

For the Audit Committee **Leadership Network**

Tapestry Networks, Inc.
1601 Trapelo Road, Waltham, MA 02451
Tel: 781 290-2270 Fax: 781 290-2271

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 select 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. 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.

Why review Chairman McDonough's public statements?

The Public Company Accounting Oversight Board (PCAOB) is responsible for the oversight of 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 that Mr. McDonough has talked about publicly 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 Corp. 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.

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Summary of Public Statements

Purpose/mission of PCAOB

“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

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PCAOB philosophy

“We board members will be the ones to consider and set audit standards.”

Journal of Accountancy, December 2003, p. 17

“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

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

“Inspection is one of the strongest tools we have to see that accounting firms fulfill the expectations of the Sarbanes-Oxley Act.”

PCAOB website – October 12, 2003, press release: “Board Approves Registration of 598 Accounting Firms”

“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.”

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

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PCAOB roles: registration

Regarding EU and US agreement on transatlantic requirements for auditors:

“If we require registration in the US, I cannot see in the name of reciprocity why we would object to registering over here.”

Reported on eupolitix.com, March 25, 2004

“Moreover, the nature and scope of the Board's oversight over non-U.S. accounting firms that audit the financial statements of U.S. public companies is the subject of ongoing dialogue between the Board and its foreign counterparts. Through this dialogue, the Board is exploring ways of accomplishing the goals of the Act without subjecting non-U.S. firms to unnecessarily redundant or conflicting requirements.”

Testimony before the House Committee on Financial Services, September 17, 2003

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 American 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.”

Canisius College Accounting Society Banquet, Cheektowaga, NY, April 28, 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

“Let's start by looking at 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

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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

“Effective risk management is based on a foundation of good corporate governance and rigorous internal controls. Taking calculated risks is part of any business enterprise. That is well understood. At the same time, each company needs to have in place the technical systems and management processes necessary not only to identify the risks associated with its activities but also to effectively measure, monitor, and control them.

“An effective risk management and control structure is not sufficient, however, if it is not accompanied by an institutional culture that ensures that written policies and procedures are actually translated into practice. Ultimately, a company's culture is determined by the board of directors and the senior management it installs. In particular, the actions of senior management and the consistency of their decisions and behavior with the values and principles they articulate are critical to shaping company culture. It is vital that managers make certain that their commitment to an environment that includes effective risk management and rigorous controls filters fully down the line to all employees in their organization.”

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

“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, an increase in the multiple by 10 times in 20 years – thoroughly unjustified, economically and morally.”

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

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

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Regarding potential legislation to control executive compensation:

“If the anger of the American people continues and business leaders do not wake up soon, I predict that there will be legislation ... I would turn to the directors and point out that there are lots of fine people in America, many of them in this room, who would be happy to be CEOs at more rational levels of income.”

Speech to the Economic Club of Chicago in late February, reported by Reuters and taken from CFO.com on March 1, 2004

“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

Opposes “check-the-box” approach to compliance

“Corporate America, Wall Street, lawyers and accountants have to resist the temptation to look at the act as a proscriptive, check-off list of rules. That kind of thinking is missing the point – not of the law, but of the reality that led to the Sarbanes-Oxley Act. Sarbanes-Oxley is not about checking the boxes. It is about accountability.”

Journal of Accountancy, December 2003, p. 16

“As you and your fellow directors examine those new rules ... let me urge you to resist the temptation to treat the rules as a “to-do” list – a list of “must do, mustn't do” items that can be tucked away once every item is checked. Checking boxes won't cut it in this new world. The people are still angry.”

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

“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

“You can chafe at what is asked of you, or you can accept the challenge for the opportunity it is.”

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

Cost of compliance

“The PCAOB is committed to seeing that small and medium-sized businesses are not unduly burdened by new auditing standards. We will be watching closely to see that auditors do not require unnecessary bells and whistles.”

Journal of Accountancy, December 2003, p. 17

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“As we heard from many public companies, these requirements are tough, and they will entail extra work and cost. [But the goal of obtaining] the best possible assurance that a company's financial statements are reliable [is] simply too important to demand any less.”

Speech to government employees, Washington D.C., March 9, 2004; reported in The Wall Street Journal, March 10, 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

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

Role of internal auditor

“We indicated in the proposal [An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements] that an auditor must obtain the principal evidence supporting his or her opinion through procedures performed by the auditor, including walkthroughs. That in no way says an internal auditor's work lacks value, and we certainly do not want to discourage internal auditors from testing and evaluating internal controls, especially those related to the timely prevention and detection of fraud.”

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

Preference for principles-based accounting

“His pragmatism means he is focused on attainable goals and he doubts the likelihood of full convergence between U.S. and international accounting rules, even though he supports the long-standing goal. Noting strong opposition in some European Union member states to international rules on derivatives, he says convergence ‘may be one of those cases where the perfect is the enemy of the good.’ Nevertheless, he criticizes the rules-based style of US accounting and says it enabled devious minds to breach the spirit, if not the letter, of the law. He hopes US accounting will become more principles-based and hints that he supports controversial plans by the Federal Accounting Standards Board ... for stock options to be treated as expenses.”

“Accountants urged to take moral stand,” Financial Times, December 19, 2003

This document was prepared exclusively for members of the Audit Committee Leadership Network, a select group of Audit Committee Chairs from 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.

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