

# **Deloitte Fireside Chat VII:** *The Profession Looks at Sarbanes-Oxley*

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**Mark Peecher:** Good afternoon, and welcome to today's Deloitte Fireside Chat broadcast live on [www.sechistorical.org](http://www.sechistorical.org). I am Mark Peecher, Deloitte Professor of Accountancy, University of Illinois in Champaign, and moderator for today's program.

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Since its debut in 2009, the Deloitte Fireside Chats have become the authoritative series on current issues in financial regulation of interest to the accounting and auditing professions. Past broadcasts, all available in the Deloitte Fireside Chats section under Programs in the virtual museum and archive, have addressed such topics as the role of professional judgment, principles versus rules-based accounting, responsibility for preventing and detecting financial reporting fraud, and the role of the SEC in accounting standards setting. I would encourage those listening to today's program to access the previous chats in both audio/mp3 and edited transcript formats at their convenience after the broadcast. They're well worth your attention.

Today, we will examine how the profession – attorneys, accountants and auditors - look at the Sarbanes-Oxley Act since its enactment a decade ago. Joining with me today are Alan Beller of Cleary Gottlieb Steen & Hamilton LLP, former director of the SEC Division of Corporation Finance, and also a trustee of the SEC Historical Society; and Joseph Ucuzoglu of Deloitte LLP, and a former senior adviser and professional accounting fellow in the SEC Office of the Chief Accountant. Welcome!

Before we begin, I would like to state that the views of the presenters are their own and do not reflect those of Deloitte LLP or the SEC Historical Society. The Society selected me to moderate the program. I have worked with the presenters to determine the topics and questions that will guide the content of our discussion.

One of the hallmarks of the Deloitte Fireside Chats is that it is an interactive series; visitors to the virtual museum and archive are encouraged to submit questions for the chats. We have received a number of questions for today's discussion and I'll be using some of them during the broadcast.

So, let me begin by turning to Alan, though I'm sure afterwards Joe will want to add his perspective. In the U.S., the Sarbanes-Oxley Act is often portrayed as the most significant regulatory intervention in the market for financial statement auditing of publicly-held clients since the 1933 and '34 securities acts. Yet, it hit me this semester when teaching an audit course at Illinois that my students were 10, 11 and 12 years old when this event occurred. They didn't really experience this watershed event.

They have been told that the Sarbanes-Oxley Act emerged after a “perfect storm” of corporate fraud and malfeasance, as well as alleged audit failures surrounding entities such as Enron and WorldCom, together with some ardent political motivations and perspectives. Alan, can you take us to the real back story?

**Alan Beller:** I don't know that it's the real back story but it's one person's recollection of the backstory. The timeline is important. Enron filed for bankruptcy in December of 2001 and after a break for the holidays, by mid- January of 2002 we were in a political regulatory press and investor frenzy. This was, among other things, I think the beginning of the SEC being on page one of The Wall Street Journal nearly every day, as opposed to page C-15. As Mark said, this was thought of as a financial reporting and an auditing crisis and indeed it was particularly a crisis, including a political crisis for the major auditing firms. In mid-January, the auditing firms had been regulated by the AICPA, a form of self-regulation up until this time and the then Chairman of the SEC, Harvey Pitt, and the then Chief Accountant, Robert Herdman, announced in mid-January - I think it was my third day at work - we had a little press conference at which we announced the end of self regulation of the auditing profession under the auspices of the AICPA and that it would be replaced by something else. In terms of the auditing profession, we were hard on the heels of the demise of Arthur Andersen, which was one of the big five accounting firms at the time. They were indicted on March 14, 2002, actually for obstruction of justice, but the clamber and the investigation also included the alleged blown audit of Enron. On March 18th, only four days after that, the Commission adopted emergency final rules for issuers that were audited by Andersen. Corp Fin had actually been working on those rules for several weeks and we had been living in fear that the indictment was going to come down, not on March 18th, because March 18th was close enough to the end of the preparation period for 10Ks that it had relatively little impact, but if it had come down on February 18th we would have had some really serious issues and that's what the rules were intended to deal with. They were done entirely in secret by a small group of people in Corp Fin with the knowledge obviously of the three Commissioners at that time. The problem being that if there was a leak that Corp Fin was working with or the Commission was working on those rules prior to the announcement of the indictment, it would have been a prediction that the demise would have come faster.

