

**WRITTEN TESTIMONY OF**

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**BEFORE THE**

**FEDERAL ADVISORY COMMITTEE ON THE AUDITING PROFESSION  
UNITED STATES DEPARTMENT OF THE TREASURY**

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Chairman Levitt, Chairman Nicolaisen, members of the Committee, Treasury staff and observers, good morning:

Thank you for the invitation to appear before you today to present PricewaterhouseCoopers' perspective on this important study aimed at enhancing U.S. capital markets' competitiveness and fostering a more sustainable auditing profession.

The auditing profession has seen a significant amount of change in the last ten years. Those changes, which in the United States included the passage of the Sarbanes-Oxley Act of 2002, culminated in the creation of a comprehensive regulatory framework that brought with it the first external oversight of the U.S. auditing profession. From my perspective, this was the most profound – and in most respects constructive -- regulatory change affecting the profession since the passage of the federal securities laws in the 1930s. I am an auditor and have led the U.S. firm of PricewaterhouseCoopers since April 2002. I can tell you that the quality of the work done by our firm and the profession has benefited from these developments.

Over the next ten years, we will see an acceleration in the pace of change affecting the profession. The growth rates of emerging economies around the world, the use of technology to draw populations and information instantaneously closer and closer together, and the increasing mobility of a global workforce will combine with profound consequences for the auditing profession. While one cannot be certain how the future will unfold, we are already seeing the impact of these trends. There is no reason to expect their influence will diminish over time.

Take, for example, the impact of technology on the operations of major American business and the collateral implications for auditing. One can imagine a scenario where continued technological innovation, when combined with geopolitical trends, will challenge the profession to significantly alter what we think of today as auditing. Technologically-driven enhancements in data quality and accessibility, coupled with the imposition of global standards and the move to an accounting model based more on fair value, could require the profession to broaden its focus beyond audits of financial statements to include more comprehensive reviews of underlying data, controls, processes and non-financial data. It also would impact how we audit, such as requiring that audit procedures be performed where the most appropriately skilled workforce resides, rather than where the client is located. And it would have implications for the requisite qualities and capabilities of the lead engagement partners, who would manage those audit teams.

We believe the time is right to focus on the future, and this view informs our enthusiasm for the work of this Committee. We would frame the overriding question as this: what changes over the next ten years are most likely to enable the auditing profession to carry out its responsibilities in a manner that will enhance U.S. capital markets' leadership in an increasingly global economy? I will devote my testimony this morning to providing you with some thoughts on what we see as the most critical issues.

## **A. Firm Structural Considerations**

Let me begin by addressing the explicit topic of this panel — Firm Structure and Finance.

### **1. The current framework**

Through a global network affiliate structure, large accounting firms import local accountability, maintain global consistency and enhance audit quality. PricewaterhouseCoopers, like many of the largest global accounting organizations, is organized as a network of global affiliates, each of which operates nationally or regionally and is regulated at that level. The network structure is driven by national regulatory requirements that restrict equity ownership in accounting firms to locally licensed public accountants.

Global reach is an increasingly important requirement for any major public accounting firm serving clients that are operating in an increasingly globalized economy. Over time and in response to a business climate that features both cross-border opportunities and cross-border risk, global accounting firm networks have increased oversight and compliance monitoring over their member firms.

The level of consistency and integration across the member firms of a global organization is correlated with the overall powers of the network (or umbrella) organization. Through membership agreements, the network organization promotes audit quality by imposing standards for the admission and continued participation of individual firms in the network. It also coordinates high quality, competent teams of professionals to make the best use of the organization's intellectual capital, while creating an environment where professional risks are anticipated and addressed. In addition, firms can achieve global firm and personnel independence of multinational clients by imposing national and global independence compliance tools, procedures and policies across the network.

The firms that comprise the PricewaterhouseCoopers' organization, like the other public accounting firms, are capitalized primarily through the equity investments of their partners. Partner capital constitutes a channel through which the firm acquires and retains human talent (*i.e.*, the auditors are themselves the owners) and firm profits do not need to be directed to outside investors as remuneration for their capital investment. The independence rules do, however, limit the firm's access to outside debt that can be necessary to finance growth or diversification.

