CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets

June 27, 2008

Advisory Committee on the Auditing Profession
Office of Financial Institutions Policy
Room 1418
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

RE: Draft Report and Addendum of the Advisory Committee on the Auditing Profession

Dear Committee Members:

Please find attached the Center for Audit Quality's comment letter to the Advisory Committee on the Auditing Profession. The attached letter contains comments regarding both the Draft Report, as published for comment on May 15, 2008, and the Draft Report Addendum, as published for comment on June 12, 2008.

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Comment Letter to the Advisory Committee on the Auditing Profession

June 26, 2008

CAQ Comment Letter: Draft Report and Addendum of the Advisory Committee on the Auditing Profession

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RE: Draft Report and Addendum of the Advisory Committee on the Auditing Profession

Dear Committee Members:

The Center for Audit Quality ("CAQ") is a public policy organization that seeks to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change that are rooted in the profession's core values of integrity, objectivity, honesty, and trust. We also seek to improve the reliability of public company audits and to enhance their relevance for investors in this time of increasing financial complexity and globalization. Any U.S. accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") may join the CAQ. The CAQ is affiliated with the American Institute of Certified Public Accountants ("AICPA"), and has approximately 800 U.S. public company auditing firms as members, representing tens of thousands of professionals dedicated to audit quality.

As an organization devoted to improving public company audits, we applaud the goals of the Advisory Committee on the Auditing Profession ("Committee") and welcome the opportunity to comment on the Draft Report of the Advisory Committee on the Auditing Profession, issued on May 5, 2008, and "Addendum to VI. Firm Structure and Finances" ("Addendum"), issued on May 30, 2008 (collectively, "Draft Report").[1]

[1] The Draft Report and Addendum were published in the Federal Register on May 15, 2008, and June 12, 2008, respectively. 73 Fed. Reg. 28,190 (May 15, 2008); 73 Fed. Reg. 33,487 (June 12, 2008). This submission represents the observations of the CAQ, but not the views of any specific firm or individual, including one former and one current member of the CAQ's governing board, KPMG Chairman and Chief Executive Tim Flynn and AICPA President and CEO Barry Melancon, respectively, who both serve on the Committee.

The CAQ appreciates the hard work and commitment shown by Committee Members in this endeavor and remains hopeful that the collective dedication of the Committee will yield final recommendations that are helpful in guiding the profession into the future. Although the CAQ supports many of the Committee's recommendations in the Draft Report, we also believe certain recommendations need further exploration and some issues have not yet been adequately addressed, particularly in light of the recent actions of the European Commission ("EC") in recommending liability reform for auditors.[2] Given that the EC's actions were published on June 5, 2008, after the Committee issued its report and Addendum, we believe the Committee should continue its deliberations with the EC's recent actions as a backdrop.

The CAQ also appreciates the opportunity to be actively engaged in providing information and assistance to the Committee since its formation.[3] For example, under the leadership of the CAQ, the six audit firms that each audit more than 300 U.S. public companies jointly prepared and voluntarily submitted five reports containing more detailed information than has ever been disclosed publicly about the structure and governance, financial circumstances, litigation experience, and human resources of the audit firms.[4] In addition, the Executive Director and five members of the Governing Board of the CAQ, along with member firms' legal counsels, human resources partners, and other senior partners, have appeared before the Committee to present the profession's views on the issues being considered and to answer the Committee's questions.[5] The CAQ has also worked with the various subcommittees.

The CAQ offers the comments below as a continuation of its cooperative efforts to assist the Committee and to suggest how the Committee's initial recommendations can be improved. We first provide an introduction of the principal issues in this comment letter and then address all of the recommendations, following the order in which they appear in the Draft Report.

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[2] *See Commission Recommendation of 5/VI/2008 concerning the limitation of the civil liability of statutory auditors and audit firms* (2008) [hereinafter "EC Recommendations"].

[3] *See, e.g.*, Center for Audit Quality Welcomes Appointments to Treasury Department Advisory Committee on the Auditing Profession (Oct. 2, 2007); http://thecaq.org/newsroom/pdfs/release_10022007.pdf; The Center for Audit Quality, DISCUSSION OUTLINE FOR CONSIDERATION BY THE ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Nov. 30, 2007).

[4] *See* The Center for Audit Quality, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Jan. 23, 2008) [hereinafter "CAQ Report"]; The Center for Audit Quality, SUPPLEMENT TO REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Mar. 5, 2008) [hereinafter "First Supplement"]; The Center for Audit Quality, SECOND SUPPLEMENT TO REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Apr. 16, 2008) [hereinafter "Second Supplement"]. The six firms are BDO Seidman LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton LLP, KPMG LLP, and PricewaterhouseCoopers LLP.

[5] *See, e.g.*, Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Feb. 4, 2008; Statement of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Feb. 4, 2008.

INTRODUCTION

The Draft Report addresses many important issues, and our commentary on these issues is set forth in detail beginning on page 7 of this letter. As an initial matter, however, we want to emphasize three key themes upon which we encourage the Committee to focus: the importance of considering international developments with a view toward aligning major capital markets; the pervasive threats to the U.S. capital markets that arise due to catastrophic liability risks confronted by the profession; and the need to carefully consider the interrelated nature of the Committee's various recommendations.

A. International Considerations

As public company audit firms serve a growing number of multinational clients, the overlapping and sometimes conflicting nature of regulatory and legal obligations in different countries can yield unnecessary inconsistencies and inefficiencies in capital markets. The continuing effort toward international convergence of accounting and auditing standards is a beginning step toward matching jurisdictional standards, regulation and practices within a global marketplace. However, even with convergence, it is likely to be the case that, as capital markets around the world continue to mature, the U.S. capital markets will face increasing competition.

We urge the Committee to develop recommendations that foster alignment of the U.S. and European capital markets. Given the EC's June 5 recommendations, as well as the adoption of the EU 8th Company Law Directive—each of which reflects significant detail in the two areas that the Committee is also debating, audit firm transparency and auditor liability limits—the Committee has a unique opportunity to approve recommendations that could align the world's two most significant capital markets. Indeed, endorsing reforms that mitigate the threat of catastrophic litigation risk for the profession in the United States will also be critical to maintaining the health and vitality of the U.S. markets. To inadequately address the issue of catastrophic liability could disadvantage profoundly the U.S. capital markets, which increasingly compete with those in other countries. The various recommendations therefore should be considered in light of convergence, the value of common regulatory standards and approaches, and the increased competitiveness in global capital markets. The Committee should seek ways to ensure that the auditing profession in the United States does not become unworkable, jeopardized or excluded when compared with other markets.

Toward this end, we found the comments of Committee Member Alan Beller during the June 3, 2008 meeting of the Committee to be thoughtful and appropriately challenging. In commenting on the panel that addressed matters before the Firm Structure and Finances Subcommittee, he explained that he found the panel to be "emblematic of the conversations that have been going on at the Committee and among members of the Committee for months now." He continued:

> One of the things this Committee I think is charged with doing is to look over hills and look around corners and see where we might be. And, I'd like to look around a five year corner. Five years from now, it is, I think, a certainty that the U.S. capital markets will be less than 30% of the market cap of the global markets. It is

> in the low 30s today I think. It was in the high 30s five years ago. So it will be less than 30. It might be 25. It might be 22. It might be 26. Second point, I think it is quite likely that one or more of the Big 4 will have established real global operating—not networks—but real global operating entities that function as single entities with single systems of corporate governance. It is 100 percent certain to me, point three, that if we do not find a better path—or let me not say a better path—but a different path from the one we are currently on, then the chances are precisely zero that the American firms will be part of those global networks. And I guess the question, having looked around that corner, is how satisfied are we going to be with the status quo five years from now?[6]

Mr. Beller then invited written answers to his commentary, which the Committee should consider carefully.

B. The Litigation Risk for Audit Firms

As noted above, after several years of study the EC clearly has identified the civil liability threat to the profession and issued recommendations to address this threat. The Commission found that the "unlimited joint and several liability" facing audit firms could "deter audit firms and networks from entering the international audit market for listed companies in the [European] Community."[7] For these reasons, it recommended that "[t]he civil liability of statutory auditors and of audit firms arising from a breach of their professional duties should be limited except in cases of intentional breach of duties by the statutory auditor or the audit firm."[8]

Moreover, the EC has recognized that these audit firm protections are necessary to protect the European capital markets. As Internal Market and Services Commissioner Charles McCreevy has explained, "we have concluded that unlimited liability combined with insufficient insurance . . . is a potentially huge problem for our capital markets and for auditors working on an international scale. The current conditions are not only preventing the entry of new players in the international audit market, but are also threatening existing firms. In a context of high concentration and limited choice of audit firms, this situation could lead to damaging consequences for European capital markets."[9]

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[6] *See* Statement of Alan Beller, Cleary, Gottlieb, Steen & Hamilton LLP, June 3, 2008, Advisory Committee On The Auditing Profession Webcast, *available at* http://www.treas.gov/offices/domestic-finance/acap/webcasts.shtml (00:04:26-56).

[7] EC Recommendations at 2.

[8] *Id.* at 3.

[9] *EC Recommends Limited Liability for Auditors, Best Practice*, June 9, 2008, *available at* http://www.bestpracticemagazine.co.uk/accountancyage/news/2218602/ec-recommends-limited-liabilty (last visited June 18, 2008).

We are hopeful that the Committee likewise will address the potential catastrophic risk that U.S. firms face. In doing so, the Committee may rely upon the data made available in early January 2008 by the largest accounting firms in the CAQ Report and subsequent data submissions to the Committee. The firms provided a considerable amount of information, under a compressed time schedule, that is valuable in demonstrating the firms' litigation risk, such as: (1) the number of cases filed in public company audit-related cases each year compared with other types of cases and other metrics; (2) the number and types of private actions with exposure greater than $100 million, including a supplemental report regarding private actions with large exposure amounts against the six largest audit firms, pending as of March 21, 2008; and (3) the number of resolved cases for type of service and the payments for resolved cases by type of service over the past 10 years.[10] The Committee should use the data made available by the firms, including data regarding outstanding litigation claims, to support its conclusion that the threat of catastrophic litigation risks is real, and to recommend that policymakers and regulators act in response.

The data submitted by the firms make clear that the potential exposure faced by the firms from pending private actions far exceeds the firms' current financial ability to withstand liability from such exposure. The "'out of pocket' damage[] formula exposes all defendants, not just auditors, to damage claims that are irrationally large and that can easily bankrupt even the most solvent institutions, while failing, in the aggregate, to achieve the essential purposes of the federal securities laws."[11]

The Second Supplement illustrates that, as of March 21, 2008, the six largest audit firms were named as defendants in 90 pending lawsuits with potential claims ranging from $100 million to more than $10 billion.[12] The aggregate amount of the potential claims in these 90 lawsuits exceeds $140 billion. Moreover, included in these 90 lawsuits are 27 claims for damages that exceed $1 billion, with exposure in excess of $10 billion in the 7 largest pending cases.[13]

The ability of a firm to withstand the financial risks of litigation requires weighing the potential size of a judgment or judgments against a partnership's ability to withstand drains on its financial position through any available insurance coverage, capital and liquid assets. As reflected in Appendix C of the CAQ Report, commercially available insurance is "becoming somewhat irrelevant" for many audit firms, with a growing number of claims exceeding insurance limits by ever-increasing margins. And, when the aggregate private action exposure is compared to the aggregate partner capital retained by the firms, the threat that catastrophic litigation poses to the viability of accounting firms is simply undeniable. Specifically, as of their most recent fiscal year ends, the partners' capital retained by the six firms (not including

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[10] CAQ Report at 36-51; Second Supplement.

[11] Written submission of Joseph A. Grundfest, W.A. Franke Professor of Law and Business, Stanford Law School, Feb. 4, 2008, at 1.

[12] *See* Second Supplement at 1.

[13] *See id.* at 1, Appendix A.

partners' undistributed earnings) totaled approximately $3.7 billion in the aggregate.[14] Thus, the potential exposure from private actions faced by audit firms is at least 37 times the size of the firms' available capital.[15]

If a firm's capital is eroded and used to pay litigation claims, it must be replenished. At some point—depending on the level of capital or earnings erosion and the risk of repeat occurrences—partners will leave the firm and profession. To be sure, it is likely that many of the claims against the audit firms will be resolved at a fraction of the claimed amount. But the mere allegation of such overwhelming claims affects the firms' sustainability. Indeed, it could take only one or two cases where settlement is not reached to threaten a firm's existence. The cycle of fleeing partners and wary clients could spell the end for a firm, if judgments or regulatory actions themselves did not. Moreover, even if a firm is able to settle 99% of its cases for amounts less than its total capital, its inability to settle 1% of such cases may be fatal to the firm. An inability to settle just one mega-claim could lead to the demise of an entire firm.

C. Interaction Among Various Recommendations

The Committee stands in the unique position of being able to observe many aspects of the profession and adopt a comprehensive approach to recommendations for the improvement and sustainability of the profession. The Committee process has involved the formation of several subcommittees that have focused on key issues (human capital, firm structure and finances, and concentration and competition) and each has produced a number of useful recommendations to assist in each of their areas. Although we discuss each of these recommendations individually below, the Committee should determine how these recommendations will work as a whole to assure the sustainability of the profession; some recommendations will need to be modified when considered with recommendations elsewhere in the Draft Report, so as not to undermine the broader purpose of the Committee's work.

This tension between various recommendations is exemplified by the consideration of transparency and competition issues. For example, recommendations in the Draft Report that support imposing additional reporting requirements could push smaller firms away from conducting public company audits, exacerbating the problem of concentration. Such a result obviously would be at odds with the goals of the recommendations designed to diminish concentration in the profession.

The issues in the Draft Report are interrelated in manners that could enhance sustainability and competition. For example, if the Committee were to recommend action to address catastrophic litigation risk, such recommendations could work toward reducing concentration. The Government Accountability Office reported that "over half (61 percent) of midsize and smaller audit firms reported that liability/tort reform would be at least somewhat

[14] *See* CAQ Report at 24.

[15] Even if the undistributed earnings were included in this calculation, the partner capital retained by the six firms would total approximately $5.8 billion in the aggregate. Using this baseline, the potential exposure from private actions would be at least 24 times the size of the firms' capital.

effective in helping them increase their market share."[16] Of course, leaving the current litigation environment unaddressed will have a negative effect on concentration. As one smaller firm representative testified: "The more threatening the liability environment the less likely smaller firms are to take on larger public company clients."[17]

* * *

The following are our more detailed comments on the Committee's draft recommendations and requests for comment.

I. HUMAN CAPITAL

The public company auditing profession faces significant human capital challenges. The CAQ agrees with the Committee that the "profession needs to continue to attract and develop professionals at all levels who are prepared to perform high quality audits in this dynamic environment."[18] Indeed, evidence presented by the CAQ to the Committee shows that the demand for individuals capable of performing public company audits has grown significantly over the past several years and is expected to continue growing.[19] The CAQ generally supports the Committee's recommendations with respect to human capital.

"Recommendation 1. Implement market-driven, dynamic curricula and content for accounting students that continuously evolve to meet the needs of the auditing profession and help prepare new entrants to the profession to perform high quality audits."[20]

The CAQ supports the Committee's recommendation to address the need to update relevant examinations, teaching materials, and curricula to reflect recent trends in the accounting profession so that graduates can provide high-quality audits.

The CAQ notes that the audit profession already supports awareness campaigns for high school and early college students, and suggests the Committee also recommend that additional efforts be undertaken to expand the awareness of students at the high school level about the opportunities in the audit profession.

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[16] U.S. Government Accountability Office, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION (Jan. 2008), at 55.

[17] Written Submission of Kenneth Nielsen Goldmann, Capital Markets and SEC Practice Director of JH Cohn LLP, May 27, 2008, at 5.

[18] Draft Report at V:1; 73 Fed. Reg. at 28,192.

[19] CAQ Report at 53-55.

[20] Draft Report at V:1; 73 Fed. Reg. at 28,192.

"Recommendation 2. Improve the representation and retention of minorities in the auditing profession so as to enrich the pool of human capital in the profession."[21]

The profession is committed to diversity and is seeking ways to build a more diverse workforce.[22] The outreach efforts proposed by the Committee should assist the profession in attracting minority students to auditing public companies. As the Draft Report recognizes, one or more of the six largest accounting firms recruit at 27 of the Historically Black Colleges and Universities ("HBCUs"), about half of the HBCUs that have accounting programs.[23] The CAQ has also encouraged the increased use of sabbaticals and internship and fellowship opportunities at audit firms.[24]

Although currently "[n]one of the [largest auditing] firms recruit[] at community colleges for purposes of hiring professional audit staff," the CAQ recognizes that appropriate outreach programs to community colleges may be an effective part of a broader recruitment and retention strategy.[25] The CAQ agrees with the Committee that continuing and broadening efforts to increase the number of minority accounting doctorates, through programs such as KPMG's Ph.D. Project, will assist the profession to achieve these objectives. The CAQ is optimistic that the implementation of the Committee's recommendations will bring similar improvements in minority recruitment and retention.

"Recommendation 3. Ensure a sufficiently robust supply of qualified accounting faculty to meet demand for the future and help prepare new entrants to the profession to perform high quality audits."[26]

The CAQ is keenly aware of the significant problems the profession faces as the result of dwindling numbers of accounting faculty. The CAQ concurs with the Committee's recommendations to increase the number of accounting faculty by seeking additional public and private funds, by providing incentives to motivate faculty research in areas related to the auditing practice, and by increasing the use of cross-sabbaticals.[27]

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[21] Draft Report at V:5; 73 Fed. Reg. at 28,193.

[22] *See* CAQ Report at 60.

[23] Draft Report at V:7 (citing the First Supplement at 1); 73 Fed. Reg. at 28,194; *see id.* (noting that there are "over fifty" HBCUs that maintain accounting programs).

[24] Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Feb. 4, 2008, at 2.

[25] First Supplement at 1; *see, e.g.*, Written Submission of Gilbert R. Vasquez, Managing Partner, Vasquez and Company LLP, Feb. 4, 2008, at 4 ("Community Colleges are overlooked and Companies should have a strategy, especially in the internship area to reach out to Community Colleges.").

[26] Draft Report at V:10; 73 Fed. Reg. at 28,195.

[27] Draft Report at V:10-V:15; 73 Fed. Reg. at 28,195-97.

As the Committee acknowledges, the profession has undertaken significant efforts to increase the number of doctoral candidates.[28] The AICPA Foundation, the 80 largest CPA firms, and state CPA societies are in the process of raising $17 million to fund additional Ph.D. candidates.[29] This $17 million will fund 120 Ph.D. candidates over the next seven years. The CAQ is hopeful that this and other similar efforts will significantly reduce the gap in doctoral candidates and boost the number of accounting faculty overall.

The CAQ recognizes, however, that providing more doctoral candidates alone will not resolve the immediate faculty crisis faced by accounting schools. That is why the CAQ "[e]ncourage[s] accreditation bodies to revise accreditation standards to allow the employment of more audit professionals, either active or retired, as adjunct professors."[30]

We have also suggested an increase in the number of H1-B visas to expand the faculty pool and enhance the global/trans-national capability of audit teams.[31] Such an increase will further enhance the ability to recruit IFRS experts from abroad to help train U.S. professionals as we move toward convergence with IFRS. As noted with respect to the second recommendation in this section, the CAQ has also encouraged the increased use of sabbaticals and internship and fellowship opportunities at audit firms.[32] The profession has also engaged in a number of other projects to support doctoral candidates, promote student interest in tax and accounting issues, sponsor faculty conferences, and promote faculty research.[33] The CAQ believes that the continuation and expansion of these programs in accordance with the Committee's recommendations should help improve the number and quality of faculty at accounting schools.

"Recommendation 4. Develop and maintain consistent demographic and higher education program profile data."[34]

The CAQ agrees with the Committee's recommendation to develop and maintain consistent demographic and higher education program profile data.[35] As the Committee noted, the CAQ has provided some of the types of information that the profession might use to obtain a

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[28] Draft Report at V:10-V:12; 73 Fed. Reg. at 28,195-96.

[29] Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Feb. 4, 2008, at 2.

[30] *Id.* at 3; *see also* Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, Feb. 4, 2008, at 14 (encouraging the Committee to consider "a recommendation to ease national accreditation requirements to permit universities to use more adjunct professors").

[31] Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Feb. 4, 2008, at 3.

[32] *Id.* at 2; *see also* Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, Dec. 3, 2007, at 4 (expressing support for faculty sabbaticals).

[33] Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, Feb. 4, 2008, at Appendix A (listing more than thirty programs).

[34] Draft Report at V:15; 73 Fed. Reg. at 28,197.

[35] *Id.*

better understanding of human capital issues,[36] and the CAQ remains willing to assist or serve as a member of any national cooperative committee established to generate and disseminate such data.

"Recommendation 5. Encourage the AICPA and the AAA to jointly form a commission to provide a timely study of the possible future of the higher education structure for the accounting profession."[37]

The CAQ agrees with the Committee that the possibility of a postgraduate professional school should be considered, especially in light of the increasing complexity of auditing and accounting standards and the need for auditors with specialized knowledge. The focus of this recommended commission would significantly impact the public company auditing profession. The CAQ therefore supports a meaningful dialogue between academia and the profession on this and other ways to help educate graduates capable of performing quality audits of public companies.

II. FIRM STRUCTURE AND FINANCES

We commend the Committee for addressing several key issues of firm structure and finance. The CAQ strongly supports working with the profession and government regulators to improve the four areas targeted by the Committee's recommendations. In particular, issues of fraud prevention and auditor mobility are highly significant to the future of the auditing profession.

We also wish to emphasize the broad consensus in the profession for additional cooperation between regulators on both the state and federal levels. Indeed, we believe that such regulatory cooperation should be encouraged on a wide range of issues beyond those discussed in the Draft Report.

"Recommendation 1. Strengthen auditing firms' fraud detection and prevention skills and clarify communications with investors regarding auditing firms' fraud detection responsibilities."[38]

In order to strengthen firms' fraud detection and prevention skills, the Committee recommends the creation of a "national center" to pool the collective expertise of the profession (and other market participants) in this area, to commission new research, and to promulgate best practices.[39] Further, the Committee urges the SEC and the PCAOB to clarify in the auditor's

[36] Draft Report at V:15-16; 73 Fed. Reg. at 28,197-98; *see also* CAQ Report at 53-60 & Appendix E (containing human capital data).

[37] Draft Report at V:16; 73 Fed. Reg. at 28,198.

[38] Draft Report at VI:1; 73 Fed. Reg. at 28,198.

[39] Draft Report at VI:2; 73 Fed. Reg. at 28,198-99.

report the auditor's role in detecting fraud and to review and update periodically the auditing standards with regard to fraud detection, in order to address the "expectations gap."[40]

We generally agree with both of these proposals—the creation of a national center and the clarification of the auditor's role—and wish to offer our views on how the Committee can strengthen and bring sharper focus to this recommendation.

A. Creation of a National Center for Fraud Prevention and Detection

The CAQ fully supports the creation of a national center to share experiences and develop best practices for fraud prevention and detection, as recommended by the Committee.[41] Our commitment to this idea is such that we volunteer to house the center within the CAQ and assume responsibility for its administration. The goals of a fraud prevention center dovetail with the central purpose of the CAQ: to enhance the quality of audits and to foster confidence in the audit process. The CAQ already assembles members of the profession, academics, investors, and government officials to pool expertise and discuss issues relating to audit quality. As Mr. Edward E. Nusbaum, Chief Executive Officer of Grant Thornton LLP, testified, a "centralized collection of data [on fraud prevention and detection] through the Center for Audit Quality would provide a broad industry view that could not be obtained by a single audit firm."[42] The CAQ also conducts research and issues recommendations to enhance the quality of public company audits, and we provide technical support to the auditors of public companies. Thus, the CAQ is well-positioned to incorporate a new center dedicated to improving those aspects of an audit that uncover potential fraud.

Clearly, the involvement of other market participants in the center is vital. The need for such wide participation reflects both the collective interest of all market participants in preventing and detecting fraud and the broad impact acts of fraud can have. Such participation also represents the best way to develop consensus best practices in this area.

One issue that we would like the Committee to address in its Final Report is whether there is a possibility that the creation of a national center for fraud prevention and detection could implicate competition laws in the United States. Based on this concern, one witness suggested that the "Committee could recommend that regulators explore with the profession and aid in resolution of any anti-trust issues that may impede such efforts."[43] Although many professions have mechanisms for sharing "best practices" without running afoul of the anti-trust laws, we are sufficiently concerned that we would like to see these questions resolved, so that the profession may proceed with creating the center. Perhaps the Committee could seek an

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[40] Draft Report at VI:3; 73 Fed. Reg. at 28,199.

[41] *See* Draft Report at VI:2; 73 Fed. Reg. at 28,198-99.

[42] Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, Feb. 4, 2008, at 10.

[43] Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, Dec. 3, 2007, at 7.

authoritative statement on the issue from the Justice Department, and include that statement in the Final Report.

B. Clarification in the Auditor's Report of the Auditor's Role in Detecting Fraud

As the Committee observes, "[t]he public may believe that auditors will detect more fraud than those in the profession believe can be reasonably expected."[44] Auditors are not capable of, nor are they responsible for, detecting all fraud that may have occurred at an audit client. To address this "expectations gap," the Committee recommends having the PCAOB and the SEC clarify the auditor's role in detecting fraud under current standards.[45] Further, the Committee recommends that "the PCAOB periodically review and update these standards."[46]

Members of the profession testified before the Committee as to the importance of closing the "expectations gap." Mr. Dennis M. Nally, Chairman and Senior Partner of PricewaterhouseCoopers, asserted that "[f]ew accounting issues are more important or, at the same time, create more confusion than the auditor's role in relation to fraud."[47] Barry Salzberg, Chief Executive Officer of Deloitte LLP, noted that "[j]uries often . . . mistakenly believe that failure to detect a fraud is conclusive evidence of recklessness" on the part of the auditor.[48] The Committee also heard from other experts about this problem.[49]

Auditors have a responsibility to plan and perform audits to obtain reasonable—but not absolute—assurance that financial statements of public companies are free from material misstatement, whether or not such misstatement results from fraud. Auditors do not, and should not, serve as full guarantors of each item in a company's financial statements. As the Committee notes, AU Section 316 requires auditors to plan and perform the audit to obtain reasonable assurance as to material misstatements, regardless of whether they arise from error or fraud.[50] But the auditing standards make clear that the auditor's duty is limited to *material* misstatements, not all misstatements evidencing fraud: "the auditor's interest specifically relates to acts that result in a *material misstatement of the financial statements*."[51] It is vital that investors and other market participants understand this, as well as the concept of *reasonable* assurance.

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[44] Draft Report at VI:3; 73 Fed. Reg. at 28,199.

[45] *Id.*

[46] Draft Report at VI:4; 73 Fed. Reg. at 28,199.

[47] Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, Dec. 3, 2007, at 6.

[48] Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, Feb. 4, 2008, at 5.

[49] *E.g.,* Written Submission of James R. Doty, Partner, Baker Botts LLP, Dec. 3, 2007, at 14.

[50] *Consideration of Fraud in a Financial Statement*, Interim Auditing Standard, AU Section 316.01 (PCAOB 2002).

[51] *Id.* at 316.05 (emphasis added).

There is also a second dimension to fraud prevention and detection that should be explained in the auditor's report. As part of educating the public about auditors' responsibilities in this area, the PCAOB and the SEC should remind investors and management of public companies that fraud prevention and detection is management's obligation as well. Indeed, AU Section 316 states this clearly: "Although this section focuses on the auditor's consideration of fraud in an audit of financial statements, it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud."[52] In reaching this conclusion, AU Section 316 cites to the October 1987 REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (the Treadway Commission) which advised—"so that public understanding of the relative and complementary obligations of corporate management and independent public accountants is improved"—that "management's primary responsibility for reliable financial reporting should be emphasized."[53]

We wish to sound a word of caution about potential changes to the auditor's report. As discussed in greater detail in our commentary on the Addendum, all efforts to alter the auditor's report should proceed with great care, in light of the potential legal and regulatory significance of any such changes. Other countries, such as those in the EU, use more expansive forms, but these countries also have vastly different legal systems and legal cultures, and greater liability protections for auditors. It would be a mistake to emulate other forms without considering their regulatory and legal context.

It is also important to recall just how difficult fraud detection can be. Those who perpetrate fraud are often adept at covering their tracks, altering books and records in order to avoid detection during audits. Further, outside conspirators can assist those within the company, for example, by providing false third party confirmations. Third party confirmations have traditionally been viewed as the most reliable form of audit evidence. This is yet another reason why all constituencies must bear responsibility for fraud prevention and detection, and why it is appropriate that investors and other market participants understand the audit report focuses on providing reasonable assurance as to whether the financial statements are materially misstated.

Finally, we support the last portion of this recommendation—that the PCAOB periodically review and update the auditing standards relating to fraud detection. Of course, we urge the PCAOB to consult with the profession as part of this ongoing review, to build on existing standards, and to recognize international standards in this area.

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[52] *Id.* at 316.04.

[53] REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (Oct. 1987), at 6.

“Recommendation 2. Encourage greater regulatory cooperation and oversight of the public company auditing profession to improve the quality of the audit process and enhance confidence in the auditing profession and financial reporting.”[54]

The second recommendation relating to firm structure and finances addresses the significant challenges faced by auditors and audit firms operating in a multi-jurisdictional regulatory environment. This recommendation has three parts.

First, in order to permit auditor mobility across state lines, the Committee advises that all U.S. states adopt the mobility provisions of the Uniform Accountancy Act, Fifth Edition (“UAA”), and if any fail to do so by December 31, 2010, then Congress should mandate such adoption by all states.[55]

Second, the Committee recommends “regular and formal” meetings of governmental regulators and enforcement bodies to reduce regulatory inconsistency and redundancy, and to improve regulatory effectiveness.[56]

Third, the Committee urges the states to grant greater operational and financial independence to their boards of accountancy.[57]

A. Congressional Mandate that States Pass the UAA’s Mobility Provisions

We appreciate the Committee’s support for greater auditor mobility across state lines. As we noted in our November 30, 2007 letter to the Committee, “[p]rofession mobility—in the U.S. and globally—is of heightened interest as firms look to staff audit engagements across state borders . . . .”[58] Understandably, divergent licensing regimes and state-by-state regulatory approaches have frustrated audit firms by hindering their ability to deploy professionals across the country.

Indeed, the Committee heard concerns about interstate auditor mobility from a number of those who testified. Mr. Salzberg of Deloitte advised that “[a] national licensing program would ease the current numerous and significant burdens placed on firms and individual professionals related to state licensing, in addition to temporary mobility considerations.”[59] Similarly, Mr. Nusbaum of Grant Thornton observed that “[c]onsistent licensing across U.S. jurisdictions

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[54] Draft Report at VI:4; 73 Fed. Reg. at 28,199.

[55] Draft Report at VI:6; 73 Fed. Reg. at 28,200.

[56] *Id.*

[57] Draft Report at VI:7; 73 Fed. Reg. at 28,200.

[58] Letter from James S. Turley, Chair, Governing Board, Center for Audit Quality; and Cynthia M. Fornelli, Executive Director, Center for Audit Quality, to Advisory Committee on the Auditing Profession (Nov. 30, 2007), at 7.

[59] Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, Feb. 4, 2008, at 10.

would allow public accounting firms to put human resources and expertise where and when they are needed most," and noted that "[s]uch mobility is consistent with the realities of modern auditing and the geographic diversity of the registrant population."[60] James S. Turley, Chairman and Chief Executive Officer of Ernst & Young, expressed the importance of this issue and asked that the Committee "recommend those states that have not yet adopted the mobility provisions of the UAA do so as quickly as possible."[61]

It is important to note that a number of states are in the process of adopting mobility provisions. Already more than 25 states have adopted mobility provisions similar to those in the UAA. David A. Costello, President and Chief Executive Officer of the National Association of State Boards of Accountancy ("NASBA"), projected that up to 45 or even 50 states will enact mobility provisions by the end of 2009.[62]

As we have stated, the CAQ agrees with the goal of this recommendation, but we believe that, for some of the reasons identified by Mr. Costello, it may be prudent to delay any federal action to observe ongoing progress in the states. If states are moving toward implementation of mobility provisions at the pace Mr. Costello described, federal legislation may prove unnecessary.

At a minimum, the December 31, 2010 deadline may not account fully for the realities of enacting new legislation in different states. The Committee acknowledges that "some state legislatures meet biannually," and yet concludes that "such a deadline should be attainable."[63] Although this technically may be sufficient time to meet the deadline, we are concerned that some legislatures will not act quickly enough. Further, there may be delays between final enactment and the effective date of bills, and some states will have to promulgate rules to make the new law effective. Consequently, if the Committee retains this recommendation, it should consider adopting a December 31, 2011 deadline while encouraging prompt actions by states that have yet to adopt the UAA mobility provisions.

We agree that the Committee should recommend that states participate in NASBA's Accountancy Licensee Database.[64] This will aid in effective oversight nationally.

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[60] Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, Feb. 4, 2008, at 7.

[61] Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, Dec. 3, 2007, at 5.

[62] Statement of David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Meeting Minutes, Dec. 3, 2007 (79:13-79:14).

[63] Draft Report at VI:5; 73 Fed. Reg. at 28,200.

[64] *See* Draft Report at VI:5-6; 73 Fed. Reg. at 28,200.

B. Regular and Formal Meetings of State and Federal Regulators

The Committee recommends establishing a formal, regular meeting of regulators—including the SEC, the PCAOB, the DOJ, state attorneys general, and state boards of accountancy—to review the enforcement of regulations that apply to accountants and accounting firms.[65] The CAQ has facilitated cooperation among regulators in an effort to improve audit quality, and we support this proposal as a way to increase regulatory cooperation and efficiency and to reduce redundancy and inconsistency.

Many entities bear responsibility for the regulation and oversight of audits in the United States. In addition to those entities listed by the Committee, the Government Accountability Office, the Department of Labor, and federal and state bank regulators also have certain oversight functions. With regard to both regulation and enforcement, under current law there will almost always be overlapping jurisdiction and, in turn, overlapping efforts on the part of different regulatory bodies. To avoid conflict and redundancy, regulators should act cooperatively and in coordination with each other whenever possible. Indeed, in an increasingly global economy, coordination of regulatory and disciplinary efforts becomes increasingly important. We see the Committee's proposal for regular, formal meetings of regulators at various levels to be a step forward in increasing this vital interaction.

C. Greater Independence for State Boards of Accountancy

The Committee, in the third component of the recommendation, addresses concerns about state boards of accountancy receiving sufficient funding and operational independence from other state entities.[66] We appreciate the Committee's caveat that this recommendation should not impede any efforts at greater cooperation between state and federal regulators, as discussed above.[67]

"Recommendation 3. Urge the PCAOB and the SEC, in consultation with other federal and state regulators, auditing firms, investors, other financial statement users, and public companies, to analyze, explore, and enable, as appropriate, the possibility and feasibility of firms appointing independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency at auditing firms."[68]

The CAQ recognizes that there may be potential benefits to including independent members on firm boards, but this issue is quite complicated and requires careful consideration. Having sounded this cautionary note, we do believe that the concepts within this proposal offer some promise. A governance regime featuring independent, outside perspectives could improve

[65] Draft Report at VI:7; 73 Fed. Reg. at 28,200.

