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Written Statement

U.S. Treasury Department
Advisory Committee on the Auditing Profession (ACAP)
Panel on General Sustainability
December 3, 2007

Chairman Levitt, Chairman Nicolaisen, members of the committee, I would like to thank you for inviting me here today to provide my recommendations on general sustainability issues impacting the auditing profession today. I am the President and CEO of Financial Executives International, also known as FEI, and my views are influenced by the views of our members, who number over 15,000 and hold senior positions in finance including CFO, Controller, Treasurer, Tax Director, and other senior positions.

Additionally, my views have been influenced by my over 35 years experience in accounting, finance and senior management positions prior to taking on my current leadership position at FEI this year. My recommendations therefore reflect a balanced perspective from being on both sides of the audit engagement - as an audit partner, and as a senior executive with a Fortune 500 company and a medium sized entity. . Specifically, I have served as an audit partner at a Big Four (then, a Big Eight) firm, Ernst & Young, as well as at a next-tier firm, BDO Seidman.

During the past 35 years, I have witnessed a number of accountant supply cycles. The macro trend of automating accounting systems, which reduced the demand for accountants, has been replaced by an increase in demand due to global economic expansion and a significant increase in governance related to recent financial scandals and the Sarbanes-Oxley law.

Following are some suggested recommendations for the committee's consideration on general sustainability issues impacting the auditing profession.

1. Structure and Ownership of Audit Firms

There is a large gap between the Big Four and the next tier, which the committee is aware of. This impacts the degree to which companies have a choice among audit firms for audits of large multinational companies, as well as within the small company sector.

Recently, efforts have been underway to review the expansion of the number of accounting firms to address international business. These discussions include consideration of the formation of different types of accounting firms, as well as, consideration of reduction in litigation risks. These efforts should continue and may relieve some of the pressure on the ability of firms to expand and cover broader geographic areas.

Separately, the potential for small companies to be overaudited by large audit firms exists, and it would be helpful to expand choice of audit firms to do a high quality audit at a reasonable fee for small companies.

In terms of specific recommendations, I would support the committee further exploring alternative structures and ownership of audit firms to accommodate the needs of the firms in this, the 22nd century. Among ideas to consider are:

- Corporate structure
- Public company ownership
- Non-CPA ownership

2. Encourage expansion of types of audit firms that can be done to add value, at lower fees

Recent studies have shown significant cost increases in audit fees paid by public companies in the post Sarbanes-Oxley period. (And the cost of private company audits, we hear anecdotally, has also risen.) We believe much of this cost increase was in excess of the value added to the audit.

Perhaps, we could consider if audit firms – or – to expand competition and reduce concentration - additional firms besides the opinion-signing audit firm, could provide certain services in support of the audit, at a lower fee than that charged by the opinion signing audit firm, which the opinion signing firm could rely on, such as:

- Audit of internal control under Sarbanes-Oxley
- XBRL related audit and controls work
- Valuation work. (Note: there should be some kind of standards for firms conducting this work)
- Other types of audit related work

The hourly fee rate charged to sign off on an audit opinion may be a relatively high all-in rate which is applied to more complex and less complex tasks. A good example of this is working in the banking industry where specialist accountants are brought in to verify accounts receivable and inventory coverage in asset based lending arrangements.

3. **Expand number, types of professionals to lessen current load, reduce turnover**

I believe one of the major impediments to attracting new talent to the accounting profession is the image of working long hours. The new generations have different ideas regarding work and life quality.

Therefore I suggest that consideration be given to creating additional lower level tracks of accountants who are trained to perform the lower level work, thereby relieving some of the burden from the traditional accounting staff.

An example could be greater use of para-professionals, such as paralegals and nurse practitioners are used in the legal and medical fields.

This tiered system of accounting professionals would address this significant issue by spreading the work among more individuals. This will in turn increase the supply of accountants.

4. **Tort reform**

As noted in studies by law professors and in the press, mass litigation fails to direct recoveries to those allegedly harmed, funnels most of the recovery to the lawyers that brought the case, and costs companies millions of hours and dollars in defense and settlement costs, which cannot be seen as a net gain to our economy, something I know is near and dear to the hearts of the U.S. Treasury Department.

I would support efforts at all levels of government and the private sector as necessary to help corral the litigation beast which is entirely out of proportion to alleged 'bad acts.'

5. **Need for change in auditor's and inspector's behavior**

Treasury Secretary Paulson asked in one of his speeches when this committee was formed: "Do auditors seek detailed rules in order to focus on technical compliance rather than using professional judgment that could be second guessed by the PCAOB or private litigants?"

Based on my experience as both an audit partner and senior executive at companies, I would have to answer Secretary Paulson by saying, Yes, I do believe auditors seek detailed rules and feel pressured to audit for technical compliance vs. professional judgment. I also believe over-auditing results from the focus on rules-based compliance.

Further, I believe the trend has escalated over the past couple of decades, with increased calls for bright line rules and checklists. I would suggest the committee seek ways to make auditors more comfortable applying professional judgment to particular fact situations under the tenets of broad principles, and likewise encourage standard setters to resist temptation for overly detailed bright lines vs. striving for sensible principles that can be applied and understood in practice by auditors and financial executives as well as by investors.

