



ADVISORY COMMITTEE ON THE AUDITING PROFESSION

DRAFT REPORT - MAY 5, 2008



THE DEPARTMENT OF THE TREASURY



**Draft Report of the
Advisory Committee
on the Auditing Profession
to the U.S. Department
of the Treasury**

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I. TRANSMITTAL LETTER

ADVISORY COMMITTEE ON THE AUDITING PROFESSION

[July 2008]

The Honorable Henry M. Paulson, Jr.
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Secretary Paulson:

On behalf of the Department's Advisory Committee on the Auditing Profession, we are pleased to submit our Final Report.

[Contents of letter to be included in Final Report]

Respectfully Submitted on behalf of the Committee,

Arthur Levitt, Jr.
Committee Co-Chair

Donald T. Nicolaisen
Committee Co-Chair

Enclosure

cc: Undersecretary for Domestic Finance Robert K. Steel

II. EXECUTIVE SUMMARY

[Contents of Executive Summary to be included in subsequent drafts of this Report]

CHAPTER III: COMMITTEE HISTORY

On November 20, 2006, the Secretary of the Treasury, Henry M. Paulson, Jr., delivered a speech on the competitiveness of the U.S. capital markets, highlighting the need for a sustainable auditing profession.¹ In March 2007, Secretary Paulson hosted a conference at Georgetown University with investors, current and former policy makers, and market participants to discuss issues impacting the competitiveness of the U.S. capital markets, including the sustainability of the auditing profession.²

On May 17, 2007, Secretary Paulson announced the Department of the Treasury's (the Department) intent to establish the Advisory Committee on the Auditing Profession (the Committee) to consider and develop recommendations relating to the sustainability of the auditing profession.³ At the same time, Secretary Paulson announced that he had asked Arthur Levitt, Jr. and Donald T. Nicolaisen to serve as Co-Chairs of the Committee. The Department published the official notice of establishment and requested nominations for membership on the Committee in the *Federal Register* on June 18, 2007.⁴ Secretary Paulson announced the Committee's membership on October 2, 2007, with members drawn from a wide range of professions, backgrounds and experiences.⁵ The Department filed the Committee's Charter with the Senate Committee on Banking, Housing, and Urban Affairs, the Senate Committee on Finance, the House Committee on Financial Services and the House Committee on Ways and Means on July 3, 2007.⁶

Committee Activities

The Committee held its initial meeting on October 15, 2007 in Washington, D.C.⁷ Under Secretary for Domestic Finance Robert K. Steel welcomed the Committee members and pro-

- 1 Treasury Secretary Henry M. Paulson, Jr., Remarks on the Competitiveness of U.S. Capital Markets at the Economic Club of New York (Nov. 20, 2006), *in* Press Release No. HP-174, U.S. Dep't of Treas. (Nov. 20, 2006) (included as Appendix C).
- 2 Treasury Secretary Henry M. Paulson, Jr., Opening Remarks at Treasury's Capital Markets Competitiveness Conference at Georgetown University (Mar. 13, 2007), *in* Press Release No. HP-306, U.S. Dep't of Treas. (Mar. 13, 2007) (included as Appendix D).
- 3 Press Release, U.S. Dep't of Treas., Paulson Announces First Stage of Capital Markets Action Plan (May 17, 2007) (included as Appendix E); Press Release, U.S. Dep't of Treas., Paulson: Financial Reporting Vital to US Market Integrity, Strong Economy (May 17, 2008) (included as Appendix F).
- 4 Notice of Intent to Establish; Request for Nominations, 72 Fed. Reg..33560 (U.S. Dep't of Treas. June 18, 2007) (included as Appendix A).
- 5 Press Release, U.S. Dep't of Treas., Paulson Announces Auditing Committee Members to Make Recommendations for a More Sustainable, Transparent Industry (Oct. 2, 2007) (included as Appendix G). This press release describes the diverse backgrounds of the Committee members. For a list of Members, Observers, and Staff, see Appendix K.
- 6 See Committee Charter (included as Appendix B).
- 7 The Record of Proceedings of this and subsequent meetings of the Committee are available on the Department's website at <http://www.treas.gov/offices/domestic-finance/acap/press.shtml>. See Record of Proceedings, Meeting of the Committee (Oct. 15, 2007, Dec. 3, 2007, Feb. 4, 2008, Mar. 13, 2008, Apr. 1, 2008, and [____]) [hereinafter Record of Proceedings (with appropriate date)] (on file in the Department's Library, Room 1428), *available at* <http://www.treas.gov/offices/domestic-finance/acap/press.shtml>.

vided introductory remarks.⁸ Also on October 15, 2007, the Committee adopted its by-laws⁹ and considered a Working Discussion Outline to be published for public comment.¹⁰ The Working Discussion Outline identified in general terms issues for the Committee's consideration. A Working Bibliography, updated intermittently throughout the course of the Committee's deliberations, provided the members with articles, reports, studies, and other written materials relating to the auditing profession.¹¹ All full Committee meetings were open to the public and conducted in accordance with the requirements of the Federal Advisory Committee Act.¹² The meetings of the full Committee were also Web or audio cast over the internet.

The Committee held its second meeting on December 3, 2007 in Washington, D.C. The agenda for this meeting consisted of hearing oral statements from witnesses and considering written submissions that those witnesses had filed with the Committee. The oral statements and written submissions focused on the issues impacting the sustainability of the auditing profession, including issues mentioned in the Working Discussion Outline. Nineteen witnesses testified at this meeting.¹³ The Committee held a subsequent meeting on February 4, 2008 in Los Angeles, California at the University of Southern California. The agenda for this meeting consisted of hearing oral statements from witnesses and considering written submissions that those witnesses had filed with the Committee. The oral statements and written submissions focused on the issues impacting the sustainability of the auditing profession, including issues mentioned in the Working Discussion Outline. Seventeen witnesses testified at this meeting.¹⁴ The Committee held additional meetings on March 13, 2008, April 1, 2008, and [____]. All were face-to-face meetings held at the Department in Washington, D.C., except for February 4, 2008, which was held in Los Angeles, California, and the meetings on April 1, 2008, and [____], which were telephonic meetings.

The Committee, through the Department, published [____] releases in the *Federal Register* formally seeking public comment on issues under consideration. On October 31, 2007, the Committee published a release seeking comment on the Working Discussion Outline,¹⁵ in response to which we received seventeen written submissions. In addition, the Department announced each meeting of the Committee in the *Federal Register*, and in each announcement notice included an invitation to submit written statements to be considered in connection with the meeting.¹⁶ In response to these meeting notices, the Committee received [____]

8 Under Secretary for Domestic Finance Robert K. Steel, Welcome and Introductory Remarks Before the Initial Meeting of the Treasury Department's Advisory Committee on the Auditing Profession (Oct. 15, 2007), *in* Press Release No. HP-610, U.S. Dep't of Treas. (Oct. 15, 2007) (included as Appendix H).

9 The Committee By-Laws are included as Appendix I.

10 The Working Discussion Outline is included as Appendix L.

11 The Working Bibliography is included as Appendix M. The Working Bibliography was subsequently updated in December 2007 and February 2008.

12 5 U.S.C. App. 2 § 1.

13 Appendix J contains a list of witnesses who testified before the Committee.

14 Appendix J contains a list of witnesses who testified before the Committee.

15 Request for Comments, 72 Fed. Reg. 61709 (U.S. Dep't of Treas. Oct. 31, 2007).

16 Notice of Meeting, 72 Fed. Reg. 55272 (U.S. Dep't of Treas. Sept. 28, 2007); Notice of Meeting, 72 Fed. Reg. 64283 (U.S. Dep't of Treas. Nov. 15, 2007); Notice of Meeting, 73 Fed. Reg. 2981 (U.S. Dep't of Treas. Jan. 16, 2008); Notice of Meeting, 73 Fed. Reg. 10511 (U.S. Dep't of Treas. Feb. 27, 2008); Notice of Meeting, 73 Fed. Reg. 13070 (U.S. Dep't of Treas. Mar. 11, 2008); Notice of Meeting, 73 Fed. Reg. 21016 (U.S. Dep't of Treas. Apr. 17, 2008).

written submissions. In total, the Committee received [] written submissions in response to *Federal Register* releases.¹⁷ All of the submissions made to the Committee will be archived and available to the public through the Department's Library.

In addition to work carried out by the full Committee, fact finding and deliberations also took place within three Subcommittees appointed by the Co-Chairs. The Subcommittees were organized according to their principal areas of focus: Human Capital, Firm Structure and Finances, and Concentration and Competition.¹⁸ Each of the Subcommittees prepared recommendations for consideration by the full Committee.

17 All of the written submissions made to the Committee are available in the Department's Library, Room 1428 and on the Department's Committee's Web page at <http://www.treas.gov/offices/domestic-finance/acap/press.shtml>. To avoid duplicative material in footnotes, citations to the written submissions made to the Committee in this Final Report do not reference the Department's Library, Room 1428.

18 For a list of members and their Subcommittee assignments, see Appendix K.

IV. BACKGROUND

[Contents of Background to be included in subsequent drafts of this Report]

V. HUMAN CAPITAL

The Committee devoted considerable time and effort surveying the human capital issues impacting the auditing profession, including education, licensing, recruitment, retention, and training of accounting and auditing professionals. The charter of the Committee charged its members with developing recommendations relating to the sustainability of the public company auditing profession. Likewise, the Committee directs the following recommendations and related commentary to those practicing public company auditing. However, the Committee recognizes that several of its recommendations regarding human capital matters would have impact beyond the public company auditing profession, impacting the accounting profession as a whole. The Committee views the accelerating pace of change in the global corporate environment and capital markets and the increasing complexity of business transactions and financial reporting as among the most significant challenges facing the profession as well as financial statement issuers and investors. These are directly impacted by human capital issues. To ensure its viability and resilience and its ability to meet the needs of investors, the public company auditing profession needs to continue to attract and develop professionals at all levels who are prepared to perform high quality audits in this dynamic environment. It is essential that these professionals be educated and trained to review, judge, and question all accounting and auditing matters with skepticism and a critical perspective. The recommendations presented below reflect these needs.

After receiving testimony from witnesses and from comment letters, the Committee identified specific areas where the Committee believed it could develop recommendations to be implemented in the relatively short term to enhance the sustainability of the auditing profession. These specific areas include accounting curricula, accounting faculty, minority representation and retention, and development and maintenance of human capital data. The Committee has also developed a recommendation to study the possible future of higher accounting education's institutional structure.

The Committee recommends that regulators, the auditing profession, educators, educational institutions, accrediting agencies, and other bodies, as applicable, effectuate the following:

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.

The Committee considered the views of all witnesses who provided input regarding accounting curricula at educational institutions.¹ The Committee believes that the accounting curri-

¹ See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Joseph V. Carcello, Director of Research, Corporate Governance, University of Tennessee, Knoxville, 8), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Carcello120307.pdf> (noting the market's expectations that university accounting curricula will expose students to recent financial reporting developments, such as international financial reporting standards and eXtensible Business Reporting Language); Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia Fornelli, Executive Director, Center for Audit Quality, 3) *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (stating the need to "[d]edicate funds and people to work with accounting professors to ensure that the curriculum is keeping pace with developments in business transactions, international economics and finan-

cula in higher education are critical to ensuring individuals have the necessary knowledge, mindset, skills, and abilities to perform quality public company audits. In order to graduate from an educational institution with an accounting degree, students must have completed a certain number of hours in accounting and business courses. Accounting curricula typically include courses in auditing, financial accounting, cost accounting and U.S. federal income taxation. Business curricula typically include courses in ethics, information systems and controls, finance, economics, management, marketing, oral and written communication, statistics, and U.S. business law.² Since the 1950s, several private sector groups have studied and recommended changes to the accounting curricula,³ but notwithstanding these pleas for reform, curricula are characteristically slow to change.⁴

cial reporting” and specifying the need to focus on ethical standards and international accounting and auditing standards); Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis Nally, Chairman and Senior Partner, PriceWaterhouseCoopers LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (stating the need to “[m]odernize and enhance the university accounting curriculum, which should include consideration of other global curriculum models to increase knowledge of International Financial Reporting Standards (IFRS), finance and economics, and process controls”).

- 2 Record of Proceedings (Feb. 4, 2008) (Written Submission of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 13), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (commenting that business students typically take two sophomore-level introductory accounting classes and accounting majors take six additional accounting courses in their final two years of schooling).
- 3 See e.g., FRANKLIN PIERSON, ET AL., *THE EDUCATION OF AMERICAN BUSINESSMEN* (1959) (noting that the main goal of a business education should be the development of an individual with broad training in both the humanities and principles of business); ROBERT A. GORDON AND JAMES E. HOWELL, *HIGHER EDUCATION FOR BUSINESS* (1959) (suggesting that accounting curriculum abandon its emphasis on financial accounting and auditing while emphasizing humanities); ROBERT H. ROY AND JAMES H. MACNEILL, *HORIZONS FOR A PROFESSION* (1967) (emphasizing the importance of a humanities background for accountants and recommending accounting graduate study); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, COMMITTEE ON EDUCATION AND EXPERIENCE REQUIREMENTS FOR CPAs, *REPORT OF THE COMMITTEE ON EDUCATION AND EXPERIENCE REQUIREMENTS FOR CPAs* (1969) (recommending a five-year education requirement for accounting students); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, *EDUCATION REQUIREMENTS FOR ENTRY INTO THE ACCOUNTING PROFESSION: A STATEMENT OF AICPA POLICIES* (1978) (recommending a change from five years to 150 semester-hours and recommending that a graduate degree requirement at the conclusion of the 150-hours should be explicitly stated); American Accounting Association, Committee on the Future Structure, Content, and Scope of Accounting Education, *Future Accounting Education: Preparing for the Expanding Profession*, *ISSUES IN ACCOUNTING EDUCATION* (Spring 1986) (examining accounting education and accounting practice since 1925 and concluding that since 1925, the profession has changed while accounting education has not changed); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, *EDUCATION REQUIREMENTS FOR ENTRY INTO THE ACCOUNTING PROFESSION: A STATEMENT OF AICPA POLICIES, SECOND EDITION, REVISED* (1988) (requiring that at least 150 semester hours are needed to obtain a CPA license); *PERSPECTIVES ON EDUCATION: CAPABILITIES FOR SUCCESS IN THE ACCOUNTING PROFESSION* (1989) (noting that graduates entering public accounting need to have greater interpersonal, communication, and thinking skills as well as greater business knowledge); and Accounting Education Change Commission, *Objectives of Education for Accountants: Position Statement Number One*, *ISSUES IN ACCOUNTING EDUCATION* (Fall 1990a) (awarding grants to schools as a catalyst for curricula changes in accounting programs).
- 4 Record of Proceedings (Dec. 3, 2007) (Written Submission of Ira Solomon, R.C. Evans Distinguished Professor, and Head, Department of Accountancy, University of Illinois, 14-15), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Solomon120307.pdf> (lamenting the slow pace of change in accounting curricula and education).

In this regard, the Committee makes the following recommendations:

(a) Regularly update the accounting certification examinations to reflect changes in the accounting profession, its relevant professional and ethical standards, and the skills and knowledge required to serve increasingly global capital markets.

Accounting and auditing professionals commonly complete the requirements of professional examinations in order to comply with legal or professional association requirements. To become licensed at the state level as a certified public accountant, an individual must, among other things, pass the Uniform CPA Examination. Professional examinations, such as the Uniform CPA Examination, influence the content of the technical, ethical, and professional materials comprising the accounting curricula.⁵

The Committee believes that evolution of professional examination content serves as an important catalyst for curricular changes to reflect the dynamism and complexity of auditing public companies in global capital markets. The American Institute of Certified Public Accountants (AICPA) already regularly analyzes and updates its examination content, through practice content analysis and in conjunction with the AICPA Board of Examiners, which comprises members from the profession and state boards of accountancy. The Committee recommends that such changes remain a focus to ensure that examination content reflects in a timely manner important ongoing market developments and investor needs, such as the increasing use of international financial reporting standards (IFRS), expanded fair value measurement and reporting, increasingly complex transactions, new Public Company Accounting Oversight Board (PCAOB) auditing and professional standards,⁶ risk-based business judgment, and technological innovations in financial reporting.

Moreover, the Committee believes that professional⁷ and ethical standards⁸ and subject matter relating to their application are an essential component of the accounting curricula and accordingly should be reflected in the professional examinations and throughout business and accounting coursework.

Finally, the Committee recommends that the market developments outlined in this section be reflected in professional examination content as soon as practicable, but not later than 2011. In addition, the Committee recommends that new evolving examination content be widely and promptly communicated to college and university faculty and administrators so that corresponding curricular changes in educational institutions can continually occur on a timely basis.

5 GARY SUNDEM, *THE ACCOUNTING EDUCATION CHANGE COMMISSION: ITS HISTORY AND IMPACT* Chapter 6 (1999), available at <http://aaahq.org/AECC/history/index.htm> (“[T]he CPA examination has certainly had a major influence on the accounting curriculum and on other aspects of accounting programs.”).

6 See e.g., *AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS*, Auditing Standard No. 5 (Pub. Company Accounting Oversight Bd. 2007).

7 See PCAOB Standards and Related Rules, available at http://www.pcaobus.org/Standards/Standards_and_Related_Rules/index.aspx.

8 See PCAOB Interim Ethics Standards, available at http://www.pcaobus.org/Standards/Interim_Standards/Ethics/index.aspx.

(b) Reflect real world changes in the business environment more rapidly in teaching materials.

Students are expected to use a variety of sources, such as textbooks and online materials, to learn. Such materials are an important element of higher education. The Committee learned that these commercial materials are generally conservatively managed and follow rather than lead recent market developments.⁹ Because developing accounting materials involves a significant investment of time and resources, commercial content providers carefully consider the potential risks and rewards before publishing new materials, even where a more prompt response to new developments might be beneficial to students.

The Committee believes that accounting educational materials can contribute to inducing curricular changes that reflect the dynamism and complexity of the global capital markets and that commercial content providers should recognize the importance of capturing recent developments in their published materials. Specifically, the Committee recommends that organizations, such as the AICPA and the American Accounting Association (AAA), meet with commercial content providers and encourage them to update their materials promptly to reflect recent developments such as the increasing use of IFRS, new PCAOB auditing and professional standards, risk-based business judgment and expanded fair value reporting, as well as technological developments in financial reporting and auditing such as eXtensible Business Reporting Language (XBRL).

Further, in order to ensure access to such materials, the Committee recommends that authoritative bodies and agencies should be encouraged to provide low-cost, affordable access to digitized searchable authoritative literature and materials, such as Financial Accounting Standards Board (FASB) codification and eIFRS, to students and faculty members. Moreover, since the content of professional examinations, such as the Uniform CPA Examination, is based upon research using digitized materials, students need to have access to, among other things, searchable accounting standards.¹⁰ The Committee believes that low-cost affordable access to such primary materials would thus enhance student learning and performance and technical research.

(c) Require that schools build into accounting curricula current market developments.

A common theme of our first set of recommendations is that accounting curricula should reflect recent developments, including globalization and evolving market factors. As a further catalyst to curricula development and evolution by educational institutions, the Committee recommends ongoing attention to responsiveness to recent developments by the bodies that accredit educational institutions. Accrediting agencies review institutions of higher educa-

⁹ Subcommittee on Human Capital Record of Proceedings (Jan. 16, 2008) (Oral Remarks of Bruce K. Behn, President, Federation of Schools of Accountancy, and Ergan Professor of Business, Department of Accounting and Information Management, University of Tennessee, Knoxville).

¹⁰ See Record of Proceedings (Feb. 4, 2008) (Written Submission of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 14), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (affirming the need for student access to digitized searchable accounting and auditing materials).

tion and their programs and establish that overall resources and strategies are conformed to the mission of the institutions. For example, the Association to Advance Collegiate Schools of Business (AACSB) and the Association of Collegiate Business Schools and Programs (ACBSP) accredit business administration and accounting programs. Since 1919, the AACSB has accredited business administration programs and, since 1980, accounting programs offering undergraduate and graduate degrees. The AACSB has accredited over 450 U.S. business programs and over 150 U.S. accounting programs. Since 1988, the ACBSP has accredited business programs offering associate, baccalaureate and graduate degrees. As of February 2008, over 400 educational institutions have achieved ACBSP accreditation. The accreditation standards at both accrediting agencies relate to, among other things, curricula, program and faculty resources, and faculty development.

The Committee believes that the accreditation process and appropriate accreditation standards can contribute to curricular changes. In particular, accreditation standards that embody curricular requirements to reflect the dynamism and complexity of the global capital markets and that evolve to keep pace in the future can be helpful in maintaining and advancing the quality of accounting curricula. The AACSB has emphasized in its accreditation standards that accounting curricula should reflect recent market developments. For example, educational institutions must include in their curricula international accounting issues in order to receive AACSB accreditation. The Committee supports the accrediting agencies' efforts to continually develop standards specifically emphasizing the need to update accounting programs.

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.

The auditing profession presents challenging and rewarding opportunities for those who pursue a career in auditing and the profession actively recruits talent from all backgrounds. Yet, the Committee was concerned by what it heard from individuals with various backgrounds about minority representation and retention in the auditing profession.¹¹ In 2004, minorities accounted for 23% of bachelor's degrees awarded in accounting, 21% of master's graduate degrees awarded in accounting, and 38% of doctoral degrees awarded in accounting-related studies.¹² In 2004, African Americans represented 1% of all CPAs, Hispanic/Latino, 3%, and

11 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Ira Solomon, R.C. Evans Distinguished Professor, and Head, Department of Accountancy, University of Illinois, 13), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Solomon120307.pdf>; Record of Proceedings (Dec. 3, 2007) (Questions for the Record of George S. Willie, Managing Partner, Bert Smith & Co., 2 (Jan. 30, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Willie120307.pdf>; Record of Proceedings (Dec. 3, 2007) (Written Submission of Julie K. Wood, Chief People Officer, Crowe Chizek and Company LLC, 2) *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Wood120307.pdf>.

12 BEATRICE SANDERS, AND LETICIA B. ROMEO, THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS-2005: FOR ACADEMIC YEAR 2003-2004 10 (2005), *available at* http://ceae.aicpa.org/NR/rdonlyres/11715FC6-F0A7-4AD6-8D28-6285CBE77315/0/Supply_DemandReport_2005.pdf.

Asian/Pacific Islander, 4%.¹³ African Americans accounted for 5.4% of new hires in 2007 in the largest six accounting firms, Hispanics, 4.6%, and Asians, 21.3%.¹⁴ In 2007, 1.0% of the partners in the six largest accounting firms were African American, 1.6% were Hispanic/Latino, 3.4% were Asian, and less than 1.0% were Native Hawaiian/Pacific Islander or American Indian/Alaska Native, aggregating less than 7% of the total partners.¹⁵

The Committee recognizes that important groups within the minority population are significantly under-represented in the accounting and auditing profession, especially at senior levels, and this under-representation of minorities in the profession is unacceptable from both a societal and business perspective. As the demographics of the global economy continue to expand ethnic diversity, it is imperative that the profession also reflect these changes. The auditing profession's historic role in performing audits in an increasingly diverse global setting and in establishing investor trust cannot be maintained unless the profession itself is viewed as open and representative. To ensure the continued health and vibrancy of the profession, it is imperative that all participants in the financial, investor, educator, and auditor community adopt and implement policies, programs, practices, and curricula designed to attract and retain minorities. In order for minority participation in the accounting and auditing profession to grow and sustain itself, minority recruitment and retention needs to be a multi-faceted, multi-year effort, implemented and championed by community leaders, families, and most importantly business and academic leaders who educate, recruit, employ, and rely on accountants and auditors.

In this regard, the Committee recognizes the importance of setting goals and measuring progress against these goals and thus makes the following recommendations:

(a) Recruit minorities into the auditing profession from other disciplines and careers.

The Committee heard from witnesses that the auditing profession has “fallen short” on its minority recruitment goals.¹⁶ Accordingly, the Committee recommends that auditing firms actively market to and recruit from minority non-accounting graduate populations, both at the entry and experienced hire level, utilizing cooperative efforts by academics and firm-based training programs to assist in this process. Generally, auditing firms hire individuals for the audit practice who are qualified to sit for the Uniform CPA Examination.¹⁷

13 BEATRICE SANDERS, AND LETICIA B. ROMEO, THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS-2005: FOR ACADEMIC YEAR 2003-2004 1 (2005), *available at* http://ceae.aicpa.org/NR/rdonlyres/11715FC6-F0A7-4AD6-8D28-6285CBE77315/0/Supply_DemandReport_2005.pdf.

14 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 59 (Jan. 23, 2008).

15 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 60 (Jan. 23, 2008).

16 See e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Julie K. Wood, Chief People Officer, Crowe Chizek and Company LLC, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Wood120307.pdf> (admitting an auditing firm had not met its goals in minority recruitment).

17 See Record of Proceedings (Dec. 3, 2007) (Questions for the Record of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 4 (Feb. 1, 2008)), *available at* <http://www.treas.gov/offices/domestic->

Further, the Committee recommends that auditing firms expand their recruitment initiatives at historically black colleges and universities (HBCUs), and explore the use of proprietary schools as another way to recruit minorities into the profession. Currently over 100 educational institutions established before 1964 to serve the African American community are designated as HBCUs and over fifty of these HBCUs maintain accounting programs. Approximately 290,000 students are enrolled in HBCUs¹⁸ and HBCUs enroll 14% of all African American students in higher education.¹⁹ Twenty-seven HBCUs have one or more of the six largest accounting firms recruiting professional staff on their campus.²⁰ Both the number of these schools visited by the largest firms and the number of firms recruiting at these schools should increase. Proprietary schools are for-profit businesses that teach vocational or occupational skills and there are over 2,000 proprietary schools in the United States.²¹ In 2005, these schools enrolled over 1 million students: African Americans accounted for 23% of these students, Hispanics, 13%, and Asian/Pacific Islander, 4%.²²

(b) Emphasize the role of community colleges in the recruitment of minorities into the auditing profession.

Community colleges are a vital part of the postsecondary education system. They provide open access to post-secondary education, preparing students for transfer to four-year institutions, providing workforce development and skills training, and offering non-credit programs. Moreover, as the cost of higher education continues its upward climb, more and more high-achieving students are beginning their post-secondary study through the community college system.

As of January 2008, approximately 11.5 million students were enrolled in the 1,200 community colleges in the United States: African Americans accounted for 13% of these students, Hispanics, 15%, and Asian/Pacific Islander, 6%.²³

In August 1992, the Accounting Education Change Commission (AECC), created in the late 1980s by the academic community to examine potential changes to accounting education, recognized the importance of two-year colleges in accounting education. The AECC noted that over half of all students taking their first course in accounting do so at two-year colleges

finance/acap/QFRs-12-3-07.pdf (noting that since 1997, Ernst & Young LLP has typically hired individuals qualified to sit for the Uniform CPA Examination).

18 STEPHEN PROVASNIK AND LINDA L. SHAFER, HISTORICALLY BLACK COLLEGES AND UNIVERSITIES, 1976 TO 2001 2 (NCES 2004-062), available at <http://nces.ed.gov/pubs2004/2004062.pdf>.

19 WHITE HOUSE INITIATIVE ON HISTORICALLY BLACK COLLEGES AND UNIVERSITIES, available at <http://www.ed.gov/about/inits/list/whhbcu/edlite-index.html>.