[66] *Id.*

[67] *See id.*

[68] Draft Report at VI:7-8; 73 Fed. Reg. 28,190, 28,201 (May 15, 2008).

public confidence in the profession, add to the diversity of perspective within audit firms, contribute to firms' best practices, and supply specific expertise.

Others have also recognized the potential value in this idea. For instance, Mr. Nusbaum of Grant Thornton testified that "Grant Thornton International's network has initiated preliminary internal discussion about the value of including independent members on its international governing board."[69] He observed that this could potentially "strengthen [the firm's] ability to serve market participants and reinforce independence."[70] Similarly, Mr. Turley of Ernst & Young noted that "inclusion of individuals from outside the firm in a director, advisory or related role" might merit consideration as means of furthering audit firms' "public interest obligations."[71]

Significantly, however, these witnesses did not categorically approve of instituting such an independent director requirement. Rather, they supported further consideration, because they, like the Committee, acknowledge the various obstacles to this suggestion.[72]

First among these concerns, as the Committee and others observed, is the possibility that such a structure would run up against various auditor independence requirements.[73] The Committee notes that "independence requirements" are among "the multiple challenges that instituting a governance structure with independent board members might entail."[74] Some firms testified that they would experience problems recruiting qualified candidates because of these rules.[75]

We share the concerns expressed before the Committee about the implication of this proposed governance change for the independence rules.[76] It is important that independence be maintained "both in fact and in appearance."[77] Having an independent director who also

[69] Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, Feb. 4, 2008, at 7.

[70] *Id.*

[71] Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, Dec. 3, 2007, at 10.

[72] *See* Draft Report at VI:9; 73 Fed. Reg. at 28,201.

[73] *See id.*; Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, Dec. 3, 2007, at 10 (stating that "the independence rules can present uncertainties and challenges to the ability of firms to utilize individuals [as independent directors]").

[74] Draft Report at VI:9; 73 Fed. Reg. at 28,201.

[75] *E.g.*, Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, Feb. 4, 2008, at 13 ("[I]t would be very difficult to recruit qualified outside advisors, because they would become subject to the firm's financial and other independence restrictions.").

[76] Draft Report at VI:9; 73 Fed. Reg. at 28,201.

[77] 17 C.F.R. § 210.2-01 (Qualifications of accountants).

happens to be affiliated with an audit client could raise concerns about the appearance of the audit firm's independence. In light of the recognized impediments stemming from auditor independence requirements, the inclusion of a limitation that calls for the PCAOB and the SEC to explore this possibility "within the current context of independence requirements and the liability regime" seems entirely counter to the recommendation. To make progress in this area, the PCAOB and the SEC need to address the recognized impediments, not acquiesce in them.

This proposal could also implicate state laws restricting the composition of firm governance bodies. As the CAQ explained in a recent report to the Committee, state law generally requires that "individuals who are licensed as certified public accountants must hold a minimum percentage of the ownership rights, in terms of financial interests and voting rights, in such accounting firms."[78] In addition, state partnership laws might also impose restrictions on the governance of a limited liability partnership, as the Committee acknowledges.[79]

Also among the concerns with this proposal noted by the Committee are "insurance availability for such directors[] and liability concerns."[80] As the CAQ demonstrated to the Committee, "[t]he insurance coverage currently available to audit firms does not protect against the largest claims."[81] This is true of not only the very largest national firms, but also for regional audit firms.[82] One would also expect firms to experience similar difficulty in acquiring an appropriate level of directors and officers liability insurance for their independent directors.[83]

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[78] CAQ Report at 2.

[79] *See* Draft Report at VI:8-9; 73 Fed. Reg. at 28,201.

[80] *See id.*

[81] CAQ Report at 52; *see also* Commission on the Regulation of U.S. Capital Markets in the 21st Century, REPORT AND RECOMMENDATIONS (March 2007), at 9 (stating that "commercial insurance simply is not available to [audit] firms in adequate amounts to cover [catastrophic] claims"); Aon, MEGA-CLAIMS: ANALYSIS OF A SELECTION OF LARGE PUBLICLY KNOWN MATTER INVOLVING AUDITORS (Sept. 21, 2005) (concluding that "the auditing profession is one of the very few where insurance protection for catastrophic losses is simply not available") (quoted in Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, Feb. 4, 2008, at 3).

[82] *See* Aon, INSURANCE AVAILABILITY STUDY: FOCUS ON NATIONAL, REGIONAL AND MEDIUM-SIZED ACCOUNTING FIRMS at 4 (reporting that, "by virtue of their financial size, a significant proportion of this segment's clientele is capable of generating liabilities that could easily exceed the limits of coverage available in the commercial marketplace"), provided in the CAQ Report at Appendix D.

[83] *See* Statement of Alan Beller, Cleary, Gottlieb, Steen & Hamilton LLP, May 5, 2008 Advisory Committee On The Auditing Profession Webcast, *available at* http://www.treas.gov/offices/domestic-finance/acap/webcasts.shtml (2:02:52–2:03:40) ("[T]he [Big 4] companies are uninsurable and there is no reason to believe that the directors are going to be any more insurable than the companies are and that's a very big difference from the rest of public corporate America . . . ."); Statement of Conrad Hewitt, SEC Chief Accountant, May 5, 2008 Advisory Committee On The Auditing Profession Webcast, *available at* http://www.treas.gov/offices/domestic-finance/acap/webcasts.shtml (2:11:31–2:12:03) ("[T]he liability issue is just insurmountable, I mean, why would any individual knowing the litigation history of the public accounting profession want to serve on the board without any liability coverage? It just doesn't make sense.").

Without sufficient insurance, it is highly unlikely that "outside" directors would be willing to serve.[84]

Finally, we note that any reform of audit firm governance must be done with the utmost sensitivity to the vast array of business models utilized by firms across the country, with different practices, of different sizes, and in different locations. If incorporating an independent board of directors into the existing firm structure were to become a requirement, each firm must retain the ability to determine the most effective structure for its business. Indeed, some consideration should be given to whether small firms will even be able to retain qualified outside directors, given the legal and regulatory burdens of such a role. Appropriate flexibility will permit each audit firm to continue to function with minimal disruption, while also allowing it to choose a structure that maximizes the benefits of the independent directors.

Of course, some firms may take up the Committee's alternative suggestion to institute an advisory board "with meaningful governance responsibilities to improve governance."[85] As the Committee notes, some firms currently use independent advisory boards, and given the obstacles discussed above, this may be a particularly attractive option.[86] The CAQ believes that this issue is worth studying.

Audit firms could benefit from the sort of independent advice and oversight employed by public companies. We simply highlight the significant number of legal, regulatory, and policy reservations with this recommendation to encourage thorough exploration of any proposal to alter audit firm structures, so that the obstacles are understood and addressed. As noted above, in light of the recognized impediments stemming from auditor independence requirements, the inclusion of a limitation that calls for the PCAOB and SEC to explore such possibilities "within the current context of independence requirements and the liability regime" seems entirely counter to the recommendation, and self-defeating.

"Recommendation 4. Urge the SEC to amend Form 8-K disclosure requirements to characterize appropriately and report every public company auditor change and to require auditing firms to notify the PCAOB of any premature engagement partner changes on public company audit clients."[87]

The fourth recommendation of the "Firm Structure and Finances" section concerns the public disclosure of changes in the auditor of a public company. We discuss each part of this recommendation separately.

[84] Indeed, the lack of insurance is one aspect of the liability problem confronting audit firms more generally, as discussed in greater detail below.

[85] Draft Report at VI:7-8; 73 Fed. Reg. at 28,201.

[86] *See* Draft Report at VI:8-9; 73 Fed. Reg. at 28,201.

[87] Draft Report at VI:10; 73 Fed. Reg. at 28,201-02.

A. Disclosure of Reasons for Auditor Change

Currently, Item 4.01 of Form 8-K requires registrants (that are not foreign private issuers) to report, among other things, if their auditor "who was previously engaged as the principal accountant to audit the registrant's financial statements . . . resigns . . . or is dismissed," or "indicates that it declines to stand for re-appointment."[88] They must similarly disclose when a new auditor is engaged.[89] The specific content of the disclosure is governed by Item 304 of Regulation S-K.[90] Among other things, Item 304 requires the registrant to reveal any disagreements with the accountant "on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreement(s), if not resolved to the satisfaction of the former accountant, would have caused it to make reference to the subject matter of the disagreement(s) in connection with its report."[91] Item 304 also inquires about the role of the board of directors in the dispute and any restrictions placed on the former auditor in discussing the matter with his or her successor.[92]

As the Committee recognizes, Item 304 does not require the registrant to detail the reasons for an auditor's departure in "the vast majority of cases."[93] Indeed, the Committee reports that approximately 30% of all auditor changes in 2006 generated such a disclosure.[94] The Committee's recommendation seeks disclosure of the details for the other 70%. "The public company would file within four days of an auditor change a Form 8-K disclosing that an auditor had resigned, was terminated, or did not seek reappointment; the company would appropriately characterize and state in all cases in plain English the reason or reasons for the change."[95] In addition to recommending this change to the SEC, the Committee advocates requiring companies to disclose whether the audit committee of its board agreed with the company's disclosure and to allow the auditor to comment on the disclosure's accuracy in an exhibit to the disclosure or in a subsequent Form 8-K filing.[96]

The CAQ agrees with the Committee (and with members of the profession who voiced support for this idea) that expanded 8-K requirements with regard to auditor changes are in the best interest of investors and the profession. Indeed, we ask the Committee to improve this recommendation by urging the SEC to institute additional disclosure requirements.

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[88] SEC, Form 8-K, Item 4.01, Changes in Registrant's Certifying Accountant.

[89] *Id.*

[90] 17 C.F.R. § 229.304(a)(2).

[91] Item 304(a)(iv) of Regulation S-K, 17 C.F.R. § 229.304(a)(iv).

[92] *Id.*

[93] Draft Report at VI:10; 73 Fed. Reg. at 28,202.

[94] *See id.*

[95] Draft Report at VI:11; 73 Fed. Reg. at 28,202.

[96] *See id.*

Most importantly, we believe that the disclosure of a change in auditor should be triggered by objective events that could be important to investors. Such facts would include details of the registrant's financial reporting and its various governance and financial reporting processes. The CAQ's primary concern is that disclosure of auditor change not be dominated by subjective "reasons" for the shift. If this reporting requirement could be satisfied with subjective information, we fear that boilerplate statements will stand in for the more useful disclosures sought by the Committee. The inclusion of objective information will ground the disclosure in matters most important to investors. We offer the following (which includes the current requirements) as suggestions for the type of objective information that a revised Item 304(a)(iv) of Regulation S-K should seek:

- any material, unresolved accounting or auditing issues pending at the time of the auditor change;

- any change in auditor that resulted from a conclusion that the auditor's independence from the registrant was impaired;

- any client-initiated request to change the lead audit partner within two years of changing audit firms;

- any restatement, issued by the registrant during the registrant's two most recent fiscal years, or any subsequent interim period, of audited or interim financial statements for a correction of an error, or other circumstances requiring a Form 8-K disclosure or amendments of prior filings for reasons relating to the financial statements and the related auditors' opinion;

- any requirements that have been imposed by a successor auditor as a condition of that successor auditor's acceptance of the audit engagement; and

- any requirement by a successor auditor, as a condition of engagement, to a change in company personnel who have a role in financial reporting oversight or in control processes.

B. Notifying the PCAOB of Engagement Partner Changes

The CAQ questions the utility of the second part of this recommendation, concerning the disclosure by the audit firm of engagement partner changes. First, we observe that making retirement the only exception to the explanation requirement is not useful, as the omission of a reason for the switch will consequently always signify retirement. Second, and more importantly, the apparent definition of "premature" is far too broad and will elicit large amounts of information that would be of little use to the PCAOB or investors.

There are many relatively common circumstances that may precipitate an unscheduled change in an engagement partner. These could include shifts in internal firm staffing needs and changes in the audit partner's personal circumstances. We do not see how such information would assist the PCAOB in regulating audit firms, or benefit investors.

Therefore, the CAQ recommends that the Committee narrow this aspect of the recommendation to focus on what specific information it thinks the PCAOB needs from the audit firm in the event of a change in engagement partner. Any reporting requirement should be tailored to obtain the specific information sought. For example, if the engagement partner is replaced at the request of the public company audit client, that could be disclosed.

III. ADDENDUM TO FIRM STRUCTURE AND FINANCES

On May 30, 2008, the Committee issued the Addendum on firm structure and finances. The Addendum contained one recommendation and three topics for discussion. We provide our views on each in turn.

"Recommendation: Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's reporting model."[97]

As discussed above on pages 12 and 13, we support revisions to the auditor's report that would more fully explain the auditor's responsibilities with respect to detecting fraud and emphasize management's responsibility for preventing and detecting fraud.[98] Beyond these revisions, however, we have concerns about further changes to the auditor's report without further exploration. The profession supports changes in the auditor's report that enhance the profession's value proposition in the capital markets; but any such changes should be thoughtfully and carefully considered in the context of the overall litigation environment. As the Committee recognizes, although countries such as Germany require issuance of a long-form report, "this debate over such disclosures is unfolding in a litigation environment different from that in the United States."[99] Not only should the PCAOB "take cognizance of the proposal's potential legal ramifications,"[100] but the Committee itself should acknowledge that the risk of catastrophic liability must inform any potential changes to the auditor's report. In addition, because they are the company's financial statements, management should have primary responsibility for assessing which areas of a financial statement require a higher level of judgment.

[97] Addendum at 1; 73 Fed. Reg. at 33,487.

[98] The CAQ notes that the recommendations issued by one of the commissions cited by the Committee have already been addressed. The Treadway Commission recommended two changes with respect to the audit report: (1) the report "should explain that an audit is designed to provide reasonable, but not absolute, assurance that the financial statements are free of material misstatements arising as a result of fraud or error" and (2) the report "should describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control." National Commission on Fraudulent Financial Reporting, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (Oct. 1987), at 13. The Treadway Commission's first recommendation is already reflected in the auditing standards, and is further considered by the Committee in recommendation 1(b) of this section; and the second recommendation has essentially been codified in Section 404 of the Sarbanes-Oxley Act.

[99] Addendum at 3; 73 Fed. Reg. at 33,488.

[100] Addendum at 4; 73 Fed. Reg. at 33,489.

Engagement Partner Signature

In the Addendum, the Committee states that it "is considering recommending that the PCAOB revise its auditor's report standard to mandate the engagement partner's signature on the auditor's report."[101] There is uncertainty about whether the requirement would result in increased liability to the signing partner. The Committee's suggestion that "the signing partner should face no additional liability than that under the current liability regime"[102] by itself offers little comfort to potential signing partners. If such a requirement were implemented without a safe harbor that made clear the partner signing the report would incur no additional liability as a result of signing the report, no one can predict how courts would address the issue. A safe harbor provision that clarifies no additional incremental liability for signing partners is intended should accompany any signature requirement.

In addition, requiring engagement partner signature could be detrimental to the human capital needs of the profession, as prospective engagement partners may be disinclined to take on real or perceived added risk associated with the signature requirement. Although, as the Committee noted, other jurisdictions may require engagement partner signatures, the Committee does not consider the different liability schemes under which those jurisdictions operate.[103] Disclosing a partner's name to the public also could create potential personal security and privacy issues for that individual.

The CAQ believes that signing a firm's name on an audit report carries a more serious connotation, as it associates the institution of the entire firm with the content of the report, and that signing by individual partners is inconsistent with the consultative environment that is fostered inside firms and the requirement that the firm as a whole stand behind the audit report. Each partner working on the audit report already knows that his or her career and reputation are on the line—not to mention the possibility of civil liability or regulatory enforcement—each time a report is issued. Moreover, given that the audit committee is already aware of the identity of the lead engagement partner and team, it is unclear what purpose a signature would serve.

Transparency

The CAQ supports increasing transparency of information that is relevant to particular audiences. This commitment to increased transparency is evidenced by the release earlier this year of a detailed report on major public company audit firm financial information and governance.[104] More broadly, in our testimony submitted to the Committee, we emphasized "our view [that] this is a topic best addressed through a robust administrative process that encourages public comment and results in either rulemaking or legislation."[105] In fact, we

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[101] Addendum at 5; 73 Fed. Reg. at 33,489.

[102] *Id.*

[103] Addendum at 4; 73 Fed. Reg. at 33,489.

[104] *See* CAQ Report.

[105] Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Feb. 4, 2008, at 6.

cautioned that such an approach is prudent in order to "help ensure that any disclosure regime does not have the unintended consequences of dissuading firms from taking on public company audit work or exiting the public company audit market due to resultant competitive disadvantages, thereby exacerbating concerns about concentration and audit firm choice."[106]

One major threshold issue which the Committee should address is the purpose of increased transparency. The goal of the transparency will dictate the type of information released and whether the information should be publicly available. We submit that there are two basic categories of audit firm information, serving two basic needs:

1. Information on the quality of audits performed by public company audit firms. Different aspects of such information will be important for regulators, investors, and audit committees.

2. Information on the financial stability and sustainability of an audit firm. This information is important for regulators and otherwise should be kept confidential.

The CAQ's position is that audit firm information should be made available to the constituencies for which it would be useful. Rather than broadly requiring additional firm transparency, the Committee should recommend that the PCAOB determine (1) the type of information that bears on audit quality and should be released publicly; and (2) the firm financial and risk information important to assess audit firm stability and sustainability that should be provided to the PCAOB and kept confidential.

With regard to the measurement of audit quality, we suggest that the Committee recommend a PCAOB study, as we discuss below when addressing the recommendation on key indicators of audit quality. We think that the point of departure for a workable set of key indicators is Article 40 of the European Union's Eighth Company Law Directive. Article 40 is just now being implemented in the EU and each member country is in the process of deciding whether it will adopt Article 40 as is, or whether it will make changes to or supplement the EU version. Clearly, the reporting model for European firms will evolve as the individual countries implement their versions and subsequently gain experience with increased transparency. The goal for the United States should be for its largest public company audit firms to make appropriate transparency reports available to investors and audit committees. Among the areas addressed should be firm quality controls, firm structure and governance, approach to audits, and the risk assessment regime. The audit firms could work with the PCAOB (and even audit committees) to determine the feasibility of additional indicators of audit quality that would be useful for investors, audit committees, regulators, and the public.

Assuming this transparency effort proceeds effectively, the largest audit firms could also begin supplying the PCAOB with financial information of such a nature and in such a format as the PCAOB requests and that fits its needs. Unlike in public transparency reports, however, this information should be treated as confidential under Section 104 of the Sarbanes-Oxley Act. The PCAOB could use the data provided to understand better the sustainability risks facing specific audit firms and the profession broadly and could communicate its findings to others in the

[106] *Id.*

policymaking community. We anticipate that this transparency process—both the public reports and the confidential submissions to the PCAOB—would evolve as the profession and regulators gained experience and received feedback from the investors and audit clients.

The CAQ is supportive of increased transparency as outlined above, but disagrees with any suggestion that firm financial statements should be released to the public. We have yet to hear a solid public policy reason for doing so or how such information will inform readers about a firm's ability to provide quality audits. To date, the primary argument for such transparency seems to be that, because "[t]here is a long standing federal securities interest in having companies . . . open their books to investors, regulators and the public," public company audit firms, "the professional businesses that assure <u>that</u> <u>openness</u>," should have a similar obligation.[107] Audit firms are *not* public companies and do *not* access the public capital markets.[108] Moreover, we note that even though they, like the auditing profession, have important responsibilities that broadly impact the public, other privately-owned, regulated industries, such as insurance companies and public utilities, are not required to disclose their financial statements to the public.

In considering this issue, it is also incumbent upon the Committee to consider, at the very least, the applicability of foreign regulations to U.S. entities. Before issuing such a recommendation, the Committee should hear testimony and review evidence on the similarities and differences between the regulatory schemes and legal systems in the United States and Europe. As Robin G. Munden, General Counsel of Crowe Chizek and Company LLC, pointed out, "[i]n some of the foreign jurisdictions class action shareholder suits are not permitted against auditors."[109] The European legal regime is far more favorable to defendants generally than is the current U.S. regime. These are important differences that should inform regulatory and public policy decisions.

We also stress that consideration of a proposal for firms to produce audited financial statements should take into account the possible harmful consequences. Increased financial transparency in the form of a public financial statement requirement could seriously exacerbate the problem of public company audit market concentration—quite properly one of the Committee's major concerns. Smaller audit firms among those affected by any such requirement may believe that revealing certain information could jeopardize a particular competitive advantage or unreasonably undermine partners' privacy.[110] Thus, they may choose to opt out of

[107] Written Submission of John H. Biggs, Audit Committee Chair, Boeing, Inc., June 3, 2008, at 2.

[108] *See* Statement of Nell Minow, Editor and Co-Founder, The Corporate Library, June 3, 2008 Advisory Committee on the Auditing Profession Webcast, *available at* http://www.treas.gov/offices/domestic-finance/acap/webcasts.html, (2:24:29-43) ("Rather than saying, 'Well, public companies have to meet GAAP and why don't we just apply GAAP to these private firms,' let's try to take a more open and creative and market-based approach.").

[109] Written Submission Robin G. Munden, General Counsel, Crowe Chizek and Company LLC, June 3, 2008, at 2.

[110] Written Submission of Neal D. Spencer, Managing Partner of BKD, LLP, Feb. 4, 2008, at 6 ("As private enterprises, public accounting firms such as BKD are not required to make internal financial information public. Although firms routinely make certain financial and organizational information available (e.g., revenues, number of personnel, etc.), firm capitalization, profitability and partner compensation are not disclosed for several reasons, including maintaining competitive advantages and protecting the privacy of our partners.").

the public company auditing arena altogether. This is especially likely because, unlike with large audit firms, public company auditing often represents a small portion of a smaller firm's revenue stream.

Neal D. Spencer, Managing Partner of BKD, LLP, made this very point. He explained that "[r]equiring financial transparency for public company audit firms may deter some firms not currently auditing public companies from even considering such a practice."[111] Further, according to Mr. Spencer, it could "influence some firms with public company audit practices to exit the market to protect their confidential financial information, particularly firms whose public company audit practice comprises a small portion of total revenues."[112] Similarly, Kenneth Goldmann, the Capital Markets and SEC Practice Director of JH Cohn LLP, suggested that "disclosure of firm financial statements" would pose "insurmountable difficulties for many smaller CPA firms, causing them to withdraw from the public company audit market."[113] Accordingly, we agree with the Committee's position, as stated in the Addendum, that its transparency recommendations should apply to larger audit firms and may not be appropriate for smaller audit firms.

This could also distort the market from the demand side. As Barry Salzberg, Chief Executive Officer of Deloitte LLP, pointed out, "audit committees may feel compelled to choose firms with the largest financial and professional resources, rather than a range of other qualified firms based on more appropriate assessments of quality and fit."[114]

Litigation

The fourth topic addressed by the Addendum is a request for comment on a possibly two-pronged recommendation related to litigation. As with other litigation risk-related recommendations in the Draft Report, this proposed recommendation is helpful in some respects, but does not adequately provide a response to catastrophic liability risk. Catastrophic liability goes to the heart of the Committee's mandate to address "the sustainability of the public company auditing profession."[115] As explained to the Committee by Lewis Ferguson, former General Counsel of the PCAOB, the threat of crippling liability affects not just competition, but also the existing level of audit firm concentration: "[S]everal features of the U.S. legal system . . . increase the risk that at some point in the future one or more of the large accounting firms

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[111] *Id.*

[112] *Id.*

[113] Written Submission of Kenneth Nielsen Goldmann, Capital Markets and SEC Practice Director of JH Cohn LLP, May 27, 2008, at 5.

[114] Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, Feb. 4, 2008, at 9.

[115] Draft Report at V:1; 73 Fed. Reg. at 28,192.

may face circumstances that could lead to its failure, further increasing concentration at the top end of the profession and creating a host of problems."[116]

The Addendum's limited discussion of this issue concludes with a request for commentary on "(1) whether it is appropriate to have exclusive federal jurisdiction for some categories of claims and a uniform standard of care; and, if so, (2) what types of claims should be subject to federal jurisdiction; and (3) what should be the uniform standard of care."[117] We think that the Committee should consider encouraging legislation that would provide exclusive jurisdiction to federal courts over audit-related claims against auditors and/or audit firms. As audit firms operate under the close regulation of the SEC and the PCAOB, and pursuant to rules approved by the SEC, it makes sense for lawsuits against them to be heard in federal court.

Additionally, such a system could resolve the difficulty large audit firms have invoking federal diversity jurisdiction. Often large audit firms, non-corporate entities with partners in nearly every state, must defend themselves in state court, because they are not "diverse" for the purposes of federal jurisdiction.

The final part of the Committee's question concerns the appropriate legal standard of care to apply to auditors. In developing such a standard of care, investors' interests will not be best served by adopting a minimal liability standard that seeks to maximize returns in litigation. Rather, such a standard should consider investors' broader interests in a clear and definite standard of care linked to culpability and audit quality. Auditors should not be "essentially . . . equivalent to insurers or guarantors of the nation's securities markets,"[118] but when they fail to meet their professional duties, they should compensate investors appropriately. In addition to retaining the right to recover from audit firms when they perpetrate frauds, investors' interests include having access to public company statements audited by a robust profession. Excessive liability for auditors undermines this interest. This should be a primary concern of the Committee.

As we discuss in the opening to this letter, the threat of catastrophic liability is the single most important issue impacting the profession's sustainability. The Committee has received testimony estimating this risk in the "tens of billions of dollars."[119] Yet, some will argue that the threat of catastrophic liability is necessary for audit firms to behave professionally. The CAQ rejects such a notion.[120] Civil liability that promotes accountability, but that avoids the threat of

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[116] Statement of Lewis Ferguson, Partner, Gibson, Dunn & Crutcher LLP, Meeting Minutes, Dec. 3, 2007 (150:17-22).

[117] Addendum at 8; 73 Fed. Reg. at 33,490.

[118] Written Submission of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, June 3, 2008, at 4.

[119] *See id.* at 2.

[120] *See* Written Submission of Michael R. Young, Partner, Willkie Farr & Gallagher LLP, June 3, 2008, at 5 ("I for one, accordingly, do not accept at face value the proposition that the risk of debilitating liability has a positive impact on audit quality.").

catastrophic loss, coupled with stringent professional standards and effective regulatory oversight is patently sufficient.

As stated at the outset, the Committee has a unique opportunity to look to the decision of the EC and its recommended approach to auditor liability published on June 5, 2008. The EC calls for member states to adopt one of three approaches to mitigating "much higher liability risks [for auditors]."[121] The three recommended approaches are: limits by contract with the audit client, caps or formula limitation, or adoption of proportionate liability. Each of these three approaches are considered an option for member states due to the variation in legal regimes across the European Union. For example, limitation by contract between auditor and client works in the UK because there is no third party liability in the UK. Caps work in jurisdictions where shareholder suits are permitted. The third option, proportionate liability, is similar to aspects of the current U.S. federal legal environment.

However, proportionate liability in the United States has not sufficiently mitigated catastrophic risk. To be sure, the adoption of proportionate liability in 1995 has in fact served to mitigate damages against auditing firms, among other defendants, to an extent. That has been largely helpful and certainly a positive step in addressing the liability issue. The problem with proportionate liability as it relates to auditors, however, rests with the growth in size of damage claims and limitations on its scope. A firm that is 30% liable on a $10 billion claim is still out of business if that outcome is adjudicated. Further, proportionality only applies to claims under the Securities Exchange Act of 1934; it does not extent to common law claims or, for auditors, to claims under the Securities Act of 1933. We believe that the June 5 EC recommendation warrants consideration given the record on which it is based, even though it would not work exactly as drafted in the United States. We urge the Committee to take advantage of this timely opportunity.

Most significantly, the Committee should consider the utility and feasibility of liability caps. The idea of liability caps is not new, as demonstrated by the American Law Institute's Federal Securities Code, which was developed in the 1970s and 1980s and would have capped civil liability unless the fraudulent statement was made with "knowledge."[122] While there are various forms that liability caps could take, the Committee should, at a minimum, urge their consideration as a logical way to protect audit firms against the threat of catastrophic liability. Liability caps could be tailored to the individual audit firm's ability to pay, or to the size of the audit fee, or the market capitalization of the audit client. Other, scalable approaches to such caps that work for firms of all sizes should be considered as well. Care should be taken so that any caps regime does not put any smaller audit firms at a disadvantage in the marketplace in order to avoid unintended concentration consequences.

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[121] EC Recommendations at 2.

[122] Written Submission of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, June 3, 2008, at 8-9.

Other possible reforms the Committee should consider include:

- Appeals Bond Caps. The Committee should consider recommending that trial court judgments be subject to affordable appeal bonds.[123] This would provide audit firms access to appellate review, which is particularly important in cases where large punitive damages awards are involved. Currently, federal and some state courts require unsuccessful defendants to post a bond equaling the full amount of the trial court's judgment in order to appeal. A large enough appeal bond can force an audit firm into bankruptcy, even if the firm is confident that it will win on appeal. Just the knowledge that an appeal might not be possible could lead an audit firm to settle a matter prior to trial court judgment, as Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, testified.[124]

- Insurance. As noted above, the Committee should consider recommending a remedy for larger firms' inability to obtain liability insurance. Other entities that are both vital for the nation's economic health and difficult to insure, like banks, can access a governmental insurance program. A liability cap regime could complement such an insurance program to insure that any fund would not be exhausted.

- Appeals of Denials of Motions to Dismiss. The Committee should also urge further consideration of the idea that defendants should be able to appeal denials of motions to dismiss. This would allow reviewing courts to correct a legal error at an early stage, preventing a costly trial or, more likely, premature settlement in order to avoid trial. Currently, once a defendant's motion to dismiss is denied, costly discovery ensues and pressure on the defendant to settle builds. If the potential liability is catastrophic, this can force defendant audit firms to settle even non-meritorious cases. It seems only fair to permit defendants to appeal denials of motions to dismiss, just as plaintiffs can appeal a decision granting a motion to dismiss.

- Strengthen Bankruptcy Defenses. The Committee should consider encouraging reinforcement of the imputation doctrine, particularly with regard to the audit context and to successors to a company's claim. Often claims against audit firms are brought on behalf of audit clients by trustees and receivers who are appointed when those clients become insolvent. Because trustees and receivers stand in the shoes of the audit client, the acts of the audit client should be imputed to them. And, in situations where the audit client's wrongful conduct was just as much a cause of the damage as the audit firm's alleged negligence, they may be barred from suing the audit firm due to that wrongful conduct being imputed to them. Some courts have not followed this rule, though. They have permitted such suits against auditors to go forward.

[123] Statement of Lewis Ferguson, Partner, Gibson, Dunn & Crutcher LLP, Meeting Minutes, Dec. 3, 2007 (152:23-153:2).

[124] *See* Written Submission of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, June 3, 2008, at 11.

- Expand Availability of Section 461(f) Trusts. Section 461(f) of the tax code permits a taxpayer to take a deduction if it "contests an asserted liability" and "transfers money or other property to provide for the satisfaction of the asserted liability," provided that "the contest with respect to the asserted liability exists after the time of the transfer" and "but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer" after taking into account the economic performance rules of Section 461(h). The Committee should consider recommending that Section 461(f) be amended to allow audit firms registered with the PCAOB to satisfy the economic performance rules by transferring money or other property, from which a potential liability—existing or anticipated—may be satisfied, to a trust or other similar vehicle. Such amendments could provide that audit firms may transfer a single asset to satisfy one or more asserted or anticipated liabilities, which would allow the use of a single fund with respect to multiple claims. Also, Section 461(f) could apply with respect to funds used to secure an appeal bond.

- Revision to Rule 10b-5. The Committee should consider recommending that the SEC amend Rule 10b-5 to provide that liability requires proof that the defendant had actual knowledge that a statement was materially false or misleading. Such an amendment should help courts, juries, and litigants distinguish appropriately between recklessness needed to meet the scienter requirement and ordinary negligence.

Although these ideas might help alleviate the threat of catastrophic loss faced by audit firms, we also think that they could improve the U.S. litigation system at large.

We want to be clear, however, that we do not advocate that these reforms be used to give audit firms a "free pass" for substandard audits. Nor do we support any type of reform that will reduce the level of audit quality. But we do strongly believe that the catastrophic litigation risks faced by audit firms should be addressed in a manner that is consistent with providing both audit firm viability and audit quality. A Committee charged with addressing "the sustainability of the public company auditing profession" must directly confront this issue.[125]

IV. CONCENTRATION AND COMPETITION

We support the Committee's recommendations to reduce the barriers to the growth of smaller audit firms. In particular, we have some suggestions with regard to the Committee's recommendation that the PCAOB develop key indicators of audit quality and effectiveness.

[125] Draft Report at V:1; 73 Fed. Reg. at 28,192.

"Recommendation 1. Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. Because smaller auditing firms are likely to become significant competitors in the market for larger company audits only in the long term, the Committee recognizes that Recommendation 2 will be a higher priority in the near term."[126]

The Committee has appropriately recognized the need to address barriers to the growth of smaller audit firms while promoting the overall goal of improving audit quality. We agree with the Committee's recommendations with respect to smaller audit firm growth. But we would like to see the Committee recognize and address some of the additional barriers to audit firm growth.

As previously submitted to the Committee by Mr. Spencer of BKD LLP, "[t]here are a number of barriers to expanding the number of firms competing in the public company auditing market," including resources, institutional bias, difficult (if not impossible) insurability, and liability risks.[127] As discussed below, the Committee should continue to consider and address these barriers to allow smaller audit firms to enter or expand their services in the public company audit markets.[128]

A. Require Public Disclosure of Third-Party Agreements that Limit Auditor Choice

We agree with the Committee's recommendation to "[r]equire disclosure by public companies in their annual reports and proxy statements of any provisions in agreements with third parties that limit auditor choice."[129] The simple act of disclosure may help to ameliorate this barrier to entry for the smaller audit firms. As submitted to the Committee, "[s]uch 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."[130]

B. Include Representatives of Smaller Auditing Firms in Committees, Public Forums, Fellowships, and Other Engagements

The Committee suggests that smaller audit firms be represented in committees, public forums, fellowships, and other engagements. We strongly agree that this is an appropriate mechanism for achieving greater visibility and recognition for smaller audit firms.

We believe that smaller firms wishing to expand their practice in the public company audit arena may find it difficult to compete due to a lack of name recognition and reputation. As recognized by the Committee, one means of developing brand recognition is to obtain visibility

[126] Draft Report at VII:3; 73 Fed. Reg. at 28,203.

[127] Written Submission of Neal Spencer, Managing Partner, BKD, LLP, Feb. 4, 2008, at 1-3.

[128] *See* Written Submission of Wayne Kolins, National Director of Assurance and Chairman of the Board, BDO Seidman, LLP, Dec. 3, 2007, at 2.

[129] Draft Report at VII:4; 73 Fed. Reg. at 28,203.

[130] Written Submission of Edward Nusbaum, Chief Executive Officer, Grant Thornton, LLP, Feb. 4, 2008, at 3.

through these types of programs. Yet another suggestion is for the PCAOB to create a practice fellowship program, which would reach out to professionals from firms of all sizes.[131]

C. Other Barriers to Audit Firm Growth that the Committee Should Address

We believe that the single most significant deterrent to smaller audit firms taking on additional public company audits is the threat of crippling liability. The Committee notes that "expanding into the large public company audit market may be unattractive for some smaller auditing firms for a variety of reasons, including increased exposure to litigation."[132] But, as mentioned previously, the Committee does not fully explore or make recommendations regarding the fact that audits of public companies carry exponentially greater liability exposure than those of nonpublic companies. Small firms' desire to expand and become active in public company audits will be limited until the underlying liability risks are addressed. The Committee should address this issue.

For example, the Committee should consider and recommend insurance reforms that would enable firms of all sizes to obtain insurance to protect themselves from catastrophic judgments.[133] As noted above, large accounting firms are currently unable to obtain adequate liability insurance for such large judgments.[134] In addition, although most smaller regional and local firms have access to commercially available professional liability insurance, substantial expansion of these firms could result in increased insurance costs, and could ultimately result in insurers being unwilling to provide coverage to these firms. Because insurability is a key consideration for smaller firms, this factor alone may discourage smaller firms from growing their practice.

Additionally, we note that the current independence regulations also may contribute to market concentration, by discouraging smaller firms from performing public company audits so as not to risk restricting other aspects of their business. The benefits from the current independence regime must be balanced against this cost. The Committee may conclude that a simplified set of independence rules would better serve investors' interests.[135]

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[131] *See* Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, Dec. 3, 2007, at 4.

[132] Draft Report at VII:3; 73 Fed. Reg. at 28,203.

[133] *See* Statement of Lewis Ferguson, Partner, Gibson, Dunn & Crutcher LLP, Meeting Minutes, Dec. 3, 2007 (153:3-153:6).

[134] *See, e.g., id.* at 152:9-12; Written Submission of James S. Turley, Chairman and CEO, Ernst & Young LLP, Dec. 3, 2007, at 6 ("In the U.S., a significant barrier to entry in the audit market is enormous liability exposure and the inability to obtain adequate insurance coverage."); *accord* Letter from Aon to the U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century (Oct. 19, 2006) ("[t]he auditing profession is one of the very few where insurance protection for catastrophic loses simply is not available").

[135] Please also see the discussion of the Committee's recommendations regarding the independence rules, below.

"Recommendation 2. Monitor potential sources of catastrophic risk faced by public company auditing firms and create a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms."[136]

We appreciate that the Committee makes reference to the fact that there are "potential sources of catastrophic risk" and the discussion of the demise of Laventhol & Horwath and Arthur Andersen, and the pending $521 million state court judgment against BDO Seidman that is on appeal. However, we feel that the Draft Report does not yet adequately address this issue. What the Committee does propose in the Draft Report—to have the PCAOB monitor sources of catastrophic risk, and to establish emergency firm and regulatory measures to try to save a collapsing firm—does not deal with the underlying problem or sufficiently correspond to the scope of the litigation threat.

Audit firms face a number of catastrophic risks, including civil litigation and regulatory actions. Indeed, it is possible that a major accounting firm "could suffer fatal liability blows in yet to surface financial frauds of their audit clients."[137] Moreover, once audit firms are subject to large judgments or—as in the case of Arthur Andersen—criminal indictment, the loss of clients, employees, and auditing network partners often follows. Thus, even if a firm is able to pay a judgment or withstand an indictment, it may not be able to survive the ensuing loss of human capital and business.

Although the Committee received testimony that "it is extremely unlikely that . . . an institutional lead plaintiff would insist on a settlement (or enforce a judgment) that would result in the failure of another audit firm," it is simply not the case that plaintiffs' lawyers understand the limits of the firms' ability to pay, or that such "plaintiff forbearance" can be a sound business strategy.[138] As Michael R. Young explained to the Committee, "aside from whether the plaintiffs' lawyers are genuinely interested in the survival of the audit firm so they can sue it again, they have very little concept of how much cash can be extracted while leaving the firm viable."[139] If a single plaintiff's lawyer misjudges the amount that a firm can pay—under the hypothesis that lawyers would even attempt such a calculation—the result could be a judgment that the firm is unable to survive.[140]

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[136] Draft Report at VII:6; 73 Fed. Reg. at 28,204.

[137] Written submission of James D. Cox, Brainerd Currie Professor of Law, Duke Law School, Dec. 3, 2007, at 2.

[138] Written Submission of John P. Coffey, Partner, Bernstein Litowitz Berger & Grossmann LLP, Jan. 22, 2008, at 6.

[139] Written Submission of Michael R. Young, Willkie Farr & Gallagher LLP, June 3, 2008, at 3.

[140] *See* Written Submission of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, June 3, 2008, at 7 ("I have heard it said on other occasions - including even in testimony before this Committee - that we really shouldn't worry about a lawsuit that would bring down the firm because plaintiffs' lawyers would never let it happen. The notion is that the plaintiffs' law firms would never allow the golden goose to die. But, aside from the obvious peculiarity of making a public policy decision based on the assumed good graces of the plaintiffs' bar, the assumption is incorrect. In my experience, the plaintiffs' bar includes many 'one-off' or 'outlier' players who would never even consider foregoing a litigation bonanza if one were within reach.").

The EC has already taken affirmative measures to limit the civil liability of auditors in Europe.[141] The security afforded to European audit firms by these measures will ensure that participants in the capital markets will have access to audited financial statements into the future, as well as sufficient choice of audit firms. The Committee should follow the EC's lead and make similar recommendations aimed at reducing the catastrophic risk faced by U.S. audit firms.

A. The PCAOB Should Monitor Potential Sources of Catastrophic Risk

Regulatory monitoring for potential sources of catastrophic risk that would threaten audit quality is essential because, as recognized by the Committee, the loss of another larger audit firm "would likely have a significant negative impact on the capital markets."[142] Among other things, the loss of a larger firm could render public companies unable to obtain timely audits.

The Committee should clarify its recommendation, however, to identify the types of potential sources of catastrophic risks that the PCAOB should be monitoring. We believe that the PCAOB should certainly monitor potential sources of risks stemming from the external legal, financial, and regulatory environment. For example, the PCAOB should monitor new developments in the law that could further increase the threat of catastrophic litigation already faced by audit firms. The PCAOB should also monitor new international standards and regulations that similarly could subject firms to catastrophic risks.

Furthermore, the PCAOB is in a position to receive information regarding the catastrophic litigation risk exposure that could result from lawsuits, and while protecting individual firm confidentiality, utilize its findings to report, through a Rule 4010 report or in collaboration with the SEC, to the President's Working Group on Financial Markets and Congress in order to inform policy considerations that would promote market stability.

On the other hand, we do not believe that the PCAOB should use its inspection powers to engage in extensive review of audit firms' pending litigation, such as, for example, by overseeing or taking responsibility for statements of litigation claims, reserves, and settlements.

Thus, we urge the Committee to clarify its proposal to recommend that the PCAOB monitor for risks arising from the external legal, regulatory and commercial environment. Identifying these external risks in advance may help regulators and others address these risks on a systemic basis, before they threaten audit firm viability.

B. Establish a Mechanism to Assist in the Preservation and Rehabilitation of a Troubled Larger Auditing Firm

The Committee has a two-step proposal. As the first step, the Committee urges that larger audit firms create an internal governance mechanism to function as a single, unified authority to address threatening circumstances.[143] We agree that each firm should create and

[141] *See* EC Recommendations.

[142] Draft Report at VII:7; 73 Fed. Reg. at 28,205.

[143] Draft Report at VII:9; 73 Fed. Reg. at 28,205-06.

maintain a contingency plan for events where a threat to the firm's viability emerges and believe many firms' leadership governance structures already provide for the same. Such plans should include streamlined decision making and a centralized process for communicating with outside constituents, the latter of which should help alleviate client and employee flight in the face of a threat. This would, of course, require no governmental imprimatur.

Step two of the Committee's proposal recommends that larger firms establish an external preservation mechanism for situations in which a firm's internal mechanism fails. Upon the triggering of this step, the SEC would appoint a court-approved trustee to address the circumstances that threaten the firm's viability, and would seek to reorganize the firm in a manner that would preserve the firm and protect its resources.

Although we commend the Committee for acknowledging that catastrophic liability could call for an extraordinary remedy, we believe that the Committee's recommendation should acknowledge that its proposal may not ultimately prevent the actual demise of a large firm. The proposal allows for the transferring of a troubled firm's decision-making authority to a smaller group of partners and then to an SEC-appointed court-approved trustee. The trustee would perhaps be designated to "manag[e] the consequences" of audit firm failures in a manner that furthers both the firm's and the public's best interest.[144] The situation this proposal seeks to address is an instance where a firm is troubled due to systemic quality issues within the firm itself, rather than situations where a firm is financially imperiled due to catastrophic private litigation.

Moreover, we urge the Committee to recognize that, in the event that the SEC appoints a trustee, there are questions about the ability of a firm to survive if its partners and the rest of its network are not comfortable with the trustee's plan for the firm's survival. Indeed, a threshold question is whether the appointment of a trustee will cause partners and clients to rush for the exits and, therefore, itself cause the firm's demise. While from the perspective of a regulator, bringing in a new managerial authority might be viewed positively, from the perspective of a firm's personnel, clients and network member firms, it could be an alarm to exit the firm.

Most importantly, the Committee should acknowledge that because its recommendations are limited, it is not suggesting that the scope of this proposal will necessarily *prevent* the demise of a firm. Thus, this need—particularly as it relates to catastrophic liability risk—is still outstanding and should be carefully considered and remedied by other policy-making parties.

This recommendation does not address the underlying threats to audit firm survival. Rather, it considers extraordinary measures only after the firm is on the verge of collapse. In addition to looking at ways to rescue a failing firm, we urge the Committee to consider the peculiar liability issues that have put the audit firms at risk in the first place and hamper their ability to take a case to trial.

[144] *E.g.*, Statement of Damon Silvers, Member of the Advisory Committee on the Auditing Profession, Meeting Minutes, Mar. 13, 2008, at 253.

"Recommendation 3. Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators."[145]

The next issue addressed by the Committee is the possibility of developing key indicators of audit quality. Should the PCAOB determine that there is such a set of key indicators of audit quality, the Committee recommends that the PCAOB monitor these indicators.[146]

The CAQ recognizes the potential usefulness of such a feasibility study in identifying a number of legitimate indicators of audit quality. Audit firms "have expanded the scope of their quality control standards, which include client acceptance and continuance, engagement performance processes, and engagement consultation and quality review" and the identification of key indicators of audit quality might be used to guide these efforts.[147]

The CAQ suggests that several principles should guide any feasibility study conducted pursuant to this recommendation. First, the Committee should articulate the overarching objectives of quality indicators so as to inform the feasibility study. For example, the CAQ thinks the Committee should emphasize that any key indicators adopted should have a demonstrable link to audit quality. Measurements should not be taken simply for measurement's sake. Without maintaining a strong link to audit quality, such quantifiable indicators run the risk of encouraging audit firms to focus their limited resources on efforts to boost indicators for the sake of the score, without increasing audit quality. We agree with the Committee that any such study should exercise caution in adopting a wide range of audit quality indicators because of the "complex factors driving the potential impact on the incentives of market actors, and the resulting effect on competitive dynamics among auditors."[148]

For example, the feasibility study should build upon, as appropriate, the efforts undertaken by other organizations, such as the Financial Reporting Council ("FRC") report mentioned by the Committee.[149] The FRC has developed the following set of drivers of audit quality: (1) the culture within an audit firm; (2) the skills and personal qualities of audit partners and staff; (3) the effectiveness of the audit process; (4) the reliability and usefulness of audit reporting; and (5) factors outside the control of auditors affecting audit quality (such as action by

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[145] Draft Report at VII:10; 73 Fed. Reg. at 28,206.

[146] *See* Draft Report at VII:10-11; 73 Fed. Reg. at 28,206.

[147] The Center for Audit Quality, DISCUSSION OUTLINE FOR CONSIDERATION BY THE ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Nov. 30, 2007), at 8.

[148] Draft Report at VII:11; 73 Fed. Reg. at 28,206.

[149] *Id.*

management).[150] The feasibility study could use as a starting point Article 40 of the European Union's Eighth Company Law Directive. Using factors such as these may serve as a useful guidepost to identifying potential key indicators of audit quality.[151]

Next, any feasibility study should take into consideration significant differences in firm size, partnership model, breadth of audit practice or audit specialty. In particular, any use of indicators should not disadvantage smaller firms. As the Committee is already aware, the internal structure and operations of the audit firms—and even certain subgroups within audit firms—can vary widely based upon a number of factors. There are also a number of factors that influence the manner in which a particular audit is conducted, such as the size of the company, its industry, the complexity of company transactions, and the number of the company's locations or subsidiaries. This variability creates the real risk that "key indicators" will not give an audit committee or others a true comparison of two firms. Indeed, a feasibility study should be open to the possibility that a truly objective or quantifiable comparison is not fully achievable or advisable and that capturing information on the inputs to an audit might be too simplistic of an approach for measuring audit quality. Richard Fleck, Global Relationship Partner at Herbert Smith LLP, explained that in the United Kingdom, although definitions have been developed to "identify certain features that are thought necessary if an audit is to be of a high quality, [ ] none of these definitions provides an objectively verifiable measure of the sufficiency of evidence that is required before an audit opinion may properly be given and, therefore, the quality of the audit undertaken."[152] Any feasibility study should also consider—as the FRC has recognized—how the key indicators being considered may vary due to factors unrelated to audit quality.

Third, the CAQ urges that any feasibility study recognize the potential costs of collecting, compiling, and reporting the necessary data points. Some indicators may be easily identifiable with data already on hand. Other indicators, however, may require audit firms to alter operations or create costly reporting mechanisms to identify, collect, and report the data. Any such study should recognize the potential difficulties involved, and the potential errors introduced, if collecting the data involves a complex process.

Any determination of the feasibility of developing indicators of audit quality should clarify that those indicators may assist in the identification of best practices for audits, but that those indicators do not establish legal standards or regulatory compliance requirements. As mentioned above, there is a great deal of complexity in both the audit firms and the companies

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[150] *See* Written Submission of Richard Fleck, Global Relationship Partner, Herbert Smith LLP, Feb. 4, 2008, at 12 (identifying these drivers). Mr. Fleck also noted that the FRC recognizes "that audit quality is a dynamic concept and that the drivers of audit quality may change over time." *Id.* at 13.

[151] As the Committee has recognized, a number of commentators have suggested possible measurements of audit quality that would also serve as a good starting point for any feasibility study. *See* Draft Report at VII:11; 73 Fed. Reg. at 28,206.

[152] Written Submission of Richard Fleck, Global Relationship Partner, Herbert Smith LLP, Feb. 4, 2008, at 8; *see also id.* at 9 ("Similarly a body of academic research has sought to investigate whether differences in 'audit quality' can be identified. Significantly, whilst such research reveals ways in which audit quality <u>in general</u> can be assessed, it has not resulted in a definition of a high quality audit that can be used as a 'standard' against which actual performance can be assessed.").

they audit that will make it difficult for a truly objective measure of audit quality. Firms may be reticent to develop processes for collecting and reporting data for key indicators if that information will only be used against them in the future with the threat of significant liability.

The CAQ also recognizes the constructive role the PCAOB can play in the development and monitoring of key indicators of audit quality. The PCAOB, through its inspection function, closely reviews a firm's auditing process and continues to hone its methodologies to make the inspection process more efficient and useful in evaluating how auditing firms can perform higher quality audits.[153] A feasibility study may identify ways that the PCAOB inspection process can become more productive. Should this study go forward, the PCAOB should be encouraged to seek the views of audit committees as to what additional information regarding audit quality might be useful. The CAQ, therefore, supports the Committee's recommendation for a feasibility study.

"Recommendation 4. Promote the understanding of and compliance with auditor independence requirements among auditors, investors, public companies, audit committees, and boards of directors, in order to enhance investor confidence in the quality of audit processes and audits."[154]

The CAQ "fully supports efforts by Congress and federal regulators to protect investors and maintain the integrity of our capital markets through ongoing efforts to support auditor independence as changes occur" and endorses the Committee's effort to promote the understanding of and compliance with auditor independence requirements.[155] The CAQ suggests that the Committee could make additional recommendations regarding independence that would benefit both the public and auditing firms.

The Committee's first recommendation, to compile various independence requirements into a single document and make that document website accessible, would achieve several key objectives. First, such a document would make it easier for auditors to understand the independence requirements that apply to them. Second, we think such a document would highlight the need, as suggested by the CAQ, of "[h]armonizing independence rules to establish a single, clear and effective standard."[156] "The ultimate goal should be an international standard, but a good place to start is to draw upon the best of rules covering auditor independence at the

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[153] *See* Statement of Wayne Kolins, National Director of Assurance and Chairman of the Board, BDO Seidman LLP, Dec. 3, 2007, at 182:12-20; 183:4-22 (describing the PCAOB as "a very effective overseer to ensure that quality is included in the audit process" and identifying the measures taken in the PCAOB inspection regime and audit firms' internal policies to enhance audit quality); Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, Dec. 3, 2007, at 12 ("To have a more positive impact on audit quality and foster greater confidence in the oversight provided by the PCAOB, the PCAOB inspection process could be increasingly focused on evaluating the quality control systems.").

[154] Draft Report at VII:12; 73 Fed. Reg. at 28,207.

[155] Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Feb. 4, 2008, at 4; *see also* Draft Report at VII:12; 73 Fed. Reg. at 28,207.

[156] Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Feb. 4, 2008, at 5.

SEC, PCAOB, Department of Labor, IFAC, AICPA[,] [GAO,] and various state regulatory bodies."[157] The CAQ believes that the Committee should go further than the current recommendation and suggest that ways be found to *harmonize* and *simplify* the complexities in various independence standards that such a document will highlight. Indeed, even the SEC's own independence regulations, standing alone, offer numerous opportunities for simplification.

The CAQ agrees with the underlying premise of the Committee's second recommendation, that auditors should receive proper training regarding independence that "foster[s] a healthy professional skepticism with respect to issues of independence that is objectively focused and extends beyond a 'check the box' mentality."[158] This recommendation, however, seems based upon the incorrect assumption that audit firms do not currently have training materials that address the application of independence and other conflicts, particularly for partners and mid-career professionals. The CAQ can assure the Committee that the firms take independence seriously, as it is "the bedrock of credibility in the auditing profession" and "essential to the profession's primary function in the capital markets."[159] The firms have significant training materials for independence issues that emphasize the professional skepticism that the Committee seeks and the firms are constantly updating those materials and trainings as best practices are developed.

The Committee also has the opportunity to address deficiencies in the independence regime that affect audit quality by, among other things, discouraging some firms from performing public company audits or expanding their auditing practice. We agree with Mr. Salzerg's testimony that "[t]here are a number of auditor independence restrictions that are overly-restrictive and do not meaningfully promote the independence of the profession . . . . [that] in fact contribute to human capital issues faced by the firms and therefore damage the attractiveness of the profession overall."[160] We have also emphasized that "[a]ppropriate adjustments to the independence restrictions could lead to greater choice for public companies in choosing auditors—without weakening the protections that help public company auditors remain independent while supporting the interests of investors and the capital markets."[161] For example, the CAQ has previously suggested to the Committee that a regulatory process be adopted for de minimis independence breaches that would be immaterial to reasonable investors when such breaches are discovered, and that the definitions of "audit client" and "affiliate" be reconsidered in light of their potential overbreadth.[162] We think that the Committee can encourage progress in

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[157] *Id.* This need for harmonization has also been highlighted by other commentators before the Committee. *See, e.g.*, Written Submission of James S. Turley, Chairman and CEO, Ernst & Young LLP, Dec. 3, 2007, at 7; Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, Feb. 4, 2008, at 4.

[158] Draft Report at VII:14; 73 Fed. Reg. at 28,207.

[159] The Center for Audit Quality, DISCUSSION OUTLINE FOR CONSIDERATION BY THE ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Nov. 30, 2007), at 14.

[160] Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, Feb. 4, 2008, at 12.

[161] Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Feb. 4, 2008, at 4.

[162] *Id.* at 4-5.

audit quality and the health of the profession as a whole by suggesting that some of the independence standards themselves be reevaluated in light of more than five years of experience after the passage of the Sarbanes-Oxley Act.

"Recommendation 5. Adopt annual shareholder ratification of public company auditors by all public companies."[163]

In developing their corporate governance policies, companies should consider whether requiring shareholder ratification of auditors will provide additional oversight and accountability to verify that the auditor selected by the audit committee is best suited for the public company's size and needs. Of course, the Committee will want to satisfy itself that such questions are most appropriately addressed at the federal level, rather than as matters of state law. Moreover, as recognized by the Committee, the "ratification process would be made more meaningful if accompanied by the development and disclosure of key indicators of audit quality."[164] We agree that, to the extent the feasibility study recommended by the Committee identifies meaningful indicators of audit quality, disclosure of that information may help shareholders provide more useful oversight of audit firm selection. However, with respect to the Committee's suggestion that the ratification process state the names of the senior audit partners on the project, we raise the same concerns as we have relative to individual audit partners' signatures on audit reports at page 23.

"Recommendation 6. Enhance regulatory collaboration and coordination between the PCAOB and its foreign counterparts, consistent with the PCAOB mission of promoting quality audits of public companies in the United States."[165]

The CAQ agrees with this recommendation and emphasizes that national audit regulators would be well served by working with its counterparts to improve worldwide audit quality. U.S. investors and the securities markets benefit through coordination and cooperation among national regulators. In an increasingly global economy, where transactions and events impacting businesses constantly cross national borders, the convergence of standards and coordination of regulatory efforts has become all the more important.

Many nations have created audit oversight entities with similar goals to the PCAOB's, such as protecting investors, enhancing audit quality, and assuring public trust in public company audits and the auditing profession. The willingness of the PCAOB to coordinate its inspection efforts with those oversight entities signals an appropriate level of respect for other nations' regulatory advancements. We therefore appreciate the PCAOB's efforts to work with other audit regulators around the world.[166]

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[163] Draft Report at VII:14; 73 Fed. Reg. at 28,207.

[164] Draft Report at VII:14 n.59; 73 Fed. Reg. at 28,208 n.173.

[165] Draft Report at VII:14; 73 Fed. Reg. at 28,208.

[166] The implementation of the PCAOB's Rule 4012 provides an opportunity for the PCAOB to coordinate efforts with other similar regulatory bodies. In deciding how to implement its guidance with respect to Rule 4012, the

CONCLUSION

We hope that this letter will assist the Committee in fulfilling its mandate to address the sustainability of the audit profession. We have vigorously supported the Committee and its work to date by providing extensive information, and we hope to continue working with the Committee as it moves toward a Final Report.

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PCAOB has the opportunity to develop positive relationships with foreign regulators and to make good use of its membership in the International Forum of Independent Audit Regulators.