### **2. Promote structural stability through alignment of the regulatory and legal framework**

We understand that the Committee will study whether financial solutions, such as a review of the means by which accounting firms might access outside equity investment, would promote firm sustainability. We believe that such study is worthwhile. At the same time, we urge the Committee to consider the broader question of whether the current legal and regulatory framework is likely to be aligned with the markets of the future. For example,

increased recognition and acceptance of well-reasoned, documented, professional judgment is especially critical to the successful implementation and long-term viability of a single set of principles-based, global accounting standards. This will be critical to ensure that the principles-based standards continue to evolve and do not suffer from the rule-based complexity that plagues our current system.

For example, at the federal level, the current disciplinary model of negligence-based professional standards should be reviewed, particularly in a world that promises a more principles-based framework. When combined with binary sanctioning under which a professional's career can effectively end in one proceeding, the negligence-based standard has the potential to disproportionately punish practitioners acting in good faith.

We also would urge the Committee to examine the protocol for PCAOB inspection teams and provide recommendations for continuing to fine-tune and enhance the collaborative exchange and respect for professional judgment. I would acknowledge that under the leadership of PCAOB Chairman Olson, this challenge has been acknowledged and progress is being made. We look forward to continuing to work together as these challenges are addressed.

Changes in the legal environment also should be considered. Ideally, the Committee's review should be broader than simply reviewing the need to provide liability relief for accounting firms. In our firm's view, solutions aimed at insulating the auditing profession from some of the consequences of the U.S. litigation system miss the point that the system itself should be examined. For example, much of the litigation risk for accounting firms stems from the firms' recurring role as defendants in securities class action litigation. Rather than beginning with consideration of liability caps or funding mechanisms to deal with the financial consequences of that kind of litigation, we would urge the Committee to study first the root causes of the problem, and consider whether the U.S. securities litigation system efficiently accomplishes the goals of compensation and deterrence. Broad-based securities litigation reform is an important component of the U.S. capital markets competitiveness debate. As participants in that debate, the accounting firms have a strong interest in the Committee's review of this broader issue.

## **B. Human Capital Considerations**

As we assess the future of our firm and the profession, no issue is more important than our ability to attract and retain talented professionals from diverse backgrounds who can be deployed efficiently in an increasingly global marketplace.

### **1. Support the benefits of an interdisciplinary firm**

Firms like PricewaterhouseCoopers – serving large, multinational, public companies - must increasingly be able to recruit and retain individuals with specialized knowledge and expertise who complement the work of the auditors. Areas such as tax, enterprise information technology applications, finance, treasury management and the use of complex financial instruments, among others, require that auditors have a fundamental understanding of these issues to conduct an audit and make reasoned judgments regarding controls and accounting, but increasingly require additional and more specialized expertise by individuals specially trained in these areas. Those specially-trained individuals help the audit engagement team to ensure the highest audit quality. The individuals who bring more specialized knowledge and expertise of these increasingly complex areas are not necessarily trained as auditors, in part because of the significant costs associated with training and maintaining highly specialized skills and knowledge. Instead, these individuals

are able to bring their expertise to assist with and enhance the quality of the audit, as well as to provide services to non-audit clients. By providing a variety of services, firms are able to coordinate the right exchange of ideas, knowledge, expertise, and experiences among their people and to deliver specialized understanding and higher quality to the audit engagement.

The ability to draw upon this specialized knowledge of a broad range of subject matter experts and the need to deploy that knowledge and expertise effectively in the context of a complex, global audit will also change the requisite skill set of the audit engagement partner. For example, the move to fair value measurement necessarily will require that engagement partners are well-versed in sophisticated valuation techniques. At the same time, determining how to deploy an increasingly global, multi-cultural workforce, and coordinating work that could lead to reporting on information generated under evolving global accounting standards promises to increase the degree of difficulty on what is already a challenging responsibility. In that context, an engagement partner should be able to draw upon process improvement experts to design an audit that is both effective and efficient. In short, we believe enhancing the profession's ability to recruit and retain individuals from a variety of educational backgrounds and professional experiences is one way the challenges of the future will be met.

