Fordham Journal of Corporate & Financial Law

Volume 9 | Issue 3 Article 1

2004

The Fourth Annual A.A. Sommer, Jr., Lecture on Corporate, Securities & Financial Law

William J. McDonough

William Michael Treanor

John FX Peloso

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LECTURE

THE FOURTH ANNUAL A.A. SOMMER, JR. LECTURE ON CORPORATE, SECURITIES & FINANCIAL LAW*

SPEAKER:

William J. McDonough[**]
Chairman, Public Company Accounting Oversight Board

DEAN'S WELCOME

DEAN TREANOR[1]: Good evening. I am Bill Treanor, the Dean of Fordham Law School, and I would like to welcome you all tonight to the Fourth Annual A.A. Sommer Lecture.

This lecture series started in 2000. We began with Arthur Levitt, then had lectures from Mary Shapiro and, last year, SEC Commissioner Harvey Goldschmid. The lecture series has grown in conjunction with our Center for Corporate Securities & Financial Law, directed by Professor Jill Fisch with the assistance of Professor Caroline Gentile.

I am delighted to introduce tonight William McDonough, our Fourth Annual Sommer lecturer, who is Chairman of the Public Company Accounting Oversight Board ("PCAOB" or "Board").

I would like to recognize Professor Fisch, Professor Gentile, and Florencia Marotta, our Corporate Center Fellow, for all their work in

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* The lecture herein was held at the Fordham University School of Law on November 11, 2003, for the fourth annual A. A. Sommer, Jr., Lecture on Corporate, Securities & Financial Law. It has been edited with the assistance of the speaker.

** William J. McDonough served as the eighth president and chief executive officer of the Federal Reserve Bank of New York for ten years, from July 19, 1993 to June 10, 2003. On June 11, 2003, he became the first Chairman of the newly created Public Company Accounting Oversight Board (PCAOB).

1. William Michael Treanor is the Dean of the Fordham University School of Law.

putting together this evening's lecture. I would like to also recognize John Peloso of Morgan, Lewis & Bockius, which was Mr. Sommer's firm. Mr. Peloso has been so instrumental in the creation of this lecture series and in the creation of our Corporate Law Center, which is rapidly remerging as one of the nation's leading think tanks in the area.

I now turn matters over to Mr. Peloso. Thank you very much.

WELCOME

MR. PELOSO[2]: Good evening, everybody.

I am here simply for the lecture, but I am also at the podium on behalf of Morgan, Lewis & Bockius to welcome you and Mr. McDonough to the Fourth Annual A.A. Sommer Lecture on Securities Law.

As I think many of you out there know, this lecture was established four years ago by Morgan Lewis as a way of interacting with Fordham Law School to stimulate the study of securities law and as a way of helping to get started a Center for Corporate Securities Law here at Fordham, which has been done, as you just heard the Dean say.

We thought a good way to do that was to have a lecture in honor of our partner who is the one most identified with the securities world, Al Sommer. Al was a Partner of Morgan Lewis for many years before retiring in 1994. He was a practicing corporate lawyer all of his career, with some time out to be a very distinguished member of the U.S. Securities & Exchange Commission and on the adjunct faculty of a number of law schools. He was very, very active in professional affairs—the list would be too long to go through. Some of it is in your program.

He was especially connected to the accounting industry from which he received in 2000 their Gold Medal of Honor Award for years of service to the accounting industry, making Mr. McDonough's presence here this evening particularly appropriate, for which we thank you.

Al was here for the first two lectures to introduce the speaker, but right before last year's lecture he passed away. I know his lovely wife Starr was going to be here, and she may be stuck in traffic. In any event,

2. John F.X. Peloso is Senior Counsel to the law firm of Morgan, Lewis & Bockius, L.P., in New York, New York.

I like to think that Al will always be with us with these lectures because it really stands as a monument to his professional career.

Morgan Lewis is very proud of its affiliation with Al through the years. He was the founder of our securities practice and somebody from whom many of us learned a lot. We are really pleased to have sponsored this lecture in his honor.

Welcome, everybody.

INTRODUCTION

PROFESSOR FISCH[3]: Good evening. On behalf of the Fordham Law School community, I am delighted to welcome you, and add my welcome, to the Fourth Annual A.A. Sommer, Jr., Lecture.

I would like to express the School's deep gratitude to the firm of Morgan, Lewis & Bockius for their generosity in establishing the lecture.

Because we are commemorating the seventieth anniversary of the Securities and Exchange Commission in 2004, we have the honor of having the SEC Historical Society join us as well.

I would also like to express our gratitude to PCAOB Chairman William McDonough for agreeing to deliver this year's lecture.

As you know, the Sommer Lecture is one of the crown jewels of Fordham's recently established Center for Corporate Securities & Financial Law. Somehow we have had the good fortune and foresight during the Lecture's short history of identifying speakers who are able to offer us early insights into some of the most significant events affecting the business community.

This year's speaker is, of course, no exception. It is, as John Peloso mentioned, particularly appropriate to welcome Mr. McDonough tonight, both because of the prominence and importance of the PCAOB and because Al Sommer was known as a strong proponent of increased auditing and accounting disclosures.

