Written Testimony of Edward E. Nusbaum, Chief Executive Officer of Grant Thornton LLP and Chairman of Grant Thornton International Board of Governors Before the Federal Advisory Committee on the Auditing Profession United States Department of the Treasury February 4, 2008

Chairman Levitt, Chairman Nicolaisen, members of the Committee, Treasury staff and observers: thank you for the invitation to present Grant Thornton's views on many of the issues that affect the sustainability of a strong, competitive and vibrant auditing profession.

Grant Thornton LLP is the U.S. member firm of the major global public accounting network, Grant Thornton International. Grant Thornton LLP has more than 5,500 personnel in more than 50 offices across the United States. The member firms of Grant Thornton International are in more than 110 countries, with some 2,200 global partners and 27,000 international firm personnel.

We are committed to serving the public interest through high quality auditing built on the guiding principles of respect, integrity, professional excellence and leadership. These values are the lifeblood of investor confidence in America's financial reporting system.

Grant Thornton and our people have an uncompromising commitment to the public interest and a culture that places the firm's professional responsibilities to the public interest ahead of other business considerations.

We recognize that for our capital markets to continue to function effectively, the public must maintain its confidence in the reliability of the financial information presented by America's public companies, in the way that information is produced, and in the professional and independent skepticism that is applied to its audit and regulatory review.

Nothing promotes and preserves investor confidence more than a strong, trustworthy and accountable financial reporting framework that includes a robust public company audit profession. This nation's public accounting firms have been granted a unique and privileged franchise, a franchise that must serve the public interest, the capital markets and investors' information rights. This franchise must sustain confidence through public company audits that promote the disclosure, deterrence and detection of material accounting errors and financial reporting fraud. Our profession can fulfill our public interest mandate only in an environment that encourages quality-based competition among providers and sustainability over the long term.

With that in mind, we are pleased to offer our thoughts about the three areas outlined by the Advisory Committee.

Auditing Profession Structure: Competition, Concentration, Independence and Other Professional Standards

Today, our collective challenge is to ensure that competition continues to define the structure of our financial markets and the market for audit services. The forces of technology and globalization have converged to spur innovations and transform the way business is done. The structure of the auditing profession must be ahead of that change.

A national survey of CFOs and senior controllers conducted by our firm last year found that 56 percent think that there are too few accounting firms to ensure robust competition and 69 percent said that more competition in the accounting profession would further increase the quality of service.[1] The recently released GAO study on audit firm concentration found that three of five of the largest public companies "viewed competition in their audit market as insufficient" and expressed concern that the loss of another large public accounting firm would "further reduce large companies' auditor choice and could affect fee competitiveness."[2]

Our experience indicates that misinformed notions about firms' capabilities, lack of public recognition by government and business leaders, and lingering misperceptions that quality is linked solely to size are fueling the market stronghold that exists today. Equally important, many of these factors contribute to the increasing concentration within global industry sectors. This inaccurate perception of quality serves to ossify registrants' decision-making processes in choosing auditors, further reducing the vibrancy of the competitive marketplace. The fact is that recent years have seen a movement toward six major global accounting networks, including Grant Thornton, that possess the characteristics to perform audits for the largest global companies.

We encourage the Advisory Committee to recognize that many of the impediments to greater choice and expanded competition can be chipped away, if not eliminated, through market and regulatory activities with little additional regulation or legislation. The Advisory Committee's encouragement of such actions, coupled with increasing public recognition of firms' status as members of *global networks* will go a long way toward breaking down perceptual barriers that slow the move to greater choice in the marketplace. We offer the following observations:

- **Misperceptions about the Capacity and Capability of all Audit Firms Reduce Competition.** There is no doubt that today's market for providing audit services for the world's very largest companies is dominated by the four largest global networks. However, the perception that they are uniquely able to provide such services is a myth – and all the more damaging because it is a self-reinforcing myth**.**

    - Grant Thornton LLP and the member firms of Grant Thornton International are proud to compete vigorously to provide audit services for public companies of all size – including many of the largest global companies. Our network meets every measure established by the Forum of Firms (of the International Federation of Accountants) recognizing audit quality by global networks. Our U.S. firm is inspected annually by the PCAOB in recognition of our position as part of a major global network. And we have the deep capability to conduct audits of many global public companies in the *Fortune* 1000 thanks to our global organization's broad international footprint. Grant Thornton's presence in this market is established and growing.

