Testimony of
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Mr. Chairman, Senator Sarbanes and members of the Committee, I am Jim Turley, Chairman and CEO of Ernst & Young, one of the largest accounting organizations in the world. We have 103,000 people in more than 140 countries working in our global network of firms.

Two years after the enactment of the landmark Sarbanes-Oxley Act (Act), it is appropriate to reflect on what we have been through, assess where we are today, and look ahead to new and remaining challenges. We should conduct this examination through the perspective of what is good for the economy and investors in the long run.

But first, let me tell you that from what I see in the marketplace everyday, the Sarbanes-Oxley Act is working. In my opinion, the Act has brought about the most significant change in securities law and our profession since passage of the Securities Exchange Act of 1934. It has allowed investors to put a wall between the corporate and accounting scandals of the past several years and the future. It is encouraging and enabling our profession to move forward and make necessary changes and it is restoring investors' confidence in the financial markets.

<u>The Accounting Profession's World Has Changed</u>

The accounting profession has undergone historic change.

I became Chairman of Ernst & Young in the summer of 2001. Since that time, our relationships with the companies we audit and their audit committees have unalterably changed. The profession's regulatory structure is fundamentally different. After one hundred years, self-regulation of the accounting profession is over. The Public Company Accounting Oversight Board (PCAOB) now inspects, investigates, disciplines, and sets standards for auditors of public companies.

I believe that the formation of the PCAOB will prove over time to be one of the best things that ever happened to the accounting profession. A tough, but fair and independent regulator will make our profession and Ernst & Young better, while helping to restore the confidence of the investing public. The PCAOB provides a credible voice to judge how well the accounting profession is living up to our commitment to quality, and how effective we are in delivering on investors' expectations. PCAOB Chairman Bill McDonough and other Board members clearly are not afraid to challenge us. As a result, the entire profession is improving.

Ernst & Young Has Changed

At Ernst & Young we are committed to cooperating with our new regulator and to being more transparent so that the investing public feels more confident about what we do, and so that the regulators understand our challenges and our commitment to doing quality work. I know this is true for other firms within the accounting profession as well.

Just as important, and perhaps not as obvious, are the changes taking place inside the accounting firms. At Ernst & Young we have completed a top-to-bottom review of our business practices. In Fall 2002, I appointed one of our most senior client serving partners to the position of Vice Chair – Quality, reporting directly to me. Importantly, this post was established to be independent of our audit, tax, and transaction service lines and the charge was to leave no stone unturned. As a result, every policy, every practice, every performance system, and every training system has been re-examined and positive changes made. All our personnel have been challenged to do the right thing.

As Chairman, I have tried to make it very explicit to every one of our people around the world that our strategy is to have the best people providing absolutely the best quality to the marketplace. Setting the tone for our firm's culture and direction is one of the most important responsibilities I have. When I talk with our personnel about our strategic approach, it is really quite simple. I try to paint a mental picture of three pillars--people, quality and growth. Having the best people delivering the best quality is the way to achieve the growth we need to reinvest in our firm and provide opportunities for our people. As we consider those three pillars, it only works from the left to the right. It doesn't work starting at the end and chasing growth for growth's sake, and then trying to find the people to do the work in a quality manner.

Quality is the key driver for everything we do. We are very mindful that maintaining this quality is key to the successful execution of the public-interest role we play in the capital markets.

Where We Are Today

Today, because of the Act and similar efforts around the globe, investors have good reason to be increasingly confident in capital markets and financial reporting. The Act has had a significant impact on audit committees, corporate management, and auditors, including the regulation of the profession.

1. Changed Behavior of Audit Committees

As you know, issuing a set of financial statements involves three key players and a system of checks and balances. Management works with the company's internal accountants year round to maintain the company's financial information and, in doing so, prepare the financial statements. The audit committee, pursuant to the Act, oversees the company's financial reporting process and hires the independent auditors. And, the independent auditors audit the company's financial statements to test management's assertions as to the accuracy and fair presentation of the financial statements before they are issued.

As part of this three-way relationship, auditors meet with management and the audit committee to discuss the financial statements. Before Sarbanes-Oxley, the conversations would regularly be a dialogue between management and the auditors, which the audit committee observed. Today that triangle has been totally changed and turned on its head. Conversations are now between the auditor and the audit committee as they critically examine the judgments and estimates underlying management's decisions affecting various components of the financial statements. Management at times is not even in the room.