As with previous lectures, tonight's lecture will be published in Fordham's specialized business journal, the *Fordham Journal of Corporate & Financial Law.*

3. Jill E. Fisch is a Professor at the Fordham University School of Law and is the Director of its Center for Corporate, Securities & Financial Law.

More generally, we expect the Lecture and the entire Corporate Center to continue to build on Fordham's strengths in business law. These strengths include Fordham's strong faculty, including a number of very distinguished adjunct faculty members; the Securities Arbitration Clinic, in which students represent small investors who lose money investing in the stock market; the School's remarkable alumni base, which includes top leaders in the field of business law, many of whom are here tonight; and the *Fordham Journal of Corporate & Financial Law*.

The Public Company Accounting Oversight Board was created by the Sarbanes-Oxley Act of 2002[4] to oversee the auditing of public companies in order to protect the interests of investors and to improve the quality of financial reporting. Established in response to revelations of accounting fraud and earnings manipulation at numerous publicly traded companies, the PCAOB is charged with, among other things, establishing auditing standards and overseeing auditor independence.

The PCAOB is a private sector, nonprofit corporation. Its chairman and members of the board are appointed by the Securities and Exchange Commission.

Currently the PCAOB is in the process of revising the auditing standard dealing with the auditors' review of an issuer's internal controls, as well as beginning its process of inspecting accounting firms.

It gives me great pleasure to introduce Chairman William J. McDonough. Mr. McDonough became Chairman of the PCAOB on June 11, 2003, joining the Board after ten years as President and Chief Executive Officer of the Federal Reserve Bank of New York. At the New York Fed, Mr. McDonough served as the Vice Chairman and a permanent member of the Federal Open Market Committee, the group responsible for formulating the nation's monetary policy. Mr. McDonough also served as a member of the Board of Directors of the Bank for International Settlements and Chairman of the Basel Committee on Banking Supervision.

Prior to joining the Federal Reserve Bank Mr. McDonough had spent twenty-two years at First Chicago Corp. and its bank, First National Bank of Chicago. Mr. McDonough also served with the U.S. State Department from 1961-1967 and was a U.S. Navy officer from

4. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2003) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.).

1956-1961. Mr. McDonough earned a master's degree in economics from Georgetown University in Washington, D.C., in 1962, and a bachelor's degree in economics from Holy Cross College in Worcester, Massachusetts, in 1956.

Auditing standards and auditor independence are certainly a focus of public attention today. Many have blamed gatekeepers such as auditors for failing to detect and prevent the widespread corporate misconduct of the past several years. Whether or not auditors can properly be blamed for those frauds, improving the independence and quality of the auditing process is clearly a key element in restoring public trust in the national securities markets. Mr. McDonough and his colleagues on the PCAOB certainly have their work cut out for them.

It is my pleasure to introduce William J. McDonough.

LECTURE

MR. McDONOUGH: Thank you.

I feel very much at home here. You can tell when you're in a Jesuit University when the sign of the University includes Latin. I received an honorary doctorate degree a couple of years ago from Holy Cross, and of course the whole thing is in Latin. I think that I have met three people who have looked at it and actually understand what it says.

I am particularly happy to be here today, but I am proud and humbled to be delivering a lecture honoring A.A. Sommer, Jr. I did not, in fact, have the good fortune to know Commissioner Sommer before he passed away last year, but I have learned enough about him to know that both investors and those of us charged with overseeing participants in our markets lost a great friend. The abuses that we have seen in our markets make the loss of a single voice of integrity all the more painful.

Few of us could have imagined three years ago that we would be where we are today, in a world in which accounting, auditing, and corporate governance would be subject to a strict new regime under the Sarbanes-Oxley Act.[5] Remember, just three years ago Enron was held up as a paragon of corporate success, modern and cutting edge, from its management structure to its grip on the world of energy contracts.

Now, you in this room need little reminder, but I think it behooves all of us to remember from whence we have come. The American

5. *Id.*

private sector has long been the envy of the world. Despite its faults—and there are many—our version of capitalism certainly beat anything that any state-supported economy had to offer for creating wealth and distributing it reasonably well.

Then, what happened in the 1990s to change this American private-sector economy model for the world to one in which our own American people have lost considerable confidence?

The economic expansion, which began in 1991, was quite slow in its early years, but began to accelerate in late 1993. The Federal Reserve began to tighten monetary policy in early 1994 and actually doubled the official interest rate over a twelve-month period. We at the Fed did that because the economy was beginning to speed its way through two limits on which virtually all macroeconomists had agreed as the policy guidance tools of the post-World War II American economy.

One was the rate at which the economy could grow without putting such strain on resources that inflation would follow. That speed limit, as I call it, is the sum of two parts: growth in the labor force and output per work hour, called labor force productivity. The labor force grows pretty steadily, at about 1 percent per year.[6] From 1973-1995 labor force productivity grew at an average of about 1.5 percent per year[7]—ergo, the speed limit was 2.5 percent (1 plus 1.5).

The other popular concept among economists was the NAIRU, the Non-Accelerating Inflation Rate of Unemployment. The idea is that below a certain level of unemployment the suppliers of labor demand more wages and benefits than the economy can deliver without inflation. Most, if not all, economists thought the NAIRU was 6 percent.[8]

But in 1995 the economy began accelerating at well above the speed limit of 2.5 percent and unemployment was falling below 6

6. U.S. Dep't of Labor, Bureau of Statistics, *Working in the 21st Century*, *at* http://www.bls.gov/opub/working/page1b.htm (last visited Feb. 5, 2004).

