the FAIR Fund in Sarbanes-Oxley to try to do that.

Chairman Donaldson, I would like to ask you, I think we both agree that we have to do everything possible to help make defrauded investors whole. Let us do everything to stop the fraud from investors.

I think that given some of the recent settlements that states have engineered, it would be interesting to hear from you how many of those States have returned the money to the injured parties through the FAIR Fund or through any other means.

Mr. DONALDSON. Right after the global settlement, our Director of Enforcement, Steve Cutler, sent a letter to the states through NASAA encouraging them to return money back to the investors through the federal FAIR Fund. We understand that there are certain State regulations that preempt monies than going to the FAIR Fund, but we definitely encourage that vehicle wherever possible.

Mrs. KELLY. Mr. Donaldson, if they can't give the money to the FAIR Fund, are there any States that you know of that have actually given the money back to the defrauded investor?

Mr. DONALDSON. I am trying to think of a couple of specific examples. Yes, there have been. I believe Missouri has used the FAIR Fund to return dollars to investors. A complete list of who has done that I guess would come from the NASD. But I think, as far as we are concerned, we are encouraging that in every way we can.

Mrs. KELLY. I wonder if you would be willing, or Mr. McDonough if you know of any States that are returning the money? I am glad to hear that Missouri is. But it would be interesting to see if the states are in fact taking action and achieving large fines against these corporations, where that money is actually going. Is there any effort at the SEC to follow that money and see whether or not it is going back to the defrauded investors, because it is actually their money?

Mr. DONALDSON. We will definitely get back to you on that. But I want to say again that I agree with the concept of the FAIR Fund and the concept contained in Sarbanes-Oxley of returning monies to defrauded investors, that is where the money should go. Again, speaking personally, I don't feel we should be building roads with those monies, but we should be returning them to the investors who have been defrauded.

Mrs. KELLY. I want to ask one more question. I have a little more time here. The Sarbanes-Oxley Act required the GAO to study the consolidation of accounting firms and the effect on competition. The GAO came back with its report in July and reported that the consolidation had occurred, and we were down to four huge firms. Yet, they didn't see that there had been an increase in the prices for audit services, which we were concerned about.

They also reported, though, that there are significant barriers to any other auditing firm trying to build a business of auditing publicly held companies that would then build up a business that could challenge the Big Four.

I am really concerned that the Big Four does not turn into the Final Four. So I am hopeful that you will answer a question about whether or not you are concerned with that kind of consolidation and if you have any plans to continue to study the trends in the industry and perhaps make sure that competition is out there, does not result in raised prices for accounting, and will in fact be a fair market for anyone trying to get in.

I would really like an answer from both of you, if that is possible. Why don't we start with you, Mr. McDonough?

Mr. MCDONOUGH. Thank you, Congresswoman.

I think that there are two aspects to your question. The GAO study I believe made it quite clear that the real world that we will live in for quite a period of time is that there will be four big firms. That gives me an interesting challenge, as Chairman of the PCAOB, rather like the challenge that I had when I was a bank supervisor: Is there such a thing as a bank too big to fail? The answer is no, because as soon as you say yes, you have de facto nationalized the banking system.

We cannot allow the Big Four accounting firms fed that any of them is too big to fail, but rather that they have to do everything internally to make sure that they improve the quality of their services, that they improve the level of their integrity in order that they deserve to stay in existence, and that is something the PCAOB will be looking at.

Since it is not very likely that there will be a formation, say, of a group of regional firms or any other thing that would come together to be a new number five or number six or number seven or number eight, I think what we have to do, and I touched on this in response to an earlier question from Mr. Kanjorski, is to do everything we can to encourage the small-and medium-sized accounting firms to stay in business, to grow their capability, to add to the services that they provide their small-and medium-size customers so that we don't get even more concentration in the Big Four.

We will be making every effort to do that. But I think it is a combination of making every effort on all of our parts to get more competition into the accounting-auditing industry, and yet recognize that it is very highly concentrated and there are certain public policy issues that flow from that.

Mrs. KELLY. Mr. Donaldson, do you want to answer that?

Mr. DONALDSON. I would concur with what Chairman McDonough has said. I believe that, when we step back from the situation, we do have a concentration. It is of concern. I think this is a policy issue.

I think we will do everything in our power to encourage, as Bill just said, competition among accounting firms, among the four, but it is a problem. And I think that we will do everything that we can to encourage the smaller accounting firms.

I think there are some 850 accounting firms in the country auditing public companies, and we will do everything we can to encourage them to continue to do so. I think that Chairman McDonough will, too, in terms of the registration of those firms and making it the least onerous it could possibly be.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Georgia, Mr. Scott.

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

Mr. Donaldson, consider me one of your foremost admirers in terms of the job that you are doing. It just seems like every day we read in the papers that the SEC is doing great work, and some of your actions. I think we have had about 443 since last October, and you are doing a great job.

But as the Securities and Exchange Chairman, I would like to get your take, and I think we might be derelict in our responsibility if we didn't put this question to you, concerning Chairman Grasso. Could you give us your take on that issue? It just seems that this

is raising some concerns about the credibility in our investing public.

I mention that with great respect for Mr. Grasso. We had an excellent time going up as guests of the Business Roundtable and opening up the stock exchange. He is a fine person.

But I do think the American people would want to know your take on this. Should he resign? Should he step down? And in your explanation of the huge compensation package, I would like to get your opinion on that, please.

Mr. DONALDSON. Let me try and put this issue in context. The SEC has a direct oversight responsibility for the governance of the New York Stock Exchange and for all the stock exchanges. Concern about the governance and the exercise of that oversight is why I sent letters to each exchange 6 months ago asking for a thorough review of their governance practices.

Now, while this review is still a work in process, the New York Stock Exchange, in particular, came back to us with a movement toward changing some of their governance practices. While that was going on, reports began to surface about executive compensation at the New York Stock Exchange. That forced me to send another letter directly to the stock exchange, to the head of their Governance Committee, requesting detailed information about how such determinations were made and further questions about detailed aspects of the corporate governance structure.

The information that we received gave us some very serious concerns about how the governance issues were being handled. Subsequent information and disclosure raised our concerns. Clearly, these are problems that have to be addressed.

We will be asking the New York Stock Exchange some further questions based on the information we receive. We will be moving forward with an overall look at and reaction to the governance mechanism.

But I want to emphasize specifically in terms of your question, your very direct question, that this is a matter of governance. You mentioned the Chairman of the New York Stock Exchange. I believe and I hope that with the publicity that has been reached here that the New York Stock Exchange Board itself will move with alacrity to look at their own internal mechanisms and look at them in terms of some of the disclosures that have been made. I think the first level of our oversight is to make sure they are doing that.

We will come along as we finish our review and we will react to what they do and we will react to what we think we should do.

Mr. SCOTT. So one can conclude then from your remarks that you don't think that Mr. Grasso should resign, but rather that the internal structure of how this came about, the compensation process itself, should be looked at. In other words, that the issue is the process, and not the person.

Mr. DONALDSON. I think that the issue here, Congressman, as I said before, is only partially the issue of exact compensation. The issue is how was that arrived at; what procedures were in place; how is it related to the other aspects of the financial side of the stock exchange. We have a responsibility, because we are active in approving fees that the stock exchange charges and so forth, so we

have to have an oversight review on just how the Board arrived where they did.

I think that my letter to the Chairman of the Governance Committee speaks for itself. I was upset by the disclosures, as were my fellow Commissioners. But I think we have got to put this in the context not of personalities, but of procedures.

Mr. SCOTT. Thank you.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Connecticut, Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman.

Mr. Donaldson, on June 25 Freddie Mac indicated its earnings could be restated by as much as $4.5 billion, and that its accounting lapses were more serious and more pervasive than previously announced.

In its statement, the company also said the disclosure processes and disclosure in connection with those transactions and policies did not meet standards that would have been required if Freddie Mac had been an SEC registrant.

Do you think Freddie Mac should be an SEC registrant under the 1933 and 1934 Act?

Mr. DONALDSON. Let me give you a little history on this.

Mr. SHAYS. Not too long a history, I only have 5 minutes. I have a question. I just need an answer to it.

Mr. DONALDSON. Our position has been that there should be registration for both Fannie Mae and Freddie Mac. As you know, Fannie Mae has voluntarily agreed to registration and Freddie Mac has also. We are in the process of helping them prepare for registration. We were in the process when some of the issues arose in the press.

I believe that they should be registered. I personally think, and we want to get to the bottom line, if we do it via voluntary registration or mandatory registration makes no difference to us.

Mr. SHAYS. Is that true under both the 1933 and 1934 Acts?

Mr. DONALDSON. I think that we would draw a distinction between and have drawn distinction between their registration and a registration of the securities representing investments that they make.

Mr. SHAYS. What?

Mr. DONALDSON. The floating of the investments that they make. We are instead talking about registration of the securities that are held by the public, ownership interests in both Freddie and Fannie.

Mr. SHAYS. The head of the Federal Reserve, Mr. Greenspan, said that, in so many words, it's a no-brainer, of course, they should be under both the 1933 and 1934 Acts. Do you think there is a distinction? Do you agree with Mr. Greenspan?

Mr. DONALDSON. Distinction between what?

Mr. SHAYS. He basically feels they should, like any other Fortune 500 company, have to comply with both the 1933 and 1934 Acts. Do you disagree with Mr. Greenspan?

Mr. DONALDSON. Well, I would like to come back to you with a specific answer on that. I think these are complicated issues.

Mr. SHAYS. It is true, isn't it, that the SEC has never taken a formal position on the 1933 Act. Is that correct?

Mr. DONALDSON. That is correct.

Mr. SHAYS. Let me ask you this. Do you believe in the 1933 and 1934 Acts? Do you think they make sense?

Mr. DONALDSON. Do we think the 1933 and 1934 Acts make sense?

Mr. SHAYS. Yes.

Mr. DONALDSON. Yes.

Mr. SHAYS. Okay. So following that simple logic, and your very generous smile, almost surprised that I would ask the question, why would we not have the 20th and 40th largest companies registered under New York Stock Exchange, and the second and fourth largest financial institutions, why shouldn't I smile in surprise that we would not have them under these Acts?

This isn't a trick question.

Mr. DONALDSON. I want to give you a correct answer to this.

In 1992, the Commission participated in a report on this subject. The Commission expressed its view that the disclosure for GSEs should comply with the disclosure requirements of the federal securities law.

The Commission did not recommend in its 1992 report, nor has it subsequently believed that it would be appropriate, to remove the exemption in the federal security laws for the offer and sale of a mortgage-backed and related securities of the two entities. We do not believe it is necessary to repeal the security law exemptions for Fannie Mae and Freddie Mac.

Mr. SHAYS. Okay. Why shouldn't I smile at the absurdity of saying that everyone else in the New York Stock Exchange has to register, and yet this company, particularly Freddie Mac that has shortchanged their statements by $4 billion or misstated them by $4 billion, shouldn't have to fit into the requirements that everyone else they compete with has to do? Why is it good for everyone else, but not Fannie Mae and Freddie Mac?

I find it astounding, and no one has told me why they shouldn't comply.

The CHAIRMAN. The gentleman's time has expired.

He may respond.

Mr. DONALDSON. I think the issue of a government-sponsored enterprise, and particularly the issues of Fannie Mae and Freddie Mac, have been before a lot of the legislatures, yourselves and others. I think there is a reexamination of just what that means.

I can only speak from the point of view of the SEC, and that is that we want to get them to register in the same way any other company does, in terms of the investor protections associated with that.

The CHAIRMAN. The gentleman from Kentucky, Mr. Lucas?

Mr. LUCAS OF KENTUCKY. Thank you, Mr. Chairman.

Chairman Donaldson, as you are aware, I know FASB has recently proposed a new rule, FIN 46, regarding accounting for special purpose entities. Concerns have been raised about the difficulties it would create should this rule apply to the franchise or franchisee business model. Some of these franchisees are mom-and-pop operations. A lot of them are very big, but some of them are operating their financial records out of a cigar box.

Do you believe that FASB should consider exempting these business models from the rules applications, the franchise or franchisee model?

Mr. DONALDSON. I think the FASB is looking at accounting associated with special purpose entities. I believe that we need to get back to you in terms of the work that the FASB is doing, and to understand better than I do right now, sitting at this table, exactly where they are at on those specific issues.

Mr. MCDONOUGH. By chance, I know that the FASB is actually having a meeting this afternoon on the very subject that you are concerned about, Congressman.

Mr. LUCAS OF KENTUCKY. Okay. Great. Because it seems like it is a practical impossibility for these folks to comply with those requirements. I mean, just to reach out that far to these franchisees who are very unsophisticated would be, I think, a virtual impossibility.

Thanks. If you could get back to me. Thank you.

The CHAIRMAN. Does the gentleman yield?

Mr. LUCAS OF KENTUCKY. I yield back the balance of my time.

The CHAIRMAN. The gentleman yields back.

The gentleman from Minnesota, Mr. Kennedy.

Mr. KENNEDY. Thank you, gentlemen, for your testimony and your response to questions and your good work in restoring investor confidence, and the Chairman for having this hearing.

I want to follow up on the questions that Congresswoman Kelly brought forth on consolidation a little bit. As part of the scandals that led to Sarbanes-Oxley, we went from five firms down to four, with one of those firms having an office that messed up, and the result being the entire firm was eliminated.

My concern is, as good a work as you are working on, I am a finance guy. I happen to be a Big Eight audit alumni. So, how do we prevent that from happening again, and was that the right result? Because, you know, one of the concerns I have is that the Pentagon can't fight a war without soldiers. The Public Company Accounting Oversight Board and the SEC can't assure investor confidence without having auditors.

And when you have people that are looking at career choices and they are seeing all those good, hard-working, honest, conscience people that were in other offices conducting their audits in commendable fashions, that all of a sudden lost everything, that doesn't create a big incentive for the young men and women of this age to be going and trying to be the best auditors in the future.

So what do we have to prevent a situation like that happening again, so we go from four to three, or even beyond? And was it right that the whole firm was eliminated as the result of the actions of particular offices?

Mr. MCDONOUGH. Congressman Kennedy, I think that you touch on an enormously important issue. The good news is, I was very concerned about whether the really good young people from really good universities would want to become accountants.

Chairman Donaldson and I were at the 30th anniversary of FASB the other day. We arrived late and there were three very attractive young women who were sitting together and there were

three empty seats. So Mr. Hertz, the Chairman of FASB, and the two of us joined them.

They had just received master's degrees and were doing an internship. They went to outstanding universities, and they were happy as clams to be newly made CPAs. They were particularly happy that they had a multiplicity of job offers, and they were pointing out that their friends who had majored in marketing or strategic planning or such things were still looking for a job. That, I think, would make both of us feel a bit more assured.

But more seriously, a major step forward has been replacing the relationship between management and the auditor by the relationship between the audit Committee and the auditor.

I think it was very difficult, especially as accounting firms in the late 1990s really began to downplay the importance of the audit, their most important product in the protection of investors, and the consulting work became the order of the day and where people went ahead in the firm. That, of course, has been fixed to a great degree by Sarbanes-Oxley and by decisions of the Securities and Exchange Commission.

Now we have a situation where it is the audit Committee which selects the audit firm, and it is the audit Committee which, in a way, is the reporting vehicle for the audit firm. So the temptation for an audit firm to keep business, or get more business, by having what became a much too close relationship with management in many cases, I think all of the cases where there have been scandals, that temptation has been by and large removed.

Now, it demands, of course, that the audit Committees take their jobs very seriously. One of the things that we will be looking at in our inspections of the Big Four firms between now and the end of the year is do we have the impression that the audit Committees are taking their work seriously. Anecdotal evidence would say that the answer to that is yes.

In looking at the audit firms, the tone-at-the-top issue I mentioned in my prepared remarks, we want to make sure that having got the message of Sarbanes-Oxley, which I think we would have to say is clearly discernible at the top of the shop in the major audit accounting firms, is being reflected throughout the entire organization.

It may very well be that you would have X in charge of the office in some city who hasn't gotten the message and has developed an inappropriate relationship with management, and there is a little cooking of the books going on with the collusion of that part of the audit.

We would hope that, first of all, that the overall management of the firm would catch the miscreant and pitch him. On the other hand, if in the course of the PCAOB inspections we spot that there is somebody in one of their offices, because we are going to be very thorough, especially starting next year when we do it once a year, we will be looking at the firm in its entirety in the United States.

We will be looking at a lot of the audits that they do, you as a pro would know, we will be looking at the high-risk audits and then doing a sampling of the more ordinary audits. Through the samples we will be able to see if there are people in the firm who

haven't gotten the message of the new virtue which they have to believe in.

I think that the likelihood, therefore, of the kind that happened to Arthur Andersen happening again, it certainly hasn't been reduced to zero, but it is very, very much less probable.

The main thing we have to count on is the accountants really have to want to reform themselves. When I was a kid or a much younger man, going into accounting was a very honorable profession. The worst anybody said is that accountants were a little boring. But your kids all thought that mom and dad were in a wonderful profession.

That isn't what they are hearing, and they are very, very concerned about it. They are very concerned about the future of their profession and they should be. But that is something that we at the PCAOB can work with in helping the accounting profession reform itself.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from New York, Mr. Crowley.

Mr. CROWLEY. Thank you, Mr. Chairman.

I thank both chairmen for being here today for your testimony and for your response to the questions put before you today.

I think I would like to continue on the questioning started by Mr. Kanjorski and followed by Ms. Kelly and by Mr. Kennedy. That is in regards to the issue of small accounting firms and their ability to compete, basically, in this market.

Chairman McDonough, I know you mentioned your concern for their future and their ability to stay in practice, to stay in business, and also expressed your desire not to do anything that could in some way have a negative effect on the Big Four as they exist right now. I understand that. There are a lot of jobs that have been consolidated within those four accounting firms.

I was very supportive of Sarbanes-Oxley, a number of amendments that had passed that created new statutes concerning conflict of interest. And it is partly a thought, partly a question, in terms of, is that possibly a vehicle by which, and I think if the law is carried through by both departments, that because of the new conflict of interest laws that were in place that Big Four firms will not be able to take certain accounts because of those conflicts. Is that a possibility? Do you see that as a vehicle by which you can encourage some of the mid-sized firms to stay in business?

And just to follow up on a couple of the suggestions that have been made. One is that I have heard from some accountants the idea of the government sponsoring malpractice insurance for smaller firms that are looking to get into the public accounting field. That could help to address some of the concerns outlined in the GAO report that Ms. Kelly and others have mentioned, such as the lack of staff, industry, and technical expertise, capital formation, global reach, liability concerns, reputations suffered by small accounting firms because of their inability to compete.

As well as another thought, and that is limiting the market share of the Big Four, in other words within the publicly traded companies and their ability to audit, thereby opening up some of that market share to smaller and mid-sized accounting firms.

If I could have both of you comment, then I would appreciate it.

Mr. MCDONOUGH. Congressman Crowley, I think that when a public company, or private company for that matter, is looking for an auditor, one of the things that you are looking at is does the auditor have the capacity to audit my company. If it is a relatively small company, lots of audit firms are able to do that.

If it is a company, let's say, with national scope, with offices, with branches, with factories in various places, you would be looking for a firm that has enough people, enough sophistication to be able to handle your company.

There are some middle-sized firms that I think in most cases could be the answer. There has been kind of the notion that if you were audited by one of the big eight, seven, six, five, now four, that there was something that was kind of prestigious.

Mr. CROWLEY. There was an inclination that if it got past them that you had passed the test, basically.

Mr. MCDONOUGH. Exactly. Now, I think we need to get away from that so that people will really go and find an auditor who can do the job, an auditor who knows what he and she is doing, and will bring a high level of integrity to the audit. In that way, I think that we can encourage competition.

I am not sure, unless you were going to say to given companies, "You may not use auditor X, Y, Z," how you would limit the market share. The market share, as the GAO report indicated, of the Big Four is huge. Whittling it down would be a great and good thing to do, but I don't think anybody can quite figure out how to do it until you get some of the medium-sized firms to get big enough that they can really start competing, and that is going to be a process that will take a while.

Mr. DONALDSON. Let me just add to that. I think Mr. McDonough brings out, obviously, that one of the greatest impediments for smaller firms is their inability to operate on a global basis or a national basis, and that is really an impediment.

Having said that, I think that there is an opportunity for those smaller firms that aspire to become bigger firms to compete on the quality of their product and the service that they give and all the other things that allow small organizations to compete with big organizations.

I think that some kind of cutting up of the marketplace and allocation of market share and so forth would not be the way to do that.

Having said that, I believe the issue of consolidation is one that is a problem and that has to be addressed in a lot of different ways. I hope it will be by the accounting profession and others.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from Illinois, Ms. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Chairman McDonough, one of the most important powers that Sarbanes-Oxley gave the PCAOB is the authority to inspect and discipline the firms engaged in the auditing. Do you think that there is any problem with confidentiality? Certainly, those firms are apt to have full information from the firm's clients.

Do you have a plan for addressing legitimate business concerns for confidentiality, while being able to provide the kind of public

disclosure that is demanded by investors and really envisioned in the Act?

Mr. MCDONOUGH. Congresswoman, in actually doing the investigations we have very rigid controls of the confidentiality of the information.

There is one aspect which was established in the statute, and that is, if we find that somebody has really made a major transgression which should be prosecuted or should be a matter for an enforcement action, we can move immediately.

But then there are the things that are not at that level, but are negatives. The statute establishes that we will not make those negative comments public for 12 months, and if the accounting firm solves all those problems within 12 months, that it will never be made a matter of public information. That is in the law, and so obviously we will enforce it.

On the other hand, being a new lad there on June 11, I asked myself, "Well, why?" I think actually it is a very good thing, because what it says is, especially since the view of the PCAOB is that we are trying to help the accounting profession to reform itself, and that if you say to somebody, "Look, here is a list of things that you are really not doing well, and you got to fix in the next 12 months, but if you do fix them in the next 12 months, they will never be made public." Twelve months is not a very long time if you have any kind of a decent-size firm.

Therefore, it is really quite a stern discipline, and I must admit that the more I get acquainted with it, the more I like it. I think it is a very good idea. It gives us a very effective vehicle to say, "Here are some things that need fixing, fix them." And the reward for fixing them is that the world doesn't know that they needed to be fixed. If at the end of 12 months they haven't been fixed, then it is a matter of public record.

Mrs. BIGGERT. So you don't think there is any concern that some of the businesses might not want to give the audit companies full information, because it might be made public? That is not an issue?

Mr. MCDONOUGH. I think it is an issue, but it is a manageable one.

Mrs. BIGGERT. Okay. Just one other quick question then. What are your views on the mandatory firm rotation?

Mr. MCDONOUGH. We now have new regulations that say that the audit partner must be rotated every 5 years, rather than every 7 years as in the past, and the concurring partner must be rotated every 5 years also.

I think that is a good step in the right direction and we should really see how much progress is made through that and the overall application of Sarbanes-Oxley and the work of the PCAOB, and then reflect in the future, rather than now, on whether the mandatory rotation of firms would really add value.