Audit committees, as surrogates for investors, are in charge today. They hire and fire auditors and evaluate the audit firms on an annual basis. Audit committees scrutinize the appropriateness of each service we deliver before we are retained to deliver it and before we deliver it. *This* is the audit committee pre-approval process that Sarbanes-Oxley demanded.

Audit committees are taking the pre-approval process very seriously. While some commentators would choose to further restrict the services that accounting firms can render to companies we audit, I think audit committees are appropriately restricting and pre-approving services based on what is in investors' best interests. The proxy data demonstrate that companies are, in fact, implementing the law. We should give Sarbanes-Oxley time to work before contemplating any further change that might reduce the flexibility afforded audit committees to promote audit quality and investors' interests.

In executing their new oversight responsibilities, audit committees that used to meet three or four times a year for an hour or so are today meeting eight, or even 10 times a year, sometimes for upwards of six to eight hours at a time. However, what gives me greatest confidence in the new enhanced audit committee is the *quality* of their focus and not just the *quantity* of their meetings.

Audit committees are increasingly and properly focused on what I call the five "C's." They are focused on understanding the *complexity* of the businesses they are serving and how that complexity translates into risk. Overly *creative* transactions are being exposed and more closely examined or eliminated. Sarbanes-Oxley's emphasis on the importance of internal *controls* is understood and embraced as a tool for helping to prevent and detect problems within companies. *Coziness*, not just between the auditor and management but also between the Board and CEO is not tolerated. And finally, the audit committees are focused on drilling into the *choices* that management is making. Day in and day out, CEOs and CFOs have to make choices related to accounting policies, estimates, judgments and everything else, and it's those *choices* that dictate whether the financial statements they prepare are conservative, appropriately so, or not.

It is an amazing change. In the past 18 months, I have attended many audit committee meetings and I wish that investors, and frankly anyone who is skeptical about the changes that are occurring, could see the positive changes taking place inside audit committees and the profession.

I know of many instances in the last two years where a company had to find a new auditor and the audit committee rejected management's recommendation and hired a different firm instead. That almost never happened before passage of the Sarbanes-Oxley Act. Audit committees are engaged in a very real way and are making decisions based on what is best for investors. We should give them and the Act time to work.

2. Changed Behavior of Management

Not to be overlooked in a discussion of the positive changes brought about by the Act is the strengthened accountability of corporate officers to investors.

The challenges posed to corporate management by the Act have been significant. While some have chafed at the new requirements and burdens of the law, the overwhelming majority of corporate executives are embracing it. Every day they are working to create value for investors, generate growth, and steer their companies forward within the boundaries set by the securities laws.

Nonetheless, it is clear that, in some cases, insufficient management oversight and inadequate financial controls were at the heart of the string of U.S. corporate failures that led to passage of the Act. Something needed to be done.

In this regard, I believe that the CEO and CFO certification requirement is one of the most important aspects of the Act in terms of driving management behavior. It requires CEOs and CFOs of public companies to sign their names to certify the accuracy of financial statements and the effectiveness of internal controls. This demand on the top has led to a process underneath that is realigning behavior. The certification requirement has helped drive change throughout all ranks of the corporate structure.

Let me give you an example. Not long ago, I was discussing Sarbanes-Oxley with the CFO of one of the world's largest companies, one that is based here in the United States. When asked about his perception of the Sarbanes-Oxley Act his response surprised me. "Jim," he told me, "in the old days I had to take out my hammer"— that's the word he used —"and beat down crazy ideas that my own people were bringing to me on a quarterly basis ideas for recognizing revenues before we'd really earned them … ideas for deferring expenses that should have been reported. But today, all of our people around the world recognize that we have to make money the old-fashioned way ư by shipping product and billing and collecting for it."

What this CFO described is a real change in behavior that has resulted in an exponential increase in dialogue within company hierarchies. Today, corporate management is more interested in transparency and accuracy and less interested in overly creative ideas. Accountability is cascading through every business unit of every company. This change is a direct result of the Sarbanes-Oxley Act.

3. Changed Behavior of Auditors

As I stated earlier, at Ernst & Young, we are re-examining every policy, every practice, every performance system, and all of our training routines and challenging ourselves to do better. Our communications, the tone from the top, and even our business strategy make it clear that quality is our key objective.

I know that our partners and other executives at our firm are renewing their commitment to "the basics" of the audit function. We are digging deeper, looking at more evidence to support representations, and documenting our work more thoroughly. We have expanded the responsibilities of the independent review partner. We have added more rigor to our audit process, but by far the most significant changes are in the mindset and behavior of our professionals. They understand that performing audits of the highest quality is their most important day-to-day responsibility.

At Ernst & Young, we also have taken many other steps over the past two years to align our organization, policies, and processes to enhance the quality of our services. Let me provide you with just a few examples of what we have accomplished.

We have reinforced the tone at the top by refocusing our processes for evaluating and compensating our audit partners. We adopted a year in advance the new SEC rule prohibiting the evaluation and compensation of audit partners based on the sale of non-audit services to their audit clients. To drive further improvements in audit quality, we are rewarding our best auditors, we are rewarding actions that enhance quality, and we are imposing sanctions where necessary.

We have significantly increased the number of technical resources who are consulted by our people and who make the firm's final decisions on accounting, auditing, and reporting matters. In addition we have established new networks, such as a senior client service partner network to mentor and share best practices with our people on client-related matters.

We have redesigned and significantly increased the amount of training provided to our audit professionals. Since December 2002, our people have participated in 460,000 hours of training in the specific areas of Section 404 and internal controls and audit risk assessment. During the same period, our people participated in an additional 60,000 hours of training focused solely on fraud and lessons learned.

We have realigned and expanded the resources devoted to our quality controls over our independence from our audit clients and have implemented many new policies, procedures, and processes, including new ones regarding business relationships with audit clients. And we are taking measures to ensure we have best-in-class procedures to verify our independence from audit clients.

We established an ethics hotline and Ethics Oversight Board to provide an environment and culture where our people can speak up, raise any concerns they may have, and get action.

Our client acceptance and reacceptance processes have been reengineered with an increased focus on determining which companies we really want as audit clients and culling out those that we do not believe have adapted to the new environment and demands on a public company.

Clearly, much of the change in the behavior of auditors comes from their own individual sense of professionalism and the changes that are being made inside firms like ours. However, as I noted earlier, the significance of the creation of the PCAOB must not be overlooked and the PCAOB's impact in driving future auditor behavior should not be underestimated. New requirements in

PCAOB standards and the close scrutiny of PCAOB inspections already demonstrate how its actions will drive auditor behavior with lasting and controlling effect across the profession.

As we look at where we are today, there is enormous and, I think, sustainable change in the behaviors of boards of directors, audit committees, corporate management, and firms like ours. From an insider's view, there is real reason for investors to regain faith in the integrity of financial information and the capital markets.

Remaining Challenges

Finally, I'd like to focus on the road ahead. The integrity and reliability of financial reporting is fundamental to the capital markets. Even with Sarbanes-Oxley in place, there are some lingering issues that the accounting profession is focused on addressing.

Some of the remaining challenges relate to what is commonly known as an "expectation gap." Our profession has struggled for years with an expectation gap between the amount of fraud detection that the public has expected and the level of assurance that a properly conducted audit is designed to reasonably deliver. Additionally, there is a break between expectations and reality as it relates to the precision of financial reporting and the exactness that results from an audit. Both of these expectation gaps, one dealing with fraud and the other with precision or exactness, must be attacked from both ends, through education on one hand and more robust audits and financial reporting on the other.

1. Fraud Expectation Gap

The accounting profession has spent decades grappling with closing the expectation gap around fraud detection. From the Cohen Commission in the 1970's, to the Treadway Commission in the 1980's, and then the Professional Oversight Board's Panel on Audit Effectiveness in the 1990's, policy makers, academics, and the profession have examined the issue and sought to educate the public as to the inherent limitations of an audit that relies in many ways on management representations and sampling. But simply trying to explain what an audit does and does not do, on its own, has never been successful and is simply not enough. More is required. We must do better.

We are committed to working with the PCAOB to address auditing standards around fraud to do all we reasonably can in light of costs and benefits to investors. The Sarbanes-Oxley Act has already given management, auditors, and investors a new tool against fraud with the strengthened effectiveness of internal controls that will result from the Section 404 requirements. And as I mentioned earlier, we are spending many more resources training our professionals on fraud detection. In conjunction with the PCAOB, we have to be more focused on deterring and detecting fraud. Yet, the investing public will have to try to understand the reality that well-conceived criminal acts may go undetected even if an audit is performed fully consistent with standards.

2. Precision of Financial Information

The second expectation gap, related to the precision of financial reporting, was described as a "brittle illusion of exactitude" in a report by the American Assembly Project, a non-partisan public policy think tank affiliated with Columbia University.

The February 2004 report, entitled "The Future of the Accounting Profession," noted the pervasive disconnect between financial statements that are, by necessity, based on educated estimates and judgments, and the expectation that financial reporting is a precise science in which a "right number" can be accurately derived. To manage expectations, the Assembly report urged auditors ư and the investing public ư to recognize that nearly every number on a balance sheet or income statement is the result of a series of estimates, assumptions, and accounting choices by managers that are reviewed and tested only to a degree by auditors.

It concluded, among other things, that the investing public must accustom itself to a new reality, one which it may find unpalatable: that the complex economy in which companies do business today makes it difficult for even the most competent of accountants, internal or external, to ascribe a precise value to many corporate assets or transactions. Demanding that degree of precision, the report concluded, is simply unrealistic. However, the need for appropriate disclosure and broader acknowledgement of such imprecision should be examined.

Addressing the expectation gaps around fraud and precision is an important step in restoring the public trust in our integrity and objectivity. The creation of the PCAOB presents an historic opportunity for the accounting profession, the PCAOB, other policy makers, academics, and the public to work together to close the expectation gaps and make sure that the investing public is best served by our profession.

3. Internal Controls Reporting

While I embrace the emphasis on internal controls set forth in Section 404 as a valuable tool for helping to prevent and detect problems within companies, I am concerned that most investors, the general public, analysts and the media know little about the 404 reporting process and what potential findings may mean. So far, much of what they have heard is concern about cost of compliance from some in the issuer community.

With the reports required under Section 404 of the Sarbanes-Oxley Act first due in early 2005, it is time to move past arguments against 404 requirements and get into educating and informing around the results. Without such an effort, there is a significant risk that the public will misinterpret, and overreact to, an assessment that a public company's internal controls are deficient and warrant improvement. Without sufficient understanding, some may wrongly equate an internal control weakness with financial statement inaccuracy.

Let me cite two aspects that will need to be addressed through communication and education. First, it appears there is the potential for many more material weaknesses to be reported and adverse opinions issued than perhaps anyone imagined. This is due to many factors other than the Act itself. For most companies, this will be the first time that internal controls have been scrutinized to the degree that 404 and the resulting SEC rules and PCAOB standards require. Scrutiny will come from both management and the independent auditor.

Although some leading companies got started before the rules and standards were even finalized, many companies have been slow to start the assessment process and may not have time before year-end to remedy any deficiencies noted during the process.

In addition, the PCAOB auditing standard is rigorous and sets a high bar for companies to achieve a passing grade. How will the public react to a potential proliferation of material weaknesses and adverse opinions? How will the capital markets react? Is it enough to say the numbers of such findings will decrease over time as weaknesses are identified and subsequently remedied? There should be an informed reaction and response when internal control problems are surfaced, but not an uninformed overreaction that undermines investor confidence in reported financial information. This is a concern that can be managed but warrants a focused and shared effort.

Second, there is the potential for a new expectation gap, a gap between the comfort that some might derive from a company and its independent auditors reporting a passing grade on internal controls and their later dissatisfaction when the company does not meet its financial goals, makes significant changes to its critical accounting estimates, or based on subsequently discovered information is required to restate previously issued financial information. The profession will conduct thorough audits of internal controls over financial reporting, but as set forth in the standards the scope of these audits will be based on the concept of providing reasonable, not absolute, assurance.

Let me be clear. The benefits to investors from the implementation of Section 404 are significant in terms of improvements in the reliability of periodic financial reports, including quarterly reports and not just annual reports subject to a financial statement audit. But along the journey of achieving these improvements in financial reporting, we cannot allow each incidence of subsequently discovered information to shake investor confidence in financial reporting through an uninformed overreaction.

We ư the profession, policymakers, issuers, directors and investor leaders ư need to collectively engage in a public dialogue to educate others regarding the new internal control reporting process and how to interpret potential findings and responses. In conjunction with the other major firms, we are beginning that effort and look forward to working with others in this effort.

4. <u>Continued Implementation of the Act</u>

It also is clear some people outside of our profession are concerned with the rigorous requirements of the Act, the strength and scope of the processes imposed, and the increased work auditors are required to perform. Some of this relates to the new internal control reporting requirements. Many of you have told me about the complaints you have heard. I have heard many of the same concerns. It is important to find the point where good corporate governance and economic performance and protection complement rather than conflict with each other. I think that is important to keep in mind as the Act is being implemented.

