TESTIMONY OF J. TERRY STRANGE ON BEHALF OF KPMG LLP

Introduction

Good afternoon. My name is Terry Strange. I am Global Managing Partner of Audit for KPMG LLP. Thank you for providing KPMG with the opportunity to testify this afternoon.

As an initial matter, we are very troubled with the rushed process that the Commission has adopted for its scope of services proposal. The proposal is complex and presents numerous alternatives and specific questions for comment and calls for respondents to perform cost-benefit analysis. Because the proposal will have profound consequences for the future of the accounting profession and for the financial reporting system upon which investors rely, it requires very careful consideration and informed comment from all quarters. The 75-day comment period is too short – we encourage the Commission to extend the comment period.

Today, we will address our broad concerns with the proposed rule’s exclusionary ban for non-audit services – services that accounting firms have provided for the benefit of their clients for decades without incident. We will provide more detailed comments in September at the next set of hearings.

The Proposed Rule On Non-Audit Services Lacks Any Factual Justification

As the staff's release recognizes, accounting firms have provided non-audit services to their audit clients for more than 100 years. The reason for this is that non-audit services have grown logically out of accountants' work in performing audits. Moreover, non-audit services enhance audit effectiveness and provide substantial value to clients. Virtually all of the research that has considered non-audit services has recognized the value provided to audit quality, to
Nonetheless, the proposed rule would forbid accounting firms from providing most non-audit services to their audit clients. The rule's premise is that an auditor lacks independence if his or her firm, or an affiliate of his or her firm, provides non-audit services to an audit client. But the proposal fails to cite any empirical evidence or study that supports the proposition that non-audit services, in fact, have harmful effects. The absence of any actual problem is confirmed by the very recent conclusion on auditor independence by the POB Panel on Audit Effectiveness—a panel formed at the request of the SEC and named the O'Malley Panel after its chairman, the former head of PricewaterhouseCoopers. The O'Malley panel, after considering prior research and conducting its own detailed empirical analysis of actual audit data stated that "it is not aware of any instances of non-audit services having caused or contributed to an audit failure or the actual loss of auditor independence." Stop and consider those words—no instance where non-audit services caused or contributed to an audit failure or the actual loss of auditor independence.

So instead of empirical evidence, the proposal is based on investors' supposed perception that a broad scope of practice impairs auditor independence. But even there, the proposal does not cite any evidence of a current problem. The staff concludes that "taken together," various studies "suggest that important constituencies see a connection between the business scope of accounting firms and auditor independence." Again, stop and consider those words, those carefully limited words. I suggest that there are four significant aspects of that claim. First, even if there were "a connection," that is far short of concluding that there is a negative impact, let alone a problem warranting governmental intervention. Second, seeing a connection is far short
of finding that there is a causal link – presumably if the staff believed the evidence supported finding causation, it would have said so. Third, the "suggestion" that unspecified "constituencies" see a connection is not a substitute for evidence. And fourth, there is no indication that any "connection" does not carry overwhelming and counterbalancing benefits. The reasoning in the proposal is not sufficient to justify government imposition of a restrictive and enormously costly rule.

The lack of empirical evidence of any problem raises a question as to the basis for this rulemaking, particularly given the far-reaching implications it has for the profession and its role in capital markets.

The Facts Show That Auditors Are Independent And Investor Confidence In The Quality Of Audits Is Strong

We certainly agree that for our financial markets to continue to be as successful and dynamic as they have been, investors must have confidence in the integrity of financial reporting. It is precisely for that reason that our reputation for integrity, quality, and independence is so fundamentally important to us. Investors form opinions about the accuracy and reliability of financial reports not based on mere speculation, but on actual evidence. In this case, the evidence is clear that, as the O'Malley Panel concluded: "both the profession and the quality of its audits are fundamentally sound."

Investors' strong confidence in the reliability of our financial reporting system is firmly supported by the demonstrated quality of auditors' performance over time and the mechanisms in place to secure reliable audits. Consider these facts about the accounting profession:

- a decades-long record of auditing excellence
• rigorous audit methodologies
• constant new investment in improved audit methodologies
• a culture of the highest ethical standards
• second partner review
• firm peer review
• requirements for auditor training and continuing education
• a highly developed professional disciplinary mechanism
• enormous disincentives to compromised objectivity — a potentially career-ending event for the individual and potential liability to the firm far exceeding any one-time consulting fee
• a century's experience of providing nonaudit services to audit clients to good effect

Given these facts, it is not surprising that investors do not penalize companies that receive non-audit services from their auditing firm by imposing a higher cost of capital. Nor do accounting firms that provide both audit and non-audit services to their audit clients experience higher liability insurance rates.

The market, thus, does not perceive any problem associated with an audit client receiving non-audit services from its auditor. There is simply no basis for concluding that a regulatory limitation on non-audit services is in any way necessary to preserve the integrity of the audit process or investor confidence in the financial reporting system. That confidence, however, could be jeopardized if accounting firms are deprived of the ability to evolve with our dynamic economy in order to continue providing comprehensive and thorough audit assurance. The Commission thus could create the very problem it is trying to avoid.
The Facts Show That Auditors In Our New Economy Require A Broad Scope Of Services

We all know how rapidly and dramatically our economy is changing. Our economy is in the midst of an unbelievable revolution driven by information technology. We are moving from the industrial age to the information age. Auditing in the information age requires skills and a degree of technological knowledge that did not even exist when our current financial reporting model was developed. In order to audit effectively in the information age, accounting firms must not fall behind in their skills and competencies. The proposal, however, will impose severe limitations on accounting firms' ability to do precisely that. The proposal will also impose an inflexible regulatory ban before Congress has an opportunity to consider more broadly the needs of our financial reporting and disclosure network in the New Economy. Just last week, for example, the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs held hearings on the financial reporting model for the 21st Century.

The technology of auditing must change, and must be permitted to change along with our economy. Auditors in our New Economy may well be reporting primarily on information systems and on values rather than, or in addition to, costs. They will be focused on assuring that the quality of information systems is sufficient to produce reliable information. The transition already underway has required substantial capital investments. The continued transitions that must occur will continue to require capital investments.

Auditing in the 21st Century will also demand personnel of the highest caliber and with a range of skills. The skills and other qualifications of these high caliber people will be demanded by other industries too, because the qualifications include expertise in information technology and cutting-edge knowledge of modern business practices. Thus there is going to be even more competition for talented college graduates, and the capacity to offer challenging opportunities
and broad career paths to them will do much to determine whether the auditing profession gets the personnel it needs. There has been a decline in the number of students choosing accounting programs. This comes at a time when there is universal agreement about the need for top-notch personnel at accounting firms to maintain audit quality. The range of careers from a broad scope of services is an attraction to college graduates, and nonaudit services often supply personnel for particular audit tasks. It is for these reasons, among many others, that the 21st Century accounting profession requires a broad scope of services.

The proposed regulatory limitation on non-audit services, however, will undermine the accounting profession's ability to adapt to the 21st Century. Some may say that the proposal is carefully limited, that accounting firms can still provide non-audit services to non-audit clients. That assertion ignores the incentives inherent in the proposed rule. Accounting firms will be driven by market forces to split their audit and "non-audit" businesses so that each aspect of the business can compete for 100% of the market. That is simple economics.

The Proposal Will Have Harmful Ramifications Around The World

As the person with global responsibility for KPMG's audit practice, I am sensitive to the international impact of the proposal. For the reasons I have already stated, the proposed rules would impact our firm beyond the U.S.

The rule ignores very different business environments in foreign countries to which it will also apply when foreign companies list shares in the U.S. In many countries, significantly expanded restrictions on the scope of services that the auditor can provide may conflict with local practices and legal requirements. The complicated and unforeseen effects on audits around
the world are yet another reason why it is ill-advised to proceed hastily with this drastic change in policy.

"Common Sense" Warrants Extreme Caution In Considering The Proposal

The proposal states that "common sense" tells us that proposed rule is the correct outcome. We believe that common sense, in fact, cuts exactly the other way.

Let's consider first the real incentives an auditor with common sense would face. Accounting firms have survived for decades on the basis of their reputation for quality and integrity. If that reputation is lost, inside or outside one's firm, the auditor's career is over. If the auditor looks the other way on an audit engagement, he or she, and his or her firm, face tremendous liability exposure. Audit relationships with a client often last many years; consulting engagements are frequently short-term and sporadic. Would an audit engagement partner jeopardize the audit relationship to preserve a short-term consulting engagement? The clear answer always has been, and continues to be, "no."

Under the proposal, an auditor is automatically presumed to lack independence because an affiliated person provides some non-audit service to the audit client. The basic premise set out by the staff is that this potential financial connection will create an appearance that the auditor lacks independence. But let's think about that reasoning. Auditors are and always have been paid for their work by the audit client – that is a direct financial interest. The audit client clearly holds the purse strings and could fire the audit firm if it desired to exercise influence over the auditor and that influence were rebuffed. That reasoning was rejected by Congress when it chose a system of independent public accountants rather than government auditors or federally-licensed auditors.
The proposal also, in our judgment, unfairly presumes that audit committees lack the judgment and ability to address independence issues. We applaud the SEC for the recent measures it promoted to increase the involvement of audit committees in evaluating and addressing any independence issues. Audit committees have the flexibility to address independence issues on a case-by-case basis, thereby preserving a corporation's ability to select its auditor for non-audit services if that is the best choice for the company and the audit committee. That is a flexible approach that safeguards the interests of shareholders; the proposed rule is an inflexible regulatory ban that will harm investors in some circumstances. The Commission should allow time for these recent auditor independence initiatives to take effect.

Common sense would also warrant proceeding slowly so that the Commission can evaluate the effects of the already announced restructurings of several firms. The Commission should see how the market responds to these changes, and whether the market will summon forth further innovations in business structure and client services, before resorting to a regulatory ban.

Finally, the Commission must carefully analyze the costs of the proposed regulatory ban not only to the accounting profession, but to public investors who rely on financial information and public companies that purchase both audit and non-audit services from accounting firms. This regulation will almost certainly impose costs running into the hundreds of millions or even billions of dollars, without any tangible benefit.

Common sense, as I hope I have demonstrated today, counsels strongly against moving forward on the proposed time line.

I am happy to respond to any questions. Thank you.