The other thing that's important about this time in the run-up to Sarbanes-Oxley was that we were in 2002, a midterm election year, and there was enormous concern at the White House and among Republicans that this crisis was going to damage their chances in November and there was corresponding hope of being able to take advantage of that by the Democrats. President

Bush called on the President's Working Group, which had been established in 1987 after the market drop, to come up with an appropriate solution to Enron. The President's Working Group was composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Chair of the SEC, and the Chair of the CFTC. The PWG consulted on what became the President's 10-point plan which was announced on March 7, 2002 and indeed that plan had a very significant amount of SEC input into it, principally from, again, Chairman Pitt. There were in that 10-point plan (this is, I think, the interesting point) a number of points that were included in Sarbanes-Oxley: CEOs, CFOs certification; a new regulatory board for auditors that ultimately became the PCAOB; faster reporting of insider trading; beefed up reporting on 8-K; officer and director boards; increased penalties; disgorgement of compensation and the like.

The President's plan was this was a program that could be implemented by his administration and the SEC without legislation. The Democrats' reaction was that we need legislation; this is inadequate. Starting in February, March and into April, there were a number of legislative proposals, which were in fact, notwithstanding the President's proposal, pretty bipartisan. There were work bills reported out of both the Senate Banking Committee and the House Financial Services Committee. They were basically a large part of what became SOX. Then they languished, and it was pretty clear at that point that the Congress was not going to do anything more. The SEC then began a rule-making effort to implement the President's 10-point plan where SEC action was appropriate and there are rules proposals that you can go read on the SEC's website for the establishment of what became under SOX, the PCAOB, for CEOs, CFO certification, for requiring companies to report insider trades within two days. We couldn't ask the insiders themselves to report because the '34 Act had the time limits in Section 16, but there was nothing that said that we couldn't make the companies report on form 8-K, and so that's what we proposed.

That was all moving along as we reached late June and then on June 25<sup>th</sup>, WorldCom announced a four billion dollar write down and an accounting fraud. The actual number ended up being twelve billion, but no one's counting when you reach those levels. That started the furor all over again and it was clear within twenty four hours after the WorldCom announcement that there was going to be legislation. It took until July 20th or so for both houses of Congress to act. The Senate passed what became Sarbanes-Oxley by ninety-nine to nothing as I recall, and the House passed Sarbanes-Oxley by two million to three, as I recall, and the President signed it on July 31, 2002 and that is the history of how you got there.

**Mark Pecher:** It's fascinating, in particular the part about how the inertia had slowed, then it built very rapidly after WorldCom. Joe, can you talk to us a little bit about some of the specifics about SOX - from the big sections with respect to corporate governance, with respect to the auditing profession.

**Joseph Ucuzoglu:** I'd be happy to. I do hope that everyone realizes what a privilege it is to be listening to Alan give a behind the scenes, first-hand account of how this all played out in the tense moments of early 2002, just fascinating. Whenever one engages in a discussion around Sarbanes-Oxley, it's really important to look to not just the list of technical rules that were enacted and we'll talk about a few of those and many were very impactful, but also the cultural effects that some of those new requirements brought about. On the rule-making side, in the

aftermath of Sarbanes-Oxley, we obviously saw the imposition of an audit requirement over internal controls. No longer was it good enough for the auditors simply to attest to the reasonableness of the numbers, but the auditor had to actually go in and audit the company system of internal control, and so in the event the company got the numbers right by accident or only after the auditor came in and fixed everything, that wasn't good enough. The company itself had to have the systems and processes in place to get the numbers right.

We saw a very significant scope of services restrictions placed upon outside audit firms with respect to services that could be provided to their audit clients and a ban on those services that were deemed to be independence impairing. Perhaps most significantly was the creation of the independent audit committee of the board. It's interesting that the role that Sarbanes-Oxley gives to the independent audit committee is somewhat unique in the corporate governance landscape. Most roles that boards play are of an oversight nature; management has the primary responsibility and the board provides an oversight function. If you actually read the statute, it's literally just one sentence, but it's very powerful and it states that, in so many words, the audit committee is directly responsible for the appointment oversight and compensation of the independent auditor. It is a tremendous responsibility and one that audit committees take very seriously and it has brought about a tightening of the relationship between the auditor and the audit committee and made very clear that the auditor's client is not the management of the company under audit. The auditor's client is the investing public that is relying upon those financial statements and the investing public is represented in the boardroom by the independent audit committee.

Alan has referenced bringing to an end the era of self regulation in the profession. These are a few of the detailed rules, then you go into what were the cultural effects and perhaps the best illustration is the requirement that management certify the financial statements under the penalty of criminal liability. It's more than just a signature; it's the cultural effect of a level of accountability that is associated with a chief executive officer or a chief financial officer putting their name on the financial statements and asserting that these are right, not that, "I didn't realize what my accountants were doing" or "These are all very complicated rules" and "It wasn't brought to my attention" but that the buck stops here. Anyone might argue that even though that might be the least costly of the set of regulations to implement, it was actually the most impactful, because of the level of accountability that came along with it.

