



**Testimony Concerning the Implementation of the Sarbanes-Oxley Act
and Restoring Investor Confidence**

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Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

Thank you for inviting me to testify today concerning the impact of the Sarbanes-Oxley Act (the Act). I appreciate having the opportunity to discuss this important subject with you.

We've seen the effects of the Act first-hand and our chief conclusions are:

- 1) The Act has had a positive influence on corporate America, financial reporting, and the accounting profession. It has been a step in the right direction to restore trust and confidence in the capital markets. Investors are the winners from this Act, with greater reliability in financial information. Grant Thornton congratulates you on having the courage and foresight to adopt this Act. With the benefit of one year of history, the Sarbanes-Oxley Act has been, in our opinion, a success.
- 2) Proper continued execution of the Act is key to restoring investor confidence. The Act contains many provisions that are just now being implemented. Government regulators, the new Public Company Accounting Oversight Board, the accounting profession, corporate America, and all other stakeholders must work together to accomplish the objectives of the Act. A principles-based approach is necessary for the successful implementation of the requirements of the Act.
- 3) And there is more that needs to be done. To improve financial reporting worldwide, each of those bodies responsible for accounting, auditing or independence standards must implement principles-based standards and international accounting and auditing standards must converge. Grant Thornton and other accounting firms must

work with the PCAOB to improve the audit process. Working as a team, corporate America, investors, the Securities and Exchange Commission (SEC), the PCAOB, the Financial Accounting Standards Board (FASB), the international standard setters, the accounting profession, and other stakeholders can improve the business reporting model and the quality and transparency of information used by investors and creditors.

- 4) Grant Thornton and other leaders in the business community have responded to both the spirit and substance of the Act. We have spoken out on the need for reform and worked hard to support the implementation of the Act. Again, we appreciate your efforts to adopt this important legislation. Grant Thornton is committed to take the steps necessary to ensure its continued success.

About Grant Thornton

Since our founding in 1924, Grant Thornton has focused on providing audit and tax services to mid-size companies, generally those with revenues between \$25 million and \$2 billion, although we have clients both larger and smaller. Grant Thornton International is the world's leading accounting, tax and business advisory organization primarily dedicated to mid-size companies. Through our network of 585 offices in 110 countries, including 50 offices in the U.S., partners of the member firms of Grant Thornton provide personal attention and seamless service delivery to public and private clients around the globe.

How the Act has positively impacted American business and the accounting profession

I believe that the tone of an organization starts at the top.

As I wrote in *CEO* magazine this past year — which was cited in the House Committee on Financial Services' recent publication, The Sarbanes-Oxley Act: The First Year; Rebuilding Investor Confidence, Protecting U.S. Capital Markets — under Sarbanes-Oxley, the role of CEO has taken on a new dimension as numerous new responsibilities and potential for penalties for corporate wrongdoing — including prison — now stop directly at the desk of the CEO.

In the past, many CEOs did not worry about the state of their internal control systems. Many CEOs, absent a specific regulatory mandate, came to believe their control system was adequate — even though they had no way to prove that to be the case if asked. Today, because of the Act, the SEC requires CEOs to back up that fact with a signature and actual evidence. The increased role of the CEO in financial reporting has been, based on our experience, a positive step.

The Act has clarified and, in some cases, strengthened the role and responsibility of boards of directors and audit committees. Boards can no longer blindly rubber-stamp the actions of management. They now must work side-by-side with the auditors to ensure the shareholder interests are protected. Audit committees must be more independent and expert in carrying out their vital duties. Again, our experience has been that most audit committees and boards

of directors have increased the number and quality of meetings, and the members of most audit committees and boards appear to be taking their role more seriously since the adoption of the Act.

The Act is forcing public companies and their auditors to make sure that the financial statements are squeaky clean as restatements have jumped 30 percent over the past year. And despite warnings of increased lawsuits against corporations, that has not happened, as according to *The Wall Street Journal*, “both the number of class-action lawsuits and the size of settlements are consistent with previous years.” (*The Wall Street Journal*, “Sarbanes-Oxley Affects Suits Little, Study Says,” by Kara Scannell, July 24, 2003.)

Thanks to the Act, the quality of information provided to investors from corporations has improved, and we believe that changes mandated by the Act prohibiting auditors from providing certain services, such as consulting, to their public audit clients has helped in restoring trust in the accounting profession.

In fact, a recent Gallup Poll found that the image of the accounting profession has improved significantly over the last year, more than any other profession tested.

According to the poll analysis, “the one industry whose image has improved the most compared to last year’s is accounting, which has risen from a net rating of 0 percent last year (i.e., as many people gave it a negative rating as a positive one) to a +31 percent this year. Other industries and business sectors tested include the computer industry, real estate, banking, the legal field, the airline industry and healthcare.” While one could argue that the

accounting profession had significant room to improve, we are pleased to see that the Act, combined with the actions of Grant Thornton and other accounting firms, has helped to restore the public's image of our profession. Most important, the Act has helped restore the public's confidence in financial reporting.

Execution of the Act is key to improvements in our financial markets

The Act established the PCAOB, which is now beginning to execute its provisions. We believe that accounting firms must not only cooperate with the PCAOB, but also act as leaders to help the PCAOB operate effectively. Likewise, the PCAOB should not only monitor and discipline accounting firms, but should work with the firms to improve the audit process. This cooperation between the new board and accounting firms should result in further improvements of the financial reporting process. The functioning of the PCAOB will be a major factor in evaluating the success of the Act in future years. The focus of the PCAOB and the government should not be on increased litigation against accounting firms, but instead on helping accounting firms work with the PCAOB and government to ensure the successful implementation of the Act into the foreseeable future.

Although there have been several well-publicized allegations of accounting misdeeds and auditing failures, there are many more instances where auditors have discharged their professional responsibilities, uncovering fraudulent acts. It is equally important that the PCAOB, in addition to disciplining auditors, find the means to recognize and reward auditors who act without self interest to protect investors.

Some provisions of the Sarbanes-Oxley Act are crystal clear. Other provisions are subject to interpretation. Grant Thornton believes that any gray areas in the Act must be implemented in the spirit of transparency and investor protection. We believe that was the intent of you, the bill's authors.

The internal control provisions of the Act are also just now being implemented. The degree of an auditor's independence is driven by the separation between management (which produces the financial information) and the users of the information provided by management. The standard for independence is heightened as that separation increases. We firmly believe that the auditors of publicly held companies must hold themselves to the highest possible standard of independence.

For this reason, Grant Thornton will not accept engagements to document, evaluate or design our public audit clients' internal controls, including engagements to document existing controls, or to perform evaluations of existing controls that management uses to support their conclusions regarding the effective design of those controls. To do so, we feel, is a conflict of interest. Instead, as auditors, we will audit the internal controls as designed, documented and evaluated by management, in accordance with the provisions of the Act.

What still needs to be done

For the last 20 months, we have been advocating the need to adopt a principles-based approach to accounting standards setting. Enron's former chief financial officer Andrew Fastow created hundreds of "special-purpose entities" to hide Enron's debt. He argued they were within the letter of the law, under the current rules-based approach to accounting. But

we must ask ourselves, “is this right?” Is this what financial disclosure is about? Or is it presenting the truth and transparency to investors and other stakeholders? I strongly believe that the accounting profession and the standards setters (the FASB, SEC, PCAOB, etc.) need to embrace a ‘spirit of the law’ versus ‘rule of the law’ approach to standards setting. The current rulebook approach for all standards setting fosters a culture of “if the rulebook does not specifically forbid it, it must be okay.”

Albert Einstein said, “The problems that we have created cannot be solved at the same level of thinking that created them.” A principles-based approach is necessary for the successful implementation of the requirements of the Act. Rather than establishing a new set of complicated rules — which is the approach that fostered the problems the Act seeks to solve — we believe a focus on principles will result in stronger adherence to the spirit of the Act. A principles-based approach would provide greater assurance to the public and investors that management, auditors and those responsible for corporate governance will do the right thing.

Convergence with international accounting standards will also improve the global quality of reporting. Consistent accounting principles throughout the world will allow global corporations and auditors the ability to improve financial reporting. Further, a principles-based approach to accounting standards would provide greater assurance to the public and investors that management, auditors and those responsible for financial reporting will provide information that is in the public’s best interest.

There also must be a renewed effort to improve the current business reporting model. Grant Thornton has taken a leadership role in this effort. In December 2002, the board of directors of the American Institute of Certified Public Accountants (AICPA) formed a special committee on enhanced business reporting (the Special Committee) and appointed our Managing Partner of Strategic Services, Mike Starr, as the chair. Under the leadership of Mr. Starr, the Special Committee adopted the following mission:

"To establish a consortium of investors, creditors, regulators, management, and other stakeholders to improve the quality and transparency of information used for decision-making."

The Special Committee has also written a monograph, *Enhanced Business Reporting*, which grounds the project intellectually and guides future activity.

Ned Regan, President of Baruch College and former New York State Comptroller, is set to meet with the Special Committee to discuss the steps necessary to establish and launch the consortium. Mr. Regan will lead the efforts to recruit a small group of very prominent U.S. business and civic leaders to help put together an Enhanced Business Reporting Consortium. The members will be high-level representatives of prominent business, accounting, auditing, investor, creditor, foundation, and government groups. This will be done carefully so that the Consortium will have representatives from all the key groups necessary to make this significant change in reporting.

It is anticipated that the Consortium members, from their positions of national stature, will be advocates for enhanced business reporting and will guide our collective activities to make the project goals a reality. When fully organized, the Consortium will be freestanding, with financial support coming from the AICPA and several foundations. Subject to Special

Committee approval, staff, research, and conference activity is expected to be headquartered at Baruch. Academic and foundation partners in other parts of the country are expected to join with Baruch in supporting the Consortium's activities.

The objective is simple; improve the quality and transparency of business reporting as part of the process to rebuild investor confidence and protect capital markets.

The first building block for improving the business reporting model is effective corporate governance, and effective corporate governance starts with a board of directors who demonstrate a fierce commitment to integrity; demand excellence in all efforts; provide leadership, and motivation; and, display respect for people, ethical standards, laws, and regulations. Strong corporate governance is the bedrock upon which high quality, transparent information is built. And executive and director compensation is the litmus test for determining the effectiveness of corporate governance.

The second building block is transparency. However, it must be noted that effective corporate governance is necessary to ensure that there is transparency in the information reported by management. Warren Buffet explained the need for transparency in his letter to the shareholders in the Berkshire-Hathaway, Inc. 2000 annual report, stating that:

“At Berkshire, full reporting means giving you the information that we wish you to give us if our positions were reversed. What Charlie and I would want under that circumstance would be all the important facts about current operations as well as the CEOs frank view of long-term economic characteristics of the business. We would

expect both a lot of financial details and a discussion of any significant data we would need to interpret what was presented.”

Investors and creditors should have the right to see an entity through the eyes of management. Competitive disadvantage should not be used as an overarching basis to avoid providing information to investors and creditors. Competitors frequently know a great deal about an entity from former employees, mutual suppliers and customers, market research, industry publications, engineering studies of products, and the marketplace itself.

Globally accepted accounting principles are at the core of enhanced business reporting. In addition to the basic financial statements, management needs to provide users with insight into management’s assessment of:

- Competition and industry factors that effect the entity’s position in the business environment;
- Current and future regulatory developments that may effect business strategy; and
- Factors such as the general economy or demographics that may effect business performance.

Currently, MD&A is nothing more than a narrative recitation of information contained in the financial statements. Management needs to provide information about the entity’s strategy, plans, opportunities and risks. These quantitative and qualitative disclosures need to focus on key performance indicators and how these indicators compare to industry peers. We need to develop commonly accepted definitions and principles for these performance indicators.

The enhanced business reporting model requires a change in the auditor's role. Auditing standards need to provide guidance on how to provide assurance on the qualitative disclosures required by information transparency. As stated above, Grant Thornton and other accounting firms must work with the PCAOB to improve the audit process.

Working as a team, corporate America, investors, the SEC, the PCAOB, FASB, the international standard setters, the accounting profession, and other stakeholders can improve the business reporting model and the quality and transparency of information used by investors and creditors. We ask you to continue to support the cooperation and efforts to accomplish this goal.

What Grant Thornton is doing

I am proud to say that in February of 2002, we issued the Grant Thornton Five Point Plan to Restore Public Trust. As a result, Grant Thornton became the first global accounting organization to provide a program of reforms to regain public trust in financial information.

The points are:

1. **The policies and reward systems of the major firms must reflect an uncompromising commitment to professional excellence.** The actions of the management of those major firms must make it clear that nothing is more important than their professional responsibility. In addition, all the major firms must collectively agree to limit the nature and extent of services provided to publicly held clients. Such agreement should specify that the firms would only provide assurance and advisory and tax services to their publicly held audit clients. For example, certain consulting services such as outsourcing should be prohibited. We must change our business models significantly in response to the demands from the public. To do

otherwise ignores a fundamental precept: that businesses set priorities based on those drivers that have the greatest impact on earnings. Assurance and advisory and tax services must once again be the business drivers and focus for the auditors of SEC registrants.

2. **Audit committees must ensure that the auditor's primary responsibility is to the shareholders and that the auditor's relationship with management is clearly subordinate to such responsibility.** Audit committees must do a better job of protecting shareholder interests. They must challenge management and the auditors on the treatment of significant accounting issues. They must be diligent in determining that their auditing firms are free of conflicts of interest. The audit committee plays a critical role in this regard. The regulators need to take the steps necessary to reinforce the audit committee's need to be truly independent of management. Audit committees must be vigilant in performing their duties to ensure that the appropriate auditor-client relationship is maintained and that management is challenged on all significant transactions, including the underlying business purpose of those transactions.
3. **The SEC must amend its rules for proxy disclosures of auditor's fees.** The amended rules should require separate disclosure of fees for (1) assurance and advisory services (i.e., those services that meet the definition for assurance services), (2) tax services and (3) all other services. The current proxy rules for disclosure of the fees paid to the auditors, which resulted from a compromise, are misleading because services that do not give rise to a conflict of interest are inappropriately

combined with services that can and, in some instances, have created conflicts of interest.

4. **A principles-based approach should be adopted for all standards setting areas: accounting, auditing and independence.** In addition, the auditing standards should be expanded to incorporate a forensic approach. A year ago, the previous administration at the SEC fueled a public debate that effectively killed the Independence Standards Board and its proposed principles-based independence framework. Those same individuals conveniently continue to ignore that this framework, properly constructed and implemented, would have addressed some of the very issues that we are trying to solve today. The current rulebook approach for all standards setting fosters a culture of "if the rulebook does not specifically forbid it, it must be okay," where there is more concern about the form of transactions than their substance. A principles-based framework for setting standards provides greater assurance to the public that management, auditors and those responsible for corporate governance will do the right thing.
5. **AICPA should coordinate a review of the audit methodologies of the major accounting firms.** We believe that Grant Thornton has an excellent auditing methodology and we are willing to share our best practices with others. We assume that others feel the same about their methodology. The best practices of these firms should be shared with the entire accounting profession. This unprecedented sharing of best practices by the major firms would serve the public interest by ensuring that all auditors of SEC registrants have access to the best practices of the leaders of the profession.

I am pleased that three out of our five proposals were included in the Act.

Grant Thornton with its staff, industry and technical expertise, and global reach has expanded its market share of public audit clients in the last two years with the consolidation of the profession. I am proud that Grant Thornton was the first of the major accounting firms to file the registration application with Public Company Accounting Oversight Board. We are anxious to begin working with the Board.

We have also taken actions to implement, and spoken out on the effective implementation of, the Act. Last month, as stated above, Grant Thornton became the first and only one of the six global accounting organizations to go on the record publicly and prohibit services for its public audit clients related to the documenting of internal controls. Consistent with our guiding principles, we will not provide these services because to do so violates the spirit of the Act. On the other hand, we have spent millions of dollars to develop auditCAREsm, our proprietary tool for controls assessment and risk evaluation, and to train our people to better audit the internal controls designed and documented by management. We have discussed our process and tools with the staff of the PCAOB.

We are also very involved in increasing transparency of information providing to investors. As mentioned above, our partner, Mike Starr, is leading these efforts and Grant Thornton has endorsed the entire process.

Grant Thornton has consistently spoken out on the need for reform, the proper execution of those reforms, and the need to continue to improve the financial information used by

investors. One of our strategic initiatives is to provide thought leadership to our clients, the accounting profession, and the business and investing community. Grant Thornton is proud and honored to be a part of this hearing, and looks forward to assisting you in any way we can to improve business reporting and restore investor confidence.

Conclusion

In 1933, Congress passed the Securities Act that led to the creation of the SEC, designed to restore investor confidence in our capital markets after an estimated \$50 billion in new securities had become worthless to investors.

Now 70 years later, Sarbanes-Oxley has further protected American investors. I know that I speak for many Americans in thanking you for the countless hours spent in bringing this landmark legislation to fruition, resulting in improvements in our financial reporting system in the past year and for many years to come.

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