In addition to enhancing audit quality and supporting an increasingly diverse workforce, this multidisciplinary approach has an important, but indirect benefit of enlarging the firm's capital pool while also spreading the risk associated with the audit practice across a larger, multi-faceted firm. We hope the Committee will take a fresh look at the current complexities and challenges associated with conducting high quality audits, as well as the firms' ability to attract individuals who have the specialized skills needed to ensure an increasingly valuable and high quality approach to the audit.

## **2. Modernize accounting education and training**

Now, and as we look forward, accounting education and training must be a priority. This is an area that we hope will attract significant attention from the Committee, in part because we believe that the impending convergence of global accounting standards signals the critical need to modernize university accounting curriculum and to address the related issue of identifying and supporting the next generation of dedicated accounting and auditing professors.

The increased call for professional judgment that principles-based standards will require further emphasizes the need for additional training for auditors and the use of specialized resources. In order to reap the benefits that a principles-based, global accounting and auditing framework will provide, the following should be considered:

- Modernize and enhance the university accounting curriculum, which should include consideration of other global curriculum models to increase knowledge of International Financial Reporting Standards (IFRS), finance and economics, and process controls.
- Encourage academia to address the time and tenure challenges related to the declining number of Ph.Ds in accounting, including promoting more funding options for faculty and curriculum improvements.
- Enhance accounting faculty education through programs such as sabbatical leave to enable time to train with firms.
- Reform immigration law to allow for a larger number of highly qualified foreign students and faculty into the U.S. for long-term residency.

- Consider the 150-credit hour requirement to ensure that in its current form it adequately contributes to the quality of preparatory education, skills and certification.
- Encourage the profession to increasingly provide a “stay and contribute” employment model which recognizes the value of having non-traditional career paths.

We recognize that the profession has a significant responsibility in supporting the modernization of accounting education, and we are prepared to do our part.

### **3. Increase the Efficiency of U.S. Regulators, Standard Setters, and Licensing Bodies**

Global standards also create increased international opportunities and mobility needs for professionals as a result of the transferability of technical skills across territories. This will provide the firms greater opportunity to deploy globally well-qualified teams, as one of the major barriers (different accounting frameworks) will have been eliminated.

Given that development, we believe the Committee should examine the consequences to accountants and auditors of streamlining what are often divergent licensing and state-by-state regulatory approaches in the U.S. A world in which a single standard for accounting standards is acknowledged and adopted around the world seems inconsistent with the current U.S. licensing regime with the potential for 50 states to establish and maintain differing licensing and other regulatory impediments for professionals practicing across state and national boundaries.

While a number of states already acknowledge this challenge and appear willing to work collaboratively toward a more consistent approach to interstate mobility, that effort only addresses one element of the current divergent state-based system of regulation. We urge the Committee to consider ways to encourage a more streamlined approach to this model where state and federal regulators work hand-in-hand to ensure a consistent and uniform approach to regulatory and licensure issues. Such changes would help to reduce complexity for large and small firms alike, and would also help to further enhance mobility.

### **4. Reassess the Application of the Independence Rules**

A final aspect of the human capital issue is the interplay of professionals and the independence rules. Independence forms the bedrock of credibility in the auditing profession, and is essential to the firms’ primary function in the capital markets. As such, the independence rules are most beneficial to investors and other stakeholders in the capital markets when they are robust, conceptually sound, well understood, and risk-based, allowing them to stay in step with an increasingly complex, global marketplace.