Likewise, PCAOB inspectors will need to adjust their behavior, and there may be considerations for SEC enforcement as well. Related to this, I already discussed the need for tort reform a few moments ago.

As this committee examines the results of Treasury's study on restatements and continues its work in the important issues raised by all four panels today, I hope the committee will continue to coordinate its objectives with those of the SEC Advisory Committee on Improving Financial Reporting chaired by Bob Pozen. I know Treasury has staff observers on the SEC committee, and vice versa; issues of complexity, behavior of auditors in being principles-based vs. rules-based, their need for protection from liability, and related issues of materiality, standard-setting, and restatements, will require much thoughtful and deliberate consideration, in a relatively short time period as advisory committees go (with the committee's stated goal of issuing recommendations by next August.)

Closing

In closing, Financial Executives International (FEI) commends the department of Treasury in forming this advisory committee to address the important goal of sustainability of the audit profession. This goal in turn is of keen interest to FEI's membership of senior financial executives, and to the capital markets as a whole, and FEI shares the committee's interest in having high quality audits.

Once again, I thank the committee for inviting me to share my views with you today. I am happy to answer any questions you may have, and we would be happy to provide any further support to the committee.

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Competitiveness of the U.S. Capital Markets:

FEI's Recommendations to Address Complexity in Financial Reporting

Background: Complexity in financial reporting harms the competitiveness of the U.S. Capital Markets.

- **Investors are not well served** by complexity of financial reporting. The complexity and technical demands of accounting and disclosure standards have increased considerably in recent years. FEI believes complexity harms the ability of users of financial statements to understand the information provided and impairs the ability of preparers to explain their financial results in a meaningful way. Nor are investors helped by frequent restatements of previously reported financial data as a result of differences of opinion between companies and regulators on the application of these complex requirements. Easier-to-understand financial statements that lend themselves to sustainable, high-quality application should be our mutual goal.
- **Investors also are not well served** by the drain on shareholder wealth from the excessively complex compliance process. The cost of meeting the increasing technical demands of accounting standards issued in recent years, coupled with new internal control requirements, are ultimately borne by shareholders. Furthermore, investors are exposed to the financial consequences of differences of opinion on interpretations of complex rules, often referred to as inadvertent non-compliance, which frequently leads to restatements and invites costly litigation.
- **The capital markets are not well served**, and U.S. competitiveness is hindered, when scarce financial resources are not used in value-enhancing business initiatives but to satisfy disclosure and accounting requirements that fail to meet cost-benefit tests. Additionally, capital markets bear an opportunity cost when intellectual capital and leadership talent is diverted from more productive and creative uses, such as developing new technologies, products and markets. Rival enterprises that operate in more principles-based regulatory regimes derive a competitive advantage by having the freedom to focus significantly more attention on their true economic mission of increasing shareowner wealth through innovation and growth.

FEI's Recommendations to Address Complexity

1. **The FASB and SEC, in coordination with key financial reporting stakeholders (preparers, auditors and financial statement users), should take steps to end the proliferation of detailed rules.**
    a. Agree to a stable platform for a specified period of time, during which no new accounting standards would be issued. Efforts would be shifted from new standards to completion of the conceptual framework, including the development of a comprehensive accounting and disclosure model that is integrated with the codification project. The objective of this effort would be to look holistically at the model from the standpoint of usefulness and understandability. Also during this time, preparers, auditors and users would work together to develop proposals to simplify the most complex accounting standards (FAS 133, FAS 140 and FIN 46, among others).
    b. Upon completion of the model, work jointly with the IASB to evaluate proposals by stakeholders to improve and simplify the most complex standards by making them more principles-based, and eliminate important differences between US GAAP and IFRS. Stakeholders in the financial reporting process should continue to encourage global convergence and mutual recognition of high-quality accounting standards.

2. **Congress should consider meaningful class-action reform.** The litigious environment in the U.S. breeds frivolous class-action lawsuits. Preparers and auditors, required to follow overly prescriptive standards and regulations, are often subject to unwarranted and expensive second-guessing. In their January 2007 report, *Sustaining New York's and the U.S.'s Global Financial Services Leadership*, New York Mayor Michael Bloomberg and U.S. Senator Charles Schumer noted that for foreign firms considering a public offering, the fear of potential litigation outweighs any incremental benefits of listing in the U.S.

3. **The SEC and PCAOB should develop a framework that provides effective regulation in a principles-based environment, one that balances the objective of investor protection with the need to maintain market competitiveness.** This effort would seek to define what investor protection means in operational terms: when should a difference of opinion between a company and a regulator or diversity in practice result in the need for any of the following actions: a staff speech or staff announcement, a request for standard setting, a restatement, an enforcement action or some other response.

4. **Stakeholders should come together to form an independent "Committee on Complexity."** FEI welcomes and fully supports calls by both SEC Chairman Christopher Cox and FASB Chairman Robert Herz to reduce complexity in financial reporting. FEI believes this effort will require coordination among all stakeholders in the financial reporting process. The Committee should be chaired by and include high-profile leaders of integrity who possess expertise in this area. FEI believes that the success of this endeavor will depend on a shared commitment by all constituents to fundamentally change those facets of the financial reporting process that contribute to complexity.

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