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

August 29, 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: Second Draft Report 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 reform 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 globalization and financial complexity. 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 audit firms as members, representing tens of thousands of professionals dedicated to audit quality.

We commented on the first Draft Report of the Advisory Committee on the Auditing Profession ("Committee"), issued on May 5, 2008, and the "Addendum to VI. Firm Structure and Finances" ("Addendum"), issued on May 30, 2008 (collectively, "Draft Report"),[1] and we are happy to have the opportunity to comment on the Second Draft Report of the Committee, issued on July 22, 2008 ("Second Draft Report").[2]

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1 *See* Comment Letter of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, June 27, 2008 ("CAQ Comment Letter of June 27, 2008").

2 The Second Draft Report was published in the Federal Register on July 30, 2008. 73 Fed. Reg. 44,315 (July 30, 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.

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The CAQ has supported the Committee's efforts throughout. The CAQ has actively assisted the Committee by commenting, by providing relevant information, and by testifying.[3] We appreciate the Committee's consideration of our views.

The Second Draft Report is a step forward from the initial Draft Report. The Committee's recommendations in several areas, including firm structure[4] and disclosure surrounding auditor changes,[5] as well as the recommendation that government regulators confer to secure more rational and effective oversight, could serve to foster helpful changes to the current processes.[6] The Committee's recognition that a company's management and board play the primary role in preventing fraud is an important point to emphasize.[7]

We believe, however, that the Committee still can make substantially more progress and believe that in a number of areas the Committee has yet to take advantage of its opportunity to provide useful recommendations that would benefit our capital markets, investors and the profession. In particular, the Committee has not yet addressed directly and concretely the threat that catastrophic liability poses to the survival of audit firms, a key concern expressed by many who appeared before the Committee and who submitted comments on the Draft Report.[8]

This letter identifies and discusses briefly the more significant concerns that we have with new material in the Second Draft Report, or with the apparent resolution of issues raised in the Draft Report. We stand behind all of our comments in the June 27, 2008 letter to the Committee regarding the Draft Report. For reasons of brevity and simplicity, we do not restate our comments on the Draft Report here. Similarly, where we have already offered comments on issues on which the Second Draft adheres to the Draft Report's

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3 *See* CAQ Comment Letter of June 27, 2008; *see also* 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); 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); 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); 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, Meeting Minutes, Feb. 4, 2008.

4 *See generally* Second Draft Report at V:1-23; Fed. Reg. at 44,330-40.

5 *See* Second Draft Report at V:11-12; Fed. Reg. at 44,334-35.

6 *See* Second Draft Report at VI:14; 73 Fed. Reg. at 44,346.

7 *See* Second Draft Report at V:14; 73 Fed. Reg. at 44,336.

8 *See, e.g.*, Comment Letter of McGladrey & Pullen, LLP, July 8, 2008, at 2; Comment Letter of Crowe Chizek and Company LLC, June 30, 2008, at 2-3; Comment Letter of Hein & Associates LLP, June 30, 2008, at 2; Comment Letter of PricewaterhouseCoopers, LLP, June 30, 2008, at 17; Comment Letter of Deloitte LLP, June 27, 2008, at 1-8; Comment Letter of Ernst & Young LLP, June 27, 2008, at 2-18; Comment Letter of David McDonnell, Chief Executive Officer, Grant Thornton International Ltd, and Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, June 27, 2008, at 5-6; Statement of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, Meeting Minutes, June 3, 2008 (138:3-140:3); Statement of James D. Cox, Duke University School of Law, Meeting Minutes, Dec. 3, 2007 (259:19-260:4); Statement of Lewis Ferguson, Partner, Gibson, Dunn & Crutcher LLP, Meeting Minutes, Dec. 3, 2007 (150:16-22).

text, we have not repeated our views here. We hope that the Committee, as it reviews the record before it, will give fresh consideration to the CAQ's previously-expressed positions, to the extent still relevant.