The independence rules should be re-evaluated periodically to examine whether the rules continue to strike the right balance between cost burden and benefit. For example, the definitions within the independence rules such as “affiliates of audit clients,” “covered period” for audit and professional engagement periods, “covered person,” “significant office,” and scope of service restrictions should be examined to ensure that the rules do not unnecessarily prohibit or restrict choice in a way that can lead to diminishing the attractiveness of the profession to necessary talent, and further exacerbating concentration challenges. We would urge the Committee to examine the current independence rules and recommend a more risk-based approach. The broader use of a materiality standard for the independence rules should also be examined, particularly those relating to global affiliates.

### **C. Improvements to U.S. Standards**

Over the last several decades, the U.S. has developed a financial reporting, accounting and auditing regimen that has served well the U.S. and the global economies. As auditors, we believe that the Committee should consider the following types of reforms to that framework.

The standard applied to determine materiality in financial reporting must be based on both an increased recognition of the use of professional judgment and a better definition of what is relevant and necessary for capital market stakeholders. The significantly increased number of restatements over the past couple of years further highlights the need for materiality to be the subject of renewed study.

Few accounting issues are more important or, at the same time, create more confusion than the auditor's role in relation to fraud. It is essential that all stakeholders engaged in financial reporting have roles to play in the prevention and detection of fraud. Nonetheless, there is a significant "expectations gap" between what various stakeholders believe auditors can and should do related to fraud based on current financial reporting requirements. While prevailing audit standards provide guidance about what auditors can do to uncover fraud if it exists, there are limits inherent in the audit process, in part because auditors are limited to indirect means such as looking for anomalies in accounts and records, interviews of employees, and a review of internal controls to ascertain whether fraud has occurred. Recognizing that the profession supports research into new approaches, methodologies and technologies, we would encourage the Committee to study what more should be done to expand the capabilities of auditors to narrow the "expectations gap."

We also believe that increased transparency by the firms can help narrow the expectation gap. Through its inspection and oversight regime, the PCAOB has been given access to a broad range of proprietary information on both client engagements and information held within the firm partnerships. We believe this information is necessary for effective oversight of the firms.

We also believe that public disclosure about key elements that drive audit quality would be a useful benefit to the capital markets. This public transparency we envision could include firm disclosure and discussion of the levels of partner and staff turnover, average hours of professional training, risk management and compliance measurements, and metrics related to the quality of management and firm governance processes.

#### **D. Evolving Global Standards**

For the U.S. to continue as a global capital markets leader, we believe it is critical for U.S. policy makers to not only recognize and embrace the globalization of the capital markets, but to formulate a comprehensive framework to address the global financial reporting requirements of the future.

The convergence and the acceptance of International Financial Reporting Standards (IFRS) and, in the longer term, international auditing standards, are issues at the heart of globalization, and the future of the auditing profession. These issues provide an important platform for addressing and reducing complexity and for increasing global consistency. However, to be effective, it will require more than just a principles-based standard that is protected by a regulatory and legal infrastructure that supports the same goal. To achieve the kinds of significant results we hope to see, entities like this Committee must take into account a number of other critical considerations – many of which I have discussed today. Only then will the framework be strong enough to ensure that the goals of this significant

change are as significant and positive for the future of the capital markets as they should be.

The same need to recognize and embrace changes in reporting standards must also be applied to auditing standards. Disparate auditing standards around the world will not allow the profession to adopt the changes necessary to address globalization. In addition, a single set of global auditing standards should enable the profession to audit in a manner that is effective, efficient, and with a level of quality that can be consistently expected worldwide.

It's not difficult to imagine a world where the combination of single reporting standards, more cohesive global auditing standards, as well as the other changes discussed above -- such as the trend to fair value measurement -- lead one to consider whether it is necessary to change the content of the auditor's report to be more relevant to the capital markets and its various stakeholders. We would support the Committee's study of the content of the auditor's report as an aspect of an important and critical forward-looking agenda.

#### **E. Conclusion**

Again, I thank Secretary Paulson, the Treasury Department and this Committee for the opportunity to appear before you this morning. I applaud your focused examination of these important issues which, when properly implemented, will enhance the U.S. capital markets competitiveness, strengthen financial reporting and foster a more sustainable auditing profession for the future. I would be happy to answer any questions you may have.