**Mark Peecher:** Very interesting. Joe, I want to stay with you for a moment and probe some particular provisions of the Sarbanes-Oxley Act. There have been several scholars and dozens of commentators who have observed that in requiring an audit of internal controls over financial reporting, that SOX created by fiat a market that did not exist on its own. Their point seems to be that, if shareholders wanted public companies' internal controls over financial reporting to be audited, then the law of supply and demand already would have made that happen. So, by mandating this new service, one could argue that regulators may have reallocated investor's capital away from what they saw as its most productive use. The other side is that you have almost as many scholars and commentators who say that SOX did not go far enough. They claim that even post-SOX, regular investors do not have sufficient voice in corporate governance. So with the mixed opinions that we see how, should students, practitioners, regulators and others

think about the limits of free markets for these kinds of services and of regulation when it comes to financial reporting?

**Joseph Ucuzoglu:** It's important to take a step back and understand the broader corporate governance infrastructure, because there is a very significant difference between who is paying for the independent audit, that being the company under audit, as opposed to who is the primary beneficiary and user of the independent audit, that being the investing public. The difficulty that we have is that in many companies, you may have literally thousands of investors who only own a couple of shares each, and you can't consult with each of them and so we have a regulatory system of investor protection where, as a precondition to accessing the public markets, we've decided upon a certain minimum standard that those companies that want to enjoy the benefits of accessing the public markets need to meet. One can always debate exactly where that line is and what that minimum standard ought to represent. Since the securities acts of '33 and '34, we have required the independent audit and the financial statements and obviously a decade ago policymakers made the judgment that that wasn't enough and that an audit of internal control ought to itself also be required. One can endlessly debate that if you actually put this to a vote of the shareholders; would they choose to expend their resources by virtue of having the company they owned expend corporate dollars on the audit of internal controls? It's an impossible question to answer because we haven't put it to a vote, but there is certainly some amount of academic research out there that would indicate there is a lower cost of capital associated with those companies that do undergo an internal control audit, which provides at least some level of evidence as to the value that investors do place on the service.

**Mark Peecher:** Absolutely, I think some the studies that come to my mind are companies that do not have material weaknesses written up in those opinions. They're the ones who enjoyed that lower cost of capital. Alan, did you have any other perspectives on that particular issue?

**Alan Beller:** My thought on this: Section 404, the internal control provisions, were clearly the most controversial part of Sarbanes-Oxley. I think and have often said that we had 22 sets of rules that we had to implement under SOX on the corporate side and my view is has always been we had about 21 pretty close to bulls-eye and one rim shot, and 404 was the rim shot. I think the notion that the market should decide by itself kind of proves too much and Joe made the point. I haven't heard for years somebody say that audited financial statements should be optional because investors can ask for them if they want them. There's too big an agency problem; in that kind of a theory, it seems to me, but I do think the internal control provisions, there's kind of a conceptual issue, there's a design issue and there's an execution issue. I think the conceptual issue was probably pretty close to right. I think the design issue, the original set of rules, AS2 as promulgated by the PCAOB and the SEC approved them, combined with the severe risk aversion at the time, among both companies and auditors, lead to a sub-optimal design of internal control audits. They were too expensive. They were too "check-the-boxy". I think you are going to get to the opposite point later on in this conversation, but the fact is they were not integrated enough with the audit to be as useful as they could be. And that's been, I think, largely corrected. The design part of that, I think, has been largely corrected and then there's an execution part, and I think that's still a work in progress. It's odd to say that we've been at this for only eight years but the fact of the matter is, we've been at this for only eight years. I think both companies and auditors will be better at it in eight more years. I don't have a huge problem with what the JOBS

Act did in cutting back the audit internal controls for smaller companies. I think there is an issue of cost effectiveness. The studies show that they are more instances of bad financial reporting at small companies than at large companies. The large companies' incidences are more expensive, but I think the control issues are less complicated. There are small complicated companies and there are large simple companies, but as a rule of thumb, smaller companies tend to be simpler than larger companies and you can justify the change the JOBS Act made on that rule of thumb.

**Mark Peecher:** Joe?

**Joseph Ucuzoglu:** It is interesting, Alan. You mentioned that 21 of the 22 rules were relatively obvious and it's the 22<sup>nd</sup> that's...

