Corporate Board Elections
and
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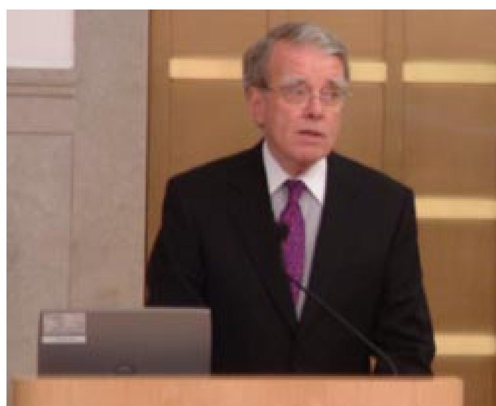

Keynote speech by William J. McDonough, Chairman of the Public Company Accounting Oversight Board

Introduction by Michael Traynor, President, The American Law Institute, and Senior Counsel, Cooley Godward LLP

Our keynote speaker this morning is William J. McDonough. He has served for over two years as the first chairman of the Public Company Accounting Oversight Board, which was established by the Sarbanes-Oxley Act. Before undertaking the challenges and responsibilities of that key position, he served for ten years as President and CEO of the Federal Reserve Bank of New York, our host for this important gathering today.

His distinguished record is summarized in your program. It includes important public and private positions, service in the U.S. Department of State, and five years as a U.S. Navy officer. Before his Navy service, he earned his bachelor's degree in economics from Holy Cross College, and after that service, a master's degree in economics from Georgetown University.

Chairman McDonough last week announced his intention to step down as Chairman of the PCAOB in November, or sooner if a successor is chosen. He was quoted in last Saturday's New York Times as saying, "I'm very interested in being extremely busy. I will be happy to hear what people have to suggest I might do with them or for them." Perhaps this conference will yield some suggestions for Chairman McDonough. He has earned the high praise of SEC Chairman Christopher Cox and others for his leadership. Last year at the ALI's Annual Meeting, our dinner speaker was my friend and law school classmate, Senator Paul Sarbanes. Paul recently praised Chairman McDonough, saying he did an outstanding job in building a first-rate institution with a superb staff. Representative Michael Oxley called him the perfect man for the job.

Earlier this year, in an interview reported in Accounting Today, Chairman McDonough was asked whether, to ensure accuracy, shouldn't standards be more or less like a checklist. He responded by identifying a question that regularly arises in courts, legislatures, and private law-reform bodies like the ALI: "That brings up the old rules-versus-principles debate. Principles demand a great deal more judgement, whereas rules are much more detailed. For example, the standard on derivatives runs more than 800 pages long. But on the other hand, take the simplest of all rules, 'thou shalt not steal.' That doesn't take a lot of moral theology to analyze. And if I didn't get it, my mother made sure I did. I actually prefer standards that leave a fair amount of judgement to the auditor." It is a great pleasure to welcome William J. McDonough to the podium.

Prepared remarks by William J. McDonough

Thank you for the gracious introduction. I am particularly pleased to be back at the New York Fed and to have the opportunity to speak to this group today.Most of you know by now that last Friday I resigned as Chairman of the PCAOB, effective November 30 or upon the appointment of my successor, whichever is sooner. I am pleased, however, to have the opportunity to speak to this important group of regulators, counselors, educators and others before I step down.

The protection of public trust has always been something of a passion for me, and I always appreciate the chance to address the people on the front lines of protecting that trust.

I am now into my third year of supervising accountants, specifically the auditors of public companies. By supervising auditors, the Public Company Accounting Oversight Board hopes to improve the reliability of financial statements – something that is of the utmost importance to corporate boards and the lawyers that counsel them.

As supervisors of important participants in our market economies, we also share a responsibility to the people who rely on us to safeguard their trust in our financial markets. That responsibility is more important now than it has ever been.

No one knows better than this audience that we live in a global economy. Any shattering of confidence in one part of the global economy, especially in the major participant countries, reverberates through the system.

In the 1990s, we lived in what appeared to be the dream economy. And then the scandals came. No physical or political boundaries could keep out the tidal wave of losses and uncertainty that came with the failures at Enron, Royal Ahold, WorldCom, Parmalat, and a number of other companies.

The political reaction to these scandals came soonest and strongest in the United States, which was not a surprise, since we had more than our share of the scandals, and they occurred before those in other countries. The U.S. Congress responded in July 2002 with legislation that became the Sarbanes-Oxley Act.

If the scandals had been the only cause of Sarbanes-Oxley, the law would have been limited to punishing criminals in business suits. But the law was not crafted to punish "bad guys," as we Americans call them. It is far broader. It is, in fact, a repudiation of the leadership of the American private sector.

No "bad guy" has been sentenced to jail for violating Sarbanes-Oxley, but, rather, for violating laws that have been on the books for a long time, going back to the commandment: Thou shalt not steal.

Sarbanes-Oxley requires the Chief Executive Officers and Chief Financial Officers of public companies whose securities trade in U.S. markets to certify every three months that the financial statements of the companies are accurate. That law is a criminal, not a civil, statute. Corporate executives can go to jail for violating it. That is a very high penalty.

Why did this highly regulatory measure become law in the country that most believes in market capitalism?

The Senate of the United States approved the legislation by a vote of 97-0. In the House of Representatives, only three members voted "no." The legislation was signed into law by a Republican President who described the law as the most important securities legislation since 1934, when Democrat Franklin Roosevelt was our President.

The legislation was passed by these extraordinary majorities because the American people were furious. And the people let their elected representatives know how angry they were. In our democracy, when the people are that angry, politicians do what the people want.

Why were the people so angry? I should share with you my view of the single most dominant theme in American history: the people are very wise. The people saw that in the course of the 1990s, in the midst of all the prosperity, the private sector was going astray.

That was particularly sad, because the American private sector in the 1990s solved a major problem caused by globalization. In a global economy, a manufacturer has great difficulty competing with producers such as China and India, where costs of labor are much lower.

U.S. manufacturers could not raise their prices. Producers of services learned that globalization hit them too, except for such purely local services as legal and health services. If a company cannot raise its prices, and labor markets are tight, as they were in the U.S. in the mid-1990s, the head of the company knows that costs of labor will rise.

Corporate managers had a problem. They could not raise prices. They could finance increased costs out of what remained of profits, but they would not remain the leader of the company very long if they did that. The alternative was to improve labor productivity, mainly by investment in information technology. It worked so well that the additional wages were subsidized, leaving lots more money for improved profits. It was quite a fine performance.

For 10 years, the United States enjoyed the longest economic expansion in the country's history. What could go wrong?

Morality went wrong. In the mid-1990s, it became fashionable for companies in America to guide allegedly independent investment analysts to a view of the company's forthcoming quarterly earnings. We know that all numbers on a financial statement are estimates, including cash if the company operates in more than one currency. As a result, there is a certain amount of room for those estimates to be shaded to make the forecast. And then it became fashionable to expect and forecast ever-rising earnings, meaning, essentially, that product cycles and unexpected shocks and even the law of gravity no longer applied. It was a formula for cooking the books—and the books got cooked.

There was another motive to cook the books. If earnings are good and always moving upward, the equity market loves it, and the stock multiple improves. That is really great if you are a senior executive, and your remuneration is related to the stock price. And that was the case. In 1993, the U.S. Congress passed a law limiting the expensing for tax purposes of the remuneration of any individual to $1 million per year, unless that remuneration is incentive-based. That law was the fairy godmother of stock options, which of course are incentive-based.

And total remuneration grew spectacularly: in 1980, the average CEO of a Fortune 500 company made 40 times more than the average employee of the company. By 2000, that multiple had leaped by a factor of 10 to 400 times. I find it grotesquely immoral – explainable by no economic theory or principle other than greed.

The American people were noticing the odd behavior in the business community -- the cooking of the books, the insane levels of executive compensation -- and the people did not like it. Remember that half of American households invested in the equity market, mainly through retirement and other mutual funds. When the tech company bubble broke in the second quarter of 2000, and the market correction reached other parts of the market, these investors noticed that their total holdings were going down in value. They were increasingly unhappy.

Then the scandals came. American investors were no longer just unhappy. They were angry -- very, very angry. And they directed their anger at business leaders. Thus, the Sarbanes-Oxley Act was born.

Some have expressed concern over whether the reforms in our law will slow economic growth. Nobody every made a business enterprise great just by playing defense. You have to have a positive vision, and you have to take intelligent risks.

Organizations are made great by great leaders, who will continue to take deliberate risks. I think any concern that such leaders have about the implementation of the Sarbanes-Oxley Act is marginal.

The investing public in the United States and around the world have expressed their mistrust of the private sector. Having spent half my life in the private sector, I find that disappointing. Therefore, I regularly call upon the leaders of the private sector in the United States to show the courage to do everything possible to run their organizations better not just in a business sense, but in a business ethics sense, and in a moral sense, to restore the public's confidence.

Failures in financial reporting were among the specific concerns addressed by Congress in the Sarbanes-Oxley Act. The reliability of a company's statements of its financial condition and results of operations – statements depended on by shareholders, management, directors, regulators, lenders and investors – is the cornerstone of our financial markets.

More specifically, Congress found that the guardians who were supposed to protect the sanctity of financial statements failed in their duties. Among these guardians are directors, members of audit committees, management and, of course, the external auditors.

To address the failings among auditors of public companies, the Congress created the Public Company Accounting Oversight Board

Let me tell you a little bit about the Board and how it works. We are a private-sector, nonprofit organization. We are a nongovernmental regulator, and we are independent of the accounting profession. All five Board members are appointed by the U.S. Securities and Exchange Commission, and the Commission approves our budget, rules and auditing standards.

We are not taxpayer-funded. Our source of funding is the public companies that benefit from independent audits. About 8,800 companies and mutual funds paid a fee to support our $137 million budget in 2005.

The Sarbanes-Oxley Act directly affects as many as 15,000 U.S. public companies. Those companies are headquartered in the United States, but they often have significant operations in other countries as well. Separately, the securities of about 1,200 public companies based outside of the United
States trade in U.S. securities markets, and those companies must follow many of the requirements of the Act.

Under the Sarbanes-Oxley Act, no accounting firm can audit a publicly traded company if the accounting firm is not registered with the PCAOB.

As a result, the Sarbanes-Oxley Act and the Board's rules require oversight of all public accounting firms that prepare or issue, or play a substantial role in the preparation or issuance of, any audit report on financial statements that are filed in the United States, regardless of where the firms are located.

We currently have 1,552 registered firms. Of those, 939 are based in the United States, and 613 are based in 80 other countries.

Beginning in the earliest months of its operation, the Board commenced a constructive dialogue with non-U.S. regulators concerning the oversight of non-U.S. accounting firms that audit public companies and the possible development of cooperative arrangements for such oversight.

This continuing dialogue has demonstrated that the Board and its non-U.S. counterparts share many of the same objectives. These include protecting investors from inaccurate financial reporting, improving audit quality, ensuring effective and efficient oversight of accounting firms, and helping to restore the public trust in the auditing profession.

Underlying this convergence of views is the global nature of the capital markets. In these markets, the effects of a corporate reporting failure in one country tend to ripple through the financial markets of another, potentially causing substantial economic damage. The Board believes that the best way to fulfill its mission—that is, protection of investors in the U.S. markets—is to participate in global efforts to protect investors in all markets. To that end, the Board believes that it is in the interests of the investing public and the Board's non-U.S. counterparts to develop effective cooperative arrangements among regulators of auditors.

The Board formally adopted this approach on June 9, 2004, in its rules for oversight of non-U.S. public accounting firms. The rules were approved by the U.S. Securities and Exchange Commission on August 30, 2004.

The Board hopes that its approach to oversight of non-U.S. public accounting firms will encourage improvements in audit quality for firms in jurisdictions that have or create independent and rigorous auditor oversight systems. Already, significant changes in the regulation of non-U.S. accounting firms are underway in certain jurisdictions, including a number of proposals for the creation of new bodies to improve audit quality and verify compliance with local auditing and related professional practice standards.

The Board's approach to the oversight of non-U.S. firms endeavors to build upon the work of new and existing oversight bodies in order to minimize administrative burdens and legal conflicts that firms face and to conserve Board resources, without undermining the Board's statutory mandates.

Specifically, the oversight rules adopted by the Board set forth a model for inspections of non-U.S. firms under which the Board may rely on the work of the home-country regulator. Non-U.S. registered firms are subject to PCAOB inspections in the same manner as U.S. firms: annual inspections for firms with more than 100 public company audit clients and inspections at least once every three years for firms with one or more public company audit clients.

Currently, one Canadian public accounting firm has more than 100 U.S. issuer clients and is subject to annual inspections. The remaining non-U.S. accounting firms registered with the PCAOB are subject to inspections at least once every three years.

The degree of reliance on home-country inspections will be based on the independence and rigor of the home-country system of oversight and agreement between the PCAOB and the home-country regulator on the inspection work program for individual firms. The more independent and rigorous the home-country system, the more the Board may rely on it to conduct an inspection of a PCAOB-registered firm.

The Board has also demonstrated its willingness to assist non-U.S. authorities in their oversight of U.S. firms that are registered with the PCAOB and are also within the regulatory jurisdiction of non-U.S. authorities. The oversight rules provide for the Board to assist non-U.S. regulators on inspections and investigations of U.S. firms subject to dual oversight.

In addition to working with its counterparts in oversight of accounting firms, the Board supports efforts of non-U.S. regulators and professional bodies to develop high-quality professional standards for auditing. The Board believes these efforts lead to the use of improved standards throughout the world, resulting in higher audit quality and more reliable financial reporting. This will benefit financial statement users everywhere, including those in the United States.

Registration is a prerequisite for accounting firms to continue their work as auditors of companies whose securities trade in U.S. markets, and it is also the foundation for the PCAOB to perform its important functions of inspection and enforcement.

Our inspections and enforcement activities will also provide robust empirical and anecdotal evidence that will enable those developing auditing standards – our Board Members and staff – to set priorities and to identify needs to develop or amend standards.
The Board's standard for audits of internal control, and the other standards we have adopted to date, were developed in an independent process designed to give the investing public confidence that its needs are addressed. We have also used our inspection authority to focus registered firms on aspects of their practices that may stand as an impediment to the highest quality audit performance.
I fear that these efforts may be for naught, however, if we fail to restore the investing public's confidence in the integrity of the auditing firms on which investors rely. Without integrity and the public perception of integrity, the purpose of even a high-quality audit is undermined.
We have told the accountants that they must restore the faith of the investing public in their profession and that they will accomplish that sooner and better if they run their firms in a way aimed at doing just that.
My impression as of now is that the accountants are taking exactly that approach and opting to see the Public Company Accounting Oversight Board as an ally. That, if I am right, is a very wise choice.

We all know that corporate executives in a sophisticated economy cannot cheat all by themselves. They need help—from accountants, bankers, and yes, my friends, from lawyers. We all know enough about the involvement of some very well-known entities in the various scandals to realize that these scandals have splashed a good deal of mud on the fine white coat of their respective industries.

It is incumbent on every one of us to do our part to restore the public's confidence in the capital markets that help drive our economies. In the wake of scandals, the participants in our public markets were weighed and found wanting, but they were also given a shot at redemption.

As Chairman of the PCAOB, my goal has been to point accounting firms toward redemption, and help them take the steps to get there, if they aren't inclined to seek redemption on their own. Over the past two years, I have witnessed the auditing profession's strong start toward that goal. But restoring and maintaining public trust and confidence is an ongoing mission, requiring unfailing focus and vigilance.

What is at stake for all of us is the trust of the people. We have an opportunity to reclaim that trust. The PCAOB is working hard to achieve the objectives the Congress set for it with that goal in mind. It is striving to do its part to reduce overall risk to the investing public. It is a worthy cause, and I have been delighted to be a part of it.

Thank you.