---

[1] **Grant Thornton LLP, "Majority of CFOs want more accounting firm choices, believe that greater competition will increase quality and reduce fees," Press Release, October 15, 2007.**

[2] **U.S. Government Accountability Office, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, January 2008, GAO-08-163.**

    - Public company audit firms and networks compete on the basis of their unique service models. The public is well served when public company registrants choose audit firms based on their own optimal mix of expertise, service quality, reach, experience and price.

- **Increased Competition and Choice Will Strengthen Capital Markets and the Profession.** Expanding competition in the audit market beyond a very small handful of firms would reduce the level of disruption to the continued supply of high quality, independent auditing caused by the demise of another major public accounting firm. Registrants would have more choice in selecting a replacement auditor should their incumbent firm fail. Current auditor independence rules, which Grant Thornton strongly supports, prohibit firms from providing most non-audit services to audit clients, very often leaving registrants with the perception that they have only one or two firms from which to choose. In addition, tearing down perceived limitations on choice of auditors will demonstrate that the audit marketplace is fair, open, and stable.

- **Movement Up-Market Faces Barriers Driven by Perception, Lack of Transparency, and Market Organization.** Many obstacles to a more competitive audit market can be removed through market-led solutions coupled with changing policymaker sensitivities. The Advisory Committee should consider:

    - Education for policymakers, opinion-leaders and the media about the capabilities of *all* global public accounting networks
    - Comprehensive disclosures about reasons for auditor switches, restrictive contracts with underwriters, and audit committees' processes for choosing, evaluating and compensating the auditor. Such transparency would create incentives for audit committees to optimize their auditor choice and help clarify that size is not always the best criterion when selecting an auditor
    - Removal of entry barriers by reducing unnecessary complexity of global regulation and financial reporting standards

- **Global Partnerships That Might Improve Audit Quality for Global Clients Would Require Significant Regulatory Changes.** The largest six global networks are all similarly structured, and the members of the networks are legally independent. The member firms of Grant Thornton International are united around a global strategy, common goals and a commitment to client service excellence. Some regulators have questioned whether the current federation-style structure of audit firms is the most appropriate to deliver consistent high-quality, independent audit work in a global fashion. In a changing world, the global networks need to remain open-minded and flexible in this regard. Any change to the current structure, including movement to a legal global partnership, would first require regulatory changes covering ownership restrictions, professional standards and liability regimes both in the U.S. and globally.

- **Auditor Independence Should Receive Continuing Attention.** Independence and professional skepticism underpin investor confidence in the profession. Continual assessment of auditor independence rules is helpful as changes occur in the public company audit environment. We ask the Advisory Committee to evaluate:

    - Reconsideration of the definitions of "audit client" and "affiliate" to identify clearly the circumstances that impair an auditor's ability to conduct a fair and impartial audit in the eyes of a reasonable investor. Currently, the SEC defines an audit client and its affiliates in a broad manner in the context of auditor independence. For example, if a registrant has received funding from an investment company complex or private equity fund, the impact of the current definition can be far-reaching.

- Harmonization of independence rules to establish a single, clear and effective standard. The goal should be a global standard, but a good start would be to adopt a global baseline standard, such as the IFAC independence standard. The baseline standard could be augmented, as needed, to satisfy the purposes of the PCAOB, U.S. federal and state regulatory agencies, and professional societies.