7. *See* "Major Sector Productivity & Costs Index," Productivity & Technology, *at* http://stats.bls.gov/data/home.htm (last visited Mar. 10, 2004). This website is linked to a database that is customizable for any time period between 1947 to 2003.

8. Philip Harvey, *Combating Joblessness: An Analysis of the Principal Strategies that Have Influenced the Development of American Employment and Social Welfare Law During the 20th Century*, 21 BERKELEY J. EMP. & LAB. L. 677 (2000).

percent.[9] Yet, not even paranoid central bankers could see inflation in sight, so the Fed held back and allowed the phenomenon to take place.

And did it ever! Growth accelerated, we began to create 3 million new jobs per year, and the unemployment rate fell below 5%—and still no inflation.[10]

Although it seemed a bit mysterious at first, we soon realized that there had been a breakout in productivity improvement. In the latter years of the 1990s, labor force productivity increased from the previous 1.5 percent to 2.5 percent, and has been rising since then.[11] In the second quarter of this year it was 7 percent, and in the third quarter it was 8.6 percent.[12] To the wonder of all economists, since the recession began in early 2001 the average rate of labor force productivity improvement has been 5 percent.[13] Why?

I believe that the real drive is globalization. Heads of business, obviously in the case of makers of goods, but also in many areas for the

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9. U.S. Dep't of Labor, Bureau of Statistics, *A-1: Employment Status of the Civilian Noninstitutional Population 16 Years and Over, 1969 to Date* (stating the unemployment rate for 1995), *at* ftp://ftp.bls.gov/pub/suppl/empsit.cpseea1.txt (last visited Mar. 10, 2004).

10. *Id.* (indicating that the unemployment rate for 1997 to 2001 was below 5%).

11. U.S. Dep't of Labor, Bureau of Statistics, *1993 Productivity and Costs – Fourth Quarter and Annual Averages (Revised)* (stating that the annual business sector productivity rate increased 1.8% for 1993), *at* ftp://ftp.bls.gov/pub/news.release/History/prod2.030894.news (last visited Mar. 10, 2004); U.S. Dep't of Labor, Bureau of Statistics, *1998 Productivity and Cost – Fourth Quarter and Annual Averages (Revised)* (stating that the annual business sector productivity rate increased 2.4% for 1998), *at* ftp://ftp.bls.gov/pub/news.release/History/prod2.030999.news (last visited Mar. 10, 2004).

12. U.S. Dep't of Labor, Bureau of Statistics, *2003 Productivity and Costs – Second Quarter (Revised)* (stating that the annual business sector productivity rate increased 7.2% for the second quarter), *at* ftp://ftp.bls.gov/pub/news.release/History/prod2.09042003.news (last visited Mar. 10, 2004) ; U.S. Dep't of Labor, Bureau of Statistics, *2003 Productivity and Costs – Third Quarter (Revised)* (stating that the annual business sector productivity rate increased 8.6%), *at* ftp://ftp.bls.gov/pub/news.release/History/prod2.12032003.news (last visited Mar. 10, 2004).

13. U.S. Dep't of Labor, Bureau of Statistics, *2003 Productivity and Costs – Fourth Quarter (Revised)* (stating that the annual average increase in business sector productivity was 4.5% for 2002-2003), *at* ftp://ftp.bls.gov/pub/news.release/History/prod2.03042004.news (last visited Mar. 10, 2004).

sellers of services, are competing in a world market with China, India, Mexico, and even Japan. It is impossible to raise prices.

Now, with no pricing power and a tight labor market requiring rising salaries and benefits, the business executive can either finance the increased labor cost through a reduction in profits, or he or she can invest in an improvement in productivity to both finance the labor costs and improve profitability. That latter choice is the one they made.

Some people thought we had a new world economic order and that the business cycle was dead. This was not completely irrational, even if wildly optimistic, because we did in fact have the longest expansion in American history—ten years.

But this was not a new economy, even though there were some ever-more-powerful information technology products. For the 93 percent of the American economy which produces neither IT hardware nor software, a lot of the investment was in information technology to reduce costs. Retailers are the most obvious example. When you check out of a store, if it is a really modern one like Wal-Mart, the bar code tells the clerk what to charge you, but it also updates the inventory record and the order book for replacements.

The result is that the store, or chain of stores, does not need clerks in the back room keeping inventory records, or warehouses to store the inventories. We have copied the just-in-time manufacturing system of the Japanese, and the goods arrive at the stores when they are needed. In this model you can see the costs go down very extensively, which is why Wal-Mart has been so enormously successful, and other companies follow.

Now, this was very good running of a business in response to international realities, but it was translated as something so revolutionary that the leaders of the American business community became confused. We saw confusion about the role of the CEO. We saw the advent of the CEO superstar, and an explosion in compensation that made those superstar CEOs actually believe that they were worth more than 400 times the pay of their average workers. Twenty years before, they had been paid an average of forty times the average worker, so the multiple went from forty to 400– an increase of ten times in twenty years. That was thoroughly unjustified by all economic reasoning, and in addition, in my view, it is grotesquely immoral.