Mrs. BIGGERT. Thank you.

Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentlelady yields back.

The gentleman from Alabama, Mr. Davis,

Mr. DAVIS. Thank you, Mr. Chairman.

Mr. Donaldson, let me try to return, if I can, to the focus of Mr. Miller's questions earlier about the requirement of a withdrawal, and notice to the SEC in the event of client misconduct.

A lot of us on this Committee, as you know, are attorneys and while that is a provision or a contemplated provision that has not gotten a lot of public commentary, certainly as an attorney I am a little bit struck by it for a number of reasons.

As I understand the current ABA rules of professional conduct that most states have mimicked around the country, an attorney or counsel can have the discretion to withdraw in the event a client is engaged in ongoing fraud. A counsel has the discretion to notify authorities in the event that a client is about to commit something that could cause immediate bodily injury.

In neither of those instances is it compelled that counsel make the disclosure, and indeed in only rare instances is it even contemplated that the counsel could even think about withdrawing.

This provision seems several steps beyond the ABA's current standards that, number one, as I understand it, it doesn't simply make withdraw discretionary, it makes it mandatory. And then, second of all, not only does it make withdraw mandatory, but it makes disclosure mandatory.

That strikes me as being enormously radical in two senses. Number one, given the fact that that is the only circumstance in which the SEC has to be notified of withdrawal in an instance of misconduct or failure to correct, if you will, by the client, it amounts to the attorney being compelled to make a statement against the interests of his or her client. I don't see how a reasonable person could really see the statement as being one other than that.

Can you comment on this proposed rule and the fact that it is so much beyond the mainstream of where the ABA stands right now on disclosure and on withdrawal?

Mr. DONALDSON. As I tried to discuss a little earlier, I think you bring up some very good points in terms of the whole issue of the noisy withdrawal and whether it is mandatory and exactly how it is done and so forth. I think one of the reasons that we have not written a rule in this area is because we are trying to evaluate some of the issues that you just brought up and trying to balance them off against people that feel differently about this.

I think the thing that we are trying to make clear is the fact that attorneys who work for corporations work for the corporation. They are not representing individual people within the corporation. They have an obligation as an attorney for the corporation to take action if they see something that they disagree with.

I think that the first step here is this reporting up rule that we have written. And I think it is only when that fails that this issue of reporting out noisily comes up. It is a very contentious issue. I can only assure you that we are going to make every effort to get it right in writing a rule.

Mr. DAVIS. Let me follow up and ask just maybe one more question along these lines. I certainly appreciate the complexity of the issue, as you do.

One of the things that occurs to me is that there is a potential ambiguity in the provision as it is contemplated and as I understand it, and it is this: What is the time frame that counsel would

have to make an evaluation of whether appropriate remedial action has been taken? Has the SEC given any thought to what that time frame would be? And closely related to that, what happens to a counsel who in good faith is not sure what his or her obligations are under this new provision if it comes about?

Let us say that you have gone up the chain of command at your company. You have reported a violation. There has not been a prompt correction, but they say in effect, "We are working on this and we are going to get back to you." Let's say, 7 months from now, they say, "We are working on this and trying to get to the bottom of it."

Realistically, to whom would counsel go to get guidance about the scope of his or her responsibilities without also, in effect, breaching the privilege and making a disclosure?

Mr. DONALDSON. For the very reason of the issues that you bring up, the specificity of what you are saying, that is what makes writing rules in this area so difficult.

I can only say that we are doing everything in our power to expose people who are working on this to the concerns that you have and the kind of, I won't even say details, very important aspects of just exactly how does this come into play is something that we are working very hard on. Give us a little time.

Mr. DAVIS. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Thank you and good afternoon. I appreciate the opportunity to be with you, and your answers, so far, quite honestly. Most of the concerns I had earlier have been raised, but I will just ask one, which will be a follow-up for Chairman Donaldson.

I just wanted to follow up on one question that was raised by a colleague from the other side of the aisle, when he shared my thoughts of congratulating you on your work in the past, Chairman, as far as your inquiry as far as the compensation packages that are being looked at right now.

Just to follow up as far as your inquiry, where you are going, it seems that your answer is that you are going to be looking more to the issue of what the procedures are or maybe just use the word the "culture," perhaps, as far as on the Boards and the way in which they got there as far as the compensation package was achieved. Is that correct?

Mr. DONALDSON. The issues associated with the governance of a stock exchange are very much in our purview, very much our responsibility, very much something that, because of what has happened recently, we are going to have to take a very hard look at.

I think I would say, in terms of the culture of the governance of the stock exchange, the same thing to the governance of corporations across America, and that is that there has to be an attention to the issues that many corporations haven't spent time on.

I think, as far as the stock exchanges are concerned, it is a much more complex situation because of what the stock exchange represents. It represents a lot of very different constituencies, the floor brokers, the specialists, and so forth. It has a responsibility to the listed companies.

It doesn't fit into a corporate governance mold. I think that what is needed here and what we will be working on is an examination of that, and I hope that we will be working eventually with whatever the stock exchange comes up with to come up with a set of procedures that make sense.

Mr. GARRETT. What do you think it says to Main Street America when you read the comments in the paper by some of the people after this has begun, and obviously some of the people who have made the decisions are basically defending their decision that they make, on the one hand, and then some other folks who are no longer in that position are making statements, like, well, maybe this was not the most appropriate decision that could have been made.

What does this say to Main Street America as far as the compensation packages of the rest of corporate America, when you consider that there may be a lapse of fiduciary responsibility by these individuals on the exchange? We see the excesses, in some people's perspective, as far as compensation packages elsewhere, but there is not responsibility at the top, at the exchange and the rest of corporate America. I would say the little guy on Main Street must be scratching his head, "Is this a place that I feel secure in anymore?"

Mr. DONALDSON. I think that the position of the stock exchanges, in particular the New York Stock Exchange as the largest market in the world, is very special as far as corporate America is concerned. I think the rules that the stock exchange writes in terms of how the place is run, what companies must do to qualify to be listed, et cetera, these are all issues where the stock exchange itself must be the exemplar of what they require of others.

All I was trying to say earlier is that the governance issue is a lot more complex in that organization because of its central position and the responsibility it has to others. I think the American people have a right to expect that from the governance of the New York Stock Exchange.

Mr. GARRETT. I close by saying I agree with you, and I hope that that message gets sent appropriately.

Thank you.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Washington, Mr. Inslee.

Mr. INSLEE. Thank you.

Mr. Donaldson, I had to come late, so I may have missed some of your testimony, but I wanted to ask you in a lay sense to comment on the enforcement activities of the New York Attorney General as it relates to the SEC regulatory and enforcement activity.

I want to relay this as a question that I get asked, in a sense, in grocery stores and it is the kind of question you get from folks on the street. I would like you to address it in that sense.

I have been asked on several occasions by people why there has been some vigorous, aggressive, apparently successful regulatory actions by the New York Attorney General involving various security-related issues, and an apparent absence by the SEC of similar regulatory enforcement activity that at least the lay people I talk to believe would be in the jurisdiction of the SEC. Maybe that is because William O. Douglas came from Washington and we are particularly proud of that history and legacy.

But I would ask for you to tell me what you think the answer should be to that type of question to our constituents as to why there is, at least to them, rigorous action from one quarter of our enforcement community and regulatory community and at least a seeming absence to the lay people on the street of our federal regulatory authority. If you could address that broadly I would appreciate it.

Mr. DONALDSON. I think that the recent action by the New York State Attorney General illustrates what I had been saying earlier, and that is that we need a combined force of Federal and State policemen, if you will, to uncover the fraud that goes on in this country. We cannot be everywhere. We depend on local law enforcement, and in particular securities enforcement agencies in the states to uncover malfeasance that may fly under our radar.

Having said that, I think that there will always be instances where a specific knowledge of a fraudulent activity gets reported to one agency or another. That was a case here recently in terms of the accusations of the problems between a hedge fund and a mutual fund. It is very hard to uncover that in your routine examinations, particularly if there are purposeful efforts to hide it, particularly in this case where we do not have the authority yet to register hedge funds or to inspect them.

So I guess what I am saying is that we welcome this activity. The only two caveats are that, one, there attempt to be the coordination that comes from colleagues working on a common problem so that there isn't redundancy. The other is that, when the remedy involves changing the laws and the regulations, that cannot be done on a state-by-state basis. There has to be a national regulator to do that.

Mr. INSLEE. I appreciate that. Let me ask you about Sarbanes-Oxley. I have some inquiries from some small cap companies who are experiencing difficulty that they relate to me with compliance, costs associated with that. The have wondered, posited if there is some relief for small caps in that regard to get to the heart of what we were driving at in that bill, but perhaps recognize some of the onerous burdens that they have. Is there anything under consideration in that regard for small caps, or should we be thinking about that in any sense?

Mr. DONALDSON. Right. Again, Sarbanes-Oxley has only been in existence in its completed form for a very short period of time. We are well aware of small cap companies, problems associated with conforming to Sarbanes-Oxley and the expenses associated with that. I think we have tried to be flexible in a number of ways in terms of phasing in conformity.

I think we need more data in terms of the cost-benefit of the Act. I think it is too early to do anything more in the rules we have written than to be aware of the greater burdens the Act places on a small company.

Whether we need to write new rules or whether there needs to be some modification of the legislation, I think it is too early to even suggest that.

Mr. INSLEE. I would heartily encourage you to consider that, because we are looking at job growth coming out of these small caps,

and hope that you can look at ways to give them a little more flexibility in that regard. Thank you.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Alabama, Mr. Bachus.

Mr. BACHUS. Chairman Donaldson, as I think all of us realize, the market goes up on good news and down on bad news, and there are market-moving events like a Microsoft announcement of earnings or a catastrophe or someone being awarded a contract.

Knowing this, I would like your views on this late trading where preferred customers have been allowed to place what is called not an order, but a possible order before the market closes, and then they get to wait until the market closes and then they get to wait to see what the market-moving events are, and they then have a better idea of whether the market the next day is going up or down.

And then those orders by the mutual fund are either placed at the expense of all the other mutual fund investors or they are destroyed, which I would think executing them is illegal, taking the order is illegal, destroying the orders is illegal, or concealment, and it is clearly in violation of the SEC rules. And as you know, the New York Attorney General has issued both criminal and civil charges and has called this larceny.

Number one, I would agree with him that it is larceny. It is stealing from the other mutual fund investors.

But my question is this, as the SEC you have clear jurisdiction under the Investment Company Act to investigate this type of activity. In the past, have your investigations led to uncovering this activity in the past?

And number two, when you discover such activity, improprieties, illegalities, concealment by mutual fund managers or directors failing to do their jobs, is this disclosed to the public so that the public can be warned?

Mr. DONALDSON. As you know, we have been out in the field examining a lot of aspects of mutual fund organizations, sales practices, particularly the disclosure incentives for the sale of particular fund shares, et cetera.

The issue of timing of mutual fund purchases has always been an abhorrence on the part of mutual fund organizations for timing, if you will, and many of them have written it into their prospectuses.

Mr. BACHUS. But the late trading is actually more than just timing. I mean, it is actually illegal under the SEC's present law, is it not?

Mr. DONALDSON. Well, there are two aspects to this. There is the illegal stamping and timing and so forth of just exactly when the order did arrive. That is obviously illegal. There is also the problem associated with different time zones, European securities, et cetera, that close much earlier than we do, and a time lag there.

We have always counseled the mutual fund industry in times of market interruptions to substitute their judgment of values on certain securities where there have been movements and the market does not reflect that. I think the whole issue now is under review, and we will see where we go on it.

Mr. BACHUS. When you find this type of activity and you discipline, will the public be advised?

Mr. DONALDSON. I am sorry?

Mr. BACHUS. When you find that there has been a violation of the law, that there has been illegal activity, there has been concealment by a mutual fund manager in your investigations, will this be kept confidential or will you disclose it so that people that have invested in that mutual fund, number one, know that their investment has been diminished by this illegal activity, and number two, to warn members of the public against, that may possibly warn them not to invest in that fund?

Mr. DONALDSON. I think that our first step is to determine how widespread some of the alleged practices have been, and we are doing that right now.

Mr. BACHUS. What is your sense?

Mr. DONALDSON. We are in the field right now. We have asked a number of questions. We have sent a number of letters. We have sent a number of our examiners in. The timing, I believe, depends upon just what we find.

In terms of answering your question directly, I believe it is the responsibility of the SEC to either reassure the American public that some of these practices are not widespread, if they are not. I think we have a responsibility to write rules and regulations addressed to correcting these problems if it is widespread.

In terms of how we display that to the public, enforcement actions, obviously, are confidential; and we do not disclose the internal workings enforcement matters until we have made a determination.

Mr. BACHUS. I will close here simply by saying that when you find these instances of concealment and illegality which have affected people's investment and I think is a clear violation of the law, I would hope that you would disclose that to those victims of that fraud.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman.

I have a lot to say in only 5 minutes. The greatest asset of the Roman Empire was arguably Rome itself. Nero fiddled while Rome burned. Arguably, the greatest asset of the United States is the trust we put in our capital markets, and we are fiddling while neighborhood after neighborhood of that metaphorical city burns, WorldCom, Enron, 92nd Street Y, Schoolgate. The list goes on and on.

I am surprised that we are not holding these hearings since we have Chairman Donaldson here, on which 100 people have been incarcerated; which assets have been seized; which special courts or constitutional amendments, or which special courts have been created, or priority in courts. Instead, we are sitting here and we just want to see how many more scandals before people lose faith in our markets.

I am flabbergasted. I mean if a street gang had done one-millionth of 1 percent of the damage that has been done by the shenanigans on Wall Street, would there be not a single person incar-

cerated? I am flabbergasted that we are just working around the edges here, but I guess that is what these hearings are about.

I do in the spirit of that want to focus my questions on Chairman McDonough. First, with the idea of the structure of accounting firms. Back when I was an auditor, we understood that financial accounting is the only game where the umpire is paid by one of the teams. The engagement partner was under incredible pressure to do whatever the client wanted and was incredibly rewarded if the client would just pay their bills.

But we had two things. We had a review department that called the final shots and we had unlimited liability for the partners of the firm, which is why they insisted that the review department call all the shots and so one of their partners bent upon advancing his own career wasn't down in Houston signing anything and everything.

The AICPA has, I think perhaps as a result of my correspondence with them, provided some guidance to the accounting firms that the review department, partners independent of the engagement, not rewarded for selling services, people who don't golf with Ken Lay, call the shots.

Has your board imposed that or about to impose that on the accounting profession or will we continue to have a circumstance in which someone's career can rise because they get the bill paid and that is the person who calls the shots and the review department acts on a "don't ask, don't tell" basis or a respond-only-to-questions basis?

Mr. MCDONOUGH. Congressman, I think it is generally believed that the demise of Arthur Andersen was a direct result of having the engagement partner be able to make the final decision and the review department could be just overlooked.

As I mentioned earlier, I think that the thing that really brought the debacle in the accounting profession is that there was a relationship between the engagement partner and the top management, the CEO and the CFO, that made it very tempting for the engagement partner.

Mr. SHERMAN. If I can interrupt, that relationship will always exist. That is why they call them the billing partner.

Mr. MCDONOUGH. What has been established, I think, which is a major step forward, is that the engagement partner now deals with the audit Committee, not with management. That is only effective as how good the audit Committee is. I think it is a very serious step in the right direction.

Mr. SHERMAN. So we are only going to have fraud where a CEO is able to stack the audit Committee of his own board. Gee, how often does that happen?

Mr. MCDONOUGH. One of the things that is going to be very challenging in our formation of our rules is the relationship between the auditor and the audit Committee.

Mr. SHERMAN. Sir, my question is the relationship inside the audit firm between the billing partner and the review department. Now, if you don't want to address that question because you want to talk about the audit Committee thing that you got out there, that is fine. But within a few years we will return to the cir-

cumstance that has been the tradition where a CEO is often able to control every aspect of the board of his corporation.

The CHAIRMAN. The gentleman's time has expired.

The gentleman may respond.

Mr. MCDONOUGH. We are in the business of setting quality control standards. It is my personal opinion that you are right, that the review area of the firm should be making the final decisions. Since I am the Chairman, I would hope that that view would prevail, but in fact the PCAOB has not yet ruled on it.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Gentlemen, the absolute necessity of Sarbanes-Oxley is readily apparent to me, as are many of the benefits. But I think that some of the costs perhaps are not so readily apparent, and I would like to use my limited time to explore those. If some of this is redundant, please forgive me, but I unfortunately missed some of your testimony.

Specifically, I would like to go back and review the impact of Sarbanes-Oxley on small cap companies. I represent a fair amount of the city of Dallas. Just recently, I had one CFO of a company called Abatix tell me that due to Sarbanes-Oxley, they have a 50 percent increase in their compliance cost in order to remain public. Another company, Electric and Gas Technology, says that their audit fees have doubled, due to compliance with Sarbanes-Oxley.

Is this a microcosm of what is going on in the marketplace? If both you gentlemen would respond.

Mr. MCDONOUGH. The real answer, Congressman, is we don't know. We are hearing anecdotes of the kind you describe.

Generically, what the PCAOB is trying to do, and we are at the stage now of both acting on inspections, but also going out and preaching the gospel, is that there has to be cost-effectiveness in what is going on.

It is absolutely contrary to what you sought to establish in Sarbanes-Oxley if we are pricing small and medium-size companies out of business.

Now, if they had no compliance capability at all and had to put one in, that is a one-time cost which is probably justified and the shareholders should think it is a very good idea. If the audit firm had been so underpricing the audit that you get what you pay for, so the audit wasn't worth a whole lot and now they get a decent audit, a proper audit, as a result of paying a more reasonable fee, that might be justified.

But as a generic, we simply cannot allow the choking off of growth in the American economy coming from small-and medium-size companies by having the implementation costs of Sarbanes-Oxley be excessive.

We are encouraging the accounting profession to use common sense and a rule of reason in, for example, when we establish what the internal control attestation requirements are, not to think that a small-and medium-size company, unless a small-and medium-size was very complicated, which most of them are not. They don't need every bell and whistle and internal controls that a General Electric should have. Therefore, it is not appropriate for those to be demanded. We will be continuing to push that very hard.

Mr. HENSARLING. Recently, I had a survey cross my desk from a securities law firm. I can't attest to their methodology, much less their credibility. But under this survey, they claim that D&O insurance is averaging an increase of 94 percent, accounting costs are up 105 percent, board compensation is up 98 percent, training up 81 percent, and compliance personnel 267 percent for small cap companies.

As the evidence starts to come in from the field, do you have any sense whether these figures may be in the ballpark, out of the ballpark?

Mr. MCDONOUGH. The other sort of scary anecdotes I have heard have not been that scary. So these would seem to be on the outer edge of what people are saying is the cost of implementation. But as I mentioned earlier, we don't have enough data yet to know what the real cost is.

I think what we have to have is what I suggest is the rule of common sense, that demands for implementation should be reasonable in relation to the nature and the size of the firm.

Mr. DONALDSON. I might just add to that, beyond just the costs associated with the auditing and accounting and so forth, there is a start-up cost, if you will, in terms of getting going on conforming to Sarbanes-Oxley, and that means the front end-loaded legal fees and so forth.

I think, as people get used to working under the Act, those costs are going to go down, and only time will tell whether I am right on that. But I think that I would just echo what Mr. McDonough has said, which is that we are very aware across the board of the costs of Sarbanes-Oxley and the potential for a disproportionate burden on small companies.

Mr. HENSARLING. Last question with my remaining time. Have you seen an increase in shareholder lawsuits, and do you have an opinion on what is happening on director retention and recruitment?

Mr. DONALDSON. I don't know the answer to that. I am sorry. I am having trouble hearing with the microphone system, but your question was, do we know whether there has been an increase in shareholder lawsuits? And I just don't have that answer, but I will get it for you.

Mr. HENSARLING. Thank you. My time is expired.

Thank you, Mr. Chairman.

The CHAIRMAN. The chair now recognizes the gentleman from Illinois to wrap up.

Mr. EMANUEL. Thank you, Mr. Chairman, for holding this hearing. Chairman Donaldson, thank you for being here.

Chairman Donaldson, I assume the SEC's report on hedge funds will be out soon. I wonder if the SEC has drawn any preliminary conclusions that you can share with the Committee? Specifically, on what type of oversight needs to be done, if any; whether Congress has a role; and what is going on in an industry that is growing exponentially.

Mr. DONALDSON. As you know, we have had for more than a year, but more intensively in the last 6 months, a look at hedge funds. We have had several meetings and roundtables. We have gathered testimony, and our people have been in the field, and our

staff has been working on the results of that investigation. The Commission is just a very short period away, very short, from receiving a report from the staff, with the results of all the work we have done and some recommendations. I think you can expect to hear from us very shortly.

Mr. EMANUEL. When the report is released, would you be willing to appear before the Committee to discuss the SEC's findings?

Mr. DONALDSON. Absolutely.

Mr. MCDONOUGH. Absolutely.

Mr. EMANUEL. Thank you. We have dealt with the issue of research and investment banking and the conflicts of interest inherent in the auditor-client relationship. My question relates to another area in which conflicts may exist. Do you think Congress should examine the "tying" issue as it relates to commercial and investment banks offering products and services under the same corporate umbrella? Do you see a significant problem in this area concerning the tying of products and services? Is the SEC currently examining this issue?

Mr. DONALDSON. The issue of tying between commercial and investment banking clearly is an area that we have looked at. We continue to review. It is an area that falls primarily in the area of bank regulation.

I think the whole thesis, if you will, of some of the mergers and acquisitions as between investment banks and banks was the thought that there could be cross-selling. You know, when does cross-selling become tying? It is a major issue. It is one that is on our agenda to take a look at.

Mr. EMANUEL. Okay. At this point you don't see it as a real problem? I'm interested in whether there is a concern among those who monitor and regulate these industries.

Mr. DONALDSON. I think it is one which, with our increased resources, we will have the resources to take a look at. It is of concern personally for me, but I am not speaking for the Commission.

Mr. EMANUEL. With that, I have no further questions. Thank you Chairman Donaldson, for taking the time to share your views and expertise with us today. I yield back the balance of my time.

The CHAIRMAN. Does the gentleman yield back? Thank you.

We are in your debt. We thank you so much for what was a very wide-ranging hearing that, perhaps as almost predictable, went beyond the narrow scope of the announced intention of the hearing. But in any event, both of your appearances and testimony were superb, and I know I speak for the entire Committee in thanking you for your service.

The Committee is now adjourned.

[Whereupon, at 12:39 p.m., the Committee was adjourned.]

A P P E N D I X

September 17, 2003

Opening statement

Chairman Michael G. Oxley

Committee on Financial Services

"Accounting under Sarbanes-Oxley: Are financial statements more reliable?"
September 17, 2003

Good morning. Last year, in the wake of an unprecedented erosion of investor confidence, the Congress responded by passing historic corporate reform legislation. The centerpiece of the one-year-old law, the Public Company Accounting Oversight Board, is charged with the critical task of ensuring that audited financial statements are informative and accurate. It is well-known that trust in the financial reporting system is the foundation of our capital markets system.