Human Capital and Its Impact on Audit Quality

The value of any audit derives from the quality, knowledge, expertise and integrity of the people who design and conduct it. A secure pipeline of highly effective accounting and auditing professionals, who are properly educated, effectively trained, appropriately compensated, and able to stand toe-to-toe with C-suite executives is a quality imperative. Today, there are growing cracks in the infrastructure provided by the colleges and universities that support the development of public company accounting and auditing expertise. This is especially obvious when compared to other professions with a public interest mandate, such as medicine and law. These cracks make it more difficult to lift new entrants into the profession and prepare them to serve the public interest. The largest public company accounting firms are working to fill in the gaps, but a longer-term solution that re-defines the role of undergraduate and graduate-level education is needed.

Today, many look at public company auditing as "proving ground" for America's young business professionals, a station in which a college graduate can learn the basics and then move on to other pursuits. If this view becomes even more pervasive, it will further erode the profession's human capital because fewer and fewer talented people will be motivated to make a long-term career in public company auditing. This occupation can be sustained as a profession only if its most talented personnel and those who affect public opinion see it as an important professional calling and an enduring service to the public at the highest levels.

We ask the Advisory Committee to consider the following:

- **Changes in Professional Undergraduate Curricula and Structure to Meet the Demands of a Modern Audit Environment.** In recent years, there has been a disturbing trend in undergraduate education away from broad professional knowledge toward overly vocational and technical training. The same shortcoming is evident in the content of the CPA examination and continuing professional education offerings. Technical expertise is the bedrock of quality auditing, but it must be coupled with broader knowledge. Accounting firms need technically proficient professionals with a solid world view, multi-disciplinary knowledge, the ability to see and solve complex problems, and a broad understanding of the issues and challenges in accounting, auditing and organizational management on a global level.

Coupled with other factors, when intellectual rigor is replaced by transactional training at the college or university, the best and the brightest often pursue other majors. And those who seek undergraduate degrees that are overly focused on rote technical training are often not adequately empowered to apply meaningful technical knowledge to their auditing work once inside a firm. The curriculum must be enhanced to increase students' mastery of related disciplines in applying their technical expertise. If an auditor is to stand toe-to-toe with a CFO or other C-suite executive, he or she must be positioned on a business platform that extends beyond accounting and auditing. Although there has been some engagement in the past 20 years between practice professionals and the academic community concerning the curriculum, most of that discussion has not led to an effective broadening of accounting and auditing education.

- **Continuing Availability of High-Quality Accounting and Auditing Faculty.** As the Advisory Committee has recognized, recent years have seen a reduction in accounting faculty, based on a wave of retirements and lack of accounting Ph.D.s coming into the system. The problem is exacerbated by the growth in the number of colleges and universities offering programs in accounting and auditing. A study conducted by the American Accounting Association found that only 23 percent of the projected demand for auditing Ph.D.s could be met by expected graduations, and 27 percent of the projected demand for tax Ph.D.s could be met. Yet some 91 percent and 79 percent of the projected demand for Ph.D.s in financial accounting and managerial accounting, respectively, could be met.[3] High caliber new entrants are deterred when professors who possess the education, research perspective and teaching skills to interest, challenge and motivate them are not available.

The composition and incentives of the accounting professorate are complex issues that require careful consideration among all who are committed to a sustainable public accounting profession. Issues to be considered include, among others:

- The effects of association between accounting firms and business schools
- The stature of accounting in private and state-based research universities, major state universities, liberal arts colleges and "teaching" colleges and universities
- The role and definition of research in the promotion and tenure process
- The future content of undergraduate business education for accountants as it relates to graduate studies, continuing education and field experience

Some have expressed the view that a solution to the faculty shortage is to recruit retired accounting and auditing professionals to fill the gap. A number of schools are moving in this direction. Grant Thornton is concerned that, while possibly an immediate-term solution, too much reliance on former practitioners will transform the acceptance of accounting within higher education from a vibrant and challenging academic discipline to trade school status taught by former practitioners.

- **New Professional Post-Graduate Degree.** We support the development of a new post-graduate educational degree in public accounting that would be widely recognized, similar to what is available in law (J.D.), business administration (M.B.A.) and medicine (M.D.). A dedicated graduate degree would contribute to the public stature of the public company auditor and further enable the auditor to operate on a platform of credibility and confidence.

Equally important, the new degree would help attract talented people who might want to join the public accounting profession even a few years after graduation. The current system generally forces students to choose accounting early in their undergraduate years. Entering public accounting later in life is an option that is not readily available. For example, a finance, marketing, computer science or

[3] R. David Plumlee, Steven J. Kachelmeier, Silvia A. Madeo, Jamie H. Pratt, and George Krull, "Assessing the Shortage of Accounting Faculty," *Issues in Accounting Education*, Vol. 21, No. 2, May 2006, pp. 113-126.

math graduate may find it difficult to re-enter college at the undergraduate level to take courses that provide the necessary grounding for entry into the audit profession. A professional degree would make a career in public company auditing more available to these individuals.

Other professions expect the choice of career at a later age. The absence of a professional post-graduate degree track creates the perception that public company auditing is a preparation for other pursuits rather than a viable long-term career.

The Auditing Firm and the Audit: Organization, Financial Resources and Communication

To uphold the honor and credibility of public company accounting, all participants must have a single focus – doing what is right for investors and other financial statement users. When the profession maintains that focus, investors and other users are better served and the credibility, reputation and sustainability of the profession are strengthened.

In recent years, policy developments have enhanced the auditor's chain of loyalty significantly, a concept we strongly support. Today the auditor's primary loyalty is to investors through the company's board of directors rather than senior management. Grant Thornton and other public company audit firms are working to meet investor expectations and those of the boards that represent them. In this new environment, a more extensive dialog between public company audit firms and market participants about the firms' transparency and governance is clearly appropriate. We ask that the Advisory Committee consider the following:

- **Enhancements to Firms' Transparency.** The PCAOB has virtually open access to information about the firms through the inspection process, and many other indices are available to the public. There may be ways in which additional relevant and meaningful information can be effectively transmitted to others to further enhance the public trust.

Grant Thornton supports the publication of an annual transparency report that publicly discloses information about each U.S. public company audit firm. The global networks intend to release such annual reports after their next fiscal year-ends.

We ask that the Advisory Committee create a process to develop a requirement for relevant and appropriate information to be disclosed in a consistent fashion across firms in a meaningful way. Annual U.S. firm transparency reports could include:

- Legal structure, arrangements and ownership of the firm
- The U.S. firm's internal quality control systems and a statement by the U.S. firm's leadership body on the effectiveness of its functioning
- A discussion of quality assurance review processes
- Information about the firm's independence policies and practices
- A list of the public registrants for which the firm provided audits in the past year
- Information about the continuous education of the firm's auditors
- Financial information showing the relative size and scope of the audit practice and a breakdown of fees charged by the firm
- Information about the basis for audit partner remuneration

This information is similar to disclosures made by audit firms registered in EU Member States and required by the EU Eighth Company Law Directive on Statutory Audits.

- **Enhancements to Firms' Governance through Inclusion of Non-Firm Board Members.** Grant Thornton International's network has initiated preliminary internal discussion about the value of including independent members on its international governing board. Such a change in the governance model may be one way to strengthen our ability to serve market participants and reinforce independence.

- **Better Coordination of the Profession's Licensing and Regulation.** Consistent licensing across U.S. jurisdictions would allow public accounting firms to put human resources and expertise where and when they are needed most. Such mobility is consistent with the realities of modern auditing and the geographic diversity of the registrant population.

We respect the current system, which has been effective for many years, but believe that it would be useful to evaluate the possibility of an interstate commission for the whole of the audit profession. Such a commission would bring together state licensing authorities, the PCAOB, and appropriate professional organizations. It would be the means to rationalize existing disparities in licensing qualifications, continuing education requirements and peer review for non-public company audit practices. It would also enable enforcement of common regulations and license discipline across state and federal jurisdictions.

- **An Equitable Professional Liability System That Meets Public Interest Criteria.** Grant Thornton supports liability reform measures that meet three public interest tests. The professional liability system must recognize that high-level professional judgments will vary, be equitable to investors and other market participants, and support a competitive audit marketplace that does not unfairly advantage any one firm or group of firms. We believe these interests are paramount to restoring the liability system's ability to promote public and global confidence in the nation's capital markets.

Grant Thornton believes there is a need for significant liability reform to limit the likelihood of a catastrophic loss that would result in the unfair and inappropriate destruction of any public accounting firm. The risk of inappropriate loss is a major concern to all public accounting firms auditing public registrants.

Grant Thornton is particularly focused on three specific propositions: 10-b5 liability recommendations, proportionate liability, and litigation process improvements. We hope that these issues can be evaluated by the Advisory Committee in the coming weeks.

Grant Thornton strongly believes that auditors must continue to enhance their performance and be appropriately accountable for wrongdoing. We would expect nothing less of other capital market participants as well.

The firm does not support caps based on fixed monetary sums because they would not be effective for firms other than the very largest. A scalable cap that could be applied across all audit firms may be a useful alternative for the Advisory Committee to evaluate. We ask that the Advisory Committee also consider the following:

- **Amend 10b-5**: Measures taken by the SEC that would improve clarity and predictability about the scope and breadth of liability under Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule

10b-5. In particular, the measures would require plaintiffs to investigate and put forth early in their case adequate proof of an actual market effect from an alleged fraud. The measures also would establish consistency and convergence of legal interpretations among jurisdictions for all market participants by, for example:

- Clarifying the definition of primary liability with respect to accountants
- Requiring that a plaintiff filing a 10(b) claim show actual reliance on specific alleged misrepresentations or omissions in the audit report
- Standardizing the scienter requirements with respect to claims against accountants by adopting the prevailing definition of accounting firm "recklessness" and requiring "clear and convincing" evidence of scienter
- Requiring an event study or other empirical evidence linking an alleged market drop to a restatement or specific disclosure
- Limiting plaintiffs to one stock drop per case, precluding use of a "creeping disclosure" argument.

- **Proportionate liability**: Measures that would allow for reasonable apportionment of liability based on market realities. For example:

  - The imputation defense, which imputes to an entity the wrongful conduct of its current and former employees, would apply to successors to a company's claim against its auditor
  - Current statutory safe harbor protections would be extended to identified accounting estimates. Changes in financial reporting standards since the current law was enacted have expanded the need for issuers and auditors to consider the use of information based on future expectations as the basis for amounts reported by issuers in their "historical" financial statements. Thus, the lack of safe harbor protection for forward-looking or "soft" financial statement information exposes both issuers and auditors to unwarranted liability when estimates or other soft information appearing in financial statements change over time.

- **Litigation process improvements**: Measures that would make it possible for defendants to thoroughly litigate legitimate defenses and even go to trial in large cases rather than face a "devil's choice" between a potentially catastrophic liability after trial or a deeply crippling and unreasonable settlement. Effective measures in this area would be:

  - Establishing an appellate bond cap or allowing for appeals without bonds
  - Providing an appeal to the federal appellate courts of a denial of a motion to dismiss a private action, particularly in "major" securities class actions

- **Financial Capitalization Rarely a Constraint to Sustainability and Growth.** Financial capital is rarely a constraining resource for the organic growth of public accounting firms such as Grant Thornton, with the possible exception of funds to cover catastrophic legal judgments. The availability of talented people with appropriate expertise and experience is generally far more important and merits greater deliberation.

Because the availability of capital has not constrained Grant Thornton's organic growth, we believe that reorganizing audit firms as public companies to increase capital availability would not enhance competition or make firms more sustainable. More important, a focus on investor returns and short-term earnings, coupled with market and stock fluctuations, could compromise the public interest and detract from the independence and integrity of the firms.

Regulators in the E.U. and the U.K.'s Financial Reporting Council have expressed the hope that loosening ownership rules, which restrict audit firm ownership to accountants, will unlock the market and allow smaller firms to grow more rapidly. We are very skeptical about the mechanics and benefits of pumping outside capital investment in audit firms. In present conditions, the catastrophic risks posed by audit liability will likely require a return that the accounting firms could not deliver. And perversely, exposing any additional capital to the hazard of plaintiffs' claims would likely feed litigation, as claims would rise to eat up available capital. Outside funding could also create unworkable conflicts of interest, as auditors might find themselves in a situation where they would be auditing an entity with some connection to an investor in the firm. And, serving those who invest in the firms may well be a diversion from focus on the public interest.

.

- **Further Support for Global Audit Quality through Reinforced Global Professional and Regulatory Infrastructures.** The major global accounting networks such as Grant Thornton International must operate under worldwide regulatory infrastructures that support uniform quality and independence. The current absence of global regulatory convergence perpetuates market concentration because the need for significant investment in compliance-oriented infrastructure acts as a barrier to entry. A single, uniform set of accounting, auditing, ethics and independence standards administered under a common regulatory and legal regime would clearly be beneficial. We support current convergence efforts and encourage continuing dedication to this challenging but important endeavor.

Grant Thornton applauds the SEC's decision last year to eliminate GAAP reconciliation for foreign private issuers when reporting financial results in the United States. It was a positive step forward for international convergence of accounting standards, but much more remains to be achieved in a timely way.

- **Support for the SEC Advisory Committee on Improvements to Financial Reporting (CIFiR).** Grant Thornton supports the continuing efforts of this important group. In particular, we believe that the professional judgment framework, with its safe harbor, is a recommendation that the Advisory Committee should seriously consider. The framework could improve the efforts of preparers and auditors while changing the regulatory and legal environment to uphold the value of professional judgment in quality auditing. It will also promote principles-based accounting standards, including IFRS. Many of the CIFiR proposals will encourage better financial reporting through the consideration, documentation and disclosure of appropriate issues, thereby benefiting investors.

- **Tools and Incentives to Help Auditors Detect and Deter Financial Fraud.** Many participants in the capital markets are involved in deterring and detecting material financial fraud. Auditors are responsible for planning and performing audits to obtain reasonable assurance about whether financial statements are free of material misstatement, whether caused by error or fraud. As a profession, we must continually enhance our own

> performance by investing in improved processes, human resources, training and technology to be successful in this endeavor. Success also requires that the profession work with standard setters and regulators to develop best practices and the infrastructure for effective audits designed to detect material financial fraud. We must also engage in a meaningful dialog with investors and other market participants about what else can be done, who can do it, under what circumstances, and with what costs and benefits.

We believe that the leading audit firms should be required to share fraud detection experiences to educate and empower all audit professionals. Such sharing is a professional obligation that should not be impeded by any individual firm's self-interest. By exchanging real-life experiences and practices through an organization such as the Center for Audit Quality, audit professionals across firms can improve their collective knowledge and become ever more adept at detecting fraud.

Any research that helps the profession improve the probability of detecting and deterring material financial reporting fraud will be valuable. For example, centralized collection of data through the Center for Audit Quality would provide a broad industry view that could not be obtained by a single audit firm. Additional information about industry norms, trends and statistics would give all auditors an advantage in identifying fraud risks and planning more rigorous and relevant analytical procedures. Information about frauds that have been detected and how they were found would help all auditors further identify risk factors and the appropriate procedures to address them. Collection of this type of data would further academic research in this area as well.

The above two examples feature a common thread: the sharing of information across the profession rather than a single-minded focus on an individual firm's competitive advantage. We recommend that the Advisory Committee offer proposals that require this kind of sharing in the public interest.

In the final analysis, the public accounting profession gives American investors peace of mind by instilling confidence throughout the financial marketplace. The best assurance of an effective and fair capital market occurs when all participants act with integrity and provide services of the highest quality. The audit profession must remain strong and sustainable to serve all those who depend on our work -- the new employee who signs up for his company's 401(k), the pensioner who depends on portfolio income to enjoy her retirement, the mother and father who open a college fund for their new child, and the hard-working teacher who is looking to a future of financial well-being. These are the people who Grant Thornton serves, the individuals who are the foundation of our capital markets.

I thank Secretary Paulson, Under Secretary Steel, the Treasury Department and this Committee for the opportunity to appear before you today. Grant Thornton supports your examination of these critical issues and I would be happy to answer any questions that you may have.

*****