We saw mass confusion over the importance of earnings reports. When the private sector pinned its success to a report, and not to actual earnings, the end was in sight. It became fashionable for public companies to encourage allegedly independent investment analysts to reach a consensus on the companies' quarterly and annual earnings, a consensus which was closely guided of course by the financial management of the company.

Then the market decided that the genius CEO was truly a genius if the company beat the estimate, which the genius had of course procreated. If he beat it by a penny or more, he was truly a genius. If he missed it by a penny or more, he was a fool. That was the atmosphere.

Now, the genius CEO really doesn't have to tell everybody in his company, or hers, to be corrupt. "You all know you all work for me. I want to make $0.45 this quarter, and we're all going to do real well, especially me, if we make $0.45 or more. So we'll make $0.45. You will all cheat just a little to make sure that we do what we say we will do. The next quarter we may have to cheat a little bit more and next quarter maybe a little bit more still." Pretty soon, it's pure *Alice in Wonderland.*

Now, the financial management of the company cannot do all these creative things without the connivance and collusion of investment bankers, commercial bankers, accountants, and even lawyers. Then the end came, and what an end it was. The shock wave started with Enron, the previous model, then rolled through Adelphia, WorldCom, HealthSouth, and others.

The American people looked at the wreckage of our vaunted private sector, and they got angry. They had been noticing that something had been going wrong, as their 401(k) plans sank south after the market broke in 2000, but they really got angry when the corporate scandals came and the perpetrators used inside information to sell the stock when the employees' 401(k) plans were frozen. The people got angry with the CEOs, with the boards, and even with those of us in the regulatory sector. In a democracy, when the people get angry, they will insist on change.

Congress and the President responded. The result was the Sarbanes-Oxley Act of 2002.[14] You have only to look at the size of the affirmative votes in Congress and the alacrity with which the President signed the bill into law to know that the politicians heard the anger too.

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14. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2003) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

Now, directors, CEOs, and accountants may be tempted to treat Sarbanes-Oxley as a "to do" list, a list of "must do/mustn't do" items, that can be tucked away once every item is checked.

But checking items and checking boxes won't cut it in this new world. Why? Because the people are still angry. I know so from meeting with many members of Congress who tell me that the mail from their constituents is heavy, and it is hot. Americans are telling their elected representatives that they are angry, and the thing they are angriest about, by the way, is executive compensation.

I am here speaking to you as an individual, and my views do not necessarily represent those of the board and the staff of the PCAOB. But I believe it is important for all of us to consider the anger of the American people and urge corrective action now.

Corporate directors should think long and hard about the compensation of the executives who head the corporations that they, the directors, are sworn to protect. In an ideal world, every CEO would go to his or her board and ask the members to reexamine executive compensation, starting with his or her own pay. What made sense two or three years ago—or probably didn't make sense two or three years ago—may certainly not make sense today.

If the CEO doesn't ask for a reexamination, I would urge board members to undertake the reexamination themselves. If the pay should be slightly reduced, what is the worst that can happen? An insulted CEO resigns or takes early retirement. He or she has the burden of finding new work or not dying of boredom in South Florida. Directors, as fiduciaries of their corporations, will have the satisfaction of having said to investors, to the public, and to the world, that "this is what the job is worth," and you and I know all kinds of people who would just love to be the CEO of that company at the new compensation package.

Now, I don't mean to oversimplify the upheaval that such a course of action would entail, but we have to start somewhere, my friends, and we have to start soon. Accountability, not just to investors but to the public at large, is what we must be all about. We are going to have to work at it, all of us, whether we are in the public sector or the private sector.

Like most you, my new job is in the private sector. The Sarbanes-Oxley Act established the PCAOB as a private-sector, nongovernmental body.[15] All five of us Board members are appointed by the Securities and Exchange Commission, and all of our rules must be approved by the SEC,[16] but there the government ties end.

The PCAOB is not a government-sponsored, taxpayer-funded enterprise. Our source of funding is the public companies that benefit from independent audits. In early August, we sent invoices to almost 8,500 public companies and investment companies for their share of our support. We are now approaching the time that we need to inform the SEC which companies have paid and which have not. Those companies that have not paid cannot get a clean opinion from their auditor—a rather strong inducement to pay.

PCAOB takes its oversight duties from the Sarbanes-Oxley Act. We exist to enforce accountability among auditors, but our responsibilities offer guidance to anyone who participates in our capital markets.

I want to say, first, that I approach my new job at the PCAOB as I approached my job as the top bank supervisor at the New York Fed. I expect that accountants, as members of a regulated profession, know what the rules are. I expect that they are following those rules both in their letter and in their spirit. I bring these expectations and the respect they engender to the table when I deal with the firms as Chairman of the PCAOB.

If they depart from those expectations—that is, if they break the rules, or if they ignore the spirit of the law even while respecting the letter—our dealings will be most unpleasant. There will be consequences, and they will be grave.

The members of the accounting profession are going to have to prove that they have earned the people's trust. They will have to work not to get back to where they were before the corporate scandals—you can never go backwards—but to a better place. They will do that by living up to the letter and spirit of the law.

I had the opportunity to share those thoughts in September in my first public speech as head of the PCAOB with the New York State Society of CPAs. I did not receive a standing ovation after my speech, but I wasn't chased out of the room by angry accountants either. I was happy to later read a report that one of their members described my

15. *Id.* at § 101.
16. *Id.* at § 107.

message as "tough love." I like that. One of my most important jobs as Chairman of the PCAOB is setting the tone for our oversight of public accounting firms, and "tough love" is a good start.

As a functioning entity, the PCAOB opened its doors on January 1st of this year. At that time there were four Board members and barely as many staff. I joined the Board on June 11th, exactly one day after I left the Federal Reserve Bank of New York.

The staff has now grown to a talented and dedicated band of almost 100 hardy souls, and we are continuing to grow. I would be remiss if I did not make a bit of a recruiting pitch here. If you have friends who you think might be right for our exciting work at the PCAOB, by all means encourage them to apply.

We don't want zealots, but we don't want pussycats either. We are looking for good, experienced accountants, and we are looking for the right spirit too. We are also looking for some very good lawyers, but a smaller number.

We want people who understand our mission: to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. In other words, we are in business to hold auditors accountable for their work.

We are going about that mission by fulfilling the four key tasks set out for us in the Sarbanes-Oxley Act: registration, inspection, enforcement, and standard setting.

Now let's start with registration. Under Sarbanes-Oxley and the Board's rules, any accounting firm that audits a company whose securities trade in U.S. markets or plays a substantial role in those audits must be registered with the PCAOB to continue doing that work.[17]

Registration requires the firms to provide the Board with a prodigious amount of information about the people who work for the firms and about the companies they audit. We did our best to make the requests for information comprehensive but not overly burdensome. Because we are modern people, all of the registration has been done on-line, no paper.

As of this week, 711 firms have applied to register with the Board, and thus far we have approved the applications of 648 public accounting firms.

17. *Id.* at § 102.

As I mentioned, registration is a prerequisite for accounting firms to continue their work as auditors of public companies. Registration is also the foundation, established in the Sarbanes-Oxley Act, for the PCAOB to perform its important functions of inspection and enforcement.

The Board recently approved our rules for investigations and hearings. The Board has also approved our inspection rules and those awaiting SEC approval.

In the meantime, we commenced limited inspection procedures at the Big Four firms with an experienced team of auditors. Now, you may think—we've got 845 firms, and you start with four. Well, if you're thinking of market share, if you look at the market capitalization of the Fortune 500 companies, the large four accounting firms have a 99 percent market share.[18] So if we save their souls, we are probably pretty well on the way to a better, more wonderful world.

Soon we will launch the regular inspections called for in the Act.[19] Regular inspections will occur every year for firms with more than 100 audit clients. All other firms will be inspected once every three years. The number that will have the joy of seeing us annually is eight, the Big Four and then the next, quite a lot smaller, four.

Also, when the Board thinks circumstances warrant, we can order a special inspection regardless of timing.

To facilitate inspections of more than 200 firms per year we have opened a regional office in New York— Esslie Hughes, an accomplished banker at the Bank of New York, is in charge of it—and we are well on our way towards opening three more regional offices: one in the San Francisco area, one in Dallas, and one in Atlanta.

Our inspectors will be looking for the compliance required in the Sarbanes-Oxley Act—that is, compliance with the Act, the rules of the Board and the SEC, and professional standards. Our inspectors will look for the tone at the top of the firm: does the managing partner and audit team leader understand what is demanded of the accounting firm in this new era of regulation and oversight? Do they understand the standards for audits? And, just as important, do they understand why

18. General Accounting Office, GAO-03-864, Public Accounting Firms: Mandated Study on Consolidation and Competition 1–2 (July 30, 2003) [hereinafter GAO Report] (stating that the "Big 4" accounting firms "currently audit over 78% of all U.S. public companies and 99% of public company annual sales").

19. Sarbanes-Oxley Act of 2002 § 104.

those standards are in place? Do the managers lead by example, demonstrating every day the value of those standards?

The Board and our inspectors want to know if the message of doing the right thing is reaching the rank and file in the firms. Obviously, the people at the top of the firm are going to say the right thing—what choice do they have? The important thing is are they getting the message down to the people on the firing line who actually do the work? So our inspectors will talk to the managers. They will also talk to the least-experienced members of the audit teams to find out if that message is reaching them. We will look at how often and how well the message is delivered.

We will look at compensation and promotion. Are the best auditors rewarded for being the best auditors, or are they rewarded for something else, like bringing in outside business? We will look at how clients are selected and how they are let go.

Obviously, our inspectors will look at individual audits as well. We will identify and examine the audits that carry the most risk, and we will sample what should be simpler, more routine audits.

Finally, I want to describe the changes ahead in audit standards. The Act charged the Board with establishing auditing and related attestation standards, quality control standards, ethical standards, and independent standards. Even to the eyes of a former bank regulator those are a lot of standards to be set.