Today we will hear from Board chairman Bill McDonough, who assumed the reins at the PCAOB just a few months ago. I have known Chairman McDonough for some time and can say with great confidence that the Board could not have a better leader. His actions to date illustrate his dedication to rigorous and effective oversight of the accounting industry.

Investors should feel confident that, under the leadership of Chairman McDonough and the other members of the Oversight Board, this new regulatory body has already changed the financial reporting system for the better, and its work has only just begun.

We will also hear from the Securities and Exchange Commission, which must approve all of the Board's proposed rules and sanctions. Chairman Donaldson has demonstrated exemplary leadership in his first year at the Commission. To cite but one example, enforcement actions against securities law violators have increased under his supervision. I look forward to his testimony.

The Public Company Accounting Oversight Board is off to a good start. It has taken a number of important organizational steps, including hiring a first-rate staff, establishing strict ethics rules and standards of conduct for Board members and staff, and reviewing hundreds of registration applications.

There are still difficult issues remaining to be resolved, including treatment of non-U.S. auditors, establishing permanent professional standards for auditors of public companies and implementing the soon-to-be-enacted inspection and investigation rules. Some have raised concerns about the costs of compliance with the new rules for smaller firms. While it is essential that the new regulations governing our financial reporting system not leave dangerous gaps, it is also important for regulators to conduct an appropriate cost-benefit analysis in crafting those regulations. I know the Board is working diligently on these matters, and I look forward to hearing more about the Board's progress on these issues today.

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Statement of the Honorable Rahm Emanuel
U.S. House of Representatives
Committee on Financial Services
September 17, 2003

Re: Hearing on "Accounting under Sarbanes-Oxley: Are Financial Statements More Reliable?"

Mr. Chairman, I would like to thank you for holding this important oversight hearing on the status of regulatory and enforcement efforts since the adoption of last year's landmark Sarbanes-Oxley Act. I also appreciate that our distinguished guests, Securities and Exchange Commission Chairman William Donaldson and Public Company Accounting Oversight Board Chairman William McDonough, have taken the time to share their views with us on these topics. We are fortunate that Chairmen Donaldson and McDonough, experienced public servants with proven intelligence, judgment and integrity, are working hard every day to protect ordinary investors.

As a former investment banker and public company board member, I have a longstanding interest in and experience with the issues we will cover today. The fundamental goal of our review process should be to ensure Sarbanes-Oxley is working as Congress intended, so that corporate malfeasance is restrained and to restore investors' confidence in the integrity of the audit process and in the veracity of public companies' financial statements. As Chairman Donaldson recently stated, public companies should be making the Sarbanes-Oxley reforms "part of their firms' DNA."

Although the mandate of Sarbanes-Oxley is expensive for some public companies to comply with, these costs represent one of the most important investments a public company will ever make. As Chairman McDonough recently said, companies will now be "competing through virtue." Indeed, those firms proactively embracing fundamental change will discover that real reform can result in competitive advantages as new investors, clients, and business partners seek out that firm, and as capital markets are more receptive. Those who resist the dictates of Sarbanes-Oxley, in contrast, will be seen as less attractive and more risky.

The SEC and PCAOB are fully aware of the scope of corporate wrongdoing and how its pervasiveness led to the need for Congress to enact Sarbanes-Oxley. Unfortunately, the Enron, Tyco and WorldCom scandals were not isolated examples. Rather, many public companies had become their senior executives' piggy banks to the detriment of their investors and employees. Worse yet, investment banks, accounting firms and law firms were complicit in this misconduct, acting as "enablers" in the audit process and promoters of abusive tax shelters in their consulting roles. Surely, an accounting firm providing tax shelter advice to the senior executives of the firm for which it is also conducting an audit is engaging in an inherent and irretrievable conflict of interest.

I commend the SEC for its expeditious and reasoned rule-making and the PCAOB for getting off to an excellent start. However, although great strides have been made in a short period of time, recent revelations of mutual fund industry abuses and attempts by ten of the Nation's largest banks to avoid millions in state taxes show that Congress, federal regulators, and the States must remain vigilant in this oversight. To that end, Congress should not attempt to weaken the state securities regulators who play a vital investigative and enforcement role as the quintessential local "cops on the beat."

Mr. Chairman, I look forward to continuing to work with my colleagues on this Committee, the SEC, the PCAOB, and the state securities regulators to ensure that Sarbanes-Oxley, is effectively implemented, and that investors receive the accurate, transparent, and timely information they need to make informed investment decisions.

OPENING STATEMENT OF
CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

HEARING ON ACCOUNTING UNDER THE SARBANES-OXLEY ACT: ARE FINANCIAL STATEMENTS MORE RELIABLE?

WEDNESDAY, SEPTEMBER 17, 2003

Last year after a spate of corporate and accounting scandals, we adopted the Sarbanes-Oxley Act. As you know, Mr. Chairman, I was intimately involved in every stage of this law's development, from the first congressional hearing on the collapse of Enron through the final meeting of our bicameral conference committee. A key section of this historic statute replaced self-regulation by the accounting industry with an independent, full-time entity known as the Public Company Accounting Oversight Board to monitor the firms that audit public companies.

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

Mr. Chairman, I am especially interested in learning from our distinguished witnesses about the effect of the Sarbanes-Oxley Act on smaller auditors. Prior to enactment of this law, approximately 850 firms conducted audits of public companies. According to information posted on the Board's website, however, just over 450 auditors had applied for registration -- including at least four firms based in Northeastern Pennsylvania -- as of Monday, September 15. Moreover, at least one management consultant has predicted that the number of accounting firms reviewing the books of public companies will drop to less than 100 over the next few years.

A recent story in the *Washington Post* further highlights my concerns as it describes how several small auditors have grappled to adjust to the new auditing oversight regime. This article specifically notes that several small accounting firms have "severely curtailed or abandoned the business of auditing public companies." Without question, the exodus of smaller firms willing to perform public company audits raises important concerns about competition in the accounting industry that the Board, the Commission, and our panel should explore today.

Beyond examining issues related to small auditors, it is also my hope that our witnesses will detail how small business has responded to the Sarbanes-Oxley Act. I have heard anecdotes about companies privatizing or choosing to remain private rather than to comply with the new law. I am therefore interested in learning of the opinion of our panelists on these matters.

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

TESTIMONY

OF

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

CONCERNING
THE COMMISSION'S EFFORTS TO STRENGTHEN THE ACCOUNTING PROFESSION

BEFORE THE COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 17, 2003

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

TESTIMONY CONCERNING
THE COMMISSION'S EFFORTS
TO STRENGTHEN THE ACCOUNTING PROFESSION

William H. Donaldson
Chairman, U.S. Securities and Exchange Commission

Before the

Committee on Financial Services

U.S. House of Representatives

September 17, 2003

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

Thank you for inviting me to testify today concerning the SEC's efforts to strengthen the accounting profession. Fourteen months ago, Congress showed tremendous leadership in passing the Sarbanes-Oxley Act aimed at reforming corporate governance and restoring investor confidence in our securities markets. The centerpiece of this legislation is the Public Company Accounting Oversight Board, or PCAOB. I want to assure you that the Commission is dedicated to working with the PCAOB to accomplish the goals of that legislation – including restoring the confidence of investors in the integrity of the audit process and in the reliability of the financial information that fuels our Nation's securities markets.

In a matter of months, the joint efforts of the Commission and PCAOB have turned what was an outline on paper into an energetic organization that is guided by a hard-working, entrepreneurial staff. The Board is absolutely vital to our markets going forward, and it has already launched a number of important measures, such as accepting

accounting firm registrations, collecting the funds authorized by Sarbanes-Oxley, initiating inspections of accounting firms, developing rules for its disciplinary programs, and writing new auditing standards.

We at the Commission were extremely pleased when Bill McDonough, also testifying before you today, assumed the Chairmanship of the PCAOB in June. Even before that, however, the other four Board members – Kayla Gillan, Dan Goelzer, Bill Gradison, and the Acting Chairman Charley Niemeier – worked hard to make significant progress in developing the Board's operational infrastructure. As a result of their efforts, the Commission certified in April, as required by law, that the PCAOB possessed the capacity to meet the requirements of the Sarbanes-Oxley Act. Under Mr. McDonough's leadership, we expect the Board to implement reforms that will restore confidence in the integrity of the financial information that investors use every day to make investment decisions.

While the PCAOB operates separate and distinct from the Commission, the Act vests the Commission with oversight authority and responsibility over the PCAOB. In addition to appointing Board members, the Commission must approve all of the Board's rules and professional standards before they may become effective, must approve the Board's annual budget and support fee, acts as an appellate authority for PCAOB disciplinary actions and disputes related to PCAOB inspection reports, and may assign additional tasks to the Board as appropriate. As part of its oversight, the Commission

also has the authority to inspect the PCAOB in much the same way that it inspects the securities exchanges and the National Association of Securities Dealers.

I am pleased to report on the Commission's active role in helping the PCAOB meet its mandate. To date, the Commission has published three notices of PCAOB rulemaking, issued six Orders related to the PCAOB's financial matters and rules, issued an affiliated Order concerning the Financial Accounting Standards Board's support fee, published a Commission Notice regarding auditors of broker-dealers' financial statements registering with the PCAOB, provided the PCAOB with three advances to fund its initial operations, and has under consideration for Commission approval two additional PCAOB rules. Many of these efforts are described below.

In the startup days of the PCAOB, before the Commission recognized it as fully operational, Commission staff had formal weekly meetings with the PCAOB and its staff, and the two staffs were in almost daily contact on matters related to the PCAOB's organization, staffing, rulemaking, and budget. Since then, frequent consultations have continued on the Board's numerous projects. We expect the close working relationship between the two organizations to continue as the PCAOB begins to expand its consideration of new and improved professional standards, to implement its inspection process, and to begin its disciplinary program.

Some of the more significant events and milestones include the following.

Interim Funding – Since January, the Commission has approved three separate advances of funds from the U.S. Treasury to the PCAOB totaling $20,342,000. These funds have been used to hire staff, rent office space, buy office and computer equipment, finance the development of information technologies, and begin operation of the PCAOB's standard setting, registration and inspection programs. The PCAOB currently anticipates repaying these advances by September 30 with funds collected from public companies and investment companies, as provided under the Act.

PCAOB Readiness – Within the time frame specified in the Act, the Commission determined on April 25, 2003, that the PCAOB is organized appropriately and has the capacity to carry out the requirements of the Sarbanes-Oxley Act and to enforce compliance with that Act. The Commission did so after considering the status of the PCAOB's programs, including, among other things, its development of a registration system for accounting firms, the adoption of interim/transitional professional standards, its plans for inspecting and disciplining accounting firms, the development of its budget and "support fees" to be assessed on public companies, and the commencement of hiring of professional staff.

Professional Standards – On April 25, the Commission also approved the PCAOB's adoption, as interim PCAOB standards, of the American Institute of Certified Public Accountants' auditing, quality control, ethics and independence standards, and

certain of the AICPA's SEC Practice Section membership requirements.[1] Adoption of these standards ensured continuity in the standards that govern audits of public companies. At the time that the PCAOB adopted these interim standards, it announced its intention to review each standard to determine whether it should be retained, repealed or modified. The PCAOB also announced that it would convene an advisory body to assist it in reviewing and revising those standards and in future standard setting.

As mandated by the Act, the PCAOB currently is writing a new auditing standard related to auditors' testing and reporting on companies' internal controls over financial reporting. This standard will complement the Commission's rule requiring managements to report the effectiveness of their internal controls. The Commission's Deputy Chief Accountant and the Director of the Commission's Division of Corporation Finance recently participated in a PCAOB roundtable on the development of that standard. We expect the PCAOB to publish a draft standard for public comment in the near future. This standard, like all PCAOB rules, is subject to Commission approval before it becomes effective.

Registration of Accounting Firms – Under the Act, only accounting firms registered with the PCAOB may issue or participate significantly in the issuance of any audit report with respect to any issuers' financial statements. On July 16, 2003, the Commission approved the PCAOB registration form and PCAOB rules that require

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[1] As permitted under the Act, the interim rules were adopted and approved by the Commission without performing the rulemaking procedures set forth in section 19(b) of the Securities Exchange Act of 1934 that generally apply to the PCAOB.

registration by all domestic and foreign firms that prepare or substantially assist in preparing audit reports filed with the Commission.

Prior to its adoption of these rules, the PCAOB held a roundtable, attended by Commissioners and staff, to solicit information regarding the implications of registration on foreign accounting firms. After consideration of the information provided at the roundtable and in other discussions with foreign regulators and accounting firms, the PCAOB made significant accommodations in its registration system for foreign accounting firms. These accommodations include providing a mechanism to ensure that foreign firms are not asked to violate laws in their home country in order to register with the PCAOB, narrowing the scope of the information provided to the PCAOB, and extending the deadline for foreign firms to register.

Bylaws – On July 23, 2003, the Commission approved the PCAOB's bylaws. The bylaws establish procedures for the business operation and administration of the PCAOB, and are intended to facilitate fulfillment of the PCAOB's obligations under the Act.

Annual Budget and Support Fees – Under the Act, the Commission is required to approve the PCAOB's budget and support fee. After close examination, we approved the PCAOB's first fiscal-year budget and support fee on August 1, 2003. Major items in the budget are information technology (including the development of its registration and billing and collection systems), salaries and benefits, and rent. The aggregate support

fee, which is allocated among and payable by issuers, generally equals recoverable budget expenses minus registration and annual fees paid by accounting firms.

Rules Related to Support Fees – Also on August 1, we approved PCAOB rules that prescribe the formula for allocating the support fee among issuers and the collection of those fees by the PCAOB. Under the formula, fees are paid by public companies with an average monthly United States equity market capitalization in excess of $25 million and by investment companies with an average monthly U.S. equity market capitalization (or net asset values) greater than $250 million. As required by the Act, the amount each company pays varies based on the company's market capitalization. The FASB is using the same formula to allocate its support fee among issuers, and the PCAOB is collecting the FASB's support fees as well as its own.

Auditors of Broker-Dealers' Financial Statements – Every broker-dealer registered with the Commission must file certified financial statements with the Commission annually. Although the Act has a deadline for auditors of issuers' financial statements to register with the PCAOB, there is no such deadline for auditors of broker-dealers. On August 4, 2003, the Commission issued a Notice stating that the registration requirements and procedures related to auditors of non-public broker-dealers still are being considered and delaying required registration until the earlier of January 1, 2005, or the adoption of applicable rules.

Ethics Code – As the body charged with maintaining the integrity of the accounting profession, the PCAOB and its staff must adhere to high ethical standards in fulfilling their duties under the Act. The PCAOB has adopted a code of conduct for its members and staff and submitted that code to the Commission for approval. The code addresses, among other things, financial and personal conflicts of interest, protection of non-public information, acceptance of gifts, outside activities, waivers of the code, restrictions on seeking other employment, and post-PCAOB employment. The Commission currently is reviewing the code prior to publishing it for public comment.

Inspection and Disciplinary Programs – The PCAOB's inspection program will involve reviewing accounting firms' quality controls and audit and business practices to assess each firm's compliance with the Act, Commission rules, PCAOB rules, professional standards, and the firm's own quality control policies. At the conclusion of each inspection, the PCAOB will report its findings to the Commission, state boards of accountancy and, except for certain confidential information and corrected internal control deficiencies, the public. Disputes regarding assessments contained in the report or whether potential defects in the firm's quality control system have been corrected satisfactorily may be appealed to the Commission.

The PCAOB staff has begun limited inspections of the four largest accounting firms, initially focusing on matters that would not be reviewed under the AICPA's peer review system. As the PCAOB hires more staff, it will expand the scope of its inspections.

The PCAOB disciplinary program will involve sanctioning accounting firms and professionals for not complying with the Act, PCAOB rules, Commission rules, or professional standards. The PCAOB currently is developing rules related to its investigations and adjudications. We look forward to establishing an effective working relationship with the PCAOB to sanction auditors who fail to fulfill their obligations to conduct diligent and independent audits and to report honestly to investors.

The PCAOB is conducting a thoughtful analysis of the nature of its oversight of foreign accounting firms that audit the financial statements of U.S. public companies and is discussing with foreign regulators ways to accomplish the inspection and disciplinary goals of the Act without subjecting foreign firms to unnecessary burdens or conflicting requirements. The Commission has encouraged the PCAOB to continue in these efforts.

In conclusion, I believe that the PCAOB is absolutely vital to the integrity of our Nation's security markets, and I am especially gratified that Bill McDonough is leading the Board's efforts. We should all realize, however, that the PCAOB alone cannot restore investor confidence in the integrity of the accounting profession. If these efforts are to be successful, each accountant, from the CEO of the accounting firm to its most recently hired employee, must demonstrate a willingness to place the interests of investors above all else. Remaining independent and "telling it like it is" is fundamental. Any accounting firm that uses the formation and work of the PCAOB as opportunities to improve the quality of its audit practice, to reassess and heighten its independence from

audit clients, and to renew its commitment to protecting the interests of investors, will be better and more effectively run and have more credible reports. For others, I assure you that the Commission and PCAOB will not hesitate to use all of the tools available under the Act and in other securities laws.

Thank you again for inviting me to testify.

PCAOB
Public Company Accounting Oversight Board

William J. McDonough
Chairman, Public Company Accounting Oversight Board

Oral Statement
Before the Committee on Financial Services
U.S. House of Representatives

September 17, 2003

William J. McDonough
Chairman, Public Company Accounting Oversight Board

Oral Statement

Chairman Oxley, Ranking Member Frank and Members of the Committee, I am pleased to appear before you today on behalf of the Public Company Accounting Oversight Board. This is the first appearance of a PCAOB member before this Committee. On behalf of the Board, I would like to begin by commending the leadership shown by the members of this Committee as you addressed the crisis in public confidence brought on by the corporate failures of the last two years. The legislation – now law – that you worked so hard on is a landmark reform of corporate governance and oversight, and you should be proud.

I am both proud and humbled to appear before you today as Chairman of one of the products of your hard work – the Public Company Accounting Oversight Board. There were many reasons I was willing to take on this job but among them were my own strong feelings about the corporate scandals and the lack of leadership in the private sector. The mission of the PCAOB, as spelled out in the Sarbanes-Oxley Act, gave me an opportunity to act on those strong feelings.

When I joined the PCAOB on June 11, I found four fabulous colleagues, all as dedicated as I am to the Board's mission. Those colleagues – Charley Niemeier, Bill Gradison, Kayla Gillan, and Dan Goelzer – had already made tremendous strides in writing the unprecedented new rules that are required by the Sarbanes-Oxley Act. We have a rapport and a collective will to maintain that momentum and fulfill the mandate you gave the PCAOB: to protect the interests of investors and the public in the preparation of informative, accurate and independent audit reports for public companies.

The Board started from scratch in January of this year, and has grown to a talented and dedicated band of about 85 full-time professional staff. We hope to be a force of 200 by year end as we perform the four primary functions that Sarbanes-Oxley set out for us – registration, inspection, enforcement, and standard-setting.

Let me start with registration. Under the Act, any accounting firm that audits a company whose securities trade in U.S. markets, and any firm that plays a substantial role in those audits, must be registered with the Board in order to continue that work. Under the law, U.S. firms must be registered with us by October 22. We have received more than 450 registration applications from U.S. accounting firms, and the Board will review each of those applications.

The Board also voted to require non-U.S. accounting firms to register if they audit companies whose securities trade in U.S. markets. We recognize the special issues that arise with that requirement, so the deadline for non-U.S. firms to register is well into next year. In addition, we have begun a dialogue with our counterparts in other jurisdictions in order to find ways to coordinate in areas where there is a common programmatic interest.

Registration is a prerequisite for accounting firms to continue their work as auditors of public companies. It is also the foundation, established in the Sarbanes-Oxley Act, for the PCAOB to perform its important functions of inspection and enforcement.

We have proposed far-reaching rules for inspections of registered firms, but we have not waited for those rules to be final to begin our inspection work. With the cooperation of the four largest firms, we have already begun limited inspection procedures at those firms in advance of registration. Going forward, our inspection staff – made up of experienced, skilled audit professionals – will annually inspect each accounting firm that audits more than 100 public company clients. Smaller firms will be inspected every three years.

Through these inspections, we will be looking, of course, for fundamental compliance with professional standards. But our inspectors will also look closely at other things that bear on the quality of firms' audit work. We will look at what we call the "tone at the top." We want to know the nature of the communications coming from the highest levels of a firm. We want to know that the leaders of the firm, and of audit teams, get the message that Sarbanes-Oxley sends about the firm's responsibilities. We want to know that the message is reaching the firm's rank and file. We want to know what kinds of work the firm rewards through its compensation system. And we want to know how a firm decides to retain or fire a client.

Registered accounting firms are subject to PCAOB inspections, and they are also subject to our enforcement authority. We are empowered to investigate possible violations of our rules, securities laws and professional standards. If we conclude that a firm has violated the rules, we have the authority and the responsibility to impose sanctions – even to the point of revoking a firm's registration or barring an individual from participating in audit work. The Board has proposed rules for investigation and hearings that are intended to implement our authority in a fair way, preserving all appropriate rights for the persons subject to our jurisdiction. We expect to adopt final rules later this week.

Finally, I want to outline our progress with respect to audit standards. The Sarbanes-Oxley Act charged the Board with establishing auditing and related attestation standards, quality control standards, ethical standards, and independence standards.

The Act gave the Board the option of setting standards on its own, or designating any professional group of accountants to propose new standards. Before I joined the Board, my fellow Board members made the decision not to delegate standards-setting to the accounting profession, but to have that responsibility rest directly on the Board's own shoulders. I firmly believe this was a wise and prudent decision, and I strongly support it.

The Board established an internal standards-setting division, and began recruiting a talented in-house staff of professional auditors. Because of our access to information from our inspections and investigations programs, the Board and our standards-setting staff will be in a unique position to understand and head off problems in practice. We

will also tap the expertise of a standing advisory group, made up of experts from a variety of fields.

The first standards to come from the Board will be those prescribed in the Sarbanes-Oxley Act relating to auditors' attestation to management's assessment of internal controls. We held an excellent public roundtable discussion on internal controls in late July, and we intend to have final rules in place by early 2004. We will hold another roundtable later this month to discuss audit documentation, as we prepare to set standards in that area.

With standards-setting, registration, inspection and enforcement, the responsibilities you gave the PCAOB through the Sarbanes-Oxley Act are tremendous. I have faith that our staff and my fellow Board members will live up to your expectations.

I have not been shy about telling members of the accounting profession that we expect a lot from them, and that they will have to work harder than they could have imagined before Sarbanes-Oxley. Through a succession of scandals, the entire profession came to be judged harshly – but you and your colleagues, through the Sarbanes-Oxley Act, did not merely judge them, but you gave them a meaningful shot at redemption. In my mind, facilitating that redemption, and not just punishing miscreants, is a key objective – one that the Board must not lose sight of even when we are, as we will need to be, tough on the profession.

As we work toward that objective, my fellow Board members and I look forward to a long and constructive relationship with this Committee.

Thank you.

Testimony Concerning the Public Company Accounting Oversight Board

William J. McDonough
Chairman, Public Company Accounting Oversight Board

Before the Committee on Financial Services
United States House of Representatives

September 17, 2003

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

I am pleased to appear before the House Financial Services Committee today on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board"). My appearance today marks the first time a representative of the PCAOB has appeared before a Congressional committee and it is fitting that it comes before a Committee whose leadership and members played such a significant role in the Board's creation. Through this Committee's hearings and subsequent passage of H.R. 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act (CARTA) on April 16, 2002, this Committee set the Congress on a path to the ultimate passage of the Sarbanes-Oxley Act of 2002. I want to commend the leadership shown by you, Mr. Chairman, and Ranking Member Frank, as well as all of the Members of this Committee, in this effort and your other efforts to restore investor confidence in the wake of the reporting failures that have plagued our capital markets in the last two years. We look forward to a long and cooperative relationship with this Committee and the Congress.

INTRODUCTION

A little over a year ago, the Congress passed and the President signed the Sarbanes-Oxley Act of 2002 (the "Act').[1] The Act, of course, established the PCAOB and charged it with "oversee[ing] the audit of public companies that are subject to the securities laws, and related matters, in order to protect the

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1 P.L. No. 107-204 (2002).

interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."[2]

To carry out this vital charge, the Act gives the Board significant powers. Specifically, subject to the oversight authority of the Securities and Exchange Commission (the "Commission"), the Board's powers include authority --

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

For the remainder of my testimony, I want to give a brief overview of the organizational steps the Board has taken and then explain the steps the Board has taken to develop its four core programs of registration, inspection, enforcement and standards-setting.

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

[3] Sarbanes-Oxley Act, Section 101(c).

Overview of the Board's Organization

Since the initial Board members took office in January, the Board has taken a number of organizational steps to position it to carry out its core programs.

Staffing. Like any other start-up, much of the Board's effort has been devoted to creating an organizational structure and hiring staff members in a manner that will foster our long-term success. One of the Board's objectives in this regard is to foster a working environment marked by enthusiasm for the Board's mission and commitment to integrity. Starting from scratch in January 2003, the Board has grown to 80 regular full-time professional staff. While the staffing effort is still underway, most of the top positions have been filled. In addition, our inspections group, which ultimately will be the Board's largest division, has grown to some 21 inspectors. The Board hopes to have as many as 200 full-time staff on Board by the end of this year and anticipates that it will have 300 employees eventually.

Office Space. The Board has leased space and opened offices in Washington, D.C. and New York City, as well as an information technology center in Northern Virginia. The Board anticipates that the space it has secured will be adequate to meet the anticipated growth of the organization for several years.

Bylaws. To govern its operations and decision-making process, the Act contemplates that the Board, like other private corporations,[4] will adopt bylaws.

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[4] Under the Act, the Board is a private body with the powers of a District of Columbia nonprofit corporation.

The Board adopted its initial bylaws at its first meeting on January 9, 2003, and amended them on April 25, 2003. The Board's bylaws were approved by the SEC on July 23, 2003.

Ethics Code. The Act also requires the Board to establish ethics rules and standards of conduct for Board members and staff. At its public meeting on June 30, 2003, the Board adopted an Ethics Code that will apply to Board members, staff, and designated contractors and consultants. The purpose of the Ethics Code is to ensure the highest standards of ethical conduct within the Board's operations, and to provide the public with confidence in the objectivity of the Board's decisions by seeking to avoid both actual and perceived conflicts of interests. As required under the Act, the Ethics Code has been submitted to the SEC for approval.

Public Accessibility. The Board recognizes the importance of keeping the investor community, the issuer community, the accounting profession, and the interested public informed of developments as the Board carries out its mission. The Board has established a general practice of conducting its rulemaking in a public forum and seeking public comment on proposed rules. We also maintain a web site, www.pcaobus.org, where we not only provide timely and detailed information about our rules and policies, but through which we also webcast our public meetings as well as the roundtable discussions that we hold to obtain public input on some of the substantive issues we are addressing.

Budget. Section 109(b) of the Act requires the Board to prepare and submit to the Commission for approval a budget for the Board's first fiscal year. At its public meeting on April 23, 2003, the Board approved a budget for the 2003 fiscal year of approximately $68 million. The SEC approved the Board's budget on August 1, 2003.

Funding. The Act establishes a mechanism for the funding, by publicly traded companies, of the Board and of the accounting standard-setting body designated pursuant to Section 19(b) of the Securities Act of 1933.[5] To implement this funding mechanism, on April 18, 2003, the Board issued final rules with respect to the allocation, assessment and collection of its accounting support fee.[6/] The SEC approved the Board's funding rules on August 1, 2003. Under the Act and the Board's rules, larger public companies and investment companies are assessed based on their average market capitalization during the preceding year.[7] As a result, about 62 percent of the issuers assessed will pay $1,000 or less in accounting support fees to the PCAOB. The largest 1,000 issuers will pay about 87 percent of the total fees due. Pursuant to its rules, the

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[5] On April 25, 2003, the SEC designated the Financial Accounting Standards Board ("FASB") as the authoritative standard-setter under Section 19(b). The PCAOB is serving as the FASB's collection agent for purposes of assessing and collecting its accounting support fee. In addition, a smaller portion of the Board's budget is to be recovered through fees assessed on registered public accounting firms, based on the estimated costs associated with processing and reviewing the firms' registration applications and periodic reports.

[6/] PCAOB Release No. 2003-003 (April 18, 2003).

[7] Pursuant to the Board's rules, issuers with average, monthly market capitalization of less than $25 million (and investment companies with net asset values, or market capitalization, of less than $250 million) are not subject to the accounting support fee.

Board sent notices of assessment to some 8,500 issuers beginning on August 4, 2003.

Registration

Under the Act and the Board's rules, by this October 22nd, all U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must be registered with the PCAOB. To implement the registration of public accounting firms, the Board adopted registration rules on April 23, 2003 and the Commission approved the Board's registration rules on July 16, 2003.[8]

Registration is critical to the Board's regulatory oversight of public accounting firms. As a legal matter, registration is the predicate for the Board's other oversight programs – compliance with auditing and related professional practice standards, inspections, and investigations and discipline. In addition, registration provides the Board with critical information about the public accounting firms that apply for registration. As required by the Act, registration applications must include, among other things, a list of issuer audit clients and

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[8] In approving the Board's registration rules, the Commission stated:

> Title I of the Act assigns the Board the formidable task of designing and implementing a registration and oversight system within a relatively short period of time. The investor protection goals of the Act justify the need for prompt action, but the importance of the Board's task and its potential impact on the public securities markets demand that it be undertaken in a thoughtful and reasoned manner. After careful review of the Board's proposed registration system, the Commission finds that it is consistent with the requirements of the Act and the securities laws and is necessary and appropriate in the public interest and for the protection of investors.

Order Approving Proposed Rules Relating to Registration System, Exchange Act Release No. 48180 (July 16, 2003).

fees billed those clients, the number and a list of the firm's audit professionals, a statement of the firm's quality control policies, and regulatory and enforcement actions against the firm and its professionals. This information will both serve as the basis for the Board's registration decisions and help inform the Board's exercise of its authority and focus its limited resources appropriately.

Registration of a public accounting firm is not automatic upon application. In order to approve an application, the Board must determine that registration of the applicant is consistent with the Board's responsibilities under the Act to protect investors and to further the public interest in the preparation of informative, accurate, and independent audit reports for public companies.

To make that determination, the Board is committed to a careful and fair review of all applications. Under the Act, the Board must, within 45 days of receiving an application, either approve the application, provide notice of disapproval, or request additional information. While this requires a great deal of hard and thoughtful work in a short time, the Board is ably assisted by staff who are up to the challenge. The review of applications is well underway, and the Board anticipates no obstacles to successfully completing this initial round of registration.

To facilitate the registration process, and to support the Board's inspection and other functions, the Board developed its own web-based system for the registration of public accounting firms. Receiving application information from registering accounting firms in electronic format expedites the registration process and allows the Board to maintain a sophisticated database of information

relevant to its other processes. To facilitate registration further, the Board published in July a collection of answers to frequently asked questions about the registration process. We have also established a Help Line staffed by the analysts responsible for reviewing registration applications. Since its inception, these analysts have responded to over 850 telephone inquiries regarding the registration process. Last month, these analysts also contacted firms known to audit public companies which had not sought access to the Board's registration system to inform the firms of the applicable deadlines for registration. Through this outreach program, the analysts contacted approximately 500 firms.

The Board received its first registration application on, August 7, 2003, and as of September 10, 2003, the Board has received 419 applications. We are currently in the process of carefully reviewing all of the applications.[9]

Registration of Non-US auditors

Under the Act and the Board's rules, non-U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must register with the PCAOB by April 19th of 2004.

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[9] In July, the Board proposed a rule on procedures by which a firm, once registered, may seek to withdraw from registration. Under the proposed rule, a registered firm may seek to withdraw its registration at any time if it is not engaged in activity for which registration is required. Withdrawal would not be automatic, but could be delayed until the completion of any pending or imminent disciplinary proceedings, or for the Board to complete other relevant processes, such as inspections and investigations. In the absence of a pending disciplinary proceeding, however, the proposed rule would not allow the Board to delay withdrawal for longer than two years. The Board is currently considering the comments it has received in response to that proposed rule.

Because registration is the predicate to all the Board's other oversight programs, an exemption from registration for non-U.S. accounting firms would be tantamount to a complete exemption from any oversight by the Board. The Board believes that investors in the U.S. markets are entitled to the same protections regardless of whether an issuer, or an issuer's auditor, is foreign or domestic, and that it should provide investors with confidence that non-U.S. issuers and auditors adhere to U.S. generally accepted accounting principles and U.S. auditing standards.

At the same time, the Board has made certain accommodations in light of the special issues raised by the registration of non-U.S. firms. Non-U.S. accounting firms need not provide certain information on their registration application if by providing such information the firm would be violating laws in the jurisdiction in which the firm is located. Moreover, the nature and scope of the Board's oversight over non-U.S. accounting firms that audit the financial statements of U.S. public companies is the subject of ongoing dialogue between the Board and its foreign counterparts. Through this dialogue, the Board is exploring ways of accomplishing the goals of the Act without subjecting non-U.S. firms to unnecessarily redundant or conflicting requirements.

Inspections

As you know, the Act requires the Board to conduct a continuing program of inspections of registered public accounting firms. The purpose of these inspections is to assess the degree of compliance of each registered public accounting firm, and associated persons of that firm, with the Act, the rules of the

Board, the rules of the Commission, and professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.

The Board's inspection program is, perhaps obviously, where we will have the most extensive contact with registered firms and their personnel. It is where we are going to find out about the quality of the audits that have been conducted, and it is one of the places where we will exert pressure to change auditor behavior, when necessary. It will provide us with a direct window into the registered firms to see how they are implementing the standards the Board sets, areas where they are doing particularly well, and areas where improvements are needed.

There are a number of areas on which our inspections will focus that have not been the traditional focus of the peer review process. These include—

- An evaluation of the "tone at the top" of registered firms. We want to know the nature of the messages that are coming from the highest levels of the firms and their frequency;
- We are going to look at partner compensation and promotion. We are going to look into what behaviors are rewarded – and thus reinforced – through compensation and promotions; and
- We will consider the firms' overall communication and training practices to all firm professionals.

On July 28, 2003, implementing the directive in Section 104 of the Act, the Board proposed rules relating to inspections of registered public accounting firms. The comment period has ended on the Board's rulemaking and the Board intends to finalize its inspection rules at an open meeting later this week.

Under the proposed rules —

- "Regular" inspections are to take place annually for those firms that issue audit reports for more than 100 U.S. public companies.
- Other firms are subject to regular inspection every 3 years.
- A "special" inspection may be authorized by the Board at any time.

For 2003, regular inspections, which will consist of limited procedures, are being conducted on the four largest accounting firms, who have agreed to cooperate with the Board prior to their registration. Those inspections are already in process. For 2004, regular inspections begin for all accounting firms. Inspections of those firms with less than 100 issuer audit clients will be phased in over the three-year inspection period.

Generally, under the Act, information obtained in inspections is confidential. Portions of a final inspection report that deal with criticisms of or potential defects in a firm's quality control system cannot be made public by the Board if the firm addresses the items to the Board's satisfaction within 12 months of the report. Final inspection reports will be provided to the Securities and Exchange Commission and appropriate state regulatory authorities, however, and the Board may refer information learned from inspections to relevant authorities and commence an investigation or disciplinary proceeding if the facts and circumstances warrant. Moreover, the Board has proposed rules pursuant to which the Board would publish reports about findings from the inspections process to discuss any matter the Board considers of public interest, including criticisms and potential defects in firms' quality control systems. Under that proposed rule, the Board would not identify specific firms in issuing such reports.

Investigations and Discipline

The Act authorizes the Board to conduct thorough investigations when there are indications that a registered firm or an associated person may have violated the Act, the Board's rules, certain provisions of the securities laws and the Commission's rules, or professional standards.[10] The Act further authorizes the Board to use the results of those investigations as a basis for formal disciplinary proceedings.[11] If a violation is established in those proceedings, the Act authorizes the Board to impose a range of sanctions on the firm or associated person who committed the violation.[12]

On July 28, the Board publicly proposed an extensive set of rules relating to investigations and disciplinary hearings.[13] We received substantial public comment on the proposal. We have been considering the comments and we expect to consider adopting final rules very shortly. We are also in the process of staffing a Division of Investigations and Enforcement, which will have responsibility for carrying out the Board's investigative work and prosecuting disciplinary proceedings.

Among other things, the Board's proposed rules implement the Act's provisions granting the Board broad authority to demand testimony, production of documents, and other cooperation from firms and associated persons during an

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10 Sarbanes-Oxley Act, Section 105(b)(1).

11 Sarbanes-Oxley Act, Section 105(c).

12 Sarbanes-Oxley Act, Section 105(c)(4).

13 PCAOB Release No. 2003-012 (July 28, 2003).

investigation. As with inspection materials, the Act provides for the confidentiality of the Board's investigative processes and protects all such information from discovery by private parties.[14] Firms and associated persons must provide the necessary information and cooperation, or risk the possibility of being sanctioned for noncooperation with an investigation. As provided in the Act and our proposed rules, noncooperation with an investigation can result in sanctions as severe as revoking a firm's registration or barring a person from association with a registered firm.[15]

The Board's investigative and disciplinary work will also necessarily involve a need to obtain documents and testimony from public companies and other persons who are not legally required to cooperate with our investigations. While the Act does not authorize the Board to compel cooperation from those persons, it does authorize the Board to ask those persons to supply information voluntarily. The Act also gives the Board the option of working through the Commission to serve legally enforceable Commission subpoenas for any such information that is relevant to a Board investigation but is not supplied voluntarily.[16] Our proposed rules would implement these provisions as well.

The proposed rules also include detailed procedures to govern the conduct of Board disciplinary hearings in order to ensure a balanced process in which the respondent has fair notice of, and a full and fair opportunity to defend

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[14] Sarbanes-Oxley Act, Section 105(b)(5)(A).

[15] Sarbanes-Oxley Act, Section 105(b)(3).

[16] Sarbanes-Oxley Act, Section 105(b)(2)(C)-(D).

against, allegations of misconduct. Like the investigative process itself, disciplinary hearings will be nonpublic unless the Board and the respondent agree otherwise, as required by the Act.[17]

Finally, the proposed rules implement the Act's provisions for imposing sanctions if a violation is established through the hearing process. The sanctions the Board may impose range from the most severe sanctions – revocation of registration and bar on association – to lesser sanctions such as monetary penalties, limitations tailored to the particular violation, requirements to retain consultants for particular purposes, and requirements to obtain additional professional education.[18]

Professional Standards

The Act directs the Board to establish certain standards related to the work done by auditors of public companies. Those standards include standards for auditing and related attestation work, standards for quality controls, ethics standards, and independence standards. As part of the authority to establish standards related to auditor independence, the Act authorizes the Board to add to the categories of non-audit services that auditors are prohibited from providing to their audit clients. Early on, the Board made the decision to establish professional standards by creating a standard-setting division of the Board, made

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[17] Sarbanes-Oxley Act, Section 105(c)(2).

[18] Sarbanes-Oxley Act, Section 105(c)(4). Under the Act, a firm or associated person sanctioned by the Board may seek review of that determination by the Commission. In the event of an appeal to the Commission, the Act provides that the sanction will be stayed unless and until the Commission affirms the sanction or otherwise affirmatively terminates the stay.

up of highly-skilled experts, rather than by delegating the standard-setting function to another body, such as the AICPA's Auditing Standards Board.

The Act required the Board to adopt professional standards as initial or transitional standards prior to the Commission's April 25, 2003, determination of the Board's capacity to carry out its responsibilities under the Act.[19] Accordingly, at a public meeting on April 16, 2003, the Board announced the adoption of certain interim auditing, attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports,[20] and the Commission approved those standards as part of its April 25, 2003 determination.

The standards adopted on an interim basis include the standards with which the profession is, or should be, familiar. They include the following standards, as they existed on April 16, 2003:

- GAAS, as previously established by the AICPA, including Statements on Auditing Standards, auditing interpretations, auditing guidance included in AICPA Audit and Accounting Guides, and auditing Statements of Position;
- Attestation Standards and related interpretations and Statements of Position as previously adopted by the ASB;
- the AICPA's Statements on Quality Control Standards and certain AICPA SEC Practice Section membership requirements;
- the AICPA's Code of Professional Conduct on integrity and objectivity; and

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19 Sarbanes-Oxley Act, Section 103(a)(3)(B).

20 See PCAOB Release No. 2003-006 (April 18, 2003).

- the AICPA's Code of Professional Conduct regarding independence, and the standards and interpretations of the Independence Standards Board.[21]

The Board has not determined that any of these standards should be permanently adopted, however, and the Board has announced plans to review systematically all of the interim professional standards and to determine whether each of the interim standards should be modified, repealed, or made permanent.

The Board has also announced its plans for a general process related to setting the permanent auditing and other professional standards. The process will include the appointment of an advisory group, as envisioned by the Act,[22] including members of the accounting profession, issuers, investors, regulators and others. The Board has adopted a rule concerning the composition of the advisory group[23] and expects to begin the process of forming the advisory group shortly after the Commission approves the rule.

We expect that the standing advisory group will be comprised of approximately 25 members with a variety of backgrounds. Our intent is that the standing advisory group act at a high level, providing advice and recommendations on policy matters, significant issues related to specific standards setting projects, and our agenda and priorities. The standing advisory group will not be a standards-setting committee, in the more traditional sense,

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[21] With regard to independence standards, if the SEC's rules are more restrictive, then registered public accounting firms are expected to comply with the more restrictive requirements.

[22] Sarbanes-Oxley Act, Section 101(a)(4).

[23] See PCAOB Release No. 2003-009 (June 30, 2003).

drafting and debating all the provisions of proposed standards. Most of that work will be done by the Board's staff.

We also plan to use other means to obtain the expertise and advice of the profession and the public, including such things as ad hoc task forces based on our need for specific expertise. We also have the option of convening roundtable discussions, which we have already held on certain issues, public hearings, and other types of public forums to obtain input and advice as needs arise.

The Act itself sets forth the Board's initial standards-setting agenda. Section 404 of the Act, which mandates public reporting on internal control over financial reporting, becomes effective for fiscal years ending in June of 2004. On July 29, 2003, the Board held a public roundtable discussion to explore whether revised auditing and attestation standards on this subject are needed. The roundtable included representatives from issuers, auditors, investors, consumer groups, and regulators.

The Act also mandates that we establish requirements in the auditing standards for the retention of audit documentation and for a second-partner review, and we already are working on those subjects.

Conclusion

The Sarbanes-Oxley Act of 2002 has frequently, and rightly, been called the most significant legislation affecting securities markets, and the investors whose confidence fuels those markets, since the Securities Exchange Act of 1934. My fellow Board members and I are keenly aware of the profound responsibility that you have entrusted to the Board to make critical elements of

the legislation work. We are committed to exercising that responsibility wisely and effectively to accomplish the goals of the Act, and we look forward to working with you toward that end.

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

October 8, 2003

The Honorable Jeb Hensarling
U.S. House of Representatives
423 Cannon House Office Building
Washington, D.C. 20515

Dear Congressman Hensarling:

I am writing to follow-up on a question you posed at the September 17th hearing before the Committee on Financial Services entitled "Accounting under Sarbanes-Oxley: Are financial statements more reliable?" You wanted to know if there had been an increase in shareholder lawsuits since the enactment of the Sarbanes-Oxley Act, and I indicated that I would get back to you with any information we had.

I believe that a recent study addresses your question. On July 10, 2003, NERA Economic Consulting, an international consulting firm, released a study of recent trends in securities class action litigation. See Dr. Elaine Buckberg, Todd Foster, and Dr. Ron Miller, Recent Trends in Securities Class Action Litigation: Will Enron and Sarbanes-Oxley Change the Tides?, NERA Study (July 10, 2003). The study concludes that, contrary to expectations, the rate of securities class action filings so far appears to be unaffected by the passage of the Sarbanes-Oxley Act. While securities litigation has been increasing as a long-term trend, the Sarbanes-Oxley Act does not appear to be affecting the trend line. This conclusion is supported by data compiled by the Stanford Securities Class Action Clearinghouse. See http://securities.stanford.edu.

The NERA study reviewed a number of developments in securities class action litigation since the passage of the Sarbanes-Oxley Act. Among its findings:

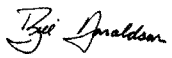
- Securities class action filings did not increase dramatically after the Sarbanes-Oxley Act. The study finds that from the bill's passage on July 25, 2002, until late June 2003, securities class action suits were filed at an annual rate of 214, compared to the average rate of 208 filings per year between 1996 and 2001. Notably, NERA's filing tallies for 2001 and 2002 did not include the IPO allocation or securities analyst cases, which differ from standard securities class action lawsuits and would have skewed the results.

- Dismissals have fallen sharply since the Sarbanes-Oxley Act. Only half as many cases were dismissed in the first eleven months after the passage of the Sarbanes-Oxley Act as in the previous eleven-month period.

- Average settlement values actually fell in the first ten months after the passage of the Sarbanes-Oxley Act. The average settlement dropped from $25.5 million for the period from January 1996 through July 2002 to $22.7 million for the period from August 2002 through June 2003.

I hope that this information responds to your question. If you have any further questions or comments, please do not hesitate to contact me.

Sincerely,



William H. Donaldson
Chairman

cc: The Honorable Michael G. Oxley
The Honorable Barney Frank