**Alan Beller:** I didn't say they were obvious, I said they were well done!

**Joseph Ucuzoglu:** It's the 22<sup>nd</sup> that's generated the controversy and I think as a result, mistakenly, many in the popular conversation refer to this one very narrow sliver of Sarbanes-Oxley interchangeably with Sarbanes-Oxley in its totality. This one requirement, Section 404(b), is but a tiny sliver of Sarbanes-Oxley and yet when folks speak of Sarbanes-Oxley they often essentially mean 404(b) and lose sight of the broader framework, much of which is far less controversial and on balance and has certainly restored a level of credibility to corporate financial reporting.

**Mark Peecher:** I know that, many times, students, when they look for this, think it must be a huge section about internal control audits, and they sometimes will miss it because it's really, as you say, a small paragraph, but let me be a little bit of a devil's advocate here perhaps. One of the things that I've observed through the years is the number of commentators identifying several downsides of SOX and maybe they're really talking about the down sides with of 404, but the things that they'll tee up are issues such as a myopic focus on narrowly defined internal controls over financial reporting instead of business process controls, or some studies have suggested that there was a depression in market prices. Equity security pricing dropped after the passage of this act. That's a tough thing to pin on the act perhaps. Decreased public ownership and other studies and of course there're the new direct costs and then one indirect cost we sometimes would hear about, and I know you've heard about as well, is firms that choose to remain private, instead of listing their shares in a U.S.-based exchange, will take their listing to an alternate exchange such as in London. Alan, let me go with you first on this one. Is there, ten years later, any continued legitimacy to these costs and have they been substantial?

**Alan Beller:** Well the initial costs were clearly very substantial, but I think they can be attributed to in a significant extent to the design issues and the initial execution issues that I referred to earlier. I think, as Joe said, some say let's repeal Sarbanes-Oxley, which I think people generally mean let's repeal 404. I think the issue with the U.S. public markets, if there is one and the statistics suggest that there may be one, goes well beyond Sarbanes-Oxley and goes well beyond 404 and is actually more a function of the fact that there are larger global capital markets and the U.S. market is a smaller portion of the whole pie. When I started practicing, it was probably fifty-plus percent. It's now around thirty and I think that goes farther to explain what's going on than a focus on 404. I am sure there are companies that don't go public because they

don't want to go through 404, but I think they're probably more companies that don't go public because in effect the totality of the burdens of being a public company in this country outweigh the advantages of access to the market.

**Joseph Ucuzoglu:** This issue of weighing the costs and benefits of regulation, in particular financial regulation, continues to be on the front burner and it's even entered the political dialogue. What is important to keep in perspective, though, is where we were starting from and the level of fear that had gripped the markets at that time. There was a wholesale lack of confidence in the accuracy of reported financial information and I'm not sure how you put a price tag on restoring that credibility. It's almost a precondition for having a functioning market, specifically with respect to this issue around the internal control costs. A good chunk of the noise does tend to come from those companies that are on the smaller end of the spectrum. I think it is a fair observation that the costs are disproportionate. You're never going to achieve a phenomenon where, as a percentage of revenue, the very largest companies are spending the same dollars as are the very smallest companies. There's an economy of scale associated with being large but there have certainly been substantial efforts to increase the scalability relative to the size of the company and the PCAOB in its issuance of AS 5, was attempting to do exactly that and again earlier this year we had the policy makers respond with the issuance of the JOBS Act to try to provide an on-boarding mechanism to at least mitigate the extent to which that disproportionality falls upon those smaller companies.

With respect to this issue of the competitiveness of the U.S. capital markets and do we see companies fleeing, I wholeheartedly agree with you Alan, that what we're seeing in large part is a leveling of the playing field and the development in other geographies of a viable alternative, not necessarily that the U.S. itself is to blame. But naturally, if there are other viable alternatives, some will go there. If you look at the regulatory regimes around the globe, they tend to be moving directionally towards Sarbanes-Oxley, not against it. Many of the proposed auditing and corporate governance reforms that are being debated in Europe right now mimic aspects that we've been living with for a decade. I don't think the answer is to strive for the lowest common denominator in the interests of stealing listings away from other jurisdictions that have raised their competitiveness.

**Mark Peecher:** Alan, I'm going to kick it back to you. We've gone through the process of listing some of these alleged, and perhaps real, downsides of SOX, but what about the flip side? You took us a little bit through the thought experiment of "What if tomorrow we woke up and suddenly, not maybe SOX in its entirety, but the 404 provisions were to go away?" Would firms continue to get this audit done on internal controls over financial reporting? And if so, there must be some benefits. Let me work in a question that some professionals from Deloitte have advanced to us today along these lines; they are curious about some of the potential benefits of Sarbanes-Oxley Act. The question is: how did audit committee members initially react to the initial responsibility and authority that they had under the Sarbanes-Oxley Act? Have they enhanced the communication that they have with members of the independent audit team, the engagement partner in particular? Let's tee those questions up in addition to any other benefits. Now some of these benefits that have come from Sarbanes-Oxley may have been planned and foreseen, but others of these benefits may have been rather almost unintended benefits. We hear

about unintended consequences all the time, so I wondered, Alan, if you had any perspectives along those lines?

**Alan Beller:** I do. To start with your first question, if the audit provisions were repealed, the internal control audit provisions were repealed tomorrow, I think it's likely that most companies would not get a piece of paper from their audit firms that say "We've audited internal control, dot dot dot," but I do think that most larger companies would go through essentially the same management exercise as they do today. I think that's now become ingrained in the way large companies prepare their financial statements and rely on controls and systems to get them right, or to increase the possibility of a likelihood that they'd be right, so I have to think that would change relatively little, at least on the large side of the spectrum. I think audit firms, and this is more Joe's point than mine, I'd be curious to know what he thinks, would probably do largely the same work they do now, even though they wouldn't necessarily deliver that piece of paper at the end. Certainly from my experience as a member of an audit committee, I think audit firms rely on that work to inform their financial statement audit. They always did that. They did that pre-404, but I think it's become a larger part of the exercise, so would it change? Yes. Would it change all that much? I actually think not, and it's kind of interesting, if you sit on an audit committee, you'd see this too, I think the number of controls that are now included in the key controls that have to be checked as a matter of the 404 work program, I think they've gone down by a very significant percentage in the eight years since these kinds of audits started. I don't want to quite say they've come down by half, but I think probably in some companies they have gone down by half and others they've gone down by a very large amount.

Your other question, which was "What were the advantages?" I really do think largely for the reasons Joe mentioned earlier, this notion of having audit committees more responsible for monitoring the work of the independent auditor was an absolutely intended consequence of the act. If the act was trying to do one thing, that's what it was trying to do and that's the reason for the independent audit committee provisions. I think the cultural change that accompanied that and the closeness of communication between audit committees and outside auditors, especially the engagement partner and well functioning audit committees, I think that may be a bonus unintended consequence. I think any well functioning audit committee, the way that the auditors and the audit committee (the PCAOB may not want to hear this) worked together in a practical sense is, I think, very important. That's also a change. When you started in 2004, Joe, you remember there was a whole furor about could the independent auditor look at drafts of financial statements or was that getting involved in the preparation and therefore impugning independence. I think we've gotten past that overly technical, overly process oriented way of behaving. I think audit committees and auditors now have a very healthy relationship where they are both doing their jobs.

**Mark Peecher:** Joe, do you want to add to some of those perspectives?

**Joseph Ucuzoglu:** I might pick up where you left off, Alan. The pendulum always swings too far and then folks figure out the right balance and there were a few examples in the immediate aftermath of Sarbanes-Oxley. One of them was exactly as Alan just mentioned, in an effort to demonstrate that the auditor is performing an independent attestation function and that the company itself is responsible for getting the numbers right so you don't have the auditors closing

the books and then auditing their own work. There was at times a tendency to say "I can't advise the company on how to actually get the numbers right. I have to then come along and audit it." You saw this kind of manifest itself in extremes, such as "I can't look at a draft white paper, you need to finalize the answer before I can tell you if you got it right." or "I can't look at a draft of the financial statements. You show me what you thought it looked like and I'll let you know if they're wrong." The PCAOB and the SEC came out in the '04-'05 time frame and very forcefully said "That kind of behavior is not conducive to high-quality financial reporting," and so let's define what it means to be working together. Working together doesn't mean management and the auditor collaborating to achieve joint objectives, but what it does mean is that both collectively are promoting an atmosphere of high-quality reporting and so to the extent that the auditor can share with the company under audit suggestions as to how to improve the quality of its accounting, how to improve the quality of its disclosure, recommendations as to internal controls that they may have seen elsewhere that would be beneficial for the company to adopt. That type of behavior is a good thing.

I think we also saw some of that pendulum swinging too far in the context of the number of controls that were identified. Seven thousand key controls. Any time you have seven thousand of something it's questionable as to whether all of them are really key. So there was a ratcheting back in a focus on what's truly important, with AS 5 placing a very clear emphasis on the auditor searching for those types of things that could go wrong, that would actually cause a material misstatement of the company's financial statements, the operative word being "material," not "any" problem with the company's financial statements.