I. ADDRESSING CATASTROPHIC LIABILITY RISK FOR AUDIT FIRMS

We are disappointed that the Second Draft Report still does not address comprehensively the catastrophic litigation threat faced by the auditing profession. In the Second Draft Report, the Committee has characterized the serious litigation risk facing audit firms as "real" and discussed past catastrophic litigation as well as the collapse of Arthur Andersen.[9] But the Second Draft Report does not contain even the limited litigation reforms discussed in the Addendum: exclusive federal jurisdiction and a uniform standard of care.[10] It also does not consider any of the measures proposed by the CAQ in our June 27, 2008 letter. These ideas include appeal bond caps, appeals of denials of motions to dismiss, strengthened bankruptcy defenses, expanded availability of section 461(f) trusts, a revised Rule 10b-5, and most importantly, a liability caps system for audit firms.[11] We believe that catastrophic liability remains the single greatest threat to the auditing profession's sustainability. If this liability concern is not addressed, many of the Committee's other recommendations will prove unworkable due to the current litigation context.[12] And as we pointed out in our first letter, we believe that fulfilling the Committee's mandate to address "the sustainability of the public company auditing profession" includes meaningfully tackling this issue.[13]

We fear that the Committee may be swayed to inaction by arguments that link high audit quality to auditor liability and the notion that massive litigation exposure is in some way *beneficial* to the profession and to the capital markets and investors.[14] To suggest that auditors will not perform well unless faced with *unlimited* liability is a totally unsupported assertion which does a disservice to the audit profession, investors and the capital markets. We agree that auditors should be "exposed to the consequences of failure, including both the legal consequences and economic consequences."[15] Clearly, potential liability can provide incentives for higher quality, more careful audits. But the extraordinary growth in auditor liability reflects audit client capitalization, not auditor misconduct.[16] The liability risk has reached such a level that it serves no practical purpose. Appropriately measured liability, on top of robust regulation, clear professional

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9 *See* Second Draft Report at VI:9; 73 Fed. Reg. at 44,344.

10 *See* Addendum at 8; 73 Fed. Reg. at 33,490.

11 CAQ Comment Letter of June 27, 2008, at 28-30; *see also, e.g.*, Comment Letter of Deloitte LLP, June 27, 2008, at 24, Appendix A; Comment Letter of Ernst & Young LLP, June 27, 2008, at 16-18; Statement of Lewis Ferguson, Partner, Gibson, Dunn & Crutcher LLP, Meeting Minutes, Dec. 3, 2007 (152:20-153:6) (all collecting and presenting litigation reform ideas).

12 *See, e.g.*, CAQ Comment Letter of June 27, 2008, at 6-7.

13 *See id.* at 30 (quoting Draft Report at V:1; 73 Fed. Reg. at 28,192).

14 Second Draft Report at VI:10; 73 Fed. Reg. at 44,344-45.

15 Second Draft Report at VI:10; 73 Fed. Reg. at 44,345; *see also, e.g.*, CAQ Comment Letter of June 27, at 30 (the CAQ does not support proposals that would reduce audit quality).

16 *See* Written Submission of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, June 3, 2008, at 1-2 (noting that "the size of the damages being claimed has grown substantially, in tandem with the growth in market capitalization of the firms' audit clients").

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standards and economic and reputational risks are strong audit quality motivators. Indeed, extreme, disproportionate liability threats can lead to (among other things) over-auditing, and inefficient and unnecessarily cautious behavior. It can also hurt the profession's ability to evolve to serve "the increasing complexity of business transactions and financial reporting" and to attract new talent.[17]

While we agree with Recommendation 2(a) of the "Concentration and Competition" section that the PCAOB should monitor potential sources of catastrophic risk that would threaten audit quality, we believe that the Second Draft Report's implications that auditing *firm conduct* is the sole cause of increased catastrophic risk is misleading. Indeed, as noted above, the threat of catastrophic loss primarily comes from factors other than audit firm conduct; it is those other factors—largely found in the litigation environment—that the PCAOB should monitor to address this problem.[18]

The catastrophic litigation threat facing major audit firms is the most challenging issue before the Committee. It should be a priority for the Committee in addressing "the sustainability of the public company auditing profession."[19]

II. CREATION OF A CENTER FOR FRAUD PREVENTION AND DETECTION

We continue to support the Committee's recommendation that there be a national center for fraud prevention and detection.[20] As the CAQ expressed in its June 27, 2008 letter to the Committee, 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."[21] For this reason, the CAQ offered to house the center.[22]

The Second Draft Report does not specify the center's location or sponsorship, although the use of brackets in the Second Draft Report's "Firm Structure and Finances" section suggests that the Committee does intend to specify some entity to oversee or sponsor the center. We urge that the center be sponsored by the CAQ. As we noted, the CAQ assembles academics, investors, government officials, and members of the profession to gather expertise and discuss issues of audit quality. Among the vital issues addressed by the CAQ are the detection and prevention of fraud.

III. AUDITED FIRM FINANCIAL STATEMENTS

Recommendation 7 of the Second Draft Report's "Firm Structure and Finances" section encourages "the PCAOB to require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements."[23] We agree with the conclusion that public dissemination of

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17 Second Draft Report at IV:1; 73 Fed. Reg. at 44,318; *see also* Second Draft Report at IV:2-25; 73 Fed. Reg. at 44,318-30.

18 *See* CAQ Comment Letter of June 27, 2008, at 34.

19 Draft Report at V:1; 73 Fed. Reg. at 28,192.

20 *See* Second Draft Report at V:1-3; 73 Fed. Reg. at 44,330-31.

21 CAQ Comment Letter of June 27, 2008, at 11.

22 *See id.*

23 Second Draft Report at V:20; 73 Fed. Reg. at 44,339

the firms' financial statements should not be required. We reiterate the position in our earlier comment letter that, contrary to the recommendation reflected in the Second Draft Report, the PCAOB should determine the nature and form of firm financial and risk information that would be important for them to assess audit firm stability and sustainability, and that the information be treated as confidential under Section 105 of the Sarbanes-Oxley Act.

IV. AUDITORS' OBLIGATION TO DETECT FRAUD

The Committee has concisely summarized managements' and auditors' responsibilities: "According to existing auditing standards and SEC rules, management prepares and has the primary responsibility for the accuracy of financial statements and for prevention and identification of fraud and the auditor's role is to provide *reasonable assurance* that the financial statements are free of material misstatement."[24]

The Committee observed, however, that the current standard auditor's report "is silent about the auditor's responsibility to *find* fraud."[25] While we agree that further dialogue is necessary to close the expectations gap, we are concerned that the report's general reference to "the role of auditors in finding and reporting fraud" could lead to more confusion and uncertainty.[26] Thus, as we advised in our June 27, 2008 letter, "all efforts to alter the auditor's report should proceed with great care."[27] In particular, clarification of the auditor's duty to detect fraud should be adopted only after a notice and comment process, and the resulting standard must emphasize the limits on the auditors' ability to uncover fraud.

V. COSTS ASSOCIATED WITH CHANGING AUDITORS

Recommendation 1 of the Second Draft Report's "Concentration and Competition" section advocates reducing barriers to the growth of smaller auditing firms. As we stated in our June 27, 2008 letter, we think this is an important goal.[28]

We take issue, however, with the new language in the Second Draft Report that "the costs associated with public companies' changing auditors . . . [include] high fees charged for the predecessor auditor's opinion on previously filed financial statements and the challenges associated with having the predecessor auditor transfer its work papers to the successor auditor."[29] The two sources cited as support for this assertion, according to the Second Draft Report's footnotes, are 1) an anonymous letter and 2) one witness's written response to a question for the record where he specifically writes, "We hear comments (no specifics), both now and back when the SEC smaller company advisory committee looked at this audit capacity issue. It was a particular concern with finding enough capacity to do SOX related work."