However, as implementation continues on many fronts, I would encourage refraining from change to the direction set forth in the Act itself. Instead, give boards, audit committees, management, auditors and others time to fully implement existing requirements.

Let me directly address this issue of implementation as it relates to our work as auditors. Yes, we are being tough. The law requires it, the PCAOB is inspecting our work every step of the way, and investors expect nothing less from us. And as we adapt to address heightened auditing standards, fraud detection expectations, internal control reporting demands and other new requirements, the amount of work we do will surely increase and, as a result, costs will surely rise. Such new requirements are part of our professional obligations for which we are increasingly held accountable if we fail to uphold them. In this process, congressional leaders and regulators have stood behind the law's requirements and the accounting profession's efforts to carry them out faithfully, and for that we are appreciative.

5. Sustainability of the Accounting Profession

Finally, I would like to address two issues on the horizon that will affect the long-term sustainability of the private sector audit function.

Unless our profession can continue to attract and retain the best people, *and* deal with the economic risks our people face as partners, the public accounting firms as we know them today could be in jeopardy.

While we have experienced a recent surge in entrants to the accounting profession, the long-term trends have been headed down. We face real challenges in sustaining the pipeline of quality people into the accounting profession. We need to attract highly competent people to the profession who are not only good with numbers, but who are also able to communicate with audit committees and management. They need to understand our values and that what they do is incredibly important to the free-market system.

In addition to new entrants to the accounting profession, it is just as important that we retain the extraordinary talent that we already have. The Sarbanes-Oxley Act's requirements and pressures put a great strain on our ability to retain sufficient personnel of the caliber we need at various experience levels to meet the demands we face. The demands of not only auditing financial statements but now also auditing internal controls have strained resources across the profession. These resource constraints cannot be allowed to put the quality of any of our work in jeopardy. In addition to the impact of tougher client acceptance and retention practices, all the larger firms are resigning from significant amounts of work in order to make available resources to do the necessary audit work in a quality manner. Even with that, the demands on our people are intense.

The second risk to our sustainability is the ever-increasing cost we bear to simply stay in business. Practice protection costs weigh heavily on our firm and the profession. Insurance premiums have soared, both absolutely and relatively as a percentage of our revenues. For our U.S. firm, practice protection has become one of our largest costs, second only to our personnel costs.

In our very litigious environment where class-action lawsuits are filed at the drop of a hat and the cost to defend against them is so high, public accounting firms face significant financial risk. While we try to minimize these costs by performing in a manner that strictly adheres to professional standards and regulatory requirements, unfortunately good auditing is all too often not a sufficient defense.

Conclusion

All of us — accounting firms, Congress, the SEC, the PCAOB, and other capital market participants — must do a better job educating the public on the reforms that have been put in place.

Recent research among investors commissioned by the four major accounting firms shows that the investors who are most aware of the reforms that have been put in place by the Sarbanes-Oxley Act have far greater confidence that what needed to be done is being done.

This research points to the need for broader education of the investing public on their new protections under the law. We should all be more proactive in highlighting the whistleblower provisions, the CEO certifications, the non-audit service restrictions, and the fact that you created a new regulator for the profession. We should be talking even more about the internal control requirements to curb fraud and how Congress made it a crime to lie to the auditor and that people can go to jail because of it.

Investors need to come to appreciate how audit committees with strengthened oversight are clearly acting as surrogates for investors' interests. There is a lot in the law and I just touched on a few things. This is something that all of us should give voice to every chance we get until investors better understand what has been done.

Finally, I would like to address the recently released PCAOB inspection reports. The inspections underscore the PCAOB's commitment, on behalf of the investing public, to review our auditing policies and processes; and our cooperative participation underscores our commitment to be transparent with our regulator.

While nobody likes to be inspected by their regulator, I truly believe that Ernst & Young and the entire profession will be better for it. Without question, in this process we will come to understand that there are things that some of the other firms might be doing better than us and the other firms will learn of things that we at Ernst & Young do better than them. I embrace the process because I think the whole profession, and investors' confidence in us, will improve markedly.

In closing, I would like to thank this Committee, the Congress, the President, the Securities and Exchange Commission and the Public Company Accounting Oversight Board for your work in creating and furthering the implementation of the Sarbanes-Oxley Act of 2002.