20 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 1 (Mar. 5, 2008).

21 THOMAS D. SNYDER, SALLY A. DILLOW, AND CHARLENE M. HOFFMAN, DIGEST OF EDUCATION STATISTICS 2007 Table 5 (NCES 2008-022), available at <http://nces.ed.gov/pubs2008/2008022.pdf>.

22 THOMAS D. SNYDER, SALLY A. DILLOW, AND CHARLENE M. HOFFMAN, DIGEST OF EDUCATION STATISTICS 2007 Table 220 (NCES 2008-022), available at <http://nces.ed.gov/pubs2008/2008022.pdf>.

23 AMERICAN ASSOCIATION OF COMMUNITY COLLEGES, available at <http://www2.aacc.nche.edu/research/index.htm>.

and that approximately one-fourth of the students entering the accounting profession take their initial accounting coursework at two-year colleges. The AECC called for “greater recognition within the academic and professional communities of the efforts and importance of two-year accounting programs.”²⁴

The Committee also heard from witnesses emphasizing the need to expand minority recruitment initiatives at community colleges.²⁵

The Committee believes that more attention to community colleges may provide, in addition to an increase in the overall supply of students, another avenue for minorities to become familiar with and attracted to the auditing profession. Currently none of the largest auditing firms recruit at community colleges because “individuals who only have associate degrees typically will not have sufficient qualifications to satisfy state licensing requirements.”²⁶ The Committee recommends that accreditation of two-year college accounting programs at community colleges be explored and implemented when viable, so that these programs can be relied upon as one of the requisite steps toward fulfilling undergraduate educational requirements. Further, the Committee recommends that auditing firms and educational institutions at all levels support and cooperate in building strong fundamental academic accounting programs at community colleges, including providing internships or financial support for students who begin their studies in two-year programs and may be seeking careers in the auditing profession. The Committee also recommends that auditing firms and four-year colleges and universities and their faculty focus on outreach to community college students in order to support students’ transition from community colleges to four-year educational institutions.

(c) Emphasize the utility and effectiveness of cross-sabbaticals and internships with faculty and students at Historically Black Colleges and Universities.

As discussed above, African Americans are significantly under-represented in the auditing profession.

The Committee recommends encouraging a concerted effort to increase the focus upon HBCUs in order to raise the number of African Americans in the auditing profession and urging the HBCUs, auditing firms, corporations, federal and state governments, and other entities to emphasize the use of cross-sabbaticals. Cross-sabbaticals are interactive relationships where

24 ACCOUNTING EDUCATION CHANGE COMMISSION, ISSUES STATEMENT NUMBER 3: THE IMPORTANCE OF TWO-YEAR COLLEGES FOR ACCOUNTING EDUCATION (Aug. 1992) *available at* <http://aaahq.org/aecc/PositionsandIssues/issues3.htm>.

25 Record of Proceedings (Feb. 4, 2008) (Written Submission of Gilbert R. Vasquez, Managing Partner, Vasquez & Company LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Vasquez02042008.pdf> (noting that auditing firms overlook community colleges where minorities, and specifically Latinos, represent a large student population); Record of Proceedings (Dec. 3, 2007) (Questions for the Record of George S. Willie, Managing Partner, Bert Smith & Co., 2 (Jan. 30, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-07.pdf> (recommending that the auditing profession increase its visibility at community colleges).

26 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 1 (Mar. 5, 2008).

faculty and seasoned professionals are regularly represented in the practice and academic environments through exchanges. Evidence suggests that such exchanges can be beneficial, and continued development of such exchanges is expected to provide substantial benefits for all parties.²⁷ Cross-sabbaticals present an opportunity for “reflective thinking” for seasoned professionals.²⁸

In addition, the Committee recommends that the over fifty HBCUs with accounting programs require one member of their accounting faculty annually to participate in a cross-sabbatical with a private or public sector entity. The Committee also recommends that the private and public sector entities provide these opportunities, as well as focus on other arrangements to build relationships at these educational institutions.

The Committee received testimony regarding the lack of minority mentors and role models²⁹ and notes that the profession has recognized this situation.³⁰ Thus, the Committee also recommends that public company auditing firms intensify their efforts to create internships and mentoring programs for students in accounting and other complementary disciplines, including those from HBCUs and community colleges, as a means to increase the awareness of the accounting profession and its attractiveness among minority students.

(d) Increase the numbers of minority accounting doctorates through focused efforts.

Some dedicated programs have succeeded in attracting minorities to enter and complete

27 See Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia Fornelli, Executive Director, Center for Audit Quality, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (recommending encouraging sabbaticals, internships, and fellowship opportunities, structured to give faculty opportunities to conduct research for promotion and tenure); Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 68), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-2-4-08.pdf> (stating that sabbaticals deliver professors “a wealth of knowledge they could bring back in the classroom”).

28 See Record of Proceedings (Mar. 13, 2008) (Oral Remarks of H. Rodgin Cohen, Chairman, Sullivan & Cromwell LLP, 69), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf> (noting that spending time in the classroom should “give the [practicing accountant] the time to do the reflective thinking.”); Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Zoe-Vonna Palmrose, Deputy Chief Accountant, SEC), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf> (commenting that sabbaticals provide the “opportunity for reflective thinking”).

29 See Record of Proceedings (Feb. 4, 2008) (Written Submission of Gilbert R. Vasquez, Managing Partner, Vasquez & Company LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Vasquez02042008.pdf> (highlighting the lack of Hispanic role models and mentors in the accounting profession).

30 See Record of Proceedings (Dec. 3, 2007) (Questions for the Record of George S. Willie, Managing Partner, Bert Smith & Co., 2 (Jan. 30, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Willie120307.pdf> (recommending the establishment of a mentor program for minority accounting students); Record of Proceedings (July 12, 2006) (Written Testimony of Manuel Fernandez, National Managing Partner—Campus Recruiting, KPMG LLP, to the Subcommittee on Oversight and Investigations of the House Financial Services Committee, 5), *available at* <http://financialservices.house.gov/media/pdf/071206mf.pdf> (identifying the lack of minority faculty mentors and role models and noting “[w]hen students of color do not see professors of their own ethnic background on the accounting faculty, they are less apt to consider the option of a career in accountancy”).

accounting doctoral studies.³¹ In particular, the PhD Project, an effort of the KPMG Foundation, has worked to increase the diversity of business school faculty.³² The PhD Project focuses on attracting minorities to business doctoral programs, and provides a network of peer support. Since the PhD Project's establishment in 1994, the number of minority professors at U.S. business schools has increased from 294 to 889.³³ Ninety percent who enter the PhD Project earn their doctorates, and 99% of those who completed their doctorates go on to teach.³⁴ The PhD Project has received over \$17.5 million³⁵ in funding since 1994 from corporations, foundations, universities, and other interested parties.³⁶

The Committee believes that programs such as these can successfully recruit minorities to accounting doctoral studies. The Committee recommends that auditing firms, corporations, and other interested parties advertise existing and successful efforts to increase the number of minority doctorates by developing further dedicated programs. Additionally, the Committee recommends that auditing firms, corporations, and other interested parties maintain and increase the funding of these programs.

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.

The Committee heard testimony from individuals regarding the need to have an adequate supply of faculty with the knowledge and experience to develop qualified professionals for the increasingly complex and global auditing profession.³⁷

31 For a list of educational support programs that auditing firms are sponsoring, see Record of Proceedings (Feb. 4, 2008) (Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, Appendix A), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Salzberg020408.pdf>.

32 For further information on the PhD Project, see <http://www.phdproject.org/mission.html>.

33 Record of Proceedings (Feb. 4, 2008) (Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, Appendix A), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Salzberg020408.pdf>.

34 See Jane Porter, *Going to the Head of the Class: How the PhD Project is Helping to Boost the Number of Minority Professors in B-schools*, BUSINESS WEEK ONLINE, Dec. 27, 2006, *available at* http://www.businessweek.com/bschools/content/dec2006/bs20061227_926455.htm.

35 See Record of Proceedings (July 12, 2006) (Written Testimony of Manuel Fernandez, National Managing Partner—Campus Recruiting, KPMG LLP, to the Subcommittee on Oversight and Investigations of the House Financial Services Committee, 5), *available at* <http://financialservices.house.gov/media/pdf/071206mf.pdf>.

36 For further information on the PhD Project, see http://www.phdproject.org/corp_sponsors.html.

37 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of David W. Leslie, Chancellor Professor of Education, College of William and Mary), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Leslie120307.pdf> (noting a 13.3% decline in accounting faculty from 1988 to 2004); Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (stating that “recent years have seen a reduction in accounting faculty, based on a wave of retirements and lack of accounting Ph.D.s coming into the system.”); Record of Proceedings (Dec. 3, 2007) (Written Submission of Ira Solomon, R.C. Evans Distinguished Professor, and Head, Department of Accountancy, University of Illinois, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Solomon120307.pdf> (stating that “the number of persons entering accountancy doctoral programs is too low to sustain the accountancy professoriate.”).

The Committee recognizes that there is a high level of concern about the adequacy of both the near and the long-term supply of doctoral faculty, especially given the anticipated pace of faculty retirements. According to National Study of Postsecondary Faculty data, the number of full- and part-time accounting faculty at all types of educational institutions fell by 13.3% from 20,321 in 1993 to 17,610 in 2004, while student (undergraduate) enrollment has increased by 12.3% over the same period.³⁸ Moreover, the current pipeline of doctoral faculty is not keeping pace with anticipated retirements. In November 2006, it was estimated that one-third of the approximately 4,000 accounting doctoral faculty in the United States were 60 years old or older, and one-half were 55 years old or older.³⁹ The average retirement age of accounting faculty was 62.4 years.

In terms of specialization within the accounting discipline, an AAA study concluded that only 22% and 27% of the projected demand for doctoral faculty in auditing and tax, respectively, will be met by expected graduations in the coming years.⁴⁰ However, 91% and 79% of the projected demand for doctoral faculty in financial accounting and managerial accounting, respectively, will be met.⁴¹

In addition to the accounting faculty supply issues, the Committee heard testimony from witnesses on the need to ensure faculty are qualified and able to teach students the latest market developments, such as fair value accounting and IFRS. The Committee learned that often new accounting faculty may have little practical experience.⁴² Witnesses testified to the difficulty of academics' acquiring "practice-oriented" knowledge as the bond between the profession and academia is underdeveloped. Witnesses did suggest improving these relationships with incentives for sabbaticals and sharing practice experience.⁴³

In this regard, the Committee makes the following recommendations:

(a) Increase the supply of accounting faculty through public and private funding and raise the number of professionally qualified faculty that teach on campuses.

38 Record of Proceedings (Dec. 3, 2007) (Written Submission of David W. Leslie, Chancellor Professor of Education, College of William and Mary), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Leslie120307.pdf>.

39 JAMES R. HASSELBACK, 2007 ANALYSIS OF ACCOUNTING FACULTY BIRTHDATES, *available at* <http://aaahq.org/temp/phd/JimHasselbackBirthdateSlide.pdf>.

40 R. David Plumlee, Steven J. Kachelmeier, Silvia A. Madeo, Jamie H. Pratt, and George Krull, *Assessing the Shortage of Accounting Faculty*, 21 ISSUES IN ACCOUNTING EDUCATION, No. 2, 119 (May 2006).

41 R. David Plumlee, Steven J. Kachelmeier, Silvia A. Madeo, Jamie H. Pratt, and George Krull, *Assessing the Shortage of Accounting Faculty*, 21 ISSUES IN ACCOUNTING EDUCATION, No. 2, 119 (May 2006).

42 Record of Proceedings (Dec. 3, 2007) (Written Submission of Joseph V. Carcello, Director of Research, Corporate Governance, University of Tennessee, Knoxville, 21), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Carcello120307.pdf>.

43 Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia Fornelli, Executive Director, Center for Audit Quality, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (noting that the auditing firms recognize the need to be more active in sharing practical experiences with academics); Record of Proceedings (Feb. 4, 2008) (Written Submission of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 19), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (“[R]elationships between practitioners and academics have so diminished that they are little more than formal liaison assignments involving very few parties from any side ... [w]here there have been opportunities for interaction (curriculum issues, policy deliberations, research matters), those opportunities have been embraced perceptibly less often”).

The Committee recognizes that ensuring an adequate supply of doctoral accounting faculty in higher education is crucial to both retaining the academic standing of the discipline on campus and developing well-prepared and educated entry-level professionals. The resource represented by these professionals is essential for high quality audits. The Committee believes that high quality audits are critical to well-functioning capital markets, and therefore the funding necessary to provide the healthy pipeline of doctoral accounting faculty to assist in providing these human capital resources must be provided. The Committee therefore recommends expanding government funding, at both the federal and state level, for accounting doctoral candidates. The Committee also recommends that private sources (including corporations, institutional investors, and foundations as well as auditing firms) continue to be encouraged to fund accounting doctoral candidates. The Committee recognizes and commends the auditing firms' support of doctoral candidates.⁴⁴

Currently, minimum accreditation requirements for accountancy faculty typically require that approximately 50% of full-time faculty have a doctoral degree. Commonly, business school deans and academic vice presidents (those making the budgetary decisions regarding faculty allotments on campuses) interpret this accreditation requirement to require that a minimum of 50% of a department's faculty hold an earned doctorate and are actively engaged in research and publication activity. Although a high percentage of faculty are expected to be professionally qualified (i.e., having recent direct business experience), at times gatekeepers for budget allocations may be less enthusiastic about maximizing the number of professionally qualified teaching slots in a given program. The Committee sees benefits to the increased participation of professionally qualified and experienced faculty, who would bring additional practical business experience to the classrooms, and notes that witnesses and commenters have underscored the benefits of professionally qualified and experienced faculty.⁴⁵ Therefore, the Committee recommends that accrediting agencies continue to actively support faculty composed of academically and professionally qualified and experienced faculty.

(b) Emphasize the utility and effectiveness of cross-sabbaticals.

As discussed above, cross-sabbaticals are interactive relationships where faculty and seasoned professionals are regularly represented in the practice and academic environments through exchanges. For example, currently, the Securities and Exchange Commission (SEC) and the FASB offer fellowship programs for professional accountants and accounting academics. Evidence suggests that such exchanges can be beneficial, and continued development of

⁴⁴ See Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia Fornelli, Executive Director, Center for Audit Quality, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf>.

⁴⁵ See Andrew D. Bailey, Jr., Professor of Accountancy-Emeritus, University of Illinois, and Senior Policy Advisor, Grant Thornton LLP, Comment Letter Regarding Discussion Outline 19 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEE-OUTLINEFINALSUBMISSION13008.doc (stating that “[t]here are clearly practice professionals that make excellent contributions to some of the most highly rated accounting programs in the country”); Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia Fornelli, Executive Director, Center for Audit Quality, 3) *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (stating that accreditation bodies “revise accreditation standards to allow the employment of more audit professionals, either active or retired, as adjunct professors”).

such exchanges is expected to provide substantial benefits for all parties.⁴⁶ Cross-sabbaticals present an opportunity for “reflective thinking” for seasoned professionals.⁴⁷ Academics often face the disincentive of being forced to forgo their full salaries in order to engage in such sabbaticals,⁴⁸ and colleges and universities may not encourage professional practice sabbaticals, preferring that the focus of faculty be directed exclusively toward academic research and the number and placement of scholarly articles. The Committee believes that changing both the academic and practice culture will require a plan and commitment of support at the highest institutional levels.

Specifically, the Committee recommends that educational institutions, auditing firms, corporations, federal and state regulators, and others engage in a two-fold strategy to both encourage cross-sabbaticals and eliminate financial or career disincentives for participating in such experiences. Further, the Committee recommends that university administrators place as high a value on professional sabbaticals for purposes of promotion and tenure for research and scholarly publication.

The Committee also recommends that accrediting agencies establish an expectation that at least one full-time member per year of each accounting faculty group participate in a sabbatical with a private sector or a governmental entity. Auditing firms, corporations, government agencies, and universities should be expected to provide these opportunities with the elimination of any financial disincentives. Further, the Committee recommends expanding faculty fellowship programs in agencies, such as those at the SEC and the FASB, and making them available at the PCAOB. The successful long-term operation of these programs at the SEC and the FASB and the application of appropriate conflict-of-interest and recusal rules have demonstrated that these programs can be maintained and expanded while protecting against conflicts of interest.

(c) Create a variety of tangible and sufficiently attractive incentives that will motivate private sector institutions to fund both accounting faculty and faculty research, to provide practice materials for academic research and for participation of professionals in behavioral and field study projects, and to encourage practicing accountants to pursue careers as academically and professionally qualified faculty.

46 See Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia Fornelli, Executive Director, Center for Audit Quality, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (recommending encouraging sabbaticals, internships, and fellowship opportunities, structured to give faculty opportunities to conduct research for promotion and tenure); Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 68), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (stating that sabbaticals deliver professors “a wealth of knowledge they could bring back in the classroom”).

47 See Record of Proceedings (Mar. 13, 2008) (Oral Remarks of H. Rodgin Cohen, Chairman, Sullivan & Cromwell LLP, 69), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf>; Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Zoe-Vonna Palmrose, Deputy Chief Accountant, SEC, 67), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf>.

48 Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 67-69), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (noting the financial disincentives associated with sabbaticals).

As discussed above, there are concerns about the adequate supply of accounting faculty and about the need to have faculty who can inject more practical experience into classroom learning. Currently, there are few specific financial incentives encouraging private sector funding of accounting doctoral faculty or sponsoring of professional accountants to teach at educational institutions. Nonetheless, the Committee notes that the profession recognizes the need to support initiatives to increase faculty and is currently directing its efforts to raise funds for such a new initiative.⁴⁹

The Committee also heard from several witnesses regarding the unavailability of data relating to auditing practice and the impact this lack of data has on research and potentially on the profession's sustainability. In particular, witnesses stated that the decline in auditing research materials, including archival or experimental data will lead to a further decline in faculty and doctoral students specializing in auditing.⁵⁰ Since educational institutions normally require publications in top tier journals for promotion or tenure, faculty and doctoral students will conduct research in accounting areas where data are prevalent.

The Committee also heard that encouraging more professionally qualified and experienced faculty will foster a stronger relationship between academia and the profession.⁵¹ Currently, there exists a need for more interaction between academia and the profession.⁵² Encouraging practicing accountants to pursue careers as academically and professionally qualified faculty would bring practical business experience to classrooms so that students are better prepared to perform quality audits in the dynamic business environment.

49 See Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia Fornelli, Executive Director, Center for Audit Quality, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (stating that “[b]ecause of the profession’s concern over the shortage of qualified faculty to teach accounting, the AICPA Foundation, along with the 80 largest CPA firms, are working to raise more than \$17 million to fund additional Ph.D. candidates at participating universities”).

50 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Joseph V. Carcello, Director of Research, Corporate Governance, University of Tennessee, Knoxville, 21), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Carcello120307.pdf> (“[D]octoral students in ... [a 2007] Deloitte [Foundation] study indicated that lack of access to public accounting firm and client data represented a severe obstacle to the research they want to conduct, and that this difficulty might result in them focusing on a different accounting sub-area. This issue must be addressed, or auditing may cease to exist as a discipline on many university campuses.”); Record of Proceedings (Feb. 4, 2008) (Written Submission of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 8), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (recommending the development of a means “for researchers to gain access to auditing related data” and noting, without this means, interest in doctoral auditing programs will continue to decline); Record of Proceedings (Dec. 3, 2007) (Written Submission of Ira Solomon, R.C. Evans Distinguished Professor, and Head, Department of Accountancy, University of Illinois, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Solomon120307.pdf> (noting the lack of auditing research data and the “drastic decline in auditing research among extant accountancy faculty and among accountancy doctoral students”).

51 Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia Fornelli, Executive Director, Center for Audit Quality, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf>.

52 Record of Proceedings (Feb. 4, 2008) (Written Submission of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 19), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf>.

Finally, the Committee recommends that Congress pass legislation creating a variety of tangible incentives for private sector institutions to establish support for accounting and auditing faculty and faculty research, to facilitate access to research data and individuals, and to sponsor transition of professional accountants from practice to teaching positions. These incentives must be sufficiently attractive to companies and auditing firms to effect rapid behavioral change, and should avoid cumbersome levels of administration. The Committee believes that these incentives would provide the necessary impetus to private sector institutions to help increase the number of accounting faculty as well as faculty with significant practical experience.

Recommendation 4. Develop and maintain consistent demographic and higher education program profile data.

The Committee heard testimony regarding the lack of consistent demographic and higher education program profile data concerning the profession.⁵³ The need for comparable, consistent, periodic information regarding the demographic profile of professional accountants and auditors, related higher education program capacity, entry-level supply and demand of personnel, accounting firm retention and compensation practices, and similar particulars are fundamental to a meaningful understanding of the human capital circumstances which affect the public company auditing profession and its future and sustainability.

Historically, there has been neither an ongoing collection of data nor a centralized location where the general public can access data. For instance, the AICPA publishes a supply and demand study every two years. Additionally, various other groups, such as the AAA, NASBA, colleges and universities, and individuals collect some of these data but not in a manner available and useful for research.

Materials such as those supplied by the Center for Audit Quality to the Committee,⁵⁴ previous AICPA Supply and Demand studies⁵⁵ and AAA-commissioned demographic research⁵⁶

53 See e.g., Record of Proceedings (Dec. 3, 2007) (Questions for the Record of David A. Costello, President and Chief Executive Officer, National Association of State Board of Accountancy, 2-4 (Feb. 6, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-07.pdf> (stating that “[s]ince 1970, ... NASBA and the AICPA have recognized the need for a national database for Certified Public Accountants and have taken steps leading to the development of the database... [c]urrently, NASBA is not aware of a mechanism or database which would provide an accurate count of CPAs, without the effect of ‘double counting.’”); Julia Grant, *Demographic Challenges Facing the CPA Profession*, 20 RESEARCH IN ACCOUNTING REGULATIONS 5 (2007) (forthcoming); Record of Proceedings (Dec. 3, 2007) (Written Submission of Ira Solomon, R.C. Evans Distinguished Professor, and Head, Department of Accountancy, University of Illinois, 13), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Solomon120307.pdf> (noting the lack of comprehensive accounting profession supply and demand data and recommending the “establishment of a continuous and comprehensive system that produces more timely and reliable supply and demand data”).

54 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).

55 BEATRICE SANDERS, AND LETICIA B. ROMEO, THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS-2005: FOR ACADEMIC YEAR 2003-2004 (2005), *available at* http://ceae.aicpa.org/NR/rdonlyres/11715FC6-F0A7-4AD6-8D28-6285CBE77315/0/Supply_DemandReport_2005.pdf.

56 DAVID LESLIE, ACCOUNTING FACULTY IN U.S. COLLEGES AND UNIVERSITIES: STATUS AND TRENDS, 1993-2004, A REPORT OF THE AMERICAN ACCOUNTING ASSOCIATION (Feb. 19, 2008).

provide examples of the necessary information. In addition, AICPA membership trends, augmented by data available from state boards of accountancy regarding numbers of licensees, may be useful data.

Therefore, the Committee recommends the establishment of a national cooperative committee, comprised of organizations such as the AICPA and the AAA, to encourage periodic consistent demographic and higher education program profile data. The Committee believes that having such data available will increase the ability of auditing firms, corporations, investors, academics, policy makers, and others to understand more fully, monitor and evaluate, and take necessary or desirable actions with respect to the human capital in the auditing profession and its future and sustainability.

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.

The Committee heard testimony regarding the feasibility of establishing a free-standing, post-graduate professional educational structure.⁵⁷ Currently, there is no post-graduate institutional arrangement dedicated to accounting and auditing. Graduate programs in accounting are generally housed within business schools and linked with undergraduate accounting programs.

The history of the development of U.S. educational programs and preparation for accounting careers reveals a pattern of evolution of increasing formal higher education, with accreditation standards following and reinforcing this evolution, and with market needs providing the impetus and context. Today, accrediting agencies have recognized over 150 accounting programs as the result of these programs' improving accounting education as envisioned by prior studies and reports.

In a November 2006 Vision Statement, the chief executive officers of the principal international auditing networks noted the challenges in educating future auditing professionals, including the sheer quantity and complexity of accounting and auditing standards, rapid technological advancements, and the need for specialized industry knowledge.⁵⁸ This development in the market leads to a clear need to anticipate and enhance the human capital elements of the auditing profession. As such, this vision statement provides the impetus to commission a group to study and propose a long-term institutional arrangement for accounting and auditing education.

⁵⁷ See e.g., Record of Proceedings (Dec. 3, 2007) (Oral Submission of Joseph V. Carcello, Director of Research, Corporate Governance, University of Tennessee, Knoxville, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/CarcelloOralStatement120307.pdf> (recommending that “the Advisory Committee consider a different model – an education model involving professional schools of auditing...”); Record of Proceedings (Feb. 4, 2008) (Written Submission of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (discounting the feasibility of free-standing professional schools).

⁵⁸ GLOBAL CAPITAL MARKETS AND THE GLOBAL ECONOMY: A VISION FROM THE CEOs OF THE INTERNATIONAL AUDIT NETWORKS 15 (Nov. 2006).

As in the past, in the face of challenges of the changing environment for the profession, the Committee believes that the educational system should thoughtfully consider the feasibility of a visionary educational model. Therefore, the Committee recommends that the AICPA and the AAA jointly form a body to provide a timely study of the possible future of the higher education structure for the accounting profession. This commission may include representation from higher education, practitioners from the wide spectrum of the accounting and auditing profession, regulators, preparers, users of the profession's services, and others. The commission would consider the potential role of a postgraduate professional school model to enhance the quality and sustainability of a vibrant accounting and auditing profession. The commission should consider developments in accounting standards and their application, auditing needs, regulatory framework, globalization, the international pool of candidates, and technology. Finally, a blueprint for this sort of enhanced professional educational structure would also require the consideration of long-term market circumstances, academic governance, operations, programs, funding and resources, the role of accreditation, and experiential learning processes.

Other Issues Under Consideration

The Committee is also considering and debating a variety of other issues. Further elaboration on these issues will be included in subsequent drafts of this Report.

VI. FIRM STRUCTURE AND FINANCES

In addressing the sustainability of the auditing profession, the Committee sought input on and considered a number of matters relating directly to auditing firms, including audit quality, governance, transparency, global organization, financial strength, ability to access capital, the investing public's understanding of auditors' responsibilities and communications, the limitations of audits, particularly relating to fraud detection and prevention, as well as the effect of litigation where audits are alleged to have been ineffective. The Committee also considered the regulatory system applicable to auditing firms.

While much data was available to the Committee, such information was not exhaustive. Certain information regarding auditors of public companies, the auditor of record, and audit fees is readily available. Auditing firms also provide on a voluntarily basis certain other information they believe useful to clients, regulators, and/or investors. Also, in connection with the work of the Committee, the largest firms provided certain additional input, through the Center for Audit Quality (CAQ), sometimes by individual firm and sometimes in summarized format.¹

After reviewing these data and receiving testimony from witnesses and comment letters, the Committee focused on a few specific areas: fraud prevention and detection; federal and state regulatory system; governance; and disclosure of auditor changes.

The Committee recommends that regulators, the auditing profession, and others, as applicable, effectuate the following:

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

Public Company Accounting Oversight Board (PCAOB) standards currently require auditors to plan and perform audits to obtain reasonable assurance whether financial statements are free of material misstatement, including those caused by fraud.² The Committee considered testimony and commentary regarding auditing firms' responsibilities and practices relating to fraud prevention and detection.³ The auditing profession itself has recognized the signifi-

1 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); 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).

2 CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT, Interim Auditing Standard AU 316 (Pub. Company Accounting Oversight Bd. 2002).

3 See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy-Emeritus, University of Illinois, and Senior Policy Advisor, Grant Thornton LLP, Comment Letter Regarding Discussion Outline 4 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINAL-SUBMISSION13008.doc; Record of Proceedings (Feb. 4, 2008) (Written Submission of Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf>.

cance of its duties with respect to fraud: “Perhaps no single issue is the subject of more confusion, yet is more important, than the nature of the obligation of auditors to detect fraud—or *intentional material misstatement* of financial information by public companies.”⁴

The Committee believes that continued enhancement of auditors’ fraud prevention and detection skills will improve financial reporting and audit quality and enhance investor confidence in financial reporting and the auditing function. In that regard, the Committee recommends the following:

(a) Urge the creation of a national center to facilitate auditing firms’ and other market participants’ sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies, and commission research and other fact-finding regarding fraud prevention and detection, and further, the development of best practices regarding fraud prevention and detection.

No formal forum currently exists where auditors and other market participants regularly share their views and experiences relating to fraud prevention and detection in the context of fraudulent financial reporting. The Committee received testimony that it would improve audit quality and benefit the capital markets and investors and other financial statement users for auditing firms to share their fraud detection experiences⁵ and to develop best practices relating to fraud prevention and detection.⁶

The Committee believes that a collective sharing of fraud prevention and detection experiences among auditors and other market participants will provide a broad view of auditor practices and ultimately improve fraud prevention and detection capabilities and enable the development of best practices. The Committee also believes that research into industry trends and statistics will help auditors focus and develop procedures to identify areas and situations at greater risk for fraud. The Committee believes that best practices regarding fraud prevention and detection will enhance the internal processes and procedures of auditing firms.

The Committee recommends the creation of a national center both to facilitate auditing firms’ sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies and to commission

⁴ SERVING GLOBAL CAPITAL MARKETS AND THE GLOBAL ECONOMY: A VIEW FROM THE CEOs OF THE INTERNATIONAL AUDIT NETWORKS 12 (Nov. 2006).

⁵ See, e.g., Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 6 (Mar. 31, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf>; Record of Proceedings (Dec. 3, 2007) (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf>.

⁶ See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 10), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (stating that “[s]uccess also requires that the profession work with standard setters and regulators to develop best practices and the infrastructure for effective audits designed to detect material financial fraud”).

research and other fact-finding regarding fraud prevention and detection. The Committee also recommends that the auditing firms, forensic accounting firms, certified fraud examiners, investors, other financial statement users, public companies, and academics develop, in consultation with the PCAOB, the Securities and Exchange Commission (SEC), international regulators, and the National Association of State Boards of Accountancy (NASBA), best practices regarding fraud prevention and detection. The Committee also recognizes that a national center and best practices will have greater impact if these concepts are ultimately extended and embraced internationally.

(b) Urge that the PCAOB and the SEC clarify in the auditor’s report the auditor’s role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards.

The Committee considered testimony and commentary regarding a long-standing “expectations gap” between the public’s expectations regarding auditor responsibility for fraud detection and the auditor’s required and capable performance of fraud detection.⁷ The public may believe that auditors will detect more fraud than those in the profession believe can be reasonably expected. This belief may be unreasonable in some circumstances given the difficulties of detecting fraud, especially before it has resulted in a material misstatement. On the other hand, public investors have raised questions when large frauds have gone undetected. The auditing standard governing fraud detection, AU Section 316, *Consideration of Fraud in a Financial Statement Audit*, notes that fraud may involve deliberate concealment and collusion with third parties.⁸ AU Section 316 states that the “auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.” This gap between public expectation and the auditor’s performance causes confusion and ultimately undermines investor confidence in financial reporting and the capital markets.

⁷ See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, and Senior Policy Advisor, Grant Thornton LLP, Comment Letter Regarding Discussion Outline 4 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008.doc (stating that “[i]f the discovery of material errors and fraud is not a major part of what the audit is about, it is not clear what value-added service the auditor offers the investor and capital markets”); Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 5 (Mar. 31, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> (“While auditors provide reasonable assurance that fraud material to the financial statements will be detected, they cannot be expected to provide absolute assurance that all material fraud will be found. Cost-benefit constraints and the lack of governmental subpoena and investigative powers, among other factors, make absolute assurance impossible.”); Record of Proceedings (Feb. 4, 2008) (Written Submission of Dennis Johnson, California Public Employees’ Retirement System, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf> (stating that “[o]f critical importance to investors is the responsibility of auditors to detect fraud and improve the timely communication of these frauds to investors and shareowners.”); SERVING GLOBAL CAPITAL MARKETS AND THE GLOBAL ECONOMY: A VIEW FROM THE CEOs OF THE INTERNATIONAL AUDIT NETWORKS 12 (Nov. 2006) (“Nonetheless, there is a significant ‘expectations gap’ between what various stakeholders believe auditors should do in detecting fraud, and what audit networks are actually *capable* of doing, at the prices that companies or investors are willing to pay for audits.”).

⁸ CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT, Interim Auditing Standard AU 316 (Pub. Company Accounting Oversight Bd. 2002).

Commentary has suggested that auditors must more effectively communicate their responsibility regarding fraud detection and prevention with investors and the capital markets. The Committee agrees with this suggestion. Accordingly, the Committee believes that the auditor's report should articulate clearly to investors the auditor's role and limitations in detecting fraud. The Committee believes that expressly communicating to investors, other financial statement users, and the public the role of auditors in fraud detection would help narrow the "expectations gap."

The Committee recommends that the PCAOB and the SEC clarify in the auditor's report the auditor's role and limitations in detecting fraud under current auditing standards. In addition, the Committee recommends, in light of this continuing "expectations gap," that the PCAOB review the auditing standards governing fraud detection and fraud reporting. Specifically, the Committee recommends that the PCAOB periodically review and update these standards.

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.

The SEC, the PCAOB, and individual state boards of accountancy regulate the auditing profession. The SEC and the PCAOB enforce the securities laws and regulations addressing public company audits. Individual state accountancy laws in 55 jurisdictions in the United States govern the licensing and regulation of both individuals and firms who practice as certified public accountants.⁹ State boards of accountancy enforce these laws and also administer the Uniform CPA Examination. NASBA serves as a forum for these boards to enhance their regulatory effectiveness and communication.

The Committee believes that enhancing regulatory cooperation and reducing duplicative oversight of the auditing profession by federal and state authorities and enhancing licensee practice mobility among the states are in the best interest of the public and the effective operation of the capital markets. In this regard, the Committee recommends the following:

(a) Institute the following mechanism to encourage the states to substantially adopt the mobility provisions of the Uniform Accountancy Act, Fifth Edition (UAA)¹⁰: If states have failed to adopt the mobility provisions of the UAA by December 31, 2010, Congress should pass a federal provision requiring the adoption of these provisions.

The American Institute of Certified Public Accountants (AICPA) and NASBA jointly author the UAA, a model bill which focuses on the education, examination, and experience requirements for certified public accountants. As the name of the bill suggests, the UAA advances the goal of uniformity, in addition to protecting the public interest and promoting high

⁹ Record of Proceedings (Dec. 3, 2007) (Written Submission of David A. Costello, President and Chief Executive Officer, National Association of State Board of Accountancy, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Costello120307.pdf>.

¹⁰ UNIFORM ACCOUNTANCY ACT (Fifth Ed. July 2007).

professional standards. In 2006 and 2007, recognizing the changing global economy and the impact of electronic commerce, the AICPA and NASBA proposed amendments to the UAA to allow for a streamlined framework for CPA “mobility” of practice among the states; that is, a CPA’s practice privileges would be valid and portable across all state jurisdictions beyond that of the CPA’s resident state.¹¹

According to NASBA, to date twenty-two states have passed mobility legislation. Twelve other states currently have mobility legislation introduced and other bills are anticipated in the 2008 legislative session. Almost every state is now discussing or considering mobility, and a number of other state boards of accountancy have voted to support and move forward with mobility.

The Committee considered testimony and commentary on the importance to auditing firms’ multi-state practices of the adoption of the UAA’s mobility provisions.¹² A NASBA representative testified, “In order for our capital market system to continue to prosper and grow, NASBA recognized the need to ensure that an efficient, effective mobility system is in place that will allow CPAs and their firms, as professional service providers, to serve the needs of American businesses, where ever they are located.”¹³

The Committee believes that, given the multi-state operations of many public companies and the multi-state practices of many auditing firms, practice mobility will foster a more efficient operation of the capital markets. The Committee recommends the following mechanism to encourage the states to adopt the UAA’s mobility provisions: If states have failed to adopt the mobility provisions of the UAA by December 31, 2010, Congress should pass a federal provision requiring the adoption of these provisions. The Committee recognizes that some state legislatures meet biannually, and for such legislatures this deadline poses a challenge. However, such a deadline should be attainable and will encourage such legislatures to place this issue high on their agenda. The Committee also recommends that the states participate

11 See Record of Proceedings (Dec. 3, 2007) (Questions for the Record of David A. Costello, President and Chief Executive Officer, National Association of State Board of Accountancy, 1 (Feb. 6, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-2007.pdf> (“As the global business community continues to expand, CPAs will be required to practice beyond the state in which they reside. Inefficiencies are created when those individuals are required to complete paperwork and submit a fee for every state in which they perform professional services.”).

12 See, e.g., Amper, Politziner and Mattia, P.C., Comment Letter Regarding Discussion Outline 2 (Nov. 14, 2007) *available at* http://comments.treas.gov/_files/AmperPolitzinerMattia.pdf (noting that “[t]he ease of performing audits in any state by a valid CPA ... without requiring to be licensed by each state would be beneficial.”); Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 5) (Dec. 3, 2008), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (noting that a number of states are cooperating and working towards adopting uniform mobility requirements); Record of Proceedings (Dec. 3, 2007) (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf> (“The Treasury Committee should suggest that the states eliminate barriers to interstate practice by universal adoption of the mobility provisions of the Uniform Accountancy Act.”).

13 Record of Proceedings (Dec. 3, 2007) (Written Submission of David A. Costello, President and Chief Executive Officer, National Association of State Board of Accountancy, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Costello120307.pdf>.

in NASBA's Accountancy Licensee Database (ALD) as a mechanism to assist in maintaining appropriate oversight of CPAs throughout the country regardless of where they practice and that appropriate authorities interpret federal and state privacy regulations to facilitate implementation of the ALD.

(b) Require regular and formal roundtable meetings of regulators and other governmental enforcement bodies in a cooperative effort to improve regulatory effectiveness and reduce the incidence of duplicative and potentially inconsistent enforcement regimes.

Under the federal securities laws, the SEC has enforcement authority over public company auditing firms and oversight authority over the PCAOB under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Sarbanes-Oxley provides the PCAOB with registration, reporting, inspection, standard-setting, and enforcement authority over public company auditing firms.¹⁴ In addition, the fifty-five boards of accountancy license, regulate, and enforce state accountancy laws pertaining to certified public accountants and their firms. In addition, the Department of Justice (DOJ) and state attorneys general can bring enforcement actions against auditing firms and their employees.

The Committee considered testimony from auditing firms on the duplicative and sometimes inconsistent federal and state oversight of the profession.¹⁵ The Committee does recognize that both federal and state regulators have made attempts to coordinate better their enforcement activities.¹⁶ One witness suggested the possible formation of a commission to help improve regulatory effectiveness.¹⁷ Another witness urged state and federal regulatory coop-

14 Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7211-7219.

15 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf>; Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf>; Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Barry Salzberg, Chief Executive Officer, Deloitte LLP, App. A 4 (Mar. 31, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> (criticizing duplicative auditing firm investigations by states with no nexus to alleged conduct).

16 See, e.g., Record of Proceedings (Dec. 3, 2007) (Oral Remarks of David A. Costello, President and Chief Executive Officer, National Association of State Board of Accountancy, 98), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-12-3-07.pdf> (noting that “[NASBA] has been working with the PCAOB very closely coordinating efforts, trying to diminish as much as possible the redundancy in enforcement”) Record of Proceedings (Dec. 3, 2007) (Written Submission of David A. Costello, President and Chief Executive Officer, National Association of State Board of Accountancy, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Costello120307.pdf> (stating that NASBA is assisting state boards in enforcement cases involving multi-state activities).

17 Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (noting that, “it would be useful to evaluate the possibility of an interstate commission for the whole of the audit profession. Such a commission would bring together state licensing authorities, the PCAOB, and appropriate professional organizations. It would be the means to rationalize existing disparities in licensing qualifications, continuing education requirements and peer review for non-public company audit practices. It would also enable enforcement of common regulations and license discipline across state and federal jurisdictions.”).

eration to ensure harmonized regulation and licensure.¹⁸

The Committee recommends mandating regular and formal roundtables of the PCAOB, the SEC, the DOJ, the state boards of accountancy, and the state attorneys general, to periodically review the overall enforcement regimes applicable to the public company auditing profession. These roundtables also should focus on regulatory coordination, improvement, and consistent approaches to enforcement to minimize duplicative efforts. Because of the difficulty and cost of bringing together many different state agencies on a regular basis, the Committee recommends that NASBA assist states by taking a leadership role in coordinating their responsibilities and interests.

(c) Urge the states to create greater financial and operational independence of their state boards of accountancy.

The Committee is concerned about the financial and operational independence of state boards of accountancy from outside influences, such as other state agencies, and the possible effect on the regulation and oversight of the accounting profession. A number of state boards are under-funded¹⁹ and lack the wherewithal to incur the cost of investigations leading to enforcement. In addition, some state boards fall under the centralized administrative “umbrella” of other state agencies and lack control of financial resources and/or operational independence necessary to carry out their mandate of public protection.²⁰ In some cases, board members are nominated by private associations whose constituencies are not necessarily focused on the protection of the public.

The Committee believes that greater independence of state boards of accountancy would enhance their regulatory effectiveness. The Committee recommends that, working with NASBA, states evaluate and develop means to make their respective state boards of accountancy more operationally and financially independent of outside influences. The Committee notes that this Recommendation to ensure the independence of state boards of accountancy is not meant to limit in any way the efforts of regulators and other governmental enforcement bodies to coordinate their regulatory and enforcement activities as recommended in Recommendation 2(b).

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 feasi-

18 Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf>.

19 NATIONAL ASSOCIATION OF STATE BOARDS OF ACCOUNTANCY, SUBMISSION IN CONNECTION WITH THE DECEMBER 3, 2007 MEETING OF THE ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Jan. 2008) (documenting the wide spectrum of funding for individual state boards of accountancy and noting the number of full-time staff per state boards of accountancy office).

20 Statement of Ronald J. Rotaru, Executive Director, Accountancy Board of Ohio, before Ohio H. Finance Committee of the Ohio House of Representatives 1 (Mar. 18, 2005) (“The evidence shows that ‘consolidated’ states have difficulty in effectively enforcing the statutes governing the profession under their central agency umbrella.”).

bility 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.

In response to the recent corporate accounting scandals, related legislative and regulatory requirements and best practices, public companies enhanced their corporate governance. One of the most prominent alterations to the corporate governance scheme was the increased representation and strengthening of independent members of boards of directors. The New York Stock Exchange and the Nasdaq enhanced their public company listing standards to call for a majority of independent board members.²¹ Best practices have gone even further, calling for a “substantial majority” of independent directors.²²

A combination of Sarbanes-Oxley provisions and exchange listing standards mandate fully independent audit committees, nominating/corporate governance, and compensation committees.²³ In addition, independent directors’ responsibilities have increased. For example, the independent audit committee now appoints, oversees, and compensates the auditor.²⁴ Although difficult to quantify the benefits of these enhancements, many have extolled these reforms as improving the quality of board oversight, reducing conflicts of interest, and enhancing investor confidence in public company operations and financial reporting.²⁵

Public company auditing firms as private partnerships are not subject to these requirements. Instead, state laws and partnership agreements determine the governance of auditing firms.²⁶ Often a firm’s governing body is comprised of elected firm partners.²⁷ Some firms are cur-

21 New York Stock Exchange, Listed Company Manual § 303A.01 (2003); Nasdaq, Manual, Rule 4350(c).

22 See, e.g., THE BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE (May 2002) (recommending, among other things, a substantial majority of independent directors and fully independent audit, corporate governance/nominating, and compensation committees); THE CONFERENCE BOARD, COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE (Jan. 9, 2003) (recommending, among other things, a substantial majority of independent directors and regular executive sessions of the independent directors).

23 Sarbanes-Oxley Act, 15 U.S.C. § 78-j (2002) (mandating audit committees comprised solely of independent directors); New York Stock Exchange, Listed Company Manual § 303A.04 (2004) (requiring nominating/corporate governance committees comprised solely of independent directors); New York Stock Exchange, Listed Company Manual § 303A.05 (2004) (requiring compensation committees comprised solely of independent directors); New York Stock Exchange, Listed Company Manual § 303A.06 (2003) (mandating compliance with SEC rules requiring audit committees comprised solely of independent directors); Nasdaq, Manual, Rule 4350(d) (mandating compliance with SEC rules requiring audit committees comprised solely of independent directors). Note that the Nasdaq listing standards do not require the existence of nominating/corporate governance committees and compensation committees.

24 Sarbanes-Oxley Act, 15 U.S.C. § 78-j (2002).

25 For example, see the commentary accompanying New York Stock Exchange, Listed Company Manual § 303A.01 (“Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.”).

26 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 2 (Jan. 23, 2008).

27 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 2-22 (Jan. 23, 2008) (detailing the various governance structures of the largest six auditing firms); Cynthia M. Fornelli, Executive Director, Center for Audit Quality, and James S. Turley, Chair, Governing Board, Center for Audit Quality, and Chairman and CEO, Ernst & Young LLP, Comment Letter Regarding Discussion Outline 13 (Nov. 30,

rently using advisory boards, although these may not be well-publicized or transparent.

Several witnesses testified to the benefits of improving auditing firm governance and suggested the addition of independent members to the boards of directors.²⁸ One witness called for an entirely independent board with enhanced responsibilities, including chief executive officer selection, determining partner compensation, and monitoring potential conflicts of interest and audit quality.²⁹ An auditing firm representative noted that his firm was considering adding independent members on its international governing board.³⁰

The Committee believes that enhancing corporate governance of auditing firms through the appointment of independent board members, whose duties run to the auditing firm and its partners/owner, to advisory boards with meaningful governance responsibilities (possible under the current business model), and/or to firm boards could be particularly beneficial to auditing firm management and governance.³¹ The Committee also believes that such advisory boards and independent board members could improve investor protection through enhanced audit quality and firm transparency. The Committee is particularly intrigued by the idea of independent board members with duties and responsibilities similar to those of public company non-executive board members.

The Committee recognizes the multiple challenges that instituting a governance structure with independent board members might entail, including compliance with state partnership laws and independence requirements, insurance availability for such directors, and liability concerns. Accordingly, the Committee recommends that the PCAOB and the SEC, in consultation with federal and state regulators, auditing firms, investors, other financial statement users, and public companies, analyze, explore, and enable, as appropriate, the possibility and feasibility, within the current context of independence requirements and the liability regime, of firms' appointing independent board members and advisory boards. The Committee notes

2007), available at http://comments.treas.gov/_files/Treasurycommentletterfinal11302007.pdf (noting the largest auditing firms have supervisory boards overseeing management).

- 28 See e.g., Andrew D. Bailey, Jr., Professor of Accountancy-Emeritus, University of Illinois, and Senior Policy Advisory, Grant Thornton LLP, Comment Letter Regarding Discussion Outline 12 (Jan. 30, 2008), available at http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008 (“[I]ndependent board members similar to those found on public company boards would be a good governance practice and would signal the markets about the firms’ positive commitment to the public good.”); Record of Proceedings (Feb. 4, 2008) (Written Submission of Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees’ Retirement System, 3), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf> (stating that independent board of directors could possibly decrease potential conflicts of interest).
- 29 Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga Jr., Vice Chairman, Capital Research and Management Company, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf>.
- 30 Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 7), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf>.
- 31 Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 7), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (“Such a change in the governance model may be one way to strengthen our ability to serve market participants and reinforce independence.”).

that the PCAOB and the SEC should consider the size of auditing firms in analyzing and developing any governance proposals.

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.

In 2006, over 1,300 public companies changed their auditor and from 2002 to 2006 over 6,500 public companies changed their auditor.³² Under current SEC regulations, a public company must disclose any auditor change on Form 8-K.³³ SEC regulations require disclosure of any disagreements on financial disclosures during the preceding two years prior to the resignation and whether some issue, such as the auditor's inability to rely on management's representations, may put into question financial disclosure reliability. SEC regulations also allow a public company to request that the auditor respond with a letter addressed to the SEC stating whether it agrees with the company's disclosure and, if it does not agree, stating why.

While the SEC does attempt to uncover through its rules whether the auditor change relates to disagreements over accounting and reporting matters, the SEC rules do not require a public company to provide a reason for the auditor's departure in the vast majority of cases. The limitations of the existing disclosure requirements have resulted in companies failing to disclose any reason for their auditor changes in approximately 70% of the more than 1,300 auditor changes occurring in 2006.³⁴

The Committee considered testimony and commentary regarding the lack of clear disclosure surrounding auditor changes. Testimony and commentary viewed the lack of transparency surrounding auditor changes as detrimental to investor confidence in financial reporting.³⁵ Testimony and commentary suggested greater transparency regarding auditor changes would compel audit committees to more closely evaluate auditor selection decisions and lead to greater competition in the audit market.³⁶

The Committee believes that explicitly stating the reason for an auditor change will assist investors in determining the quality of financial reporting and subsequent investment decisions.

32 See Mark Grothe and Blaine Post, *Speak No Evil*, GLASS LEWIS & CO RESEARCH 12 (May 21, 2007).

33 Form 8-K, *available at* <http://www.sec.gov/about/forms/form8-k.pdf>.

34 See Mark Grothe and Blaine Post, *Speak No Evil*, GLASS LEWIS & CO RESEARCH 12 (May 21, 2007).

35 See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy-Emeritus, University of Illinois, and Senior Policy Advisor, Grant Thornton LLP, Comment Letter Regarding Discussion Outline 4 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008.doc (recommending SEC and PCAOB disclosures of auditor changes to enhance the growth of smaller auditing firms); Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 193-94), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-2-4-08.pdf> (calling for expanded Form 8-K disclosure requirements as "in the best interest of investors");

36 See e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (noting that the Committee should examine "[c]omprehensive disclosures about reasons for auditor switches").

sions. The Committee recommends that the SEC amend its Form 8-K disclosure on auditor changes by providing for the following mechanism: 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. The company would also disclose whether its audit committee agreed with the disclosure it has provided. The company would also provide the auditor with a copy of the disclosure and request a response as to the accuracy of the disclosure. The company would include any response as an exhibit to the company's Form 8-K filing, or if received following the due date for the Form 8-K, in a subsequent Form 8-K. As discussed above under current SEC regulations, the public company can request that the auditor respond to the company's statements in the Form 8-K regarding disagreements over accounting and financial matters.

In addition, the Committee recommends that auditing firms notify the PCAOB of any engagement partner changes on public company audits if made before the normal rotation period and, other than for retirement, the reasons for those changes.³⁷

Other Issues Under Consideration

While the work of the Committee is incomplete at this point, the Committee has tentatively concluded it will not make a recommendation regarding vehicles to access outside capital. The Committee notes that some witnesses have suggested changing the capital structure of auditing firms to allow access to capital.³⁸

The Committee is also considering and debating a variety of other issues. Further elaboration on these issues will be included in subsequent drafts of this Report.

37 But cf., Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga Jr., Vice Chairman, Capital Research and Management Company, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf> (calling for public disclosure on audit partner changes other than for rotation requirements); Record of Proceedings (Feb. 4, 2008) (Oral Remarks of D. Paul Regan, President and Chairman, Hemming Morse Inc., 194-195 (Feb. 4, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-2-4-08.pdf> (commenting that "if an audit partner is ... rotated [early] off of an issuer, there ought to be a disclosure, and there ought to be communication from the partner who was rotated off early as to [the reason for the early rotation] ... because in many instances ... there [i]s controversy...").

38 See, e.g., Record of Proceedings (Dec. 3, 2007) (Questions for the Record of James R. Doty, Partner, Baker Botts LLP, 3 (Feb. 19, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-2007.pdf> (suggesting allowing auditing firms to organize as limited liability companies or corporate entities to allow for the issuance of equity or debt securities).

VII. CONCENTRATION AND COMPETITION

The Committee analyzed public company audit market concentration and competition. In its work the Committee focused on concentration and competition in the context of their impact on audit quality and effectiveness. In turn, consideration of the sustainability of the auditing profession was also subject to examination in the context of audit quality and effectiveness. The recommendations set out below reflect this focus.

During the course of its deliberations, the Committee received testimony and commentary from the Government Accountability Office (GAO), the Public Company Accounting Oversight Board (PCAOB), academics, auditing firms, investors, and others regarding audit market concentration and competition.

In January 2008, the GAO issued *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*,¹ updating its 2003 report on audit market concentration.² The GAO concluded that the four largest auditing firms continue to dominate the large public company audit market. In 2006, the four largest auditing firms audited 98% of the 1500 largest public companies with annual revenues over \$1 billion and 92% of public companies with annual revenues between \$500 million and \$1 billion. However, concentration in the small and mid-size public company audit market has eased during the past five years. The largest firms' share in auditing small public companies with annual revenues under \$100 million has declined from 44% in 2002 to 22% in 2006 and in auditing mid-size public companies with annual revenue between \$100 million and \$500 million from 90% in 2002 to 71% in 2006.³

The Committee considered the testimony of several witnesses regarding the reasons for the continued concentration in the large public company audit market. Auditing firms, public companies, market participants, academics, investors and others reasoned that large public companies with operations in multiple countries need auditing firms with global resources and technical and industry expertise to deal with an increasingly complex business and financial reporting environment.⁴ These needs limit auditor choice to only the largest audit-

1 U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION*, GAO-08-163 (Jan. 2008) [hereinafter 2008 GAO REPORT].

2 GAO, *PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION*, GAO-03-864 (July 2003) (finding that "although audits for large public companies were highly concentrated among the largest accounting firms, the market for audit services appeared competitive according to various indicators").

3 2008 GAO REPORT 19. The GAO also found that the largest firms collected 94% of all audit fees paid by public companies in 2006, slightly less than the 96% they collected in 2002. 2008 GAO REPORT 16.

4 See, e.g., 2008 GAO REPORT 21 (surveyed companies most frequently cited size and complexity of their operations (92%), the auditor's technical capability with accounting principles and auditing standards (80%), and the need for industry specialization or expertise (67%)); Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 2), *available*

ing firms for many large public companies. The Committee heard from witnesses who also described barriers to the growth of smaller auditing firms, including the behavior of underwriters and other capital market participants.⁵

In analyzing these data on concentration and limited auditor choice in the large public company audit market, the Committee focused on the potential negative impact of concentration on audit quality. Some have suggested the lack of competition may not provide sufficient incentive for the dominant auditing firms to deliver high quality and innovative audit services.⁶ Notwithstanding the increasing number of public company financial restatements,⁷ the Committee heard from several witnesses that audit quality had improved.⁸ For example, the GAO observed that market participants and public company officials had noted improvement in recent years in audit quality, including auditing firm staff's technical expertise, responsiveness to client needs, and ability to identify material financial reporting matters.⁹ Much of the improvement was credited to the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), which enhanced auditor independence, replaced the self-regulation of the auditing profession with the PCAOB, mandated evaluation and disclosure of the effectiveness of internal controls over financial reporting,¹⁰ and strengthened audit committee membership, independence, and responsibilities.

Although industry concentration can lead to increased prices, the Committee notes that the GAO concluded that higher audit market concentration has not been associated with higher fees. Public companies, auditing firms, and other market participants believe the considerable increase in audit fees in recent years is due not to market power of a concentrated industry, but to the increased requirements under Sarbanes-Oxley, the complexity of accounting and financial reporting standards, the need to hire and retain qualified audit staff, and the independence requirements (which have led to the possible re-pricing of audits to their unbundled market price).¹¹ The Committee also considered the impact of the possible loss of

at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>; Record of Proceedings (Feb. 4, 2008) (Written Submission of Neal D. Spencer, Managing Partner, BKD, LLP, 1-4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Spencer020408.pdf>.

- 5 Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Brad Koenig, Former Managing Director and Head of Global Technology Investment Banking, Goldman Sachs, 219-220), *available at* <http://www.treas.gov/offices/domestic-finance/acap/Koenig020408.pdf> (describing underwriters' views of auditing firms other than the largest four auditing firms).
- 6 2008 GAO REPORT 31-32.
- 7 See, e.g., SUSAN SCHOLZ, *THE CHANGING NATURE AND CONSEQUENCES OF PUBLIC COMPANY FINANCIAL RESTATEMENTS 1997-2006* (April 2008).
- 8 2008 GAO REPORT 5; Public Company Accounting Oversight Board, Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms, PCAOB Rel. No. 2007-010 (Oct. 22, 2007).
- 9 Record of Proceedings (Dec. 3, 2007) (Questions for the Record of Ms. Jeanette M. Franzel, Director, Financial Management and Assurance Team, U.S. Government Accountability Office, 2 (Jan. 30, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-2007.pdf> (observing that the market believes the "bar had been raised" on audit quality). See also CENTER FOR AUDIT QUALITY, *REPORT ON THE SURVEY OF AUDIT COMMITTEE MEMBERS* (March 2008) (concluding that: 17% of surveyed audit committee members view audit quality as good, 53% as very good, 25% as excellent, while 82% say overall quality has improved somewhat/significantly over the past several years).
- 10 2008 GAO REPORT 32.
- 11 2008 GAO REPORT 27-29. On the re-pricing of audits, see also James D. Cox, *The Oligopolistic Gatekeeper: The U.S. Accounting Profession*, in *AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNIZING SECURITIES REGULA-*

one of the four largest accounting firms in light of the high degree of concentration of public company auditing, and especially large public company auditing, in those firms. The GAO noted the possibility of this loss due to issues arising out of firm conduct, such as civil litigation, federal or state regulatory action or criminal prosecution, or economic events, such as a merger.¹² The GAO posited potential negative effects of such a loss, including the following: further limitations on large public company auditor choice, costs associated with changing auditors, and companies' inability to obtain timely financial statement audits.¹³ However, the GAO did not recommend insulating auditing firms directly from either the legal or market consequences of their actions.

With the above considerations in mind, the Committee recommends that regulators, the auditing profession, and other bodies, as applicable, effectuate the following:

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.

The GAO concluded that concentration in the large public company audit market will not be reduced in the near term by smaller auditing firms. The Committee considered testimony regarding the reasons that smaller auditing firms are unable or unwilling to enter the large public company audit market. Challenges facing these firms' entry into this market typically include the following: lack of staffing and geographic limitations on both the physical span of their practices and experience and expertise with global auditing complexities; inability to create global networks necessary to serve global clients, due to lack of auditing firms abroad to act as potential partners; the need for greater technical capability and industry specialization; lack of name recognition and reputation; and limited access to capital.¹⁴ In addition, expanding into the large public company audit market may be unattractive for some smaller auditing firms for a variety of reasons,¹⁵ including increased exposure to litigation, the possibility that their business model is not scaleable, and the fact that for some smaller firms other aspects of their business (such as private company auditing and other work) has greater potential for expansion.

To address these issues, the Committee recommends that policy makers press for the reduc-

TION IN EUROPE AND THE U.S., Chapter 9, Oxford, forthcoming, available at <http://ssrn.com/abstract=926360>.

12 2008 GAO REPORT 34-35.

13 2008 GAO REPORT 35-36.

14 2008 GAO REPORT 37. See also Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf> (describing as barriers for smaller auditing firms liability risks, overly complex independence rules, and an array of factors that audit committees may review in choosing an auditor that best matches the company); Record of Proceedings (Feb. 4, 2008) (Written Submission of Neal D. Spencer, Managing Partner, BKD, LLP, 1), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Spencer020408.pdf> (noting that barriers include resources, institutional bias, insurability, and liability).

15 2008 GAO REPORT 38.

tion of barriers, to the extent consistent with audit quality and other public interest factors, to the growth of smaller auditing firms. For smaller firms, this includes encouraging and promoting development of technical resources in such areas as international financial reporting standards and fair value accounting, and development of specialized or “niche” practices or industry “verticals” where they are in the best interests of investors and can lead to more effective competition. Pressure also should be applied against non-justifiable resistance to using smaller firms on the part of a variety of market actors.

The Committee believes that the following specific and incremental actions would assist in the growth of the smaller firms and their entry into the large public company audit market:

(a) Require disclosure by public companies in their annual reports and proxy statements of any provisions in agreements with third parties that limit auditor choice.

The Committee considered testimony and commentary that certain market participants, such as underwriters, banks, and lenders, may influence and effectively limit public company auditor selection decisions.¹⁶ For instance, certain contractual arrangements limit public companies’ auditor choice.¹⁷ Consistent with the large public company audit market, this practice is particularly prevalent in the initial public offering (IPO) arena, where an underwriter may include in the underwriting agreement a provision limiting the company’s auditor choice to a specified group of auditing firms.¹⁸ Evidence suggests that auditor choice may be more limited among the largest IPOs: While midsize and smaller firms’ combined share of the IPO market (by number of IPOs) has increased progressively (rising from 18% in 2003 to 40% in 2007),¹⁹ the largest firms continue to audit the majority of the largest IPOs.²⁰

16 See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (noting that transparency regarding “restrictive contracts with underwriters” could improve auditor choice). See also 2008 GAO REPORT 47.

17 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Lewis H. Ferguson, III, Partner, Gibson Dunn & Crutcher, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Ferguson120307.pdf> (“Sometimes lenders, investors, investment bankers or credit rating agencies will insist that a company seeking to access the capital markets have its financial statements audited by one of the largest accounting firms, adding a bias that has the practical effect of being a barrier to entry.”).

18 See, e.g., Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Brad Koenig, Former Managing Director and Head of Global Technology Investment Banking, Goldman Sachs, 219-220), *available at* <http://www.treas.gov/offices/domestic-finance/acap/Koenig020408.pdf> (noting underwriter practices in auditor selection). See also Edwin J. Kliegman, CPA, Comment Letter Regarding Discussion Outline 2 (Nov. 26, 2007).

19 2008 GAO Report 44.

20 Record of Proceedings (Feb. 4, 2008) (Written Submission of Brad Koenig, Former Managing Director and Head of Global Technology Investment Banking, Goldman Sachs, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/Koenig020408.pdf> (noting that from 2002-2007 the largest four auditing firms had an 87% market share of the 817 initial public offerings that exceeded \$20 million). See also 2008 GAO REPORT 44 (“Staff from some investment firms that underwrite stock issuances for public companies told [GAO] that in the past they generally had expected the companies for which they raised capital to use one of the largest firms for IPOs but that now these organizations were more willing to accept smaller audit firms.... However,...most of the companies that went public with a mid-size or smaller auditor were smaller. In addition, these firms’ share of IPOs of larger companies (those with revenues greater than \$150 million) rose

The Committee believes these provisions impair competition by limiting public company auditor choice and the ability of smaller auditors to serve a greater share of the public company audit market. Accordingly, the Committee recommends that the Securities and Exchange Commission (SEC) require public companies to disclose any provisions in agreements limiting auditor choice. The disclosure should identify the agreement and include the names of the parties to the agreement and the actual provisions limiting auditor choice.²¹

(b) Include representatives of smaller auditing firms in committees, public forums, fellowships, and other engagements.

The Committee considered testimony that the lack of smaller firms' name recognition and reputation have hindered smaller auditing firms' ability to compete in the large public company audit market. The GAO noted that name recognition, reputation, and credibility were significant barriers to smaller auditing firm expansion.²² The PCAOB has registered and oversees 982 U.S. auditing firms and 857 foreign auditing firms.²³ While it is not possible to include all smaller firms, the Committee received testimony and comment letters suggesting that there should be greater inclusion and participation of smaller firms in public and private sector committees, roundtables, and fellowships.²⁴ One auditing firm representative suggested the creation of a PCAOB professional practice fellowship program, reaching out to professionals from auditing firms of various sizes.²⁵

The Committee believes increasing name recognition and reputation could promote audit market competition and auditor choice. Accordingly, the Committee recommends that

from none in 2003 to about 13 percent in 2007.”).

- 21 The Committee notes that a group of market participants put together by the United Kingdom's Financial Reporting Council to study audit market competition has suggested similar disclosure of contractual obligations limiting auditor choice. See FINANCIAL REPORTING COUNCIL, FRC UPDATE: CHOICE IN THE UK AUDIT MARKET 4 (Apr. 2007) [hereinafter FRC UPDATE] (recommending that “when explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms”).
- 22 2008 GAO REPORT 44 (“Fifty percent of accounting firms responding to [GAO’s] survey that want to audit large companies said that name recognition or reputation with potential clients was a great or very great impediment to expansion. Similarly, 54 percent of these firms cited name recognition or credibility with financial markets and investment bankers as a great or very great impediment to expansion.”). See also Edward J. Kliegman, Comment Letter Regarding Discussion Outline (Nov. 16, 2007).
- 23 Data are as of Feb. 21, 2008.
- 24 See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, and Senior Policy Advisor, Grant Thornton LLP, Comment Letter Regarding Discussion Outline 16 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008.doc; Record of Proceedings (Dec. 3, 2007) (Questions for the Record of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 4 (Feb. 1, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-2007.pdf>.
- 25 Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>. See Chapter V (recommending the creation of a PCAOB fellowship program). While maintenance and extension of professional fellowship programs are also considered in the Committee’s recommendations relating to human capital matters, extending these opportunities increasingly to firms of various sizes could assist smaller firms in their ability to compete in the public company audit market.

regulators and policymakers, such as the SEC, the PCAOB, and the Financial Accounting Standards Board, include representatives of smaller auditing firms in committees, public forums, fellowships, and other engagements.²⁶

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.

The Committee considered testimony regarding the variety of potentially catastrophic risks that public company auditing firms face. These risks include general financial risks and risks relating to failure in the provision of audit services and non-audit services, including civil litigation, regulatory actions, and loss of customers, employees, or auditing network partners due to a loss of reputation.²⁷

The Committee believes these risks are real and notes that over the past two decades two large auditing firms have gone out of existence. In 1990, Laventhol & Horwath, at the time the seventh largest auditing firm in the United States, filed for bankruptcy protection due in part to a failure in the provision of non-audit services, and subsequent class action litigation, loss of reputation, and inability to attract and retain clients.²⁸ In 2002, Arthur Andersen, at the time one of the five largest auditing firms in the United States, dissolved. The Department of Justice (DOJ) had criminally indicted the auditing firm on obstruction of justice charges relating to the audit of Enron. The resulting inability to retain clients and partners and keep together its global affiliate network led to the collapse of Arthur Andersen.²⁹

In addition, KPMG recently faced the possibility of criminal indictment relating to its provision of tax-related services. In the end, KPMG entered into a deferred prosecution agreement with the DOJ.³⁰ Many have suggested that a criminal indictment would have led to the dissolution of the firm.

²⁶ For a similar recommendation, see SEC ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES, FINAL REPORT 114 (Apr. 23, 2006).

²⁷ See, e.g., 2008 GAO REPORT 32-36; Zoe-Vonna Palmrose, *Maintaining the Value and Viability of Independent Auditors as Gatekeepers under SOX: An Auditing Master Proposal*, in BROOKINGS-NOMURA SEMINAR: AFTER THE HORSES HAVE LEFT THE BARN: THE FUTURE ROLE OF FINANCIAL GATEKEEPERS 12-13 (Sept. 28, 2005). Civil litigation was the risk most often cited by witnesses before the Committee. See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of James D. Cox, Brainerd Currie Professor of Law, Duke University School of Law), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Cox120307.pdf>. See also Eric R. Talley, *Cataclysmic Liability Risk among Big Four Auditors*, 106 COLUM. L. REV. 1641 (Nov. 2006) (“On one hand, the pattern of liability exposure during the last decade does not appear to be the type that would, at least on first blush, imperil the entire profession. On the other hand, if one predicts historical liability exposure patterns into the future, the risk of another firm exiting due to liability concerns appears to be more than trivial.”).

²⁸ See, e.g., 2008 GAO REPORT 33.

²⁹ See, e.g., U.S. GOVERNMENT ACCOUNTABILITY OFFICE, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION 12 (July 2003) (“The criminal indictment of fourth-ranked Andersen for obstruction of justice stemming from its role as auditor of Enron Corporation led to a mass exodus of Andersen partners and staff as well as clients.”).

³⁰ 2008 GAO REPORT 56-57, n. 60. Note that the Department of Justice did indict several individuals.

Currently, BDO Seidman is appealing a \$521 million state judgment involving a private company audit client. The auditing firm's chief executive has publicly stated that such a judgment amount would threaten the firm's viability.³¹

As discussed above, the Committee believes that the loss of one of the larger auditing firms would likely have a significant negative impact on the capital markets. Of greatest concern is the potential disruption to capital markets that the failure of a large auditing firm would cause, due to the lack of sufficient capacity to audit the largest public companies and the possible inability of public companies to obtain timely audits.³² The Committee believes these concerns must be balanced against the importance of auditing firms and their partners, as private, for-profit businesses, being exposed to the consequences of failure, including both the legal consequences and economic consequences.

In consideration of these competing concerns, the Committee makes the following recommendations:

(a) As part of its current oversight over registered auditing firms, the PCAOB should monitor potential sources of catastrophic risk which would threaten audit quality.

The PCAOB's mission is to oversee auditing firms conducting audits of public companies. Its audit quality-focused mission is intertwined with issues of catastrophic risk, as most often risks to firms' survival historically have been largely the result of significant audit quality failures or serious compliance issues in the non-audit services aspect of their business.

Sarbanes-Oxley provides the PCAOB with registration, reporting, inspection, standard-setting, and enforcement authority over public company auditing firms.³³ Under its inspection authority, the PCAOB inspects audit engagements, evaluates quality control systems, and tests as necessary audit, supervisory, and quality control procedures. For example, in its inspection of an auditing firm's quality control systems, the PCAOB reviews the firm's policies and procedures related to partner evaluation, partner compensation, new partner nominations and admissions, assignment of responsibilities, disciplinary actions, and partner terminations; compliance with independence requirements; client acceptance and retention policies and procedures; compliance with professional requirements regarding consultations

31 *Jury Awards Rise Against BDO Seidman*, ASSOC. PRESS, Aug. 15, 2007.

32 See 2008 GAO REPORT 35, 36 (observing that further audit market concentration would "leave large companies with potentially only one or two choices for a new auditor" and that "the market disruption caused by a firm failure or exit from the market could affect companies' abilities to obtain timely audits of their financial statements, reducing the audited financial information available to investors"). See also LONDON ECONOMICS, FINAL REPORT TO EC-DG INTERNAL MARKET AND SERVICES, STUDY ON THE ECONOMIC IMPACT OF AUDITORS' LIABILITY REGIMES 24 (Sept. 2006) ("The adjustment to a situation in which one of the Big-4 networks fails is unlikely to be smooth. But the long run consequences are likely to be limited provided the overall statutory audit capacity does not fall significantly. Among the various economic sectors, financial institutions may find such a situation particularly difficult as their statutory audits are viewed as more risky and...two Big-4 firms dominate the market for statutory audits of financial institutions. The situation is likely to be much direr if a second Big-4 network fails shortly after the first one. Investors' confidence will be in all likelihood seriously affected and the adjustment to the new situation is likely to be difficult.").

33 Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7211-7219.

on accounting, auditing, and SEC matters; internal inspection program; processes for establishing and communicating audit policies, procedures, and methodologies; processes related to review of a firm's foreign affiliate's audit performance; and tone at the top.³⁴

The PCAOB also has authority to require registered auditing firms to provide annual and periodic reports. In May 2006, the PCAOB issued *Proposed Rules on Periodic Reporting by Registered Public Accounting Firms* requiring annual and periodic reporting.³⁵ The PCAOB has not yet finalized this proposal.

The Committee therefore recommends that the PCAOB, in furtherance of its objective to enhance audit quality and effectiveness, exercise its authority to monitor meaningful sources of catastrophic risk that potentially impact audit quality through its programs, including inspections, registration and reporting, or other programs, as appropriate. The objective of PCAOB monitoring would be to alert the PCAOB to situations in which auditing firm conduct is resulting in increased catastrophic risk which is impairing or threatens to impair audit quality.

(b) Establish a mechanism to assist in the preservation and rehabilitation of a troubled larger auditing firm. A first step would encourage larger auditing firms to adopt voluntarily a contingent streamlined internal governance mechanism that could be triggered in the event of threatening circumstances. If the governance mechanism failed to stabilize the firm, a second step would permit the SEC to appoint a court-approved trustee to seek to preserve and rehabilitate the firm by addressing the threatening situation, including through a reorganization, or if such a step were unsuccessful, to pursue an orderly transition.

The Committee considered testimony regarding the importance of the viability of the larger auditing firms and the negative consequences of the loss of one of these firms on the capital markets. The Committee also considered commentary regarding issues auditing firms faced in addressing circumstances that threatened their viability, including, in particular, problems arising from the need to work with regulators and law enforcement agencies.³⁶ Several witnesses suggested the development of a mechanism to allow auditing firms facing threatening circumstances to emerge from those situations.³⁷ Committee member and former Federal

34 See, e.g., PCAOB, Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms within 12 Months after an Inspection Report, PCAOB Release No. 104-2006-078 (Mar. 21, 2006). See also the PCAOB's completed inspection reports at http://www.pcaobus.org/Inspections/Public_Reports/index.aspx#k.

35 PCAOB Release No. 2006-004 (May 23, 2006).

36 See, e.g., Securities and Exchange Commission, Temporary Final Rule and Final Rule: Requirements for Arthur Andersen LLP Auditing Clients, SEC Release No. 33-8070 (Mar. 18, 2002); Securities and Exchange Commission, Press Rel. No. 2002-39 and Order Rel. No. 33-8070 (March 18, 2002) (indictment of Arthur Andersen); SEC Staff Accounting Bulletin No. 90 (Feb. 7, 1991) (bankruptcy of Laventhol & Horwath).

37 Record of Proceedings (Dec. 3, 2007) (Written Submission of James R. Doty, Partner, Baker Botts L.L.P., 11-13), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Doty120307.pdf> (suggesting that the Bankruptcy Code be amended to prevent creditors whose claims relate to violations of professional standards from opposing reorganization under a court-approved plan; an automatic stay against partners facilitating partner retention; expanding the SEC's emergency powers to enable the SEC to act by summary order to address the registered firm's ability to continue to provide audit services; and encouraging the SEC or PCAOB to discourage "client poaching" by requiring public companies to show

Reserve Chairman Paul Volcker opined that, “[I]f we had [such an] arrangement at the time Andersen went down, we would have saved it.”³⁸ The Committee recommends the following two-step mechanism described below.

First Step – Internal Governance Mechanism

The Committee notes that auditing firms operate as partnerships, generally led by a centralized management team, with a supervisory board of partners overseeing management’s strategy and performance.³⁹ In the event of threatening circumstances at a larger auditing firm, the Committee believes that a lack of effective centralized governance mechanisms may delay crucial decision making, impede difficult decisions that could sustain the firm and its human assets, and lessen the firm’s ability to communicate with maximum responsiveness and effectiveness with private, regulatory and judicial bodies.

The Committee therefore recommends that larger auditing firms (those with 100 or more public company audit clients that the PCAOB inspects annually) establish in their partnership agreements a contingent internal governance mechanism, involving the creation of an Executive Committee (made up of partners or outsiders) with centralized firm management powers to address threatening circumstances. The centralized governance mechanism would have full authority to negotiate with regulators, creditors, and others, and it would seek to hold the firm’s organization intact, including preserving the firm’s reputation, until the mitigation of the threat, or, failing that, the implementation of the second step outlined below. The auditing firm voluntarily would trigger the operation of this mechanism upon the occurrence of potentially catastrophic events specified in the partnership agreement, such as civil litigation or actual or significantly threatened government or regulatory action. If necessary, the SEC and the PCAOB could encourage the firm to trigger the mechanism through private communications, public statements, or other means. Regulators could also assist in maintaining the firm’s organization intact by, for example, increasing the time period for registrants that are audit clients to have audits or reviews completed and providing accelerated consultative guidance to registrants that are audit clients.⁴⁰ The Committee recognizes the precise details of such a mechanism would vary from auditing firm to auditing firm, depending on firm structures, history, and culture.

Second Step – External Preservation Mechanism

that switching auditors was not related to mega-judgments against audit affiliates in other jurisdictions).

See also Record of Proceedings (Dec. 3, 2007) (Written Submission of Peter S. Christie, Principal, Friemann Christie, LLC, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Christie120307.pdf> (“If it remains possible that a firm can fail for reasons other than liability claims it may be attention needs to be given to devices that will permit a firm to re-emerge.”).

38 Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Committee Member Paul Volcker, 317), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf>.

39 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 13 (Jan. 23, 2008).

40 See, e.g., Securities and Exchange Commission, Temporary Final Rule and Final Rule: Requirements for Arthur Andersen LLP Auditing Clients, SEC Release No. 33-8070 (Mar. 18, 2002); Securities and Exchange Commission, Press Rel. No. 2002-39 and Order Rel. No. 33-8070 (March 18, 2002) (indictment of Arthur Andersen); SEC Staff Accounting Bulletin No. 90 (Feb. 7, 1991) (bankruptcy of Laventhol & Horwath).

The Committee also recommends that the larger auditing firms establish in their partnership agreements a rehabilitation mechanism under SEC oversight. The failure of the internal governance mechanism to preserve the auditing firm outlined in the first step above would trigger this second step, which would require legislation. Upon triggering of the second step, either voluntarily by the firm or by the SEC, the SEC would appoint a trustee, subject to court approval, whose mandate would be to seek to address the circumstances that threaten survival, and failing that, to pursue a reorganization that preserves and rehabilitates the firm to the extent practicable, and finally, if reorganization fails, to pursue an orderly transition. If this second mechanism is to include an element that addresses claims of creditors (which could include investors with claims, audit and other clients, partners, other employees, and others), legislation to integrate this mechanism with the judicial bankruptcy process may be necessary.

It is important that this mechanism not be used as insurance for partner capital; that is, this mechanism should not be developed to “bail out” a larger auditing firm, but rather to preserve and rehabilitate the firm in order to ensure the stable functioning of the capital markets and the timely delivery of audited financial statements to investors and other financial statement users. Accordingly, there must be powers that can be exercised in furtherance of the objective of holding the firm together.⁴¹

The Committee also notes that the larger auditing firms are members or affiliates of global networks of firms and rely on these networks to serve their global clients. Since the networks are maintained through voluntary contractual agreements, the fact that a U.S.-based firm may be facing threatening circumstances could lead to the disintegration of the network. In this regard, in developing this mechanism, auditing firms, regulators, policy-makers, and other market participants must consider the practical implications resulting from the relationship between the U.S.-based firms and the global networks.

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.

A key issue in the public company audit market is what drives competition for audit clients and whether audit quality is the most significant driver. Currently, there is minimal publicly available information regarding indicators of audit quality at individual auditing firms. Consequently, it is difficult to determine whether audit committees, who ultimately select the auditor, and management are focused and have the tools that are useful in assessing audit

⁴¹ Record of Proceedings (Dec. 3, 2007) (Written Submission of James R. Doty, Partner, Baker Botts L.L.P., 11), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Doty120307.pdf> (Dec. 3, 2007) (“It is an anecdotal but firmly held perception of the profession that no accounting firm has entered bankruptcy and emerged to continue its practice. The hard assets of the firm are not significant: the professionals and the clients are the lifeblood of the registered firm. With any anticipation of bankruptcy, these mobile assets are gone.”).

quality that would contribute to making the initial auditor selection and subsequent auditor retention evaluation processes more informed and meaningful.⁴² In addition, with the majority of public companies currently putting shareholder ratification of auditor selection to an annual vote, shareholders may also lack audit quality information important in making such a ratification decision.⁴³

The Committee believes that requiring firms to disclose indicators of audit quality may enhance not only the quality of audits provided by such firms, but also the ability of smaller auditing firms to compete with larger auditing firms, auditor choice, shareholder decision-making related to ratification of auditor selection, and PCAOB oversight of registered auditing firms.

The Committee recognizes the challenges of developing and monitoring indicators of audit quality, especially in light of the complex factors driving the potential impact on the incentives of market actors, and the resulting effect on competitive dynamics among auditors.⁴⁴

The Committee has considered testimony and comment letters⁴⁵ as well as other studies and reports in developing this recommendation. A possible framework for PCAOB consideration is reviewing annual auditing firm reports in other jurisdictions. For example, one auditing firm's United Kingdom affiliate lists in its annual report nine "key performance indicators, including average headcount, staff turnover, diversity, client satisfaction, audit and non-audit work, proposal win rate, revenue, profit, and profit per partner."⁴⁶ The Financial Reporting Council recently published a paper setting out drivers of audit quality.⁴⁷ In addition, the

42 See, e.g., New York Stock Exchange, Listed Company Manual § 303A, which the SEC approved on November 4, 2003, for the responsibilities of exchange-listed companies' audit committees.

43 INSTITUTIONAL SHAREHOLDER SERVICES, U.S. CORPORATE GOVERNANCE POLICY – 2007 UPDATES 3 (2006).

44 If the idea proves to be workable, implementation could be a major undertaking for the PCAOB. Developing meaningful quality indicators, defining how they should be measured, and rolling out the measurement process could take significant PCAOB time and effort. Auditing firms, public companies, investors, and academics would all likely have valuable ideas as to approaches the PCAOB could take. However the indicators were devised, firms would have to build their internal processes for measuring the audit quality indicators and the PCAOB would have to develop procedures and training to monitor those processes.

45 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf> (recommending the issuance of regulatory guidance on qualitative factors to be used to evaluate auditing firms); Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (suggesting that disclosure of "key elements that drive audit quality would be a useful benefit to the capital markets" and could include a "discussion of the levels of partner and staff turnover, average hours of professional training, risk management and compliance measurements, and metrics related to the quality of management and firm governance processes"); Anonymous Retired Big 4 partner, Comment Letter Regarding Discussion Outline (Nov. 2007) (recommending public disclosure of the following audit quality drivers: 1) average years of experience of audit professionals, 2) ratio of professional staff to audit partners, 3) chargeable hours per audit professional, 4) professional chargeable hours managed per audit partner, 5) annual professional staff retention, and 6) average annual training hours per audit professional).

46 See KPMG LLP, UK ANNUAL REPORT 2007 46.

47 FRC UPDATE 4.

PCAOB also could consider some of the factors that auditing firms present to audit committees, such as engagement team composition, the nature and extent of firm training programs, and the nature and reason for client restatements.⁴⁸

The Committee therefore recommends that 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 requiring auditing firms to publicly disclose these indicators. Testimonies and comment letters have suggested specific audit quality indicators, such as the average experience level of auditing firm staff on individual engagements, the average ratio of auditing firm professional staff to auditing firm partners on individual engagements, and annual staff retention. The Committee also recommends that, if the proposal is feasible, the PCAOB, through its inspection process, should monitor these indicators.

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.

The Committee considered testimony and comment letters regarding the significance of the independence of the public company auditor—both in fact and appearance—to the credibility of financial reporting, investor protection, and the capital formation process.⁴⁹ The auditor is expected to offer critical and objective judgment on the financial matters under consideration, and actual and perceived absence of conflicts is critical to that expectation.

The Committee believes that auditors, investors, public companies, and other market participants must understand the independence requirements and their objectives, and that auditors must adopt a mindset of skepticism when facing situations that may compromise their independence. In that regard, the Committee makes the following recommendations:

(a) Compile the SEC and PCAOB independence requirements into a single document and make this document website accessible. The American Institute of Certified Public Accountants (AICPA) and states should clarify and prominently note that differences exist between the SEC and PCAOB standards (applicable to public companies) and the AICPA and state standards (applicable in all circumstances, but subject to SEC and PCAOB standards, in the case of public companies) and indicate, at each place in their standards where differences exist, that stricter SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements. This compilation should not require rulemaking by

48 Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>.

49 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (“Independence forms the bedrock of credibility in the auditing profession, and is essential to the firms’ primary function in the capital markets.”); Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf>.

either the SEC or the PCAOB because it only calls for assembly and compilation of existing rules.

In the United States, various oversight bodies have authority to promulgate independence requirements, including the SEC and PCAOB for public company auditors, and the AICPA and states for public and private company auditors.⁵⁰ The Committee recommends that the SEC and PCAOB compile and publish their independence requirements in a single document and make this document easily accessible on their websites. The Committee recommends that the AICPA and states clarify and prominently state that differences exist between their standards and those of the SEC and the PCAOB and indicate, at each place in their standards where differences exist, that additional SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements.⁵¹

(b) Develop training materials to help foster and maintain the application of healthy professional skepticism with respect to issues of independence and other conflicts among public company auditors, and inspect auditing firms, through the PCAOB inspection process, for independence training of partners and mid-career professionals.

The Committee considered testimony and commentary that, to comply with the detailed and complex⁵² requirements, some auditors may be taking a “check the box” approach to compliance with independence requirements, and losing focus on the critical need to exercise independent judgment or professional skepticism about whether the substance of a potential conflict of interest may compromise integrity or objectivity, or create an appearance of doing so.⁵³

50 See, e.g., SEC Regulation S-X, Article 2, Rule 2-01 -- Qualifications of Accountants, 17 CFR § 210.2-01; SEC Financial Reporting Policies, Sec. 602.01 – Interpretations Relating to Independence; SEC Final Rule, Amendments to SEC Auditor Independence Requirements “Strengthening the Commission’s Requirements Regarding Auditor Independence”; SEC Rel. No 33-8183 (2003); SEC Final Rule, Revision of the Commission’s Auditor Independence Requirements, SEC Rel. No. 33-7919 (2001); PCAOB, Interim Independence Standards, ET Sections 101 and 191; Independence Standards Board, Independence Standards Nos. 1, 2, and 3, and ISB Interpretations 99-01, 00-1, and 00-2; PCAOB Bylaws and Rules, Section 3, Professional Standards; AICPA Code of Professional Conduct, ET Sections 100-102.

51 The Committee took note of concerns expressed regarding independence issues from a variety of perspectives. See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, and Senior Policy Advisor, Grant Thornton LLP, Comment Letter Regarding Discussion Outline 9 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEE-OUTLINEFINALSUBMISSION13008.doc (suggesting simplifying the current SEC independence standards); Dana R. Hermanson, Kennesaw State University, Comment Letter Regarding Discussion Outline 1 (Oct. 4, 2007), *available at* http://comments.treas.gov/_files/HermansonStatement10407.pdf (stating that consulting and auditing were incompatible and posed a significant threat to the long-term sustainability of the profession); Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (“The independence rules should be re-evaluated periodically to examine whether the rules continue to strike the right balance between cost burden and benefit.”); Record of Proceedings (Dec. 3, 2007) (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf> (recommending consideration of potential changes to aspects of independence rules).

52 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Michael P. Cangemi, President and Chief Executive Officer, Financial Executives International), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Cangemi120307.pdf>; FINANCIAL EXECUTIVES INTERNATIONAL, RECOMMENDATIONS TO ADDRESS COMPLEXITY IN FINANCIAL REPORTING (March 2007).

53 See, e.g., CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT, Interim Auditing Standard AU 316, Paragraph .13 (Pub. Company Accounting Oversight Bd. 2002) (“Professional skepticism is an attitude that

The Committee recommends that auditing firms develop appropriate independence training materials for auditing firms, especially partners and mid-career professionals, that help to foster a healthy professional skepticism with respect to issues of independence that is objectively focused and extends beyond a “check the box” mentality. The training materials should focus on lessons learned and best practices observed by the PCAOB in its inspection process and the experience of other relevant regulators as appropriate. To ensure the implementation of this training on an overall basis, the PCAOB should review this training as part of its inspection program.

Recommendation 5. Adopt annual shareholder ratification of public company auditors by all public companies.

Although not statutorily required, the majority of public companies in the United States—nearly 95% of S&P 500 and 70%-80% of smaller companies—put auditor ratification to an annual shareholder vote.⁵⁴ Even though ratification of a company’s auditor is non-binding, the Committee learned that corporate governance experts consider this a best practice serving as a “check” on the audit committee.⁵⁵ Pursuant to Sarbanes-Oxley, audit committees of exchange-listed companies must appoint, compensate, and oversee the auditor.⁵⁶ SEC rules implementing Sarbanes-Oxley specifically permit shareholder ratification of auditor selection.⁵⁷ Ratification allows shareholders to voice a view on the audit committee’s work, including the reasonableness of audit fees and apparent conflicts of interest.

The Committee believes shareholder ratification of auditor selection through the annual meeting and proxy process can enhance the audit committee’s oversight to ensure that the auditor is suitable for the company’s size and financial reporting needs.⁵⁸ This may enhance competition in the audit industry. Accordingly, the Committee encourages such an approach as a best practice for all public companies. The Committee also urges exchange self-regulatory organizations to adopt such a requirement as a listing standard. In addition, to further enhance audit committee oversight and auditor accountability, the Committee recommends that disclosure in the company proxy statement regarding shareholder ratification include the name(s) of the senior auditing partner(s) staffed on the engagement.⁵⁹

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.

includes a questioning mind and a critical assessment of audit evidence.”).

54 INSTITUTIONAL SHAREHOLDER SERVICES, ISS U.S. CORPORATE GOVERNANCE POLICY – 2007 UPDATE 3 (Nov. 15, 2006).

55 INSTITUTIONAL SHAREHOLDER SERVICES, REQUEST FOR COMMENT -- RATIFICATION OF AUDITORS ON THE BALLOT 1.

56 Sarbanes-Oxley Act, 15 U.S.C. § 78j-1 (2002).

57 SEC, Final Rule: Standards Related to Listed Audit Committees. Release No. 33-8220 (Apr. 9, 2003).

58 See also FRC UPDATE 5, 7 (recommending that “the FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection decision,” and that “investor groups, corporate representatives, firms and the FRC should promote good practices for shareholder engagement on auditor appointment and re-appointments”).

59 As discussed above, the Committee also believes that this ratification process would be made more meaningful if accompanied by the development and disclosure of key indicators of audit quality.

The globalization of the capital markets has compelled regulatory coordination and collaboration across jurisdictions. Regulators of public company auditors are no exception, as companies increasingly seek investor capital outside their home jurisdictions and the larger auditing firms create, expand, and, in some audits, increasingly rely on global networks of affiliates in order to provide auditing and other services to companies operating in multiple jurisdictions.⁶⁰ The Committee considered commentary regarding the PCAOB's regulatory role on a global basis.⁶¹

The PCAOB has the statutory responsibility for ensuring quality audits of public companies. In a world of global business operations and globalized capital markets, the PCAOB benefits from cooperation with foreign auditing firm regulators (many created and modeled after the PCAOB) to accomplish its inspections of registered foreign auditing firms, including firms that are members of global auditing firm networks.

In May 2007, the PCAOB hosted its first International Auditor Regulatory Institute where representatives from more than 40 jurisdictions gathered to learn more about PCAOB operations. In 2006, the PCAOB formally joined the International Forum of Independent Audit Regulators, created to encourage regulatory collaboration and sharing of regulatory knowledge and experience.

The Committee believes that these types of global regulatory coordination and cooperation are important elements in making sure public company auditing firms of all sizes are contributing effectively to audit quality. The Committee strongly supports the efforts of the PCAOB to enhance the efficiency and effectiveness of its programs by communicating with foreign regulators and participating in global regulatory bodies. The Committee urges the PCAOB and its foreign counterparts to continue to improve regulatory cooperation and coordination on a global basis.

Other Issues Under Consideration

The Committee is also considering and debating a variety of other issues. Further elaboration

60 See Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 16), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (noting the "growing consensus that regulators on every continent would be well served by working more closely together in the interest of improving worldwide audit quality"); PCAOB Press Release, PCAOB Meets with Asian Counterparts to Discuss Cooperation on Auditor Oversight (Mar. 23, 2007), *available at* http://www.pcaobus.org/News_and_Events/News/2007/03-23.aspx ("The PCAOB strongly believes that dialogue and cooperation among auditor regulators are critical to every regulator's ability to meet the challenges that come with the increasingly complicated and global capital markets.").

61 See, e.g., PCAOB Briefing Paper, Oversight of Non-U.S. Public Accounting Firms (Oct. 28, 2003); PCAOB Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms, PCAOB Rel. No. 2004-005 (June 9, 2004); Request for Public Comment on Proposed Policy Statement: Guidance Regarding Implementation of PCAOB Rule 4012, PCAOB Rel. No. 2007-001 (Dec. 5, 2007); PCAOB Chairman Mark Olson and EU Commissioner Charlie McCreevy Meet to Discuss Furthering Cooperation in the Oversight of Audit Firms, PCAOB Press Rel. (March 6, 2007); PCAOB Meets with Asian Counterparts to Discuss Cooperation on Auditor Oversight, PCAOB Press Rel. (Mar. 23, 2007); Establishment of the International Forum of Independent Audit Regulators, Haut Conseil du Commissariat aux Comptes Press Rel. (Sep. 15, 2006); PCAOB Enters into Cooperative Arrangement with the Australian Securities and Investments Commission, PCAOB Press Rel. (July 16, 2007); Board Establishes Standing Advisory Group, PCAOB Press Rel. (Apr. 15, 2004).

VIII. SEPARATE STATEMENTS

[The contents of Separate Statements to be included in subsequent drafts of this Report]

IX. APPENDICES

Appendix A

DEPARTMENT OF TRANSPORTATION

Surface Transportation Board

[STB Docket No. AB-33 (Sub-No. 243X)]

**Union Pacific Railroad Company—
Abandonment Exemption—in DeKalb
County, IL**

Union Pacific Railroad Company (UP) has filed a notice of exemption under 49 CFR 1152 Subpart F—*Exempt Abandonments* to abandon a 2.3-mile portion of its Barber Greene Spur, from milepost 23.5 to milepost 25.8, in DeKalb County, IL. The line traverses United States Postal Service Zip Code 60115.

UP has certified that: (1) No local traffic has moved over the line for at least 2 years; (2) there is no overhead traffic on the line; (3) no formal complaint filed by a user of rail service on the line (or by a state or local government entity acting on behalf of such user) regarding cessation of service over the line either is pending with the Board or with any U.S. District Court or has been decided in favor of complainant within the 2-year period; and (4) the requirements of 49 CFR 1105.7 (environmental report), 49 CFR 1105.8 (historic report), 49 CFR 1105.11 (transmittal letter), 49 CFR 1105.12 (newspaper publication), and 49 CFR 1152.50(d)(1) (notice to governmental agencies) have been met.

As a condition to this exemption, any employee adversely affected by the abandonment shall be protected under *Oregon Short Line R. Co.—Abandonment—Goshen*, 360 I.C.C. 91 (1979). To address whether this condition adequately protects affected employees, a petition for partial revocation under 49 U.S.C. 10502(d) must be filed.

Provided no formal expression of intent to file an offer of financial assistance (OFA) has been received, this exemption will be effective on July 18, 2007, unless stayed pending reconsideration. Petitions to stay that do not involve environmental issues,¹ formal expressions of intent to file an OFA under 49 CFR 1152.27(c)(2),² and trail use/rail banking requests under 49

¹ The Board will grant a stay if an informed decision on environmental issues (whether raised by a party or by the Board's Section of Environmental Analysis (SEA) in its independent investigation) cannot be made before the exemption's effective date. See *Exemption of Out-of-Service Rail Lines*, 5 I.C.C.2d 377 (1989). Any request for a stay should be filed as soon as possible so that the Board may take appropriate action before the exemption's effective date.

² Each OFA must be accompanied by the filing fee, which is currently set at \$1,300. See 49 CFR 1002.2(f)(25).

CFR 1152.29 must be filed by June 28, 2007. Petitions to reopen or requests for public use conditions under 49 CFR 1152.28 must be filed by July 9, 2007, with the Surface Transportation Board, 395 E Street, SW., Washington, DC 20423-0001.

A copy of any petition filed with the Board should be sent to UP's representative: Mack H. Shumate, Jr., Union Pacific Railroad Company, 101 North Wacker Drive, Room 1920, Chicago, IL 60606.

If the verified notice contains false or misleading information, the exemption is void *ab initio*.

UP has filed environmental and historic reports which address the effects, if any, of the abandonment on the environment and historic resources. SEA will issue an environmental assessment (EA) by June 22, 2007. Interested persons may obtain a copy of the EA by writing to SEA (Room 1100, Surface Transportation Board, Washington, DC 20423-0001) or by calling SEA, at (202) 245-0305. [Assistance for the hearing impaired is available through the Federal Information Relay Service (FIRS) at 1-800-877-8339.] Comments on environmental and historic preservation matters must be filed within 15 days after the EA becomes available to the public.

Environmental, historic preservation, public use, or trail use/rail banking conditions will be imposed, where appropriate, in a subsequent decision.

Pursuant to the provisions of 49 CFR 1152.29(e)(2), UP shall file a notice of consummation with the Board to signify that it has exercised the authority granted and fully abandoned the line. If consummation has not been effected by UP's filing of a notice of consummation by July 18, 2008, and there are no legal or regulatory barriers to consummation, the authority to abandon will automatically expire.

Board decisions and notices are available on our Web site at <http://www.stb.dot.gov>.

Decided: June 8, 2007.

By the Board, David M. Konschnik, Director, Office of Proceedings.

Vernon A. Williams,
Secretary.

[FR Doc. E7-11483 Filed 6-15-07; 8:45 am]
BILLING CODE 4915-01-P

DEPARTMENT OF THE TREASURY

Advisory Committee on the Auditing Profession

AGENCY: Department of the Treasury, Departmental Offices.

ACTION: Notice of intent to establish; request for nominations.

SUMMARY: The Department of the Treasury (the "Department") intends to establish the Advisory Committee on the Auditing Profession (the "Committee") to assist the Department in evaluating the sustainability of a strong and vibrant auditing profession. The Department is seeking nominations of individuals to be considered for selection as Committee members, and names of professional and public interest groups that should be represented on the Committee.

DATES: Nominations must be received on or before July 11, 2007.

ADDRESSES: Nominations should be sent to ACAPmembership@do.treas.gov or Advisory Committee on the Auditing Profession Membership, Office of Financial Institutions Policy, Department of the Treasury, Main Treasury Building, Room 1418, 1500 Pennsylvania Avenue, NW., Washington, DC 20220.

FOR FURTHER INFORMATION CONTACT: Gerry Hughes, Financial Analyst, or Timothy M. Hunt, Financial Analyst, Office of Financial Institutions Policy, Department of the Treasury, 1500 Pennsylvania Avenue, NW., Washington, DC 20220, (202) 927-6618 (not a toll-free number).

SUPPLEMENTARY INFORMATION: In accordance with the requirements of the Federal Advisory Committee Act, 5 U.S.C. App. II, the Department is publishing this notice that the Department intends to establish the Committee. The Committee's objective will be to provide informed advice and recommendations to the Department on the sustainability of a strong and vibrant public company auditing profession. The Committee's charter is expected to direct it to consider, among other things, the auditing profession's ability to attract and retain the human capital necessary to meet developments in the business and financial reporting environment; audit market competition and concentration; and the financial resources of the auditing profession, including the effect of existing limitations on auditing firms' structure. A resilient and quality public company auditing profession is essential to the strength of the nation's capital markets. Auditors oversee the integrity of financial reporting and disclosure, critical to investor confidence and market efficiency. Because of the importance of the auditing profession to the prosperity and stability of the capital markets in the United States and the rest of the world, the Department

affirms that the Committee is necessary and in the public interest.

The Committee will be directed to conduct its work with a view to furthering the mission of the Department, as the steward of the economic and financial systems of the United States, to promote and encourage the conditions for prosperity and stability in the United States and the rest of the world and to predict and prevent, to the extent possible, economic and financial crises. The charter will provide that the Committee's duties are solely advisory and only extend to the submission of advice or recommendations to the Department. The Committee is expected to meet at such intervals as necessary to carry out its duties. The charter is

expected to provide that the full Committee will meet no more than eight times. Meetings of subgroups of the full Committee may occur more frequently.

To achieve the Committee's objective, the Department will assure that the Committee reflects balanced membership and includes a cross-section of between 15 and 21 members representing the views of non-government entities or groups having an interest in the auditing profession, such as auditors, investors, public companies, and other financial market participants. In order to select Committee members who represent the greatest range of interest in the auditing profession, the Department is soliciting suggestions for potential Committee members from a variety of sources,

including, but not limited to, professional and public interest groups. Nominations should describe and document the proposed member's qualifications for Committee membership. In addition to individual nominations, the Department is soliciting the names of professional and public interest groups that should have representative members participating on the Committee. Committee members will not receive compensation, but they will be reimbursed for travel expenses consistent with governing Federal law and regulations.

Dated: June 8, 2007

Taiya Smith,

Executive Secretary.

[FR Doc. E7-11700 Filed 6-15-07; 8:45 am]

BILLING CODE 4811-42-P

Appendix B

**CHARTER OF THE
ADVISORY COMMITTEE
ON THE AUDITING PROFESSION**

This charter is prepared and filed in accordance with the Federal Advisory Committee Act, as amended, (the “Act”) (Public Law No. 92-463, 5 U.S.C. App. 2).

A. Official Title. The official title of the Committee is the Advisory Committee on the Auditing Profession (the “Committee”).

B. Objective and Scope. The objective of the Committee shall be to provide informed advice and recommendations to the Secretary of the Treasury and the Department of the Treasury on the sustainability of a strong and vibrant public company auditing profession. The Committee should consider, among other things, 1) the auditing profession’s ability to attract and retain the human capital necessary to meet developments in the business and financial reporting environment; 2) audit market competition and concentration; and 3) the financial resources of the auditing profession, including the effect of existing limitations on auditing firms’ structure.

The Committee should conduct its work with a view to furthering the mission of the Department of the Treasury, as the steward of the economic and financial systems of the United States, to promote and encourage the conditions for prosperity and stability in the United States and the rest of the world and to predict and prevent, to the extent possible, economic and financial crises.

The Department of the Treasury shall assure that the Committee reflects balanced membership and includes a cross-section of members representing the views of non-government entities or groups having an interest in the auditing profession, such as auditors, investors, public companies, and other financial market participants.

C. Period of Time Necessary to Carry Out Purpose. The Committee shall operate until the earlier of the termination date set forth in paragraph I below or the date on which the Department of the Treasury determines that the Committee’s continuance is no longer necessary.

D. Reports. Reports and recommendations shall be provided to the Secretary of the Treasury, or his delegate, who shall be solely responsible for any action taken with respect to such reports or recommendations.

E. Support. The Department of the Treasury, Office of Domestic Finance, shall provide any necessary support services to the Committee, including maintaining any and all records and reports required under the Act.

F. Duties. The duties of the Committee shall be to identify issues, analyze information, and provide recommendations regarding the objectives set forth in paragraph B above. The members of the Committee shall offer constructive observations

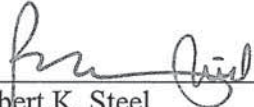
and suggested improvements for the auditing profession. The duties of the Committee shall be solely advisory and shall extend only to the submission of advice or recommendations to the Department of the Treasury. No determination of fact or policy shall be made by the Committee.

G. Costs. The estimated annual operating costs of the Committee are approximately \$195,000.00 and 1.3 staff year. Annual operating costs include travel, staff salary, and other operating expenses. Committee members shall not be paid for their time or service. Members shall be reimbursed for their travel-related expenses to attend meetings in accordance with 5 U.S.C. 5703 (as for persons employed intermittently in the government service).

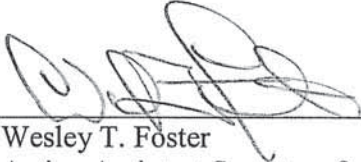
H. Number and Frequency of Meetings. The Committee shall meet at such intervals as are necessary to carry out its duties. It is estimated that the Committee will meet not more than eight times.

I. Termination Date. The termination date of the Committee shall be the second anniversary of the date the charter is filed.

J. Filing Date. The charter of the Committee is filed with the appropriate committees of Congress, the General Services Administration, and the Library of Congress on JUL 3 2007.

Submitted By: 
Robert K. Steel
Under Secretary for Domestic Finance
U.S. Department of the Treasury

May 17, 2007
Date

Approved By: 
Wesley T. Foster
Acting Assistant Secretary for Management
U.S. Department of the Treasury

6-5-07
Date

Appendix C

November 20, 2006
hp-174

Remarks by

Treasury Secretary Henry M. Paulson, Jr.
on the Competitiveness of U.S. Capital Markets Economic Club of New York.
New York, NY

Thank you, Barbara. It's good to be in New York City, the financial capital of the world. What happens in our financial markets is an indicator of the overall state of our economy. And I am pleased to report that our economy is strong.

We are experiencing sustained growth and low unemployment. The economy has added more than 6.8 million new jobs since August 2003. Productivity, an indicator of future growth, has grown at an annual rate of 3 percent since the first quarter of 2001. And, very importantly, this productivity is now translating into higher wages, so more Americans are sharing in our economic success. The U.S. economy is the envy of the world, and we must keep it that way. Capital markets are the lifeblood of our economy. They connect those who need capital with those who invest or lend capital. They play a vital role in helping entrepreneurs implement new ideas and businesses expand operations, creating new jobs. They give our citizens the confidence to invest, earn higher returns on their savings, and reduce the cost of borrowing for student loans, mortgages, and consumer credit.

Our capital markets are the deepest, most efficient, and most transparent in the world. We are the world's leader and innovator in mergers and acquisitions advice, venture capital, private equity, hedge funds, derivatives, securitization skills, and Exchange Traded Funds. This expertise has made our leading financial institutions, many of them headquartered right here in New York, leaders in Asia, Europe, and Latin America. U.S. commercial and investment banks contribute greatly to economic success all around the globe.

Recent Past

Yet, our markets are not immune to challenges. After years of economic expansion and the excesses and exuberance of the late 1990s, we faced what some called the perfect storm: the technology and telecom bubble burst, the U.S. economy went into recession, terrorists attacked us on September 11, 2001, and a wave of corporate scandals undermined investor confidence.

We weathered the storm. The President, both parties in Congress, and regulators moved quickly to address the business scandals, which helped to restore investor confidence. And the President's economic policies and tax cuts laid a strong foundation for recovery.

In the United States, whenever there is a major problem in our capital markets, we shine a light on it and move quickly to clean it up. The vast majority of corporate leaders are honest people, but those executives who put their personal interest above the interests of their share-

holders undermined confidence in our markets. That's not competing, that's cheating. And perpetrators are being punished.

We responded to the corporate scandals with the Sarbanes-Oxley Act of 2002, new listing rules for public companies, and regulatory and legal enforcement actions to alter certain business practices. These changes have been extensive and significant, so it is quite naturally taking time for companies to understand, process, and implement the new rules and requirements. Many of the results have been positive. At the same time, as corporations, financial institutions, and regulators continue to adapt, questions are being raised about the long-term impact of these changes. Our goal is to preserve the integrity of our markets while maintaining their competitiveness.

Recently, Mayor Bloomberg and Senator Schumer emphasized this point in a Wall Street Journal Op-Ed that was right on target. They highlighted a discussion that many in the financial community are having: Does the decline in initial public offerings in U.S. capital markets signal potentially broader challenges to our competitiveness?

An IPO occurs when a private company decides to sell its shares to the public. Our public markets provide the lowest-cost capital. Access to these markets – as it should – brings regulatory, governance, and disclosure responsibilities. Historically, the U.S. markets have represented the gold standard, and a significant number of premier foreign companies have willingly adhered to our standards in order to access our markets.

Yet recently, in the wake of new, heightened regulatory and listing requirements for all public companies in the U.S., we have witnessed changes in IPO activity. Despite our strong economy and stock market, IPO dollar volume in the U.S. is well below the historical trend and below the trend and activity level in a number of foreign markets.

Moreover, existing public companies in the U.S. are deciding to forgo their public status – with its attendant regulatory requirements – and go private. This is occurring in record numbers, at record volumes, and, as a percentage of overall public company M&A activity, is approaching levels we have not seen in almost 20 years. This development is being facilitated by ever-growing private pools of capital.

Given domestic trends, it is not surprising that the U.S. share of the total volume of foreign IPOs has also declined. Determining the causes and potential effects of these trends is more complicated. Are they temporary, harmless phenomena, or more like the coal miners' canary? What is the implication for America's investors and our existing public companies, which remain subject to the new regulatory standards? And what does this mean for America's economic competitiveness?

Let me begin by discussing the importance of regulation. Truly competitive capital markets must inspire investor confidence. They must be fair and they must be perceived to be fair. Of course, fairness does not guarantee success. Laws and regulation cannot prevent investors from losses, nor should they attempt to do so. We should not discourage risk taking, but we

should make sure that investors have reliable information on which to base their decisions. In a recent speech, former Treasury Secretary Bob Rubin said this about regulation: “Our society seems to have an increased tendency to want to eliminate or minimize risk, instead of making cost/benefit judgments on risk reduction in order to achieve optimal balances.” When it comes to regulation, balance is key. And striking the right balance requires us to consider the economic implications of our actions. Excessive regulation slows innovation, imposes needless costs on investors, and stifles competitiveness and job creation. At the same time, we should not engage in a regulatory race to the bottom, seeking to eliminate necessary safeguards for investors in a quest to reduce costs. The right regulatory balance should marry high standards of integrity and accountability with a strong foundation for innovation, growth, and competitiveness.

Some observers cite the decline of foreign IPOs in the U.S. market as an indicator of the competitiveness of our capital markets. We should go beyond the numbers and examine some of the possible reasons for this decline. Several factors contribute to the recent trends, including public policies in other countries. But several other contributing factors offer a framework to assess our own capital markets. These include:

- ◆ The development of markets outside the U.S., particularly in London and Hong Kong – and the ability of U.S. investors to participate in these offerings;
- ◆ A legal system in the U.S. that exposes market participants to significant litigation risk;
- ◆ A complex and confusing regulatory structure and enforcement environment;
- ◆ And new accounting and governance rules which, while necessary, are being implemented in a way that may be creating unnecessary costs and introducing new risks to our economy.

Each of these warrants deeper discussion.

Foreign Market Development

First, let me say unequivocally, the development of competitive capital markets overseas is a positive. Efficient capital markets lower the cost of capital, creating more growth, more jobs, and higher living standards. And economic growth abroad creates markets for our products and jobs here at home.

In three weeks, I will travel to Beijing for the first session of our recently initiated Strategic Economic Dialogue with China. We will encourage China to open up their financial markets to competition in order to accelerate the development of those markets and support sustainable economic growth – growth that will bring benefits to both our nations.

A number of foreign markets have developed excellent standards and protocols. In some parts of the world, particularly Europe, public companies adhere to the International Financial Reporting Standards – an accounting system that differs from ours.

One important feature of the IFRS accounting system is that it is principles-based, rather than rules-based. By “principles-based,” I mean that the system is organized around a relatively small

number of ideas or concepts that provide a framework for thinking about specific issues. The advantage of a principles-based system is that it is flexible and sensible in dealing with new or special situations. A rules-based system typically gives more specific guidance than a principles-based system, but it can be too rigid and may lead to a “tick-the-box” approach. I will be talking about the difference between principles-based and rules-based systems in a number of contexts today.

International companies that list in the United States must reconcile their IFRS statements with U.S. Generally Accepted Accounting Principles, or GAAP. We should recognize that the time and cost that go into reconciling and restating IFRS statements may not be a worthwhile expense for a foreign company considering the U.S. market. Because of progress being made in converging accounting standards, the U.S. and EU have developed a “roadmap,” with the goal of allowing listings in the U.S. market on the basis of statements prepared using IFRS, and likewise continuing to permit listings in the EU on the basis of statements prepared according to GAAP. These efforts are encouraging.

A number of foreign exchanges have also aggressively embraced technology and developed innovative business models that increase efficiencies and reduce costs to investors in their markets. These competitive forces have spurred responses in our country. In the most recent example, the Chicago Mercantile Exchange and Chicago Board of Trade announced plans to merge and offer investors a broader range of exchange-traded derivatives, with the goal of creating efficiencies in technology and operations.

Ten years ago, premier foreign companies seeking to raise attractively priced equity capital turned almost exclusively to the United States. That’s no longer the case, as alternatives have developed around the world. But certain challenges to doing business in the U.S. market also are contributing to the recent trends, and these challenges merit a closer look.

Legal Burden

Let’s begin with one challenge that will take a concerted effort over the long term to correct – the need for reform of our legal system. My own 32-year experience in the private sector – working in the capital markets with U.S. and foreign companies alike – has convinced me that legal reform is crucial to the long-term competitiveness of our economy.

A sophisticated legal structure – with property rights, contract law, mechanisms to resolve disputes, and a system for compensating injured parties – is necessary to protect investors, businesses, and consumers. But our legal system has gone beyond protection. In 2004, U.S. tort costs reached a record quarter-trillion dollars, which is approximately 2.2 percent of our GDP. This is twice the relative cost in Germany and Japan, and three times the level in the UK. The consulting firm Towers-Perrin found that the tort system is highly inefficient, with only 42 cents of every tort dollar going to compensate injured plaintiffs. The balance goes to administration, attorney’s fees, and defense costs. Inefficient tort costs are effectively a tax paid by shareholders, employees, and consumers. Simply put, the broken tort system is an Achilles heel for our economy. This is not a political issue, it is a competitiveness issue and it must be addressed in a bipartisan fashion.

Regulatory Structure

Another issue to consider in assessing the competitiveness of our financial markets is regulation. Over the course of our nation's history, we have added multiple regulators to respond to the issues of the day. Our regulatory system has adapted to the changing market by expanding, but perhaps not always by focusing on the broader objective of regulatory efficiency.

For example, while the business of banking has converged over time, we still have four separate banking regulators. We have a similar dynamic with the securities and commodities markets, and their related self-regulatory structures. Each of these organizations has different statutory responsibilities and a number have different regulatory philosophies. We also have a dual federal-state regulatory system in the banking and securities markets – and the degree of federal preemption over state law in these areas varies greatly. Another large and important part of our financial sector, insurance, is regulated solely at the state level.

A consequence of our regulatory structure is an ever-expanding rulebook in which multiple regulators impose rule upon rule upon rule. Unless we carefully consider the cost/benefit tradeoff implicit in these rules, there is a danger of creating a thicket of regulation that impedes competitiveness.

Our rules-based regulatory system is prescriptive, and leads to a greater focus on compliance with specific rules. We should move toward a structure that gives regulators more flexibility to work with entities on compliance within the spirit of regulatory principles.

Rules by themselves cannot eliminate fraud. Wrongdoers will seek out loopholes or ways to circumvent the rules. For instance, in the recent business scandals, management at some companies remained technically within the rules while offering deceptive financial statements.

Some rules developed in the past have proved to be deficient in today's dynamic marketplace and some that are developed today are likely to be sub-optimal in a few years unless they are rooted in principles which will stand the test of time.

There is a growing awareness in the financial community of the desirability of streamlining the regulatory system. One example is the decision of the New York Stock Exchange and the NASDAQ to consolidate their regulatory operations. This is a positive development, and I encourage them to focus on achieving the right principled result as opposed to just combining the two rule books.

While no nation's regulatory structure is perfect, ours has served us very well for many years. It is second to none. And to ensure that it meets the challenges of the years ahead, we should be open to learning from our own experience and from the experience of others. We should ask ourselves: What changes are needed to make our regulatory structure more efficient and effective in today's world?

At times, our legal system and regulatory structure produce unintended consequences. Consider the area of enforcement. Over the last several years different regulators at the state and federal level have been focused on finding and prosecuting wrongdoing – a worthy, necessary, and successful effort. But when multiple jurisdictions and entities are involved, each with their own objectives and approaches, the enforcement environment can become inefficient and, to the regulated, can appear confusing and threatening.

Given the business scandals, this is understandable. And some violations from years ago are just coming to light. Almost every week we read about another act of corporate wrongdoing, many representing egregious violations of shareholder trust. Let's be clear: Those who commit corporate fraud are guilty of stealing from shareholders, employees, and consumers. That behavior can never be tolerated. Our challenge is to make sure the tools are in place to punish bad actors, while recognizing that the vast majority of business leaders are honest, capable, and focused on the interests of shareholders and employees.

Today, we have an opportunity to make the enforcement environment more constructive. In such an environment, public companies would be able to work with regulators to resolve ambiguities and make the right decisions. Such regulatory guidance should be easy, quick, and relatively costless to obtain. The combination of enforcement and guidance is likely to be more effective and more efficient than relying on enforcement alone, particularly in an environment in which there is a greater degree of trust between the regulators and the regulated. In a sign of increasing openness to considering new approaches, the Justice Department has been seeking input from outside groups and is currently considering revisions to the "Thompson Memorandum," which deals with criminal prosecution of companies. If it appears that changes are warranted, in the public interest, and consistent with the need to safeguard the integrity of our economic system, I am confident the Justice Department will revise its policy.

Sarbanes-Oxley and Governance

When discussing the competitiveness of our markets, we should acknowledge that Sarbanes-Oxley and the related public company listing rules brought necessary reforms to our corporate governance and capital markets. These reforms are rooted in the basic principles that underpin a robust corporate governance system – accountability, transparency, and the need to identify and manage conflicts of interest.

These changes were necessary to rein in abuses. But significant changes always cause stress, and early implementation of new rules may produce uneven results. We must recognize the benefits of the new rules, and remain open-minded about how they affect the system, both positively and negatively. At this time, I do not believe we need new legislation to amend Sarbanes-Oxley. Instead, we need to implement the law in ways that better balance the benefits of the legislation with the very significant costs that it imposes, especially on small businesses. By far the single biggest challenge with Sarbanes-Oxley is section 404, which requires management to assess the effectiveness of a company's internal controls and requires an auditor's attestation of that assessment. Companies should invest in strong internal controls and shareholders welcome this development because it is in their best interest. However, section 404

should be implemented in a more efficient and cost effective manner. It seems clear that a significant portion of the time, energy, and expense associated with implementing section 404 might have been better focused on direct business matters that create jobs and reward shareholders.

Businesses around the world are eager to see how we address this issue. The Chairman of the SEC, Chris Cox, recognizes the severity of this problem and is providing strong leadership to address it. He understands that it will take an aggressive forward-leaning approach to change the implementation of Section 404 and make it more efficient.

Mark Olson, the Chairman of the Public Company Accounting Oversight Board, shares Chris Cox's viewpoint. Collectively, they have responsibility for providing guidance on implementing Section 404. The SEC will soon seek comments on a new and much improved auditing standard aimed at ensuring that the internal control audit is top down, risk based, and focused on what truly matters to the integrity of a company's financial statements. This new guidance for both companies and their auditors should encourage common sense reliance on past work, and on the work of others. Moreover, the SEC and the PCAOB are going to provide tailored guidance for small companies that recognizes their specific characteristics and needs.

Overall, I believe our corporations are better governed today. Directors are more independent, more aware of real and perceived conflicts, more diligent about their fiduciary responsibilities, and they spend much more time engaged in compliance processes. But good corporate governance is a means to an end, not an end in itself. We do not need a process-oriented mentality to corporate governance. We need better managed, more competitive corporations that earn investor confidence through sound leadership, thoughtful governance, and outstanding performance. One important indicator of the effectiveness of corporate governance changes will be the ability of companies to attract experienced, competent board members who can add real value – and who are able to spend more time at board meetings overseeing the business and developing strategies, and less time on regulatory compliance.

We should remember that we cannot legislate or rule-make our way to ethical behavior, whether it be in the business world or any other endeavor. Proper corporate governance processes increase the likelihood that well-intentioned people will do the right thing. But they do not guarantee such an outcome – and they certainly do not guarantee that unethical people will do the right thing. In my judgment, we must rise above a rules-based mindset that asks, “Is this legal?” and adopt a more principles-based approach that asks, “Is this right?”

Several weeks ago, Warren Buffett offered a warning to his leadership team at Berkshire Hathaway when he wrote, “The five most dangerous words in business may be ‘Everybody else is doing it.’” As usual, Warren Buffett was right. The ability to avoid these pitfalls takes moral leadership, starting right at the top.

Accounting

The corporate scandals were, for the most part, accounting scandals, so it is not surprising that so much of the recent reform has focused on the accounting industry. Our accounting system

is the lifeblood of our capital markets. And it has historically represented a very high standard. But it was abused in the corporate scandals by manipulation and smoothing of earnings.

Capital markets rely on trust, which is based on financial information presumed to be accurate and to reflect economic reality. The ultimate responsibility for accurate and transparent financial statements must rest with management. The role of the external auditor is to examine a company's financial statements in order to express an opinion that conveys reasonable, but not absolute, assurance as to the truth and fairness of the statements. Auditors do this by evaluating management's adherence to Generally Accepted Accounting Principles.

The Sarbanes-Oxley reforms were intended to increase the quality of corporate audits. They have had a significant effect on the accounting industry, fundamentally altering the interactions between auditors and corporate management and boards in a number of ways, some of which are not constructive. Also, we have been left with only four major accounting firms, each of which is exposed to potentially large legal liabilities.

This may not be healthy. The big four firms dominate the industry in terms of revenues and professional staff. The remaining accounting firms face significant barriers to competing with the big four, at a time when auditors are in real demand. The current situation forces us to ask questions about the industry's sustainability and effectiveness:

- ◆ Given the importance of accounting to our financial system, is there enough competition?
- ◆ Will our reformed accounting system produce the high-quality audits and attract the talented auditors we need?
- ◆ Do auditors seek detailed rules in order to focus on technical compliance rather than using professional judgment that could be second-guessed by the PCAOB or private litigants?

A common theme in my remarks today is the desirability, where practical, of moving toward a principles-based system. Nowhere is this issue more relevant than in the accounting system. Added complexity and more rules are not the answer for a system that needs to provide accurate and timely information to investors in a world where best of class companies are continually readjusting their business models to remain competitive.

Last year, approximately 1,200 publicly listed companies in the United States restated their financials. As of September 30 of this year, the number is more than 1,000. Some of these companies were involved in the business scandals. Many others were well-intentioned companies struggling to cope with a redefinition of rules in a complex system. These restatements draw time and attention away from other value-enhancing activities – and they represent an added cost to shareholders. Businesses and auditors are searching for something that doesn't exist in today's constantly changing world – a rules-based safe haven that still provides investors with an accurate portrayal of a company's financial performance.

Auditors should be able to focus on one fundamental objective – ensuring the integrity and economic substance of management's financial statements. To get there, we must recognize that accounting is not a science. It is a profession, requiring judgments that cannot be prescribed in a one-size-fits-all manner that undermines the usefulness of financial statements to investors.

The PWG, Derivatives, and Hedge Funds

In assessing the condition and competitiveness of our capital markets we have also initiated a broad review of recent changes, including the growth of derivatives and private pools of capital and their implications for the stability of the system. Credit derivatives have altered the financial landscape in many positive ways, most notably by dispersing the concentration of risk. They also pose potential risks themselves.

Hedge funds are among the largest users of derivatives. Over the past five years, the number of hedge funds has nearly doubled, while their assets under management have more than tripled. These investment managers engage in a wide variety of strategies, generate substantial transaction volumes, and introduce significant leverage into the system. They have also made our capital markets more efficient, facilitating the dispersion of risk. And hedge funds have developed an impressive global presence. Given their explosive growth, the instruments they trade, and the evolution of our financial marketplace, we must continually assess their actions and impact on the market.

The SEC, which has broad anti-fraud and civil liability authority over hedge funds, is well-positioned to focus on investor protection. Another group of regulators aims to minimize the potential for systemic risk by working with the regulated financial institutions that extend credit to and transact business with hedge funds. And the President's Working Group on Financial Markets – comprised of the Treasury Secretary and the Chairmen of the Federal Reserve Board, the SEC, and the CFTC – continues to review and monitor markets, assess issues related to the performance of derivatives, and study the activities of hedge funds in three broad areas: investor protection, operational risk, and potential for systemic risk. We have begun a series of educational meetings with a broad array of participants in the hedge fund community to gain insight as we move forward with our deliberations.

Conclusion

In conclusion, competitive capital markets will pave the way for continued economic growth that benefits all Americans. The issues I've outlined are crucial to ensuring that our capital markets remain the best in the world. And certain principles should guide us going forward.

First, it is necessary to take a global view. We don't operate in isolation, so it is very important to consider how changes we make affect the ability of our companies to compete globally and how these changes affect our interaction with markets and regulators around the world.

Second, our regulatory structure should be more agile and responsive to changes in today's marketplace.

Third, to stand the test of time, rules should be embedded in sound principles.

Fourth, regulators should take a risk-based approach to regulation, weighing the cost to shareholders against the benefits.

Fifth, our enforcement regime should punish and deter wrongdoing and encourage good behavior without hindering responsible risk-taking and innovation.

And, lastly, the best way our business leaders can protect the integrity and competitiveness of our markets is to exert moral leadership, where the threshold question is, “Is this right?” not “Do the rules allow us to do this?”

Our capital markets remain strong and competitive, but they face some significant challenges that do not lend themselves to easy answers or quick fixes. The Treasury Department plans to host a Conference on Capital Markets and Economic Competitiveness early next year. We will invite participants with a wide range of perspectives, particularly the investor perspective. The Conference will cover the three primary areas I have discussed today – our regulatory structure, our accounting system, and our legal system – all of which impact our capital markets and are critical to the overall economic competitiveness of our nation. Our objective will be to stimulate bipartisan discussion and to lay the groundwork for a long-term strategic examination of these issues.

In all that lies ahead, we must remember that the competitiveness of our capital markets depends to a large extent on our nation’s overall economic competitiveness. We are fortunate that because our economy is so strong, we approach our challenges from a position of strength. And we should use this position of strength to tackle long-term challenges that will affect our economic competitiveness. We must:

- ◆ reform our entitlement programs;
- ◆ advance energy security;
- ◆ maintain and strengthen trade and investment policies that benefit American workers;
- ◆ focus on economic and educational policies that will add jobs, improve productivity, and result in tangible income growth for all Americans;
- ◆ and, of course, strengthen and maintain the competitiveness of our capital markets.

I came to Washington determined to accomplish as much as possible over the next two years. These challenges won’t be easy, but I’m very grateful for the opportunity to work with the President and the other members of his economic team to help America keep its competitive edge in the 21st century.

Thank you very much.

Appendix D

March 13, 2007
HP-306

Opening Remarks by

Treasury Secretary Henry M. Paulson, Jr.
at Treasury's Capital Markets Competitiveness Conference Georgetown University

Washington, DC

Thank you very much, President DeGioia. We are pleased to be here at Georgetown University. Georgetown is a world-class institution that trains leaders in a number of areas, and we are especially pleased to be joined in our discussions by faculty and students from Georgetown's McDonough School of Business.

The participants in today's Conference are a distinguished group of leaders in U.S. capital markets, and I welcome you and thank you all for being here. You have many areas of expertise and you bring a variety of perspectives: years of valuable experience in academia, government, the business world, Wall Street, or as investor advocates. All of your views are welcome and appreciated. This is a very knowledgeable group of people and I am looking forward to an engaging discussion.

As the Treasury Secretary, my goal is to promote the conditions for American prosperity and economic growth – and maintaining the competitiveness of our capital markets is central to that goal. Capital markets are the lifeblood of our economy. They help entrepreneurs implement new ideas and businesses expand operations, creating new jobs. They give our citizens the confidence to invest, earn higher returns on their savings, and reduce the cost of borrowing.

U.S. capital markets are the deepest, most efficient, and most transparent in the world. We are the world's leader and innovator in mergers and acquisitions advice, venture capital, private equity, hedge funds, derivatives, securitization skills, and Exchange Traded Funds. With this expertise, our major financial institutions have contributed greatly to economic success throughout the world.

One of the great strengths of our markets is their dynamism. They change with the times to serve the needs of investors and businesses. Yet, our markets are not immune to challenges. After years of economic expansion and the excesses and exuberance of the late 1990s, the technology and telecom bubble burst and a wave of corporate scandals undermined investor confidence. We weathered the storm. The President, both parties in Congress, and regulators moved quickly to address the business scandals, which helped to restore investor confidence.

We responded to the corporate scandals with the Sarbanes-Oxley Act of 2002, new listing rules for public companies, and regulatory and enforcement actions to alter certain business practices. These changes have been extensive and significant, so it is quite naturally taking time for companies to understand, process, and implement the new rules and requirements.

But the principles behind them have been positive, as have many of the results.

As U.S.-listed companies are adapting to these rules, global capital markets around the world are evolving and developing, introducing new competition for our markets. At the same time, we have witnessed extraordinary growth in private pools of capital, including hedge funds. Each of these changes presents its own set of benefits and challenges. The question we have to consider is the individual and cumulative impact of these changes on U.S. public companies.

Our markets are, indeed, the best in the world. Yet we must be vigilant, and we must do everything we can to ensure they stay that way. We at Treasury have some ideas and our fellow regulators are working on these issues as well. There are some obvious adjustments, such as the recent administrative actions regarding Section 404 which should mitigate a major problem related to Sarbanes-Oxley implementation. But these are complex, interrelated issues and I am confident that we can benefit greatly from the views of the people in this room.

In particular, we will focus on three issues: our regulatory structure; the accounting industry; and our legal and corporate governance environment.

Our regulatory system has served us very well over the course of our history. It is part of the foundation for our prosperity and growth. And, robust and balanced regulation is critical to ensuring that we continue to have the strongest capital markets in the future. Yet, the addition of new regulators over many years, and the tendency of these regulators to adapt to the changing market by expanding, as opposed to focusing on the broader objective of regulatory efficiency, is a trend we should examine. We should assess how the current system works and where it can be improved, with a particular eye toward more rigorous cost-benefit analysis of new regulation. And we should also consider whether it would be practically possible and beneficial to move toward a more principles-based regulatory system, as we see working in other parts of the world.

Because many of the corporate scandals of the late 90s were, for the most part, accounting scandals, it is not surprising that much of the reform focused on the accounting profession. This reform has helped to restore investor confidence. This is key because capital markets rely on trust, which is based on financial information presumed to be accurate and to reflect economic reality. But the cumulative impact of all the change has significantly affected the accounting industry, fundamentally altering the interactions between auditors and corporate management and boards in a number of ways, some of which might not be constructive. Also, we have seen great concentration among the major accounting firms and there are legitimate questions about the sustainability of the accounting profession's business model.

We should also consider whether our system is producing the high-quality audits and attracting the talented auditors we need, whether there is currently enough competition in the accounting profession, and the desirability of moving toward more principles-based accounting standards.

The basic principles that underpin a robust corporate governance system are accountability, transparency, and the need to identify and manage conflicts of interest. As a result of Sarbanes-Oxley and other regulatory changes, corporate directors are more independent, more

aware of real and perceived conflicts, more diligent about their fiduciary responsibilities. Of course, directors must now spend much more time engaged in compliance processes and finding the right balance on the use of director time is critically important. But good corporate governance is a means to an end, not an end in itself. Our goal should be better managed, more competitive corporations that earn investor confidence through sound leadership, thoughtful governance, and outstanding performance. In my judgment, we must rise above a rules-based mindset that asks, “Is this legal?” and adopt a more principles-based approach that asks, “Is this right?” And we should consider whether our legal system appropriately protects investors or gives too much latitude to unscrupulous lawyers.

Throughout the day, the fundamental question we must ask is: Have we struck the right balance between investor protection and market competitiveness – a balance that assures investors the system is sound and trustworthy, and also gives companies the flexibility to compete, innovate, and respond to changes in the global economy?

At today’s conference there are no pre-determined answers. We are looking for a real discussion, with rigorous questioning and candid and collegial debate.

At the end of the day, I hope each of us will have had one of our opinions challenged, or been given the opportunity to view an issue from a new perspective. Given the cumulative wisdom and experience in this room, I am confident the day will be thought-provoking and productive.

At Treasury, we will carefully consider the views we have heard today along with the recommendations of a number of other groups which have studied this subject. Together they will inform us as we develop specific follow up steps in the coming months to keep US capital markets the strongest and most innovative in the world. There will be things we at Treasury, working with the regulatory agencies, will do in the near term and some other actions over a longer time frame to address these challenges to our competitiveness. This is a high priority for me.

My great thanks again to the students, faculty, and administrators of Georgetown for hosting us. And thank you to all of our conference participants for taking the time to lend your voices to this process. Given the importance of our capital markets to our long-term economic growth and competitiveness, it is essential to have our best minds engaged on this matter.

Now, let’s get started. Please welcome to the stage our first panel participants.

Appendix E

May 17, 2007
HP-408

Paulson Announces First Stage of Capital Markets Action Plan

Washington, DC

U.S. Treasury Secretary Henry M. Paulson, Jr. announced initiatives today to enhance U.S. capital markets competitiveness, focused on strengthened financial reporting and a more sustainable and transparent auditing profession.

“Strengthening the competitiveness of America’s capital markets has been a priority issue for me since taking office,” said Secretary Paulson. “I have listened carefully to many diverging views on this issue, and I heard a common theme throughout: A transparent financial reporting system and vibrant auditing profession form the backbone of a marketplace investors can trust. Any plan to strengthen our capital markets must be based upon this principle.”

Today’s initiatives are one piece of the follow up from the Capital Markets Competitiveness conference Secretary Paulson and Securities and Exchange Commission Chairman Christopher Cox co-chaired in March. At that conference, financial reporting was one of the main topics of discussion among leading experts representing investors, auditors, public companies and financial regulators. The conference raised other issues important to the competitiveness of our capital markets, and Treasury will be unveiling plans to follow up in those areas in the near future.

Today’s initiatives are part of an ongoing effort to address the issues affecting U.S. capital markets competitiveness. Initiatives announced include:

Provide Investors with A Transparent and Sustainable Auditing System

The Treasury Department intends to charter a non-partisan committee to develop recommendations to consider options available to strengthen the industry’s financial soundness and its ability to attract and retain qualified personnel. Treasury has asked former SEC Chairman Arthur Levitt, Jr. and former SEC Chief Accountant Donald T. Nicolaisen to serve as co-chairs for this public forum.

Gain Better Understanding of Reasons for Increasing Financial Restatements

Restatements have soared during the past decade from 116 in 1997 to 1,876 in 2006. Treasury intends to commission a rigorous analysis of the factors driving financial restatements and their impact on investors and the capital markets. Results of the analysis will be made public upon completion.

Additionally, the Treasury Department believes the following initiatives are important to maintaining the competitiveness of our capital markets:

Enhance Financial Reporting

U.S. Generally Accepted Accounting Principles are comprised of more than 2000 individual pronouncements issued by various regulatory bodies. Investors often seek information not provided under financial reporting requirements. The Treasury Department is supportive of the SEC and the Financial Accounting Standards Board's efforts to enhance financial reporting transparency and accessibility for investors.

Streamline Accounting Requirements to Encourage International Companies to List on U.S. Exchanges and Increase Investor Opportunities

U.S. public markets should not be closed off to companies that adhere to high quality internationally accepted accounting standards. The Treasury Department is supportive of the SEC's action to eliminate the U.S. GAAP reconciliation requirement by 2009 of International Financial Reporting Standards reporting companies and the continued convergence of U.S. GAAP and IFRS.

Secretary Paulson will continue to provide follow up steps to other ideas discussed at the March conference.

Appendix F

May 17, 2007
HP-407

Paulson: Financial Reporting Vital to US Market Integrity, Strong Economy

Washington, DC

The Financial Times published the following opinion editorial today from U.S. Treasury Secretary Henry M. Paulson, Jr., discussing the first stage of his plan to enhance U.S. capital markets competitiveness:

The Key Test of Accurate Financial Reporting is Trust

By Henry Paulson

Accurate and transparent financial reporting is vital to the integrity of our capital markets and the strength of the US economy. In an address last November, I spoke about the importance of strong capital markets, pointing out that capital markets rely on trust. That trust is based on financial information presumed to be accurate and to reflect economic reality.

Our capital markets are the best in the world and so is our financial reporting system. We must work to keep them that way. On Thursday, the Treasury department is announcing several important steps to ensure we preserve an efficient financial reporting system that provides reliable information, is supported by a sustainable auditing industry, and has enhanced compatibility with foreign reporting standards.

In March, Christopher Cox, the Securities and Exchange Commission chairman, and I co-chaired a conference on capital markets competitiveness. Financial reporting was one of the main topics of discussion.

A strong auditing profession is essential for a well-functioning reporting system. The auditor's role is key: to examine financial statements and express an opinion that conveys reasonable, but not absolute, assurance as to the truth and fairness of those statements. The Sarbanes-Oxley Act of 2002 enhanced financial reporting integrity, including mandating major changes affecting the auditing profession. The act created the Public Company Accounting Oversight Board to replace self-regulation, and mandated auditor independence requirements. As these changes took effect, new challenges arose. We now have fewer major accounting firms, and legitimate questions about the sustainability of the auditing profession's business model.

These new challenges require understanding and solutions. To achieve this, the Treasury has asked Arthur Levitt, former SEC chairman, and Donald Nicolaisen, former SEC chief accountant, to serve as co-chairs of a non-partisan committee to address auditing industry concen-

tration, and to consider options available to strengthen the industry's financial soundness and its ability to attract and retain qualified personnel. Through this public forum, investors, advocates, and companies can present a wide range of views, engage in informed debate and provide recommendations.

In addition to changes in the auditing profession, Section 404 of Sarbox appropriately emphasised the importance of internal controls over financial reporting. However, implementation has proven more costly and burdensome than originally anticipated. Mr Cox, Mark Olson, PCAOB chairman, and their commissioners and board members have sought to improve the application of Section 404. A more risk-based implementation will be a positive step.

Another emerging challenge is the soaring number of financial restatements over the past decade. In 1997, there were 116 restatements; in 2006, there were 1,876, or more than 10 per cent of public companies. Restatements pose significant costs on our capital markets. They have the potential to confuse investors and erode public confidence in financial reporting. Some of these restatements might not be material to investors, and others may simply reflect new accounting standards interpretations.

This volume of restatements reflects, in part, the complexity of our financial reporting system. Mr Cox and Robert Herz, Financial Accounting Standard Board chairman, are to be commended for their efforts to reduce that complexity. To complement this move, the Treasury intends to commission a rigorous analysis of factors driving financial restatements, and their impact on investors and the capital markets.

The increasing globalisation of our markets also means that we must enhance the comparability of foreign company financial statements. Mr Cox's leadership has been instrumental. He has taken positive steps towards the convergence of US GAAP and International Financial Reporting Standards, and eliminating the US GAAP reconciliation requirements for IFRS-reporting foreign companies by 2009.

As the SEC has said, its actions are key steps "toward a future regulatory framework in which IFRS may be used on a stand-alone basis by foreign private issuers and possibly also by US issuers." When fully implemented, this will enhance financial statement consistency and facilitate cross-border transactions and cash flows.

We will pursue each of these initiatives, and other steps that will be part of the broader competitiveness discussion, to ensure that US capital markets remain efficient, innovative and continue to drive capital to its most productive uses. Our markets must retain the integrity and efficiency that has contributed greatly to prosperity in America and around the globe.

The writer is US Treasury secretary.

Appendix G

October 2, 2007
hp-585

Paulson Announces Auditing Committee Members to Make recommendations for a More Sustainable, Transparent Industry

Washington, DC

Secretary Henry M. Paulson, Jr. announced the members of the Treasury Advisory Committee on the Auditing Profession today. The public committee, which Secretary Paulson first announced in May, will make recommendations to encourage a more sustainable auditing profession. The Treasury Department worked with Committee Chairmen Arthur Levitt, Jr., former Securities and Exchange Commission Chairman, and Donald T. Nicolaisen, former SEC Chief Accountant, to choose members through a public nomination process and based on their diverse experiences and perspectives.

“Investor trust in the integrity of our capital markets is vital to the strength of the U.S. economy. Investor trust is based on accurate financial reporting, and a vibrant auditing profession is essential for a well-functioning financial reporting system,” said Secretary Paulson. “This Committee has been chartered to develop recommendations as to what can best be done to sustain a vibrant auditing profession, a profession whose work is critical to investor confidence in our capital markets.”

Secretary Paulson announced a series of initiatives this year to enhance U.S. capital markets competitiveness, one of his top priorities since taking office. Areas of focus include strengthening financial reporting and seeking a more sustainable auditing profession.

The committee will examine auditing industry concentration, financial soundness, audit quality, employee recruitment and retention, in addition to other topics. Treasury expects the committee to produce findings and recommendations by early summer 2008.

The committee structure will encourage an open and public discussion, with no predetermined outcomes. Meetings will be open to public attendance and comment at the Committee website. The committee members represent a broad range of perspectives, including investors, auditors, large and small public companies, insurance companies, lawyers and regulators. Treasury also selected official observers representing the domestic and international regulatory and policy bodies.

The first meeting will be held at the Treasury Department on Monday, October 15 at 10:00 a.m. in the Cash Room.

Committee members include:

Arthur Levitt, Jr. (Co-Chair) was the 25th Chairman of the SEC. First appointed by President Clinton in July 1993, and reappointed in May 1998, he was the longest serving SEC Chairman when he left on February 9, 2001. He is presently Senior Advisor to The Carlyle Group and Wisdom-Tree, on the Board of Bloomberg LLP as well as a member of the American Academy of Arts & Sciences.

Donald T. Nicolaisen (Co-Chair) was the Chief Accountant at the SEC from September 2003 to November 2005. He serves on the Board of Directors of Morgan Stanley, MGIC Investment Corporation, Verizon Communications Inc. and Zurich Financial Services. In addition, Mr. Nicolaisen is on the Board of Advisors for the University of Southern California, Leventhal School of Accounting. Mr. Nicolaisen also serves in a variety of advisory capacities to other Fortune 25 companies.

Alan L. Beller is a partner at Cleary Gottlieb Steen & Hamilton LLP. Mr. Beller was the Director of the Division of Corporation Finance of the SEC and Senior Counselor to the SEC from 2002 until 2006.

Amy Woods Brinkley is the Global Risk executive for Bank of America. She serves on the Risk & Capital Committee, which oversees allocation of capital to all business lines, and is a member of the bank's Management Operating Committee.

Mary K. Bush is President of Bush International and serves on the Boards of four publicly traded companies--Briggs and Stratton (Audit Committee), Discover Financial Services, ManTech Corporation and United Air Lines (Audit Committee)--and the Pioneer Family of Mutual Funds.

H. Rodgin Cohen is Chairman of Sullivan & Cromwell LLP. He has acted in most of the major U.S. bank acquisitions as well as in numerous leading cross-border and cross-industry acquisitions.

Timothy P. Flynn is Chairman and Chief Executive Officer of KPMG LLP. He is a member of the Governing Board of the Center for Audit Quality, and the Boards of Trustees of the Financial Accounting Foundation (FAF), FAF's Audit, Development and Strategic Planning committees, and the University of St. Thomas.

Robert Glauber is a Lecturer at Harvard's Kennedy School of Government. Previously, he served as Chairman and Chief Executive Officer of NASD (now FINRA) from September 2001 to September 2006, after becoming NASD's CEO and President in November 2000 and a member of NASD's Board in 1996.

Ken Goldman is Chief Financial Officer of Fortinet, Inc. He is a member and former President of The Financial Executive Institute, Santa Clara chapter, and served as an advisory council member of the Financial Accounting Standards Board from 2000 to 2004.

Gaylen R. Hansen is an audit partner at Ehrhardt Keefe Steiner & Hottman PC and serves on the Colorado State Board of Accountancy and the board of directors of the National Association of State Boards of Accountancy. He is also a member of the Standing Advisory Group that advises the Public Company Accounting Oversight Board.

Barry C. Melancon is the President and Chief Executive Officer of the American Institute of Certified Public Accountants. Prior to joining the AICPA, Mr. Melancon served for eight years as Executive Director of the Society of Louisiana CPAs.

Anne M. Mulcahy is Chairman and Chief Executive Officer of Xerox Corporation. In addition to the Xerox Board, Ms. Mulcahy serves on the Boards of Citigroup Inc., Fuji Xerox Co. Ltd., Target Corporation, and is the Chairman of the Corporate Governance Task Force of the Business Roundtable.

Richard H. Murray is Managing Director and Chief Claims Strategist of Swiss Re. Mr. Murray serves on the Supervisory Board of the Centre for the Study of Financial Innovation, the Advisory Board of Oxford Analytica, the Advisory Board of the Northeast Business Law Center, as a member of the Commission on the U.S. Capital Markets in the 21st Century, and the Institute of International Finance.

Gary John Previts is a Professor of Accountancy at Case Western Reserve University. He is a member of the Accountability Advisory Council of the U.S. Government Accountability Office and President of the American Accounting Association.

Damon A. Silvers is an Associate General Counsel for the AFL-CIO. Mr. Silvers led the AFL-CIO legal team that won severance payments for laid off Enron and WorldCom workers.

Richard A. Simonson is Executive Vice President and Chief Financial Officer of Nokia Corporation. Mr. Simonson has been a member of the Group Executive Board of Nokia since 2004 and the Board of Nokia Siemens Networks since April 1, 2007.

Sarah E. Smith is the Controller and Chief Accounting Officer of Goldman Sachs. She also serves on the firm's Risk Committee, the Commitments Committee, the Partnership Committee and the Private Equity Investment Committee and has oversight of Operational Risk. She is a member of the Washington-based Committee for Economic Development.

William D. Travis has been President and Chief Executive Officer of Bailiwick Data Systems, Inc. since 2007 and currently serves on the Board of Directors of McGladrey & Pullen, LLP, where he was previously Managing Director and Chairman.

Lynn E. Turner served as the Chief Accountant at the SEC from 1998 to 2001. He serves as a senior advisor to Kroll Zolfo Copper and is a member of the Standards Advisory Group of the Public Company Accounting Oversight Board and the Financial Accounting Standards Board Investor Technical Advisory Committee.

Paul A. Volcker served as Chairman of the Board of Governors of the Federal Reserve System. He is former Chairman of Wolfensohn & Co., Inc., as well as Professor Emeritus of International Economic Policy at Princeton University. He was recently Chairman of the Board of Trustees of the International Accounting Standards Committee.

Ann Yerger, CFA, is the Executive Director of the Council of Institutional Investors. She joined the Council in early 1996 as the Director of the Council's Research Service. She was named Executive Director in January 2005.

Committee observers include:

Robert H. Herz, Chairman of the Financial Accounting Standards Board

Mark W. Olson, Chairman of the Public Company Accounting Oversight Board

Zoe-Vonna Palmrose, Deputy Chief Accountant for Professional Practice in the Office of the Chief Accountant at the Securities and Exchange Commission

Michel Prada, Chairman of the Autorité des Marchés Financiers in France

Sir David Tweedie, Chairman of the International Accounting Standards Board

Appendix H

October 15, 2007
hp-610

Under Secretary for Domestic Finance

Robert K. Steel

Welcome and Introductory Remarks Before the Initial Meeting of the
Department of the Treasury's Advisory Committee on the Auditing Profession

Washington D.C.

Good morning. Welcome to the Department of the Treasury. Thank you for being here today at the initial meeting of the Advisory Committee on the Auditing Profession. I want to extend my gratitude as well as that of Secretary Paulson and the Department to the members of the Committee. We appreciate the generosity of your service.

I want to thank, in particular, the Co-Chairs of the Committee, former Securities and Exchange Commission Chairman Arthur Levitt, Jr. and former SEC Chief Accountant Donald T. Nicolaisen. The high regard in which these two gentlemen are held is reflected in the willingness of the distinguished individuals gathered around this table to serve as members of this Committee.

As many of you know, this Committee stems from the capital markets competitiveness initiatives that Secretary Paulson has spearheaded. Nearly a year ago, the Secretary delivered a speech on the need to maintain and enhance U.S. capital markets competitiveness. He specifically pointed out the sustainability of the auditing profession as a vital component to this competitiveness.[1]

The link between the auditing profession and capital markets competitiveness was established during the adoption of the federal securities laws almost 75 years ago. To assist in restoring investor confidence and encouraging capital development after the 1929 crash, the auditing profession, itself, lobbied for independent audits of financial statements as part of the legislative reforms Congress was considering.[2]

Agreeing with the profession, Congress mandated in the federal securities laws independently audited financial statements for all public companies. Certifying financial statements, the independent auditor would help accomplish the aims of the Securities Act of 1933 "to restore the confidence of the prospective investor in his ability to select sound securities; ...and to bring into productive channels of industry and development capital which has grown timid." [3]

Congress had decided then to bestow on the public company auditor a critical role of trust, integral to investor confidence, integral to the flow of capital. This trust clearly broke down at the beginning of this century when public company accounting scandals challenged the credibility of the auditing profession. Congress, considering what would eventually become the Sarbanes-Oxley Act of 2002, harshly reminded the profession: "[T]he franchise given to

public accountants by the securities laws is conditional; it comes in return for the CPA's faithful assumption of a public trust."^[4]

To restore credibility in the profession, the Sarbanes-Oxley Act mandated several major changes, the most prominent being the move from self-regulation and peer review to a system of federal oversight: The Public Company Accounting Oversight Board, whose creation has been termed the "centerpiece" ^[5] of the Act, now registers and inspects all public company auditing firms and sets and enforces auditing standards. The Sarbanes-Oxley Act also enhanced auditor independence standards, required mandatory auditing firm partner rotation, and strengthened the audit committee's role in monitoring the auditor and the audit process.

Five years have passed since the passage of this landmark legislation. The profession continues to adapt to these changes as it reasserts its role in enhancing investor confidence and the competitiveness of our capital markets. At the same time, the profession faces considerable challenges.

Secretary Paulson outlined these challenges in his competitiveness speech last year. I repeat his precise words:

- ◆ "Given the importance of accounting to our financial system, is there enough competition?"
- ◆ "Will our reformed accounting system produce the high-quality audits and attract the talented auditors we need?"
- ◆ "Do auditors seek detailed rules in order to focus on technical compliance rather than using professional judgment that could be second-guessed by the PCAOB or private litigants?"^[6]

The Department has charged the Committee with developing recommendations taking into consideration the issues impacting the sustainability of the auditing profession, including those raised by these questions. Neither the difficulty nor the importance of this task should be underestimated.

Again, we are grateful for your service. Secretary Paulson and the Department await your recommendations. I now yield the floor to the Co-Chairs for their meeting. Thank you.

[1] Henry M. Paulson, Jr., Secretary of the U.S. Department of the Treasury, *Remarks on the Competitiveness of the U.S. Capital Markets Before the Economic Club of New York* (Nov. 20, 2006).

[2] Gary John Previts & Barbara Dubis Merino, *A History of Accountancy in the United States: The Cultural Significance of Accounting* 723 (1998).

[3] S. Rep. No. 47, 73rd Cong., 1st Sess. 1 (Apr. 17, 1933).

[4] S. Rep. No. 205, 107th Cong., 2nd Sess. 6 (July 3, 2002).

[5] Douglas R. Carmichael, *The PCAOB and the Social Responsibility of the Independent Auditor, Accounting Horizons Vol. 18, No. 2, 127-33* (June 2004).

[6] Henry M. Paulson, Jr., Secretary of the U.S. Department of the Treasury, *Remarks on the Competitiveness of the U.S. Capital Markets Before the Economic Club of New York* (Nov. 20, 2006).

Appendix I

U.S. Department of the Treasury
Advisory Committee on the Auditing Profession

By-Laws and Operating Procedures

The following By-Laws and Operating Procedures (the “By-Laws”) will govern the operations of the Department of the Treasury (the “Department”) Advisory Committee on the Auditing Profession (the “Committee”).

Section I: Purpose, Organization, and Operation.

The purpose of the Committee is to provide informed advice and recommendations to the Department on the sustainability of a strong and vibrant public company auditing profession. The Committee will consider, among other things, the auditing profession’s ability to cultivate, attract, and retain the human capital necessary to meet developments in the business and financial reporting environment and ensure audit quality for investors; audit market competition and concentration and the impact of the independence and other professional standards on this market and investor confidence; and the organizational structure, financial resources, and communication of the auditing profession. The Secretary of the Treasury (“Secretary”) (or his designee) has determined that the establishment of the Committee is in the public interest. The Committee has been formed under the authority of the Federal Advisory Committee Act, 5 U.S.C. App. 2 §§ 1-16, as amended (“FACA”), which governs the creation and operation of advisory committees by federal agencies, by the filing of its Charter on July 3, 2007 with the Committee on Finance and the Committee on Banking, Housing, and Urban Affairs of the United States Senate and the Committee on Ways and Means and the Committee on Financial Services of the United States House of Representatives. In the event of any inconsistencies between the By-Laws and FACA (including its implementing regulations), the Committee will carry out its Charter in accordance with FACA (including its implementing regulations), as the same may be amended from time to time.

Section II: Members and Observers.

The Members of the Committee are appointed by the Department and serve at the sole discretion of the Secretary (or his designee) as may be appropriate for the accomplishment of the Committee’s purposes and in order to balance the viewpoints required to effectively address those purposes. Non-member Observers are invited by the Department to serve as observers of the Committee; they also serve at the sole discretion of the Secretary (or his designee). Observers do not have the right to vote or make a motion for a vote.

Section III: Meetings.

(A) **In General.** The Committee will meet at such intervals as are necessary to carry out its duties. Meetings may be called either by the Co-Chairs of the Committee with the approval of the Designated Federal Officer of the Committee appointed in accor-

dance with FACA (the “DFO”), or by the DFO. The Co-Chairs of the Committee will preside at all meetings of the Committee, unless the Secretary (or his designee) directs the DFO to preside in accordance with FACA. The presiding officer of the Committee may specify the use of rules of parliamentary procedure consistent with the By-Laws. Subject to such reasonable guidelines and procedures as the presiding officer of the Committee may adopt, Members and Observers may participate in a meeting by means of conference telephone or similar communications equipment if all Members and Observers can hear one another at the same time and members of the public entitled to hear them can do so.

(B) Notice. The Department will publish a notice of each meeting in the Federal Register at least 15 calendar days before the meeting, unless there are exceptional circumstances in which case the reasons will be included in the Federal Register notice. The notice will include (1) the name of the Committee; (2) the time, date, place, and purpose of the meeting; (3) a copy or summary of the agenda; (4) a statement as to whether all or part of the meeting will be open to the public and, if any part is closed, a statement as to why, citing the specific statutory provision that serve as a basis for closure; (5) any notice required by Section III(F) if oral public comment is to be excluded; and (6) the name and telephone number of the DFO or other Department official who may be contacted for additional information concerning the meeting.

(C) Agenda. The Co-Chairs of the Committee will draft an agenda for each meeting of the Committee sufficiently in advance of the meeting to permit a copy or summary of the agenda to be published with the notice of the meeting, if required. The DFO must approve the agenda before publication. The Department staff will distribute the approved agenda to the Members and Observers before each meeting and will make available copies of the agenda to members of the public attending the meeting. Items for the agenda may be submitted to the Co-Chairs through the DFO by any Member or Observer of the Committee or by any member of the public.

(D) Quorum. A quorum will consist of a simple majority of the Members (including the Co-Chairs of the Committee) then serving on the Committee, not including Observers.

(E) Voting. A Member must attend a Committee meeting either in person or by telephone, to cast a vote. When a decision or recommendation of the Committee is required, the presiding officer will request a motion for a vote. Any Member may make a motion for a vote and vote. No second after a proper motion will be required to bring any issue or recommendation to a vote. Committee action based on a vote requires a simple majority of the votes cast at a meeting at which there is a quorum.

(F) Open Meetings. Unless otherwise determined in advance, all meetings of the Committee will be open to the public. Once an open meeting has begun, it may not be closed for any reason. If, during the course of an open meeting, matters inappropriate for public disclosure arise during discussion, the presiding officer will order such discussion to cease and will schedule the matter for closed session in accordance

with FACA. All materials brought before, or presented to, the Committee during an open meeting will be made available to the public for review or copying during the meeting. All such materials also will be made available on the Department's web site as soon as practicable afterwards. The Co-Chairs of the Committee, with the approval of the DFO, may decide in advance to exclude oral public statements during a meeting, in which case the meeting notice published in the Federal Register will invite written statements as an alternative. Members of the public may submit written statements to the Committee at any time.

(G) Activities Not Subject to Notice and Open Meeting Requirements. Consistent with FACA regulations, the following activities are excluded from the procedural requirements contained in Sections III(B) and III(F): (a) Preparatory work. Meetings of two or more Committee Members or subcommittee members convened solely to gather information, conduct research, or analyze relevant issues and facts in preparation for a meeting of the Committee, or to draft position papers for deliberation by the Committee; and (b) Administrative work. Meetings of two or more Committee Members or subcommittee members convened solely to discuss administrative matters of the Committee or to receive administrative information from a Federal officer or agency.

(H) Closed Meetings. All or parts of meetings of the Committee may be closed in limited circumstances in accordance with applicable law. Requests for closed meetings must be submitted by the DFO to the Secretary (or his designee) under FACA, generally at least 30 days in advance of the publication of the meeting notice in the Federal Register. The appropriate Department official must determine that closing the meeting is consistent with the provisions of the Government in the Sunshine Act. Consistent with Section III(B)(4), the notice of the Committee meeting published in the Federal Register must include information on the closure.

(I) Hearings. The Committee may hold hearings to receive testimony or oral comments, recommendations and expressions of concern from the public. The Committee may hold hearings at open meetings or in closed session in accordance with the standards in the By-Laws for closing meetings to the public. The Co-Chairs of the Committee may specify reasonable guidelines and procedures for conducting orderly and efficient hearings, such as requirements for submitting requests to testify and written testimony in advance and placing limitations on the number of persons who may testify and the duration of their testimony.

(J) Minutes. The DFO will prepare minutes of each meeting of the Committee and submit them to the Co-Chairs of the Committee for certification of their accuracy. The minutes must be certified by the Co-Chairs of the Committee within 90 calendar days of the meeting to which they relate. The DFO will distribute copies of the certified minutes to each Member and Observer. Minutes of open or closed meetings will be made available to the public, subject to the withholding of matters about which public disclosure would be harmful to the interests of the Government, industry, or others, and which are exempt from disclosure under the Freedom of Information Act.

The minutes will include a record of persons present (including the names of Committee Members and Observers, names of Department and Committee staff providing support services to the Committee, and names of members of the public who presented written or oral statements); a complete and accurate description of the matters discussed and conclusions reached; and copies of all reports or other documents received, issued or approved by the Committee at the meeting.

Section IV: Officials.

(A) Co-Chairs. The Co-Chairs of the Committee are appointed by the Department and serve at the sole discretion of the Secretary (or his designee) to perform the duties specified in the Charter and the By-Laws. The Co-Chairs of the Committee will work with the DFO to establish priorities, identify issues that should be addressed, determine the level and types of staff and financial support required, and serve as the focal point for the Committee's membership.

(B) Vice Chair. The Vice Chair of the Committee is appointed by and serves at the sole discretion of the Co-Chairs of the Committee. The Vice Chair will provide assistance to the Co-Chairs of the Committee and will in the absence or incapacity of both of the Co-Chairs will perform the duties of the Co-Chairs as specified in the By-Laws.

(C) Counselor to the Co-Chairs. The Counselor to the Co-Chairs of the Committee is appointed by and serves at the sole discretion of the Co-Chairs. The Counselor to the Co-Chairs of the Committee will provide advice and assistance to the Co-Chairs.

(D) Designated Federal Officer. The DFO is designated by the Secretary (or his designee) and serves as the Department's agent for matters related to the Committee's activities. Under FACA, the DFO must, among other things, approve or call all meetings of the Committee, approve meeting agendas, attend meetings, and adjourn meetings when he or she determines such adjournment is in the public interest. In addition, the DFO is responsible for providing adequate staff support to the Committee, including staff to assist the DFO and the Co-Chairs of the Committee in the performance of the following functions: (1) notifying Members and Observers of the time and place for each meeting; (2) maintaining the roll; (3) preparing the minutes of all meetings of the Committee and its subcommittees, as required by FACA; (4) attending to official correspondence; (5) maintaining official Committee records, including subcommittee records, as required by law; (6) maintaining a website for the Committee; (7) acting on behalf of the Department to collect, validate and pay all vouchers for pre-approved expenditures of the Committee authorized by law; and (8) preparing and handling all reports, including the annual report of the Committee required by FACA.

(E) Support Staff. The Secretary (or his designee) has agreed that staff from the Department's Office of Domestic Finance, and in particular the Office of Financial Institutions, and other offices as necessary, will be available to the DFO to provide adequate staff support for the Committee. The Committee may, with the approval of the DFO, obtain such other staff or advisory or assistance services appropriate to the goals of the Committee.

Section V: Subcommittees.

The Co-Chairs of the Committee, with the approval of the DFO, may convene subcommittees to support the Committee's functions and may appoint Members and Observers to, and Chairs of, any subcommittees so convened. The Co-Chairs, the Vice Chair, and the Counselor to the Co-Chairs, will be ex officio members of all subcommittees. Only Members of the Committee will have the right to vote and make a motion for a vote in a subcommittee. No subcommittee will have any authority to provide advice or recommendations (1) directly to the Department or (2) to be adopted by the Committee without discussion or consideration at an open meeting of the Committee. All activities of the subcommittees will be in compliance with FACA.

Section VI: Steering Committee.

The Co-Chairs of the Committee, with the approval of the DFO, may convene a Steering Committee to support the Committee's functions and facilitate communication between the Chairs of subcommittees, if established, and the Co-Chairs, the Vice Chair, and the Counselor to the Co-Chairs. No Steering Committee will have any authority to provide advice or recommendations (1) directly to the Department or (2) to be adopted by the Committee without discussion or consideration at an open meeting of the Committee. All activities of the Steering Committee will be in compliance with FACA, as applicable.

Section VII: Records.

All documents, reports and other materials prepared by or submitted to the Committee constitute official governmental records and must be maintained and made publicly available in accordance with applicable law.

Section VIII: Expenses.

Expenses related to the operation of the Committee that are authorized by law will be borne by the Department. Expenses of any kind must be approved in advance by the DFO.

Section IX: Amendments.

The By-Laws may be amended from time to time by the affirmative vote of a majority of the Members (including the Co-Chairs) then serving.

Appendix J

Witnesses Who Testified Before the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession

December 3, 2007 Meeting

Panel I: Human Capital

Joseph V. Carcello, Director of Research, Corporate Governance Center, University of Tennessee

David W. Leslie, Chancellor Professor of Education, College of William and Mary

Ira Solomon, R.C. Evans Distinguished Professor, and Head, Department of Accountancy, University of Illinois

George S. Willie, Managing Partner, Bert Smith & Co.

Julie K. Wood, Chief People Officer, Crowe Chizek and Company LLC

Panel II: Firm Structure and Finances

Peter S. Christie, Principal, Friemann Christie, LLC

David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy

Lawrence A. Cunningham, Professor of Law, George Washington University Law School

James R. Doty, Partner, Baker Botts LLP

Dennis M. Nally, Chairman and Senior Partner, PriceWaterhouseCoopers LLP

Panel III: Concentration and Competition

Paul Boyle, Chief Executive, Financial Reporting Council

Lewis H. Ferguson, Partner, Gibson, Dunn & Crutcher LLP

Louis Grumet, Executive Director, New York State Society of Certified Public Accountants

Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP

Jeffrey C. Steinhoff, Managing Director, Financial Management & Assurance, U.S. Government Accountability Office

Panel IV: General Sustainability

Michael P. Cangemi, President and Chief Executive Officer, Financial Executives International

James D. Cox, Brainerd Currie Professor of Law, School of Law, Duke University

Ashwinpaul C. Sondhi, President, A. C. Sondhi & Associates LLC, and Member, CFA Institute

James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP

February 4, 2008 Meeting

Panel I: Human Capital

David B. Burritt, Chief Financial Officer and Vice President, Global Finance & Strategic Support Division, Caterpillar Inc.

Cynthia M. Fornelli, Executive Director, Center for Audit Quality

Brian James Jennings, Chief Financial Officer, Energy Transfer Partners L.P.

Philip M. J. Reckers, Professor of Accountancy, Arizona State University

Barry Salzberg, Chief Executive Officer, Deloitte LLP

Gilbert R. Vasquez, Managing Partner, Vasquez & Company LLP

Panel II: Firm Structure and Finances

John P. Coffey, Partner, Bernstein Litowitz Berger & Grossman LLP

Richard Fleck, Global Relationship Partner, Herbert Smith LLP

Joseph A. Grundfest, W. A. Franke Professor of Law and Business, Stanford Law School

Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System

Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors

D. Paul Regan, President and Chairman, Hemming Morse Inc.

Panel III: Concentration and Competition

Annalisa Barrett, Vice President and Senior Research Associate, The Corporate Library LLC

Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company

Brad Koenig, Former Managing Director and Head of Global Technology Investment Banking, Goldman Sachs

Neal D. Spencer, Managing Partner, BKD, LLP

Glenn W. Tyranski, Senior Vice President, Financial Compliance, NYSE Regulation Inc.

Appendix K

Committee Members, Observers, and Staff of the Advisory Committee

Members:

Arthur Levitt, Jr., Co-Chair
Senior Advisor, The Carlyle Group

Donald T. Nicolaisen, Co-Chair
Board Member, Morgan Stanley Corporation, MGIC Investment Corporation, Verizon Communications Inc., and Zurich Financial Services

Alan L. Beller
Partner, Cleary Gottlieb Steen & Hamilton LLP

Amy Woods Brinkley
Global Risk Executive, Bank of America Corporation
(Subcommittee on Human Capital)

Mary K. Bush
Board Member, Briggs and Stratton Corporation, Discover Financial Services, ManTech Corporation, and United Airlines Inc.
(Subcommittee on Concentration and Competition)

H. Rodgin Cohen
Chairman, Sullivan & Cromwell LLP
(Subcommittee on Concentration and Competition)

Timothy P. Flynn
Chairman and Chief Executive Officer, KPMG LLP
(Subcommittee on Firm Structure and Finances)

Robert R. Glauber
Board Member, Moody's Corporation, Freddie Mac Corporation, XL Capital Ltd., and Quadra Realty Trust
(Chair, Subcommittee on Firm Structure and Finances)

Ken Goldman
Chief Financial Officer, Fortinet Inc.
(Subcommittee on Concentration and Competition)

Gaylen R. Hansen

Board Member, National Association of State Boards of Accountancy, and Principal, Director of Accounting and Auditing Quality Assurance, Ehrhardt Keefe Steiner & Hottman PC
(Subcommittee on Firm Structure and Finances)

Barry C. Melancon

President and Chief Executive Officer, American Institute of Certified Public Accountants
(Subcommittee on Human Capital)

Anne M. Mulcahy

Chairman and Chief Executive Officer, Xerox Corporation
(Subcommittee on Human Capital)

Richard H. Murray

Managing Director and Chief Claims Strategist, Swiss Re
(Subcommittee on Firm Structure and Finances)

Gary John Previts

Chair, American Accounting Association, and Professor of Accountancy, Weatherhead School of Management, Case Western Reserve University
(Chair, Subcommittee on Human Capital)

Damon A. Silvers

Associate General Counsel, The American Federation of Labor and Congress of Industrial Organizations
(Chair, Subcommittee on Concentration and Competition)

Richard A. Simonson

Executive Vice President and Chief Financial Officer, Nokia Corporation
(Subcommittee on Concentration and Competition)

Sarah E. Smith

Controller and Chief Accounting Officer, Goldman Sachs Inc.
(Subcommittee on Human Capital)

William D. Travis

Director and Former Managing Partner, McGladrey & Pullen LLP
(Subcommittee on Firm Structure and Finances)

Lynn E. Turner

Former Chief Accountant, Securities and Exchange Commission, and Senior Advisor, Kroll Zolfo Cooper LLC
(Subcommittee on Firm Structure and Finances)

Paul A. Volcker
Former Chairman, Board of Governors, Federal Reserve System

Ann Yerger
Executive Director, Council of Institutional Investors
(Subcommittee on Firm Structure and Finances)

Observers:

Robert H. Herz
Chairman, Financial Accounting Standards Board

Conrad W. Hewitt
Chief Accountant, Securities and Exchange Commission

Mark W. Olson
Chairman, Public Company Accounting Oversight Board

Zoe-Vonna Palmrose
Deputy Chief Accountant for Professional Practice, Office of the Chief Accountant, Securities and Exchange Commission

Michel Prada
Chairman, Autorité des Marchés Financiers

Sir David Tweedie
Chairman, International Accounting Standards Board

The Department of the Treasury:

Robert K. Steel
Under Secretary for Domestic Finance

David G. Nason
Designated Federal Officer
Assistant Secretary for Financial Institutions

Kelly A. Ayers
Financial Economist
Office of Financial Institutions Policy

Michael Briskin
Senior Counsel
Office of the General Counsel

Ethan Carrier
Attorney-Advisor
Office of the General Counsel

Heidi Cohen
Senior Counsel
Office of the General Counsel

Gerry Hughes
Financial Analyst
Office of Financial Institutions Policy

Timothy M. Hunt
Financial Analyst
Office of Financial Institutions Policy

Kristen E. Jaconi
Senior Policy Advisor to the Under Secretary for Domestic Finance

Steven D. Laughton
Senior Counsel
Office of the General Counsel

Serita D. Winborne
Travel Coordinator
Secretary to the Deputy Assistant Secretary of Financial Institutions Policy

Jennifer Zuccarelli
Director
Office of Public Affairs

Appendix L

Working Discussion Outline

Advisory Committee on the Auditing Profession

Over-Arching Principles

- The work and recommendations of the Advisory Committee on the Auditing Profession should be designed to further the mission of the Department of the Treasury to promote and encourage prosperity and stability by both improving the quality of the audit process and audits and ensuring the viability and resilience of the public company auditing profession.
- Enhancing the quality of the audit process and audits should contribute to the viability and resilience of the public company auditing profession.
- Confidence in the public company auditing profession is enhanced and strengthened when the profession operates in a manner transparent to investors and market participants, and adopts governance best practices.
- The quality of the audit process and audits is accomplished when the credibility of the audit meets the needs of investors and increases as the following objectives are achieved.
 - The audit process and audits should contribute to investor confidence in the financial statements by ensuring that the financial statements are reliable, complete, and timely.
 - The audit process and audits should contribute to the transparency of financial reporting for preparers and investors.
 - Audits should lower the cost of capital to companies that are audited (as a group and over time).
 - The benefits of the audit process and audits to investors, preparers, and the marketplace should outweigh the costs of the audit process and audits to preparers and their owners.
 - Investors and the marketplace should understand the purposes, limitations, and results of the audit process and audits, and have confidence in the credibility of the audit provided and the quality of the services performed.
 - Material financial frauds are detected and reported in a timely fashion adding to investor confidence in the reliability of the audit process and audits.

- The viability and resilience of the public company auditing profession are enhanced when a high quality audit is delivered to investors and the following objectives are achieved.
 - o The public company auditing profession should attract and develop employees adequately prepared to perform high quality audits.
 - o The public company auditing profession should be financially and structurally sound.
 - o The public company auditing profession should operate under standards of independence necessary to maintain investor confidence and the quality of audit processes and audits.
 - o The audit market benefits from a competitive and innovative population of auditing firms.

1. Consideration of Prior Recommendations.

- 1.1. Consider the recommendations of past committees studying the auditing profession, including:
 - 1.1.1. Commission on Auditors' Responsibilities ("Cohen Commission") (1978).
 - 1.1.2. National Commission on Fraudulent Financial Reporting ("Treadway Commission") (1987).
 - 1.1.3. Panel on Audit Effectiveness ("O'Malley Panel") (2000).

2. Human Capital and Its Impact on Audit Quality.

- 2.1. Consider whether the increase and enrichment of the pool of human capital in the public company auditing profession can improve audit quality.
- 2.2. Identify and consider potential areas of inquiry and courses of action:
 - 2.2.1. Recruitment and training.
 - 2.2.2. Retention, professional advancement, and alternatives.
 - 2.2.3. Education.
 - 2.2.3.1. Undergraduate.
 - 2.2.3.2. Graduate.
 - 2.2.3.3. Continuing education.
 - 2.2.3.4. Relationship between continuing education and professional development.
- 2.3. Consider the recruitment, training, retention of accounting graduates.

2.3.1. Recruitment.

- 2.3.1.1. Demand for accountants predicted to grow 18-26% through 2014 (U.S. Bureau of Labor Statistics).
- 2.3.1.2. Increasing level of retirements and lack of commensurate replacement may portend a shortage of qualified accountants.
- 2.3.1.3. Enrollments in accounting programs and accounting graduates up 19% from 2000 to 2004. Increase of 9% to 40,400 Bachelor's degree recipients from 2003 to 2004.
- 2.3.1.4. Women were more than half of the 2006 accounting graduates. In 2004, minorities accounted for 23% of accounting graduates. Women account for 19% of all auditing firm partners. Minorities held 13.5% and caucasian women held 32.4% of all "officials and managers" positions in the accounting industry; 7% of auditing firms CPAs are minorities (AICPA).
- 2.3.1.5. Consider the actions that can be undertaken to seek to ensure that there is a sufficient number of graduates to meet the growing demand for auditing services.
- 2.3.1.6. Consider the actions that can be undertaken to seek to ensure the attraction of a diverse group of individuals to the auditing profession.
- 2.3.1.7. Consider and compare the competitiveness of auditing industry recruitment with other industries and disciplines who recruit similar students and the reasons for the success of some of these other industries and disciplines. Consider the compensation structure in these other industries and disciplines.

2.3.2. Training and supervision, and evaluation; continuing education.

- 2.3.2.1. The largest auditing firms offer training programs to employees as a supplement to undergraduate and post-graduate education.
- 2.3.2.2. Consider whether and how training can be enhanced to seek to ensure high quality audits.

- 2.3.2.3. Consider whether and how training can be enhanced to foster recruitment, retention, and professional advancement.
- 2.3.2.4. Consider whether high ethical standards are incorporated into training and employee evaluations.
- 2.3.2.5. Consider whether employees are trained and evaluated to make decisions that ensure the representational faithfulness of the financial statements.
- 2.3.2.6. Consider the impact of the size of an auditing firm and its ability to recruit, retain, and offer training to accounting graduates on audit quality.
- 2.3.2.7. Consider whether and how continuing education programs can be enhanced to seek to ensure high-quality audits.
- 2.3.2.8. Consider whether and how continuing education can be enhanced to foster recruitment, retention, and professional advancement.
- 2.3.2.9. Consider how the use of the Internet and other technological developments can be used to enhance training and continuing education.
- 2.3.2.10. Consider whether and how training and continuing education relating to International Financial Reporting Standards and international auditing standards need to be enhanced.
- 2.3.2.11. Consider whether and how training and continuing education relating to financial reporting tools and developments, such as eXtensible Business Reporting Language, can be enhanced.
- 2.3.2.12. Consider whether improved supervision at the auditing firms is needed to ensure high-quality audits. Consider ways to foster improved supervision, if needed. Consider whether and how training and continuing education can be enhanced to provide accountants with improved management and supervisory skills as they reach the supervisory levels.
- 2.3.2.13. Consider the processes by which auditing firms train and

develop employees for the appropriate auditing assignments.

2.3.2.14. Consider whether the Public Company Accounting Oversight Board should have a role in enhancing training, supervision, and continuing education, and, if so, what that role should be. Consider interviewing the PCAOB regarding its inspection process.

2.3.3. Retention.

2.3.3.1. AICPA survey: 15-20% turnover rates at the largest auditing firms; lower turnover rates at smaller firms.

2.3.3.2. Consider the ways auditing firms can improve retention of quality partners and employees. Consider the reasons accountants are leaving the profession. Consider whether the public company auditing profession is viewed as providing a challenging and fulfilling work environment. Consider whether the public company auditing profession is respected and whether the degree of respect impacts employee retention. Consider whether and how liability risk impacts partner and employee retention. Consider whether and how the auditor independence standards impact partner and employee retention. Consider whether the auditing firms are investing in technologies that can improve employee retention and experience. Consider the compensation structure of auditors vis-à-vis other financial services industry professionals.

2.4. Consider the state of accounting education and CPA licensing requirements.

2.4.1. Consider the accounting curriculum.

2.4.1.1. Multi-disciplinary approach vs. technical approach.

2.4.1.1.1. Debate since the late 1950s.

2.4.1.1.2. Consider whether the accounting curriculum should focus on technical accounting standards or also reflect to a greater degree a multi-disciplinary approach focusing on business, finance, law, and ethics and other areas.

- 2.4.1.1.3. Consider what approach is more likely to ensure high quality audits.
- 2.4.1.1.4. Consider what approach teaches high ethical standards.
- 2.4.1.1.5. Consider whether there is a role for increased clinical education at the undergraduate or graduate level. Consider whether the current accounting curriculum prepares accounting graduates for their first positions in the auditing industry.
- 2.4.1.1.6. Consider the impact on the curriculum of the potential acceptance of International Financial Reporting Standards and international auditing standards.
- 2.4.1.1.7. Consider the impact on the curriculum of the Internet and technological developments, such as eXtensible Business Reporting Language.
- 2.4.1.2. The 150-hour requirement, the 120-hour requirement, and the professional school of accountancy.
 - 2.4.1.2.1. In 1998, the American Institute of Certified Public Accountants approved the 150-hour requirement for application for AICPA membership, reasoning the extra year or 30 hours of post-graduate education should replace the 120-hour requirement, given accounting complexity.
 - 2.4.1.2.2. 48 of 54 states and jurisdictions have adopted the 150-hour requirement, thus making 150 hours mandatory to be licensed as a CPA. Yet many states test at the 120-hour level.
 - 2.4.1.2.3. Consider the costs and benefits of the 150-hour requirement.
 - 2.4.1.2.4. Consider the impact of the 150-hour require-

- ment upon the recruitment of undergraduates as accounting majors.
- 2.4.1.2.5. Consider whether the 150-hour requirement has improved audit quality.
- 2.4.1.3. Academics and practice.
- 2.4.1.3.1. Some observers have suggested that much academic research focuses on social science research rather than the skills and judgments needed to ensure high quality audits. Consider the possible “schism” between the academic and practice communities.
- 2.4.1.3.2. Consider what “common body of knowledge” accounting students should acquire.
- 2.4.1.3.3. Consider whether accounting academics need to be encouraged to undertake a more “practice-oriented” approach, including more practice-oriented research.
- 2.4.1.3.4. Consider whether professional training programs and continuing education better provide the additional information and perspective beyond technical skill and academic education that can assist in developing the judgment and other practical skills necessary for high-quality audits.
- 2.4.2. Consider the status of accounting faculty.
- 2.4.2.1. Shortage of faculty PhDs.
- 2.4.2.1.1. In 1967, the Association to Advance Collegiate Schools of Business decided that the doctorate was the terminal degree needed to teach accounting in the collegiate setting. To maintain the AACSB accreditation, 50% of faculty must have doctorates in accounting.
- 2.4.2.1.2. One-half of accounting faculty is eligible to

retire in the next few years: One-third of accounting faculty is 60 or older; one-half is 55 or older.

2.4.2.1.3. Consider the reasons for this potential accounting faculty shortage, including doctoral program recruitment and compensation.

2.4.2.1.4. Consider ways to increase the number of accounting faculty. Consider the AACSB accreditation requirements.

2.4.2.2. The impact of an increasingly complex and globalized financial reporting environment on accounting faculty.

2.4.2.2.1. Consider ways to ensure that accounting faculty is able to prepare students to undertake high quality audits in a complex financial reporting environment. Consider ways to encourage faculty to keep apprised of financial reporting and auditing profession developments.

3.1. Consider the state licensing regime.

3.1.1. Consider the impact of a multi-state licensing regime on audit quality.

3.1.2. All 50 states and 5 territories through state licensing boards license certified public accountants. State boards set requirements for moral character, higher education, continuing education, experience, and examination for licensure as a CPA. State boards set ethical and continuing practice standards and possess disciplinary powers.

3.1.3. Consider the costs and benefits of a multi-state licensing regime.

3.1.4. Consider whether the Uniform Accountancy Act, promulgated by the American Institute of Certified Public Accountants and the National Association of State Boards of Accountancy and aiming to increase licensing uniformity, addresses the inefficiencies of multi-state licensing.

3.1.5. Consider the relationship between the multi-state licensing regime and the Public Company Accounting Oversight Board.

- 3.2. Consider whether a professional qualification or other mechanism for public company auditing firms, in addition to registration with the Public Company Accounting Oversight Board, should be established similar to what currently exists for individuals with CPA licensing.
- 3.3. Consider whether and, if so, how the Public Company Accounting Oversight Board can enhance qualification and related mechanisms for public company auditing firms as a result of its registration, inspection, or disciplinary regime.
 - 3.3.1. Examining qualifications of individuals or firms.
 - 3.3.2. Training or remediation.
 - 3.3.3. Monitoring and supervision.
- 3.4. Consider insurability and liability risk.
 - 3.4.1. Liability.
 - 3.4.1.1. A September 2006 European Commission study reported that the total costs of judgments, settlements, legal fees, and related expense for U.S. audit practices of the largest accounting firms had risen to \$1.3 billion in 2004, or 14.2% of revenue, up from 7.7% in 1999.
 - 3.4.1.2. Consider the impact of auditor liability risk on human capital, the nature of the audit process, and the conduct of audits, including the use of judgment and possibility of “defensive auditing,” and other aspects of audit quality, including whether potential liability increases audit quality.
 - 3.4.1.3. Consider major financial frauds and how auditor behavior and/or audit failure has contributed to increased liability exposure and costs.
 - 3.4.1.4. Consider whether any potential changes should be considered in auditor liability regimes.
 - 3.4.1.5. Consider how altering auditor liability regimes would impact audit quality.
 - 3.4.1.6. Consider how altering auditor liability regimes would impact investors.

- 3.4.1.7. Consider the costs and benefits of various auditor liability regimes (and corresponding disclosure regimes) to investors and the marketplace (including issues of moral hazard).
- 3.4.2. Status of insurability.
 - 3.4.2.1. Smaller auditing firms are generally able to purchase commercial insurance to cover professional liability claims. Smaller firms can purchase insurance through American Institute of Certified Public Accountants, which established the AICPA Professional Liability Insurance Program in 1967, currently serving over 24,000 auditing firms.
 - 3.4.2.2. The largest auditing firms are unable to purchase commercial insurance directly in the marketplace and must use captive insurance funds.
 - 3.4.2.3. Understand the insurance and risk management practices of the larger auditing firms in the United States.
 - 3.4.2.4. Consider how major audit failures have impacted the insurability of the auditing firms.
 - 3.4.2.5. Consider the impact of potential litigation exposure on audit quality.
 - 3.4.2.6. Consider whether auditing firms in the United States should be required to maintain a certain level of insurance.
 - 3.4.2.7. Consider the reasons why the largest auditing firms are prevented from being offered commercial insurance.
 - 3.4.2.8. Consider how altering insurance structures or regimes would impact audit quality.
 - 3.4.2.9. Consider the costs and benefits of various insurance structures and regimes to investors and the marketplace (including issues of moral hazard).
- 3.5. Consider organizational structure.
 - 3.5.1. Most auditing firms in the United States are organized as limited liability entities, the largest being limited liability partnerships. The largest auditing firms have global networks of affiliates.

- 3.5.2. Consider the impact these limited liability entities have on the quality of corporate governance, including management succession, oversight, compensation, and audit quality.
 - 3.5.3. State law and independence standards may prohibit investment of outside capital, typically limiting capital investment and partnership interests to the auditing partners themselves.
 - 3.5.4. Consider whether alternative structures exist for auditing firms beyond the limited liability entity model and whether and how any such structure could enhance audit quality.
 - 3.5.5. Consider how the global network of affiliate structure impacts audit quality.
 - 3.5.6. Consider whether and how consistency is ensured across auditing firms. Consider whether there is consistency between auditing firms' global affiliate structure and their integrated global marketing activities and practice activities. Consider whether and how any such inconsistencies within a network impact audit quality.
 - 3.5.7. Consider whether there is an approach to a global structure and organization that could lead to enhanced audit quality. Consider the feasibility of such a structure and any regulatory or financial consequences. Consider how liability and insurance issues relate to global structuring issues.
 - 3.5.8. Consider how the varying degree of quality in financial reporting and auditing and regulatory and enforcement regimes impact organizational structure and capital resources.
 - 3.5.9. Consider how the potential acceptance of International Financial Reporting Standards in the United States and the greater use of fair value and mark-to-model accounting will impact the largest auditing firms' network of affiliates.
- 3.6. Consider transparency and governance.
- 3.6.1. Auditing firms provide the Public Company Accounting Oversight Board with proprietary information. The European Union recently adopted reporting requirements (to be effective in June 2008) for public company auditors relating to issues such as a firm's legal structure and ownership, governance, and internal quality control system.
 - 3.6.2. Consider what, if any, governance failures at the auditing firms occurred and contributed to failures in the provision of audit services and non-attest services.

- 3.6.3. Consider to what extent, if any, auditing firms should disclose to the public their internal organization, governance, and financial resources and whether and how such a practice could enhance audit quality.
- 3.6.4. Consider whether and, if so, there should be public participation in firm governance, for example through an advisory board or ombudsman or other mechanism, and whether and how such a mechanism could enhance audit quality.
- 3.6.5. Consider whether the auditing firms, themselves, should prepare audited GAAP financial statements for filing with the Public Company Accounting Oversight Board or the public.
- 3.6.6. Consider how increased transparency and strengthened governance affects audit quality.
- 3.6.7. Consider how state laws and auditor independence standards impact auditing firm governance.
- 3.6.8. Consider whether and how governance matters impact issues and conclusions regarding liability and insurance.
- 3.7. Auditor responsibility for fraud detection and improving communication with investors.
 - 3.7.1. Examine the auditor's responsibility for fraud detection and whether it is resulting in enhanced investor confidence in the reliability of the financial statements.
 - 3.7.2. The standard auditor report consists of a standardized four paragraphs stating management and auditor responsibilities, the nature of the audit, the auditor's opinion on the financial statements, and, if the audited company is subject to the Sarbanes-Oxley Act, the effectiveness of internal controls.
 - 3.7.3. Consider whether the auditor report should be more descriptive so as to improve communication with the public and investor community.
 - 3.7.4. Consider whether and, if so, how the auditor report could more clearly define the role of the auditor vis-à-vis financial statements.
 - 3.7.5. Consider the role of the auditor in the audit.
 - 3.7.6. Consider the expectations of investors and the marketplace relating to the auditor report and the audit. Consider whether and, if so, what sort of fraud investors and the marketplace expect auditors to detect.
 - 3.7.7. Consider the impact, if any, of changes in auditor reports on audit quality.

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

- 4.1.1. According to a 2004 GAO Report, the largest auditing firms audit over 78% of U.S. public companies and 99% of public company revenues. According to a 2004 J.D. Power & Associates survey, about one of every eight public companies retained three or more of the largest auditing firms for attest and non-attest work.
- 4.1.2. Examine whether there should be fundamental changes made in who pays the audit fee to the auditor.
- 4.1.3. Consider the impact on the structure of the public company auditing profession of the following:
 - 4.1.3.1. Auditor independence standards.
 - 4.1.3.1.1. Consider how the auditor independence standards impact audit quality, audit market competition, and the pool of human capital.
 - 4.1.3.1.2. Consider whether there is an “appropriate balance” between the auditing services and the non-attest services that auditing firms are providing today.
 - 4.1.3.1.3. Consider how auditing firms’ employee assignment process relating to auditing services and non-attest services impacts the pool of human capital.
 - 4.1.3.2. Mandatory partner and firm rotation.
 - 4.1.3.2.1. Consider whether and, if so, how mandatory partner rotation impacts auditing firms and their ability to ensure audit quality.
 - 4.1.3.2.2. Consider whether mandatory partner rotation impacts both the larger and smaller auditing firms in the same way.
 - 4.1.3.2.3. Examine the benefits and costs of periodic firm rotation.
 - 4.1.3.3. Other professional standards.

- 4.1.3.3.1. Consider whether, and, if so, how other professional standards or requirements impact the structure of the public company auditing profession.
- 4.1.3.4. Complexity.
- 4.1.3.4.1. Consider whether, and, if so, how the complexity of business and financial products affects audit quality, including the auditing firms' educational and supervisory roles. Consider whether the complexity of business and public companies, along with the accompanying financial reporting, accounting, and auditing standards prevents auditing firms with fewer resources from entering into the larger public company audit space.
- 4.1.3.4.2. Consider whether the global convergence of accounting standards and the global convergence of auditing standards encourage more audit market competition.
- 4.1.3.5. Globalization.
- 4.1.3.5.1. Consider the relative financial, human resources, and geographical capabilities of the largest auditing firms, the mid-size auditing firms and the smaller auditing firms.
- 4.1.3.5.2. Consider and compare the capabilities of the different sizes of auditing firms with the requirements of the large, mid, and small capitalization public companies.
- 4.1.3.5.3. Consider how the increasing globalization of the capital markets affects audit market concentration among the largest auditing firms who have global networks of affiliates.
- 4.1.3.5.4. Consider whether larger auditing firm resources are necessary for a high quality audit for larger, international companies.
- 4.1.3.5.5. Consider the ability of certain firms to carve out niches among certain multi-national sectors.
- 4.1.3.5.6. Consider how the potential acceptance of International Financial Reporting Standards and international auditing standards will impact audit market competition.

- 4.1.4. Consider how audit market concentration impacts audit quality.
 - 4.1.4.1. Consider the reasons for public companies' seeking new auditors.
 - 4.1.4.2. Consider whether auditing firms are competing for services based on audit quality.
 - 4.1.4.3. Consider the bases on which auditing firms compete today in the United States and internationally, including an assessment of audit fee changes when auditors compete for new audits.
- 4.1.5. Consider the potential consequences of a larger auditing firm failure.
 - 4.1.5.1. Consider the sort of risks a larger auditing firm failure poses to the marketplace and investors.
 - 4.1.5.2. Consider the causes of major audit failures and steps that could be taken to prevent their reoccurrence.
 - 4.1.5.3. Consider whether and, if so, how, securities and auditing firm regulators should attempt to mitigate the risk or the impact of a larger auditing firm failure.
- 4.1.6. Consider ways to increase audit market competition.
 - 4.1.6.1. Consider the impact of auditing firm mergers on industry competition and whether a public policy change with respect to a lack of competition is warranted.
 - 4.1.6.2. Consider whether regulators are now faced with a "Too Big to Fail" public policy, and if so, consider whether public policy changes are warranted and the nature of those changes.
 - 4.1.6.3. Consider how greater auditor choice can be fostered in the marketplace by the public and private sectors.
 - 4.1.6.4. Consider whether there are public company sectors where audit market choice is growing.
 - 4.1.6.5. Consider the ability of certain auditing firms to create niche-markets.
 - 4.1.6.6. Consider how private sector participants, such as underwriters and lawyers, impact audit market choice.

Appendix M

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