We also saw audit committees evolve. At first this was all so overwhelming the number of new requirements that were imposed upon the committee and that tends to bring with it, a "checklist" might be too harsh of a word, but a procedural mentality of making sure I've covered all of the things I'm supposed to do and if you spend the whole meeting going through a checklist you don't leave time for the substance of really delving into the few issues that are important. I think we've reached a point now where we have a much better balance of making sure that we don't get lost in the minutiae, and that in fact the few critical, most important issues do in fact rise to the top. In terms of unintended benefits, I would say that this might not be the wholesale view across corporate America, but you do more and more hear executive level folks from companies talking about the benefits that they've seen from the 404(b) internal control process extend beyond just "I know I have good financial controls", but that there's actually an operational benefit to running a tight ship and having a certain level of discipline in place to make sure that appropriately high standards are being consistently complied with and that fosters an overall higher level of quality of business conduct.

**Alan Beller:** Let me add a couple of things to that. On Joe's last point, you talk about business process controls. I actually think well functioning, well controlled companies think about SOX and non-SOX controls together and yes, the audit extends only to the SOX controls, but when you're on an audit committee and you're listening to the head of internal audit report every quarter, they're combined. We're not looking at the business process controls. I think that that is, in fact, the unintended benefit that is happening. The other thing I'd say that we've talked about internal control, there's another set of controls out there which is not directly tied to the audit function, but we've talked about CEO/CFO certification. I don't think you think about CEO/

CFO certification in a vacuum. You think about it in conjunction with the other requirement that those rules produced, which is a company has to have disclosure controls and procedures and the reason that's important is the CEO/CFO certification says "To my knowledge, these are materially correct, materially clean." The theory of disclosure controls is the company has a system to get in front of the CEO or the CFO all the information he or she needs in order to make that judgment, and so the disclosure control procedures support the overall certification system. The CEO can't just say "Well, nobody told me," because if the disclosure controls and procedures are working the way they're supposed to if that's something he or she wasn't told was really important then it should have gotten up to their attention and if you go back and look at the theory behind disclosure controls and procedures, I think that's in fact another unintended consequence and benefit of the statute. You really do have a much better disclosure culture at well-functioning companies. I don't want to say it was "hit or miss" because that's over exaggerating on the other side, but there was not necessarily a well-thought-out, well constructed system getting information to where it should be for disclosure purposes.

**Joseph Ucuzoglu:** I think that before Sarbanes-Oxley, there was a different mindset as to what accounting and financial disclosure were about and some would have viewed them as being a compliance exercise and at the extreme "How do I minimally comply?" versus a culture of transparency that "No, this isn't just an exercise in making sure I meet the minimum government regulations; this is a communication with shareholders and I ought to go into it not with a checklist that I complied with rule one, rule two and rule three but have I really faithfully portrayed the financial performance of my company to my constituents, the owners?"

**Mark Peecher:** Looking at Sarbanes-Oxley as a portfolio, I think was one of the big points that I heard you guys both make just now, one of the organizations created by the Sarbanes-Oxley Act was the PCAOB, the Public Company Accounting Oversight Board and this is a question that comes to us today from Anthony Bucaro. He notes that officially the mission of the PCAOB is to oversee the audit of public companies in order to protect the interest of investors and to promote the preparation of informative, accurate and independent audit reports. Unofficially, the world seems to think the mission is to improve audit quality. So, one of the ironies we have here is that for a long time, firms have been trying to make the case of we're improving or maintaining audit quality, but now we have the PCAOB claiming that audits have improved as a result of their oversight inspection processes. Do you feel that the evidence that's provided points in that direction?

**Joseph Ucuzoglu:** There is no question in my mind that the overall quality of audits throughout corporate America is substantially improved if you compare today to ten years ago. As an insider who is out there doing these audits myself, in part of the firm that does a fair percentage of the overall audits, there is no question that assertion is accurate. It is exceptionally difficult to come up with metrics to prove it. Folks better than I have tried. One would probably have to start with defining audit quality and even that term is subject to a diverse set of perspectives. What does audit quality mean? Once you can agree on a definition, if you can, then you can set about trying to come up with quantitative metrics to demonstrate. People talk about input type metrics: "How long does it take?", "What's the expertise of the people doing it?" More folks care about output metrics: "How do I actually know that the end product was good?" and by that measure there are several things that people might look at, none of which is individually determinative. It is well-

documented that restatements are down tremendously in the ten years since Sarbanes-Oxley was enacted. Now how much that credit goes to some of the regimes that are applicable to companies and therefore companies producing better information versus how much of that is really attributable to the incremental rigor of the audit. We could debate, but what the investor at the end of the day cares about is "Were the numbers right?" They're less concerned with who exactly got them right and so by that measure the number of circumstances where a financial statement was originally issued and later had to do the amended because it was materially misstated is drastically down - unquestionably a positive. Securities litigation is way down in the area of alleged misstatements in financial statements. Then you can get into some of the direct measures of auditor performance, things like inspection results. We certainly, across the profession, have seen increases in inspection findings. Recently there's no question that the level of rigor in the inspection process is bringing things to firms' attention that warrants very significant efforts to remediate those issues, which in turn, drives incrementally higher levels of auditor performance so all of these things converging, I do think, lends support to that notion that audit quality is in fact getting substantially better and continuing to get better.

**Alan Beller:** I think that's right. I think there's no question that the quality of audits is up. The quality of care, the focus on the things that are potentially most troublesome, I think both have gone up. As Joe says, it's hard to measure, but I'm morally certain it's correct based on watching the work of auditors and audit committees on a daily basis, which is what I basically do. The other interesting thing about the quote you just read is there's been over the last couple of years in particular, there's been the PCAOB has focused a lot and has put out a couple of concept releases of this notion of serving investors better means more transparency to investors. That's a mantra that we've often heard and the PCAOB has picked it up. I think that understates the importance of what we've been talking about. I actually think investors are best served by really high quality performance by outside auditors and oversight of that and communication about that with audit committees. I think that's the key to quality audits. Making sure the audit committee really understands what the auditors doing and not doing. There are some things I'd like to see in audit reports that you don't currently see, but I'm not persuaded that longer audit reports is the key to better audit quality. I think the key to better audit quality is to continue to refine the model we are currently working on, which is "Let's make sure the audit committees of the auditors are doing their jobs as well as they can."

**Mark Peecher:** Let me tee up something that may really have as much to do with an expectations gap more than anything else. One of the things that I have to explain to students and other close associates would be when they ask something like this: "Why if SOX was so great did it do nothing to prevent the financial crisis and is it possible that this type of audit work may have distracted auditors from maybe communicating with one another and picking up more forcefully on an erosion in the quality of financial reporting of banks, and others, involved in what we now think of almost everywhere as sub-prime and prime mortgage backed securities?" Joe, can you help us think a little bit about the relation, if any, between legislation like the Sarbanes-Oxley Act and the horrific financial crisis from which are still trying to recover?

**Joseph Ucuzoglu:** The financial crisis is a very different phenomenon from what we experienced a decade ago leading up to the passage of Sarbanes-Oxley. A decade ago, what we had was essentially a financial reporting crisis - in many cases it was outright fraud: making up

numbers and reporting them to investors. The financial crisis largely was not about problems with accounting. There are very few cases where financial statements, even now in hindsight, were determined to have been materially misstated at the time. Failures in risk management, certainly, but not in accounting. As a matter of fact, some have actually accused the auditors of having been too tough, and that when the financial crisis hit, things were obviously headed downhill and the auditors were taking a very hard line in requiring that many of these securities that were held by financial institutions to be marked down to fair value, which some characterized as kind of unrealistically low fire sale prices, alleging that this was making a crisis worse because of a pro-cyclicality, where in the face of bad news these markdowns were creating yet more bad news that was feeding off of itself. So, you almost have this phenomenon where some would say "Where were the auditors?" in that the watchdog didn't bark and some were saying that the watchdog was actually too tough. I think that the fact that this wasn't so much a crisis in accounting is reflective of what ultimately manifested itself as the policy maker's response to the financial crisis, that being Dodd-Frank. There's very little in Dodd-Frank that is accounting or auditing related, a tiny, tiny sliver, and very little interaction between the accounting and auditing provisions of Sarbanes-Oxley and the response to the financial crisis in Dodd-Frank. That's not to say that there aren't lessons to be learned. I think anytime we go through as severe a shock as the financial crisis, all participants in the capital markets have to look introspectively and learn the lessons of that era and what we can do better. Certainly, there's a renewed emphasis on disclosure and forward-looking information highlighting risks. You see some of that manifest itself in the recently issued risk assessment standards by the PCAOB which place a very significant emphasis on the auditor looking at the quality and accuracy of a company's disclosures, but I do believe we're dealing with a very different phenomenon this time around.

**Mark Peecher:** Alan, do you have anything to add?

**Alan Beller:** No, I completely agree with that. I think the one common accounting thread between the two crises, which were otherwise very different, is that in both cases it's not an auditing question as much as a finance reporting question. In both cases, the financial reporting model is inadequate as to how you keep track of things that aren't on the balance sheet.

**Mark Peecher:** Interesting.

**Alan Beller:** Other than that, it's not an accounting crisis.

**Mark Peecher:** Alan, let me stick with you just for another question here. One of the things that came up as a big issue right when SOX first came out was whether there's going to be an internal control audit over financial reporting, so here again I'm focusing in on 404. Is it a good idea to have one firm do the financial statement audit and another firm do the internal control audit? And, hopefully what emerged was "No, that's not the way we're going to go. Let's actually mandate that one and the same firm does both." We could have gone down a different path. Can you give me some perspective on whether the path that was selected was the right path or would this have been another thing that the market could have figured out on their own.

**Alan Beller:** I suppose the market could have come out the other way. I've always thought that the way this came out was the right way. And the reason I say that is the trouble with the way 404 was initially designed is that it didn't sufficiently integrate the two audits and therefore having good controls in and of themselves is a sterile objective. Who cares? One wants good controls because one wants good financial reporting. Obviously, the better the controls, the better the chances of good financial reporting. To follow that premise, you want the two exercises to proceed in lockstep, because, in fact, that's the way that you most likely to have the controls audit inform what happens with the financial statement audit. I think the other way, you lose that benefit.

**Joseph Ucuzoglu:** This is an issue I have a pretty strong perspective on. Most of the people who know me would say I'm pretty balanced. I generally understand both sides of an issue. On this one though, I would fail to understand how we would actually improve quality by trying to separate what has essentially become inseparable. The audit itself has become so integrated that I couldn't tell you how much of the audit effort was the internal control audit and how much of the audit was the financial statement audit. The very design of the auditing standards, and appropriately so, is to start by understanding where could there actually be a risk of material misstatement in the financial statements and that to determine what controls the company has in place to mitigate that risk and test the effectiveness of those controls. Then take what you learn from testing the effectiveness of those controls and use it in actually designing the tests of the underlying numbers, the so-called substantive tests. It's a process that flow seamlessly.

**Mark Peecher:** Let me in the last few minutes we have today, Alan and Joe, not that you're necessarily holding yourselves out to be great prognosticators, but what would you say we should be thinking of in terms of the next major regulatory intervention in the auditing profession? Alan?

**Alan Beller:** I think the PCAOB has put us on notice of two that they're thinking about very seriously. One is mandatory auditor rotation. The reaction to that has been certainly, on both the preparer and the auditor's side, uniformly negative and strongly negative. Investors believe that that would promote skepticism and independence and lack of capture in ways that could be helpful. My own view is that that will not come to pass in exactly that fashion, but there's going to be more struggle about it. The audit committee has to, in effect, go out and look every x years as to whether they should change auditors.

**Mark Peecher:** Joe, anything that comes to your mind about auditor's reporting model or otherwise?

**Joseph Ucuzoglu:** I would focus on the underlying issue the policy makers are trying to solve for versus the prescription, and that is an ever vigilant effort to ensure the auditors are acting independently, objectively and skeptically in challenging management and there's different ideas as to how you do that. I would predict that we will continue to see regimes put in place to reinforce and continue to strengthen what was started with Sarbanes-Oxley, which was to power up a very strong, independent, effective audit committee to then set the tone for and oversee a rigorous independent audit function. You can dream up a thousand different things you think might contribute to that objective, but that's the objective that we all share.

**Mark Peecher:** Thank you so much Alan and Joe, for your informed discussion taking us back to the inception of Sarbanes-Oxley and, at the end of the day, looking ahead.

Today's program will be an important addition into the collection of materials on the Sarbanes-Oxley Act in the museum. I would encourage you to watch the July 30<sup>th</sup> broadcast on the 10<sup>th</sup> anniversary of the act with Senator Sarbanes and Representative Oxley. You may also want to plan to watch the upcoming November 15<sup>th</sup> "A Measured Response?" broadcast looking at the enactment of Sarbanes-Oxley as a case study of public outrage inspiring financial regulation.

This broadcast will soon be available in audio/mp3 format in the museum; an edited transcript will be added later. I invite you to return on Wednesday, November 7<sup>th</sup> for the next Deloitte Fireside Chat looking at international convergence. Professor James McKinney of the University of Maryland will be the moderator. The presenters will be Robert Herz, former chairman of FASB and retired senior partner at PricewaterhouseCoopers LLP, and Joe Ucuzoglu. The live broadcast will take place at 2 PM Eastern Time - free and accessible worldwide.

On behalf of the SEC Historical Society, I would like to thank Deloitte LLP for its generous support and assistance in making today's program possible. Thank you for joining with us today. Good afternoon.