Perhaps in recognition of the magnitude of the charge, the Act gave the Board the power to designate or recognize any professional group of accountants to propose new standards. However, before I arrived in June, my fellow Board members determined not to exercise the authority to delegate, but instead voted to set the standards from within the PCAOB. It was a decision I heartily endorse and clearly was consistent with the intent of Congress. As all of you know, in understanding any act of Congress you have to go look at the legislative history and find out what they really wanted in addition to what they wound up putting on paper. As sometimes happen, we had that option, but we shouldn't have used it, and we didn't.

As we go about our work, the Board is fortunate to have the expertise of Chief Auditor Doug Carmichael and his Deputy, Tom Ray. They have assembled an excellent team, and they and the Board will be drawing on the expertise of a standing advisory group, which is in the process of being formed. We are now accepting nominations to that group, and we have posted the information on our Web site. I hope some of you will consider service as an advisor on auditing standards.

The first standards to come from the Board are those prescribed in the Act relating to auditors' attestation to management's assessment of internal controls.[20] It sounds like something a lawyer would create, doesn't it? In other words, do they have internal controls over financial accounting, and do they work?

We proposed those standards in early October and received comments through November 6th. These proposed standards are important because they require new oversight of the corporations and carry direct consequences for audit committees.

In those proposed standards, the Board suggested that auditors should make note of the effectiveness of the corporation's audit committee, including whether the committee is independent of management.[21] Some commentators have suggested that such a requirement places auditors and audit committees in an untenable conflict: because an audit committee must approve the outside auditor, does the auditor really plan to go and say the audit committee which picked him is incompetent? I had to think about that myself, as you can tell by the way I just expressed it.

But I have come to believe that our proposed standards would empower both auditors and audit committees. Think of it: why would an audit committee be ineffective? Because the management wants a ineffective audit committee, and hopefully not a very good audit firm, because if you are planning to do a little graceful, creative cooking of the books you don't want the cops to be very vigilant. By empowering the auditor and the audit committee, we make them both lean on the management and say "this has to be taken seriously." So if you are a director or sitting on an audit committee, you should welcome an assessment, I think, by the auditor you hired, and the auditor should feel comfortable giving a report card on the directors in charge of the appointment.

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20. *Id.* § 404.

21. PCAOB, Briefing Paper, Proposed Auditing Standards: An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements 9 (Oct. 7, 2003), *at* http://www.pcaobus.org/rules/2003-10-07_Proposal_Brief-Proposed_Auditing_Standard.pdf (last visited Mar. 22, 2004).

As for other audit standards, the Board adopted certain existing standards on an interim basis. Those are in place and enforceable as Board rules while we conduct an exhaustive review of what is on the books now and set our priorities for creating new standards.

Standard setting alone is a big job for a brand-new organization. As a functioning entity, the PCAOB will reach a first birthday in about two months. Add to the standard setting the unprecedented registration of public accounting firms, as well as inspections and enforcement, and you can see why I am intensely proud of the staff at the PCAOB.

You may be wondering why, after I had announced my plans to retire from the Federal Reserve, I could be persuaded to take on the chairmanship of a fledgling organization with such a huge amount of work ahead of it. I was amenable for a lot of reasons, not the least of which was eleven years of Jesuit education on top of eight years of Dominican nuns, which makes me incapable of refusing public service.

But I took the job because of the opportunity to make a difference, to do my part to help restore some of the confidence that people lost in our markets and our public companies. The PCAOB is going to require more work than I might have intended to do at this stage of my life. The opportunity was undeniable.

In the wake of Enron and Arthur Andersen, 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 job is to point accounting firms towards redemption and help them take the steps to get there if they aren't inclined to seek redemption on their own.

What is at stake for all of us is the trust of the American people in our markets and the companies that drive our economy. We have an opportunity to reclaim that trust, and I for one am delighted to grab that opportunity, and I hope very influential people like all of you, especially including the students, will join me.

Thank you very much.

I have been allowed by Jill to actually field questions myself. Going back to my life as a central banker, there is no such thing as an indiscreet question. Answers can be quite indiscreet.

Would anybody like to ask the first question so that I don't have to start asking you questions?

QUESTION: How do you feel about lawyers providing non-lawyer services, as the accounting firms have done so in the past, and that led to some conflicts?

MR. McDONOUGH: I guess I know more about accountants providing non-accounting services, like legal services, than I do about lawyers providing non-legal services, largely because I have spent so much time with lawyers in my life that I think they are geniuses and experts on everything, so how could they not? I really can't give a serious answer, so let me shift to the accountant side of it.

My job is a little frustrating because the area of responsibility that we have in dealing with an accounting firm is partial, not total. We have responsibility only for the work that they do on audits of public companies. They do all kinds of work, including legal work in some firms, for companies for which they do not do an audit, and nobody controls that unless it is against the law.

Now, I heard, as some of you did here, Senator Carl Levin of Michigan give a rather fiery speech yesterday at the Crime Commission in midtown. What he is talking about, with very good reason, is tax avoidance shelters. My view on that is that if an accounting firm is attempting to regain public confidence, how can it be giving advice to anybody that is so close to the edge of the law, and frequently over the edge of the law, that it is going to bring discredit on the firm? I think that is a very dumb thing to do, because I think we are in a position in which they have to restore confidence in them by the American people.

Anybody else?

QUESTION: Could you comment on the reasons behind the choice of a nonprofit organization as a forum, and how might that influence the international cooperation that was mentioned in a recent [inaudible] paper?

MR. McDONOUGH: We were created as a not-for-profit corporation largely so the PCAOB could pay better than government. I think the history of the Act is that the PCAOB part of it began in the Senate with the then-Chairman Paul Sarbanes of Maryland, Christopher Dodd of Connecticut, and John Corzine of New Jersey being very actively involved. They realized that they were piling an immense responsibility on a startup, and so one of the things they figured out is you're going to have to pay people better than the government can pay people.

So we are competitive with a big accounting firm, and we pay about twice as much as the U.S. Government can pay for a similar position. That is why we are a not-for-profit.

It didn't give us any trouble at all in our recent discussions on the international aspect—and thank you for letting me get into that.

When I arrived on the scene in June, there was an absolute exchange of heavy intercontinental missiles going back and forth across the Atlantic. People on this side were saying, "We will not negotiate anything"; and people on the other side were saying, "It is extraterritorial, and who are these Americans to come and inspect our accounting firms?" I inherited that.

Well, formerly I was Chairman of the Basel Committee on Banking Supervision, and I dealt with exactly the same people in Europe, Japan, and Canada and every place else. So I decided, "*Piaci*, *piaci*, peace shall be made," and took myself over to Brussels to the European Commission and said, "Look, all this extraterritorial stuff really doesn't make a whole lot of sense. We all have a problem in that the world economy is a single geopolitical, geo-economic entity. Laws are those of the nation state, and the two will never work perfectly together. What the Sarbanes-Oxley Act is trying to do is to protect American investors from phony financial statements. Well, a lot of people who invest in securities in the United States are not Americans. A lot of Americans invest in securities issued in other countries. Once you think back, you think aren't we both trying to protect investors?"

"Right."

"Well then, why don't we do it together."

We contacted the European Commission deliberately because you have the efficiency of dealing with fifteen countries at the same time. Also, I knew the people there. We have worked out an arrangement by which they will help us, and we will help them. We are in the position now that the entire confrontation has been removed.

How will it work? If, for example, we have to go and inspect an accounting firm in Paris, I am the only fluent French speaker at the PCAOB. I don't want to go do the inspection. If I send fifteen people who speak wonderful English but no French, they will get some great meals, but they won't accomplish anything. So wouldn't it be a lot better if we had a deal with the French overseers, who are very good, by the way; and they are about to pass a statute[22] which would make them essentially identical to our structure, so independent of the profession financially and organizationally. So we will ask the French inspectors to do it for us.

If they have a reason to inspect an accounting firm in the United States that audits a French company, we will do it for them. Everybody has decided this is one great idea and that it can work out very well.

Now obviously, if you have an issuer of securities in a place where the rule of law is not all that it might be, then we will have to be much more penetrating. But the alternative of the people in that country is that we will just de-list the securities. That is pretty serious stuff.

So it is working out very well.

Sir?

QUESTION: I'm just wondering. You alluded to the oligopoly essentially that exists with respect to auditing, at least for the Fortune 500 companies, and probably extends below the Fortune 500. Is that harmful to your efforts to regulate the industry? I mean, should steps be taken, in your opinion anyway, to change that?

MR. McDONOUGH: It is a marvelous question. The answer is we don't know what to do about it.

The General Accounting Office did a very, very good report on the concentration in the accounting profession.[23] It came to the conclusion that the first thing you think of is that four are too few, so let's create some big ones by putting together good regional firms, and then you say, "Okay."

They are not there. If you put the next five firms together, they would be about half the size of number four. So you don't accomplish very much that way. You think it might happen over time, but over time is going to be quite a long time.

Then the next logical idea that comes to your mind is, "Let's break up the Big Four and make eight." But when you get into exactly how

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22. Financial Security Act, passed August 1, 2003 (statute no. 2003-706 of 1 August 2003).

23. *See* GAO Report, *supra* note 18.

you would do it and whether you would have eight damaged animals instead of four healthy oligopolies, you come to the conclusion that that isn't a very good idea either.

So I think we live in the real world of four, which is why you have to really lean on them to get their act together. To put it in religious terms, as I did in my prepared remarks, what I have told the people in the Congress and then the people in the firms is, "I don't have enough cops to have you rise to a new level of morality and culture unless you want to do it yourselves."

Now, they are making all the right noises about wanting to do it themselves. And why shouldn't they? Who benefits more from their restoring their reputations than they do? And I understand that.

They don't like the fact that—you know, ten years ago if you made a joke about accountants, it was that they're boring. Now they may still be boring, but they also have been helping companies cook the books. Well, that's not so good, and they are feeling kind of ashamed of themselves, even the ones who say, "I never did that, but the guy down in the next office might have." So I am quite convinced that they want to change.

Now, we represent the public interest, so if there is a flagging of enthusiasm on their part, we take a little torch and get them going again. But what I told the Congress and told them is, "We do not have to prove that the PCAOB is tough, or that its Chairman is a tough guy, by hanging people in public in order to prove how macho we are." That would be a very dumb thing to do. It's tempting, but it's not very smart.

So we want to be, I would say, a just but firm representative of the public interest and not Savonarola burning people at the stake to illuminate the square of the lovely city of Florence.

One last question. Professor Gardner?

QUESTION: Do you feel that the abuse of stock options is a major explanation for the excesses of the 1990s, and what changes in accounting rules would you recommend?

MR. McDONOUGH: Many people would attribute the importance of stock options in the 1990s as the law of unintended consequences from a very well-meaning piece of legislation that said that a company could not expense the salary of any individual at more than $1 million unless it was performance-related.[24] Stock options are performance-related, and so the stock option industry came in.

Then the executive compensation advisers came in. Let me tell you how that works. I'm a wonderful, brilliant CEO. I hire you as my consultant on compensation. The first thing you say to me is, "Bill, you're really a genius." Well, how does this person know I'm a genius? We just met. He knows I'm a genius because I hired him or her. So by definition I'm a genius, and I have great judgment.

Then he decides: "Okay, here's a peer group, which just happens to be a group that is very well paid, and since you're just so damn smart, you've got to make in the top 25 percent of the peer group." That, I think, was more insidious than the instrument of the stock option.

I think it's highly likely, because they have already said they are going to do it, that the Financial Accounting Standards Board will say that stock options should be expensed. Now, that doesn't happen until and if the SEC approves it.

A difficulty with that is that it is very difficult to figure out how you value options. The famous Black-Scholes model is kind of the best we have, but you can shoot holes through it fairly easily. If you work for me and I say, "Dick, I'm giving you a bunch of stock options, but when you exercise them, if you sell one, you're a dead man and out of here," that means that that stock option is worth much, much less than if I hadn't told you that. And nobody is altogether sure how you value that.

So I think we will be expensing stock options. There will probably be agreed-on formulae to do it. I don't think it in and of itself will accomplish very much, because a lot of firms are doing what Microsoft announced: instead of stock options, they are going to give stock grants, which are immediately expensed. Therefore they are a little bit cleaner in that respect.

But I think what we really have to get to is a view of how much are people really worth? The reason that I harp on this issue and why I talk so much about the anger of the American people is that I think that what we're really in danger of these scandals continuing.

The mutual fund scandal is one big mess. If there is anything that would have made most Americans angry, that is it—more than Enron, more than WorldCom. If you're being screwed on your mutual fund, that doesn't make you feel too good.

24. 26 U.S.C. § 162(a) (2003).

Now, if this persists, the deal that made the United States of America work is at risk. The deal is that you could be born in a very poor family, but you had a chance to be president of the United States, you had a chance to be the head of U.S. Steel, you could be the dean of the Fordham Law School—anything was open to you. The number of people who in surveys say they are sure they are going to be millionaires is way above the number that are ever going to be millionaires, but it proves that people think it is there.

If people begin to think that the top of the heap is filled with people who are crooked and have their own little club, and admission will be either difficult or you've got to be crooked too—or in a university which is supposed to train people to be straight, to be honest—well, then the American dream goes away.

What would be the practical effects of that? Well, the American dream doesn't exist in most of the countries very much like us in continental Europe. So government is much bigger, the private system doesn't work as well, and the system that I think has worked pretty well for us could be in danger.

That is what makes me think that the leaders of the private sector—and, unfortunately, there is not a great deal of evidence that they are doing it—are simply going to have to understand that they have to look as if they have a new view of ethics and morality in order to win back the confidence of the American people.

And this I think is not a pipe dream. I think that the belief of the American people in the system is at risk, and that's why people like us have to do something about it.

Thank you very much for your attention.

1956-1961. Mr. McDonough earned a master's degree in economics from Georgetown University in Washington, D.C., in 1962, and a bachelor's degree in economics from Holy Cross College in Worcester, Massachusetts, in 1956.

Auditing standards and auditor independence are certainly a focus of public attention today. Many have blamed gatekeepers such as auditors for failing to detect and prevent the widespread corporate misconduct of the past several years. Whether or not auditors can properly be blamed for those frauds, improving the independence and quality of the auditing process is clearly a key element in restoring public trust in the national securities markets. Mr. McDonough and his colleagues on the PCAOB certainly have their work cut out for them.

It is my pleasure to introduce William J. McDonough.

LECTURE

MR. McDONOUGH: Thank you.

I feel very much at home here. You can tell when you're in a Jesuit University when the sign of the University includes Latin. I received an honorary doctorate degree a couple of years ago from Holy Cross, and of course the whole thing is in Latin. I think that I have met three people who have looked at it and actually understand what it says.

I am particularly happy to be here today, but I am proud and humbled to be delivering a lecture honoring A.A. Sommer, Jr. I did not, in fact, have the good fortune to know Commissioner Sommer before he passed away last year, but I have learned enough about him to know that both investors and those of us charged with overseeing participants in our markets lost a great friend. The abuses that we have seen in our markets make the loss of a single voice of integrity all the more painful.

Few of us could have imagined three years ago that we would be where we are today, in a world in which accounting, auditing, and corporate governance would be subject to a strict new regime under the Sarbanes-Oxley Act.[5] Remember, just three years ago Enron was held up as a paragon of corporate success, modern and cutting edge, from its management structure to its grip on the world of energy contracts.

Now, you in this room need little reminder, but I think it behooves all of us to remember from whence we have come. The American

5. *Id.*