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24 Second Draft Report at V:14; 73 Fed. Reg. at 44,336 (emphasis in original).

25 Second Draft Report at V:15; 73 Fed. Reg. at 44,336 (emphasis in original).

26 Second Draft Report at V:18; 73 Fed. Reg. at 44,338.

27 CAQ Comment Letter of June 27, 2008, at 13.

28 *See* CAQ Comment Letter of June 27, 2008, at 31.

29 Second Draft Report at VI:4-5; 73 Fed. Reg. at 44,342.

It is true that after changing auditors, public companies typically must continue to compensate the predecessor auditor in connection with obtaining consent for the re-issuance of prior audit reports. However, there are a number of considerations that may affect the fees charged, which in any event we believe are relatively low compared to the overall audit. Further, in normal circumstances the predecessor auditor is willing to provide access to its work papers to the successor auditor, although there are some circumstances that affect the willingness of the predecessor auditor to provide normal access to its work papers, such as pending legal and regulatory actions. We believe the fact that the Committee does not explore these issues, coupled with a lack of substantiated information and data to form the basis for the Committee's recommendation, call for the removal of this language from the Committee's final report.

VI. ADVANCES IN HUMAN CAPITAL

Finally, the Committee should build upon its recognition of the significant advances made in the human resources arena by audit firms.[30] As Committee Member Barry C. Melancon noted at the Committee's July 22, 2008 meeting, the profession "has a leg up in winning" the human capital challenges it faces.[31]

A number of firms have implemented progressive programs to improve their recruitment and retention of minorities in the profession.[32] Indeed, the Committee would be well served to focus not just on the human capital areas where the profession needs improvement, but also on the successes and achievements of the profession.[33] The Committee's Second Draft Report is a slight improvement from the Draft Report in that respect. For example, in addition to the discussions of minority opportunities included in the Draft Report, the Committee's Second Draft Report acknowledges, albeit in a footnote, that the percentage of women partners in the profession has nearly doubled since 1994.[34] As noted by Committee Member Timothy P. Flynn, the profession's achievements in increasing diversity—as well as workplace quality and retention—should be celebrated.[35]

There is still room for improvement. But the Committee should place greater emphasis on the advances made, and encourage the profession to build on the momentum from its successes in the years ahead.

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30 *See* Second Draft Report at IV:6-9 & n.17; 73 Fed. Reg. at 44,320-22.

31 Statement of Barry C. Melancon, Committee Member, Meeting Minutes, July 22, 2008 (16:8-12).

32 *See, e.g.*, Comment Letter of PricewaterhouseCoopers, LLP, June 30, 2008, at 5; Comment Letter of Deloitte LLP, June 27, 2008, at 10; Comment Letter of Ernst & Young LLP, June 27, 2008, at 22 (describing firm efforts to advance diversity).

33 *See* Statement of Donald T. Nicolaisen, Committee Chairman, Meeting Minutes, July 22, 2008 (40:6-14).

34 Second Draft Report at IV:7, n.17; 73 Fed. Reg. at 44,320, n.38 (citing American Institute of Certified Public Accountants, *A Decade of Changes in The Accounting Profession: Workforce Trends and Human Capital Practices* 5 (Feb. 2006).

35 *See* Statement of Timothy P. Flynn, Committee Member, Meeting Minutes, July 22, 2008 (38:5-10).

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CONCLUSION

We reiterate our commitment to assist the Committee in its important work. The CAQ is proud to aid the Committee, and we appreciate the hard work and careful consideration the Committee has devoted to a number of significant issues. We anticipate that the Committee's final report will be beneficial to investors, regulators, the markets and the profession.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality