

The thoughts of Chairman William McDonough

A summary of public statements by the PCAOB chairman

About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from some of North America's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

InSights is produced by Tapestry Networks to provide concise assessments of key issues of concern to audit committees. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view on these important issues. This revised North American edition replaces the original version dated April 16, 2004.

Why review Chairman McDonough's public statements?

The Public Company Accounting Oversight Board (PCAOB) is a private-sector, nonprofit corporation, created by the Sarbanes-Oxley Act of 2002 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. Since becoming chairman of the PCAOB in June 2003, William McDonough has had many opportunities to speak about the role of the PCAOB, the future of the accounting profession, and the state of the U.S. business environment.

Some members of the Audit Committee Leadership Network have expressed an interest in learning more about Mr. McDonough's public comments. This document summarizes some of the key themes of Mr. McDonough's public speeches since taking the helm of the PCAOB.

Biography

Before joining the PCAOB, William McDonough spent 10 years as president and chief executive officer of the Federal Reserve Bank of New York. He served as the vice chairman and a permanent voting member of the Federal Open Market Committee (FOMC), the group responsible for formulating the nation's monetary policy.

Mr. McDonough also spent 22 years with First Chicago Corporation and its bank, First National Bank of Chicago. He was vice chairman of the board and a director of the bank holding company from 1986 until his retirement in 1989. Before joining the New York Fed, Mr. McDonough served as an adviser to a variety of domestic and international organizations. In his early career, Mr. McDonough was with the U.S. State Department from 1961 to 1967 and was a U.S. Navy officer from 1956 to 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, MA, in 1956.



Summary of public statements

Purpose/mission of PCAOB

“Our mission is 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.”

Testimony before the Securities Industry Association, Boca Raton, FL, November 4, 2004

“Accountability – not just to investors, but to the public at large, indeed, to the world – is what we must be about.”

Journal of Accountancy, December 2003, p. 16

“Our role is to bolster the integrity of the American economic system and restore public confidence.”

PCAOB website – Message from PCAOB Chairman Bill McDonough

“What’s 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.”

Speech to the New York State Society of Certified Public Accountants, September 9, 2003

“I have not been shy about telling members of the accounting profession that we expect a lot from them and that they will have to work harder than they could have imagined before Sarbanes-Oxley. Through a succession of scandals, the entire profession came to be judged harshly – but you and your colleagues, through the Sarbanes-Oxley Act, did not merely judge them; rather, you gave them a meaningful shot at redemption. In my mind, facilitating that redemption, and not just punishing miscreants, is a key objective – one that the Board must not lose sight of even when we are, as we will need to be, tough on the profession.”

Testimony before the Senate Committee on Banking, Housing and Urban Affairs, September 23, 2003

Personal reasons for joining 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 a Jesuit upbringing that rendered me incapable of refusing public service. I took this job because of the opportunity to make a difference...”

Speech to the New York State Society of Certified Public Accountants, September 9, 2003

“Among the many reasons I was willing to take on this job were my own strong convictions about the need for an aggressive response to the corporate scandals and the lack of leadership in the private sector.”

Speech to the New York State Society of Certified Public Accountants, September 9, 2003



Role as PCAOB chairman

“I had the opportunity to share those thoughts recently 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 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. ‘Tough love’ is a good start.”

Speech to the National Association of Corporate Directors, October 20, 2003

PCAOB philosophy

“We will pry into your records and your work habits, and, yes, the rules will change as we go along.”

Speech to the New York State Society of Certified Public Accountants, September 9, 2003

“... we are in the midst of a recruiting drive, to find qualified people for each of our offices. We don’t want zealots, but we don’t want pussycats, either.”

Speech to the American Institute of Certified Public Accountants, December 12, 2003

“I expect that you, as members of a regulated profession, know what the rules are. I expect that you are following those rules, both in their letter and their spirit ... I start with the expectation that you are doing the right thing.”

Speech to the New York State Society of Certified Public Accountants, September 9, 2003

“On the weekend, when you went to the church or synagogue of your choice, you would have a bit of examination of your last week’s performance, and say: ‘Has everything I have done in the last week been consistent with moral principles?’ I think if we all did that the confidence in the accounting profession would come back sooner than anything else I think we could do.”

Reported in “Accountants urged to take moral stand,” Financial Times, December 19, 2003, describing a meeting with accountants in Atlanta

“We will continue to push forward, step by step, toward the world envisioned in the [Sarbanes–Oxley] Act. It is a world in which public accounting firms are strong, reliable businesses that compete based on virtue.”

Testimony before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, June 24, 2004

“... we had some extremely direct discussions with the leaders of the large accounting firms, and they decided that making love was much more pleasant than making war. It’s also more pleasant for me.”

Speech to First International Conference, National Council on Corporate Governance, Moscow, Russia, June 3, 2004

PCAOB roles: inspection and enforcement

“... no amount of regulation or oversight will stop a crook hell-bent on breaking the rules for his or her own gain. That is where our strict disciplinary powers will be used to their utmost.”

Journal of Accountancy, December 2003, p. 17

“If you depart from those expectations – that is, if you break the rules, if you ignore the spirit of the law even while meeting the letter – woe be unto you. There will be consequences, and they will be grave.”

Speech to the New York State Society of Certified Public Accountants, September 9, 2003

“[Accounting firms] can see the PCAOB as their overseer and they can cooperate in restoring the confidence. Or they can fight us and we will make them do it. It will be a lot less painful if they cooperate ... The Big Four have seen that the path of cooperation is the only one that makes sense. The law is sufficiently strong and the PCAOB has sufficient powers. But it’s a work in progress. It is continuing, not a finished product.”

Speech at Canisius College Accounting Society Banquet, Cheektowaga, NY, April 28, 2004

“Our discussions with the accounting firms about deficiencies may start a process that results in a company restating its financial statements. Indeed, we are aware that some issuers have publicly described recent restatements as related to questions raised by PCAOB inspectors during the 2003 limited procedures.

That may continue to happen as we proceed with our 2004 inspections. But the Board is firm in its belief that it is plainly in the public interest that errors caught in our inspections be corrected, where appropriate, through restatements, and we will take all necessary steps to bring errors to the attention of persons responsible for seeing that they are addressed.”

Speech before the Securities Industry Association, Boca Raton, FL, November 4, 2004

“I should note that our reports do not identify the companies whose audits we examine. We do describe our observations about apparent failures or deficiencies in individual audits, but we do not identify the clients involved.”

Speech to Financial Executives International, New York, November 9, 2004

Why Sarbanes-Oxley was necessary

“Instead of wisdom, what we saw in the boom of the 1990s was something akin to mass confusion ... 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.”

Speech to the National Association of Corporate Directors, October 20, 2003

“The people got angry with the CEOs, with the Boards, and even with those of us in the regulatory sector. In a democracy, when people get angry, they will insist on change.”

Speech to the National Association of Corporate Directors, October 20, 2003

“Corporate leaders and their advisers failed. People lost their livelihoods and their life savings. The faith of America and the world in U.S. markets was shaken to the core. The American people thought that the business leadership in general and accountants in particular needed a sharp lesson.”

Speech at Canisius College Accounting Society Banquet, Cheektowaga, NY, April 28, 2004

“As you have surely noted, the political reactions to business failures were not aimed at the obvious bad guys. We did not need new legislation to get them. The executives heading off to jail were not found guilty of violating the Sarbanes–Oxley Act, but of laws long on the books.”

Speech to the National Association of State Boards of Accountancy’s 97th Annual Meeting, Chicago, IL, October 18, 2004

“I believe Sarbanes–Oxley came to be because the leadership of the American private business sector failed. The gatekeepers who were supposed to keep the leaders in line either fell asleep on the job or joined in the skullduggery by abandoning the gates. Those gatekeepers were the accountants, the lawyers, and, yes, the directors elected by shareholders.”

Speech before the Directors’ Institute on Corporate Governance, New York, October 14, 2004

“Now anybody with a memory knows that there is a business cycle, a product cycle, and the law of gravity. However, if quarter after quarter you have to match or beat the last quarter’s results to stay in favor, there is an immense incentive to cook the books. And the books got cooked by company managements, all too often with the collaboration or collusion of bankers, investment bankers, lawyers, and accountants, irrespective of the true cost to the nation, not to mention to the participants themselves. It was this sickness, a kind of moral blindness and lack of courage to do what is right, that threatened to strike at the very soul of our national confidence.”

Speech before Women in Housing and Finance, Washington, D.C., January 14, 2004

“... what was truly lost with Enron and WorldCom and Arthur Andersen[?] The profession lost the trust of the people – again, not just the investors, but ordinary citizens who believed that U.S. markets and U.S. companies are the best in the world. When that trust was broken, the people did what they ought to in this best democracy in the world, and they asked their elected representatives to fix it.”

Speech to the New York State Society of Certified Public Accountants, September 9, 2003

“Most business executives would say the least supervision possible, and I agree with them, because a market economy ... works best if business executives can take risk. But since the people do not completely have confidence in the business executives, they say ... the state should have the responsibility of some regulation.”

Speech to First International Conference, National Council on Corporate Governance, Moscow, Russia, June 3, 2004

Section 404

“... the portions of Sarbanes–Oxley setting new internal control requirements for public companies were drawn directly from the Federal Deposit Insurance Corporation Improvement Act of 1991.”

Speech to America’s Community Bankers Annual Convention, Washington, D.C., October 19, 2004

“The examination of internal control helps the auditor better plan and conduct the audit of the financial statements and determine whether those statements are fairly presented. In this way, the integrated audit helps to achieve the Congress’s intention to improve the quality and integrity of both corporate controls over financial reporting and of independent financial statement audits.”

Speech to Financial Executives International, New York, November 9, 2004

“It is safe to say that we don’t know how investors will react to [auditors’ assessments of companies’ internal control over financial reporting]. That is why it is incumbent on corporate managers and directors to start thinking now about how investors will respond to the auditor's report on internal control, as well as the company’s disclosures regarding any weaknesses.”

Speech to the Directors’ Institute on Corporate Governance, New York, October 14, 2004

“It is possible that an auditor will issue an adverse report on internal control at the same time he or she issues an unqualified opinion on a company’s financial statements, having concluded that the material weaknesses – which will likely have been disclosed and discussed in management’s own assessment, as required by Sarbanes–Oxley – in no way contributed to a material misstatement in that year’s financial statements.

Again, I say ‘it is possible.’ We won’t know until the auditors’ work is done. But I am encouraged that corporate leaders are considering their responses to deficiencies within their companies’ internal control – not just in making plans to correct those deficiencies but in deciding how they will communicate your corrections to investors and the larger public that relies on transparency in our markets.”

Speech to Financial Executives International, New York, November 9, 2004

“We do expect some mindfulness to costs. An audit of internal control does not come in ‘one size fits all.’ What is needed to assess internal control at a big, complex company may not be needed at a small company. At every opportunity, we encourage auditors to exercise judgment as they implement this standard, and we also encourage audit committees to be diligent in discussing costs with the auditors.”

Speech to the Securities Industry Association, Boca Raton, FL, November 4, 2004

“Section 404 and the Board’s requirements will entail extra work and, for companies, extra expense, however, particularly in the first year of implementation. Companies that had good internal control to start with will experience less of an implementation burden than those that did not, and companies that have materially weak internal control at the time of the internal control audit will, under Section 404 and the Board’s standard, receive an adverse auditor’s report on internal control.”

Testimony before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, June 24, 2004

“McDonough said the U.S. accounting oversight board hasn’t done an independent analysis to project costs associated with the new rule, but believes costs will be outweighed by the benefit to investors.”

“US Accounting Board OKs Internal Control Rule,” The Wall Street Journal, March 9, 2004

Corporate response to Sarbanes–Oxley

“Sadly, I do not see the private sector in this country dignifying itself by an heroic response to this challenge. Some companies are doing the right thing and some business groups are saying the right things. Vastly more needs to be done – and soon.”

Speech before the Securities Industry Association, Boca Raton, FL, November 4, 2004

“... Sarbanes–Oxley isn’t going away. It is the law of the land for public companies. I chide the CEOs and CFOs of public companies who gripe about having to personally vouch for the accuracy of their companies’

financial statements. What did they think their jobs were in the first place? Looking at the law more broadly, is there anything in Sarbanes–Oxley that doesn’t make good business sense?”

I have real trouble picturing the chairman ... of a major public company making a rational decision that the next few quarters would be a lot more profitable without internal controls and without independent auditors looking over the books. If a chairman wants to go that far, he or she might as well stack the board, because independent directors can ask a lot of annoying questions.”

Speech to America’s Community Bankers Annual Convention, Washington, D.C., October 19, 2004

Tone at the top

“We’re going to look for the ‘tone at the top’ of the [audit] firm ... The Board and our inspectors want to know if the message of doing the right thing is reaching the rank and file in your firms.”

Speech to the New York State Society of Certified Public Accountants, September 9, 2003

“Accounting firms and corporate management should be on notice that the PCAOB takes a dim view of the so-called ‘partner switching’ that has been known to occur when managers believe an audit partner is being too tough.”

Speech to the Directors’ Institute on Corporate Governance, New York, October 14, 2004

Executive compensation

“As corporate directors, you should think long and hard about the compensation of the executives who head the corporation you are sworn to protect ... What made sense two or three years ago may not make sense today.”

Speech to the National Association of Corporate Directors, October 20, 2003

Observing that CEO pay in 1980 was 40 times that of the average worker, increasing to over 400 times by 2000: “I knew a lot of CEOs in 1980, and I can assure you the CEOs of 2000 were not 10 times better.”

Speech to the Committee for Economic Development, Washington, D.C., April 13, 2004

“And if the [executive] pay should be rightfully 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. You as directors – as fiduciaries of your corporation – have the satisfaction of having said to investors, to the public, to the world that THIS is what this job is worth.”

Speech to the National Association of Corporate Directors, October 20, 2003

“The American people are sufficiently angry that if the private sector doesn’t get its act together reasonably soon – and at a considerably faster pace than is noticeable today – they’re going to get Sarbanes–Oxley No. 2, No. 3, No. 4, and it will curl your hair. I have been asked by many members of Congress if I could figure out a way that they could pass a law controlling compensation. Can you imagine that?”

Speech to the National Association of Corporate Directors, reported on issproxy.com, October 24, 2003

“My friends in Congress are still receiving heavy constituent complaints about grotesquely excessive executive compensation and responding to the latest examples of questionable financial reporting.”

Speech to America’s Community Bankers Annual Convention, Washington, D.C., October 19, 2004

Opposes “check-the-box” approach to compliance

“Do not look on [the] demands [of Sarbanes-Oxley] as a check-the-box list for business leaders. Remember what gave birth to the Sarbanes-Oxley Act: a complete undermining of confidence in the companies that seek capital in our public markets.”

Speech to the Securities Industry Association, Boca Raton, FL, November 4, 2004

“Given the depth of the public anger, it surprises me that some participants in the financial system – including auditors and issuers – approach Sarbanes-Oxley as a list of burdensome new requirements whose primary attributes are extra costs and risks. Checking the boxes under the new requirements will in fact incur additional costs and extra risks, but merely checking boxes provides few real benefits. Nor will ‘checking the boxes’ fix the problems that the Congress and the President intended to address. Indeed, that approach misses the point and, in fact, diminishes the value of the audit.

“If auditors cannot distinguish for investors financial reporting problems from financial downturns, then the audit function can be written off.”

Speech to the American Institute of Certified Public Accountants, December 12, 2003

Assessment of audit committee performance by external auditors

“Some commentators have suggested that such a requirement [to have auditors make note of the effectiveness of the audit committee, including whether the committee is independent of management] places auditors and audit committees in an untenable conflict ... I had to think hard about that myself, but I have come to believe that our proposed standard would empower both auditors and audit committees. If you as a director are sitting on the audit committee, shouldn’t you welcome an assessment by the auditor you hired? And shouldn’t the auditor feel comfortable giving a report card on the directors in charge of the appointment?”

Speech to the National Association of Corporate Directors, October 20, 2003

This document was prepared exclusively for members of the Audit Committee Leadership Network, a group of audit committee chairs from some of America’s leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

This material is copyright Ernst & Young and prepared by Tapestry Networks. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends.