

COUNCIL OF INSTITUTIONAL INVESTORS

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Via Email

March 31, 2008

Nancy M. Morris
Federal Advisory Committee Officer
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

*Re: Progress Report of the SEC Advisory Committee on Improvements to
Financial Reporting (File Number: 265-24)*

Dear Ms. Morris:

The Council of Institutional Investors (“Council”) appreciates the opportunity to provide our input on the Progress Report of the SEC Advisory Committee on Improvements to Financial Reporting (“Progress Report”).¹ The Council is an association of more than 130 public, corporate, and union pension funds with combined assets of over \$3 trillion.²

As a leading voice for long-term, patient capital, the Council believes that accurate, transparent, and understandable financial accounting and reporting information is critical to investors in making investment decisions and to the overall well-being of the capital markets. That strong belief is reflected in the Council’s policy on “Independence of Accounting and Auditing Standard Setting”³ unanimously approved by our General Members⁴ last year.

¹ Progress Report of the SEC Advisory Committee on Improvements to Financial Reporting, Securities Act Release No. 8896, Exchange Act Release No. 57,331 (Feb. 14, 2008), *available at* <http://www.sec.gov/rules/other/2008/33-8896.pdf> [hereinafter *Progress Report*].

² A list of the members of the Council of Institutional Investors (“Council”) can be downloaded at http://www.cii.org/about/council_members.

³ Council, Policies on Other Governance Issues, Independence of Accounting and Auditing Standard Setting 1 (adopted Mar. 20, 2007), *available at* <http://www.cii.org/UserFiles/file/council%20policies/Redesigned%20CII%20Policies%20on%20Other%20Governance%20Issues%201-29-08.pdf> [hereinafter *Council Policies*]. The governance policies of the Council are part of a living document that is constantly reviewed and updated. Council, Council Policies (2008), *available at* <http://www.cii.org/policies>. Those policies are intended to set standards or recommended best practices that the Council members believe companies and boards should adopt. *Id.*

⁴ Council “General Members” are restricted to employee benefit plans, state or local agencies officially charged with the investment of plan assets, non-profit endowment funds and non-profit foundations. Council, General Members (2008), *available at* http://www.cii.org/about/council_members. General members are eligible to participate in all Council meetings and seminars sponsored by the Council and are

The Council's policy on the Independence of Accounting and Auditing Standard Setting states:

. . . [F]inancial statements and their related disclosures are a critical source of information to institutional investors making investment decisions. The well-being of the financial markets—and the investors who entrust their financial present and future to those markets—depends directly on the quality of the information audited financial statements and disclosures provide. The quality of that information, in turn, depends directly on the quality of the standards that: . . . preparers use to recognize and measure their economic activities and events The result should be accurate, transparent, and understandable financial reporting.

The responsibility to issue and develop accounting and auditing standards should reside with independent private sector organizations with an appropriate level of government input and oversight. Those organizations should possess adequate resources and the technical expertise necessary to fulfill this important role. Those organizations should also include significant representation from investors and other users of audited financial reports on the organizations' boards and advisory groups. Finally, those organizations should employ a thorough public due process that includes solicitation of public input on proposals and consideration of user views before issuing final standards. The United States Congress, the Securities and Exchange Commission ("SEC"), and other federal agencies and departments should respect and support the independence of the designated accounting and auditing standard setting organizations and refrain from interfering with or overriding the decisions and judgments of those bodies.⁵

the only voting members of the Council. *Id.* A list of the Council's General Members can be downloaded at http://www.cii.org/UserFiles/file/about/general_members_list_1-18-2008.pdf.

⁵ *Council Policies*, *supra* note 3, at 1.

Consistent with the basis for the Council's policy, we generally support the U.S. Securities and Exchange Commission's initiative ("SEC" or "Commission") to charter the Advisory Committee on Improvements to Financial Reporting ("Committee") and to assign the Committee the objective of examining the "U.S. financial reporting system in order to make recommendations intended to increase the usefulness of financial information to *investors*, while reducing the complexity of the financial reporting system to *investors*, companies, and auditors."⁶

We are hopeful that the Committee will, in accordance with its assigned objective and the Progress Report's description of "key themes," "give pre-eminence to the needs of investors" in developing its final report.⁷ We are also hopeful that the SEC will similarly focus on its obligation "to protect investors" in determining which of the Committee's recommendations, if any, should be further pursued.⁸ It is in that context, that we respectfully offer the following comments in response to certain of the Progress Report's developed proposals and conceptual approaches that are of particular interest to Council members:

Developed Proposal 2.1: Additional investor representation on standards-setting bodies is central to improving financial reporting. Only if investor perspectives are properly considered by all parties will the output of the financial reporting process meet the needs of those for whom it is primarily intended to serve. Therefore, the perspectives of investors should have pre-eminence. To achieve that pre-eminence in standards-setting, the SEC should encourage the following improvements:

- ***Add investors to the Financial Accounting Foundation (FAF) to give more weight to the views of different types of investors, both large and small***
- ***Give more representation on both the FASB and the FASB staff to experienced investors who regularly use financial statements to make investment decisions to ensure that standards-setting considers fully the usefulness of the resulting information.***

⁶ *Progress Report*, *supra* note 1, at 1 (emphasis added).

⁷ *Id.* at 2.

⁸ U.S. Securities and Exchange Commission ("SEC"), *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation 1* (modified February 21, 2008), available at <http://www.sec.gov/about/whatwedo.shtml>.

As a general matter, the Council, as suggested by our policy on Independence of Accounting and Auditing Standard Setting, does not support the Committee directing this or any of its proposals regarding the Financial Accounting Foundation (“FAF”) or the Financial Accounting Standards Board (“FASB” or “Board”) to the SEC. As strong believers in the benefits to investors of maintaining an independent private sector accounting standard setting system, we believe that any Committee recommendations regarding the procedures of the FAF or FASB should give deference to the existing structure of independent private sector standard setting by directing those recommendations to the FAF or the FASB rather than to the Commission.⁹

The Council generally agrees with the Committee that input to the accounting standard setting process has historically been dominated by large company preparers and large audit firms and this imbalance has contributed to accounting standards that have sometimes failed to meet the needs of investors “for which it is primarily intended to serve.”¹⁰ We also agree with the Committee that there are at least two related means of addressing this imbalance and enhancing the utility of financial reports to investors: (1) by increasing “investor representation on standards-setting bodies;” and (2) by financial reporting regulators and standard-setters truly adopting the view that the “perspectives of investors should be pre-eminent . . . , because all stakeholders benefit from a system that allocates capital more efficiently.”¹¹

Thus, analogous to the Committee’s proposal to “[a]dd investors to the . . . FAF,” the Council has publicly expressed support for “increasing the investor representation on the FAF.”¹² We also agree with the Committee that the FAF’s recently adopted changes to “nominating and electing the FAF Trustees”¹³ fell short of ensuring and maintaining “additional investor representation on the FAF. . . .”¹⁴

⁹ See Rules of Procedure 4-8 (Fin. Accounting Standards Bd. amended & restated through Dec. 1, 2002) (on file with Council) (describing the organization of the Financial Accounting Foundation (“FAF”), Financial Accounting Standards Board (“FASB”), and the Financial Accounting Standards Advisory Council).

¹⁰ *Progress Report*, *supra* note 1, at 34.

¹¹ *Id.*

¹² Letter from Jeff Mahoney, General Counsel, Council, to Teresa S. Polley, Chief Operating Officer, FAF 2-3 (Feb. 11, 2008) [hereinafter *Letter from Jeff Mahoney*].

¹³ FAF Board of Trustees, Corporate Governance Changes to Oversight, Structure, and Operations of the FAF, FASB, and GASB 3 (Fin. Accounting Found. adopted on Feb. 26, 2008), *available at* <http://www.fasb.org/faf/FAFGovernanceResolutions02-27-08.pdf> [hereinafter *FAF Board of Trustees*]

¹⁴ *Progress Report*, *supra* note 1, at 34.

The Council also generally agrees with the Committee's proposal for more "representation on both the FASB and the FASB staff to experienced investors . . . to ensure that standards-setting considers fully the usefulness of the resulting information." We have publicly taken the position, compatible with the view expressed in 1992 by then SEC Chairman Richard C. Breeden,¹⁵ that "at least two of the seven members of the FASB should be qualified investors or other qualified users of financial reports."¹⁶

The Council, however, generally disagrees with the Committee's view that the FAF's recent decision to reduce the size of the Board from seven to five members "increase[s] the influence of investors;"¹⁷ particularly since the absolute number of investors on the FASB (one) was not changed.¹⁸ We and many, if not most investors, preparers, and auditors of financial reports, strongly opposed the FAF's decision.¹⁹ We, and many of those commentators, concluded that such a change would not be in the best interests of investors for a number of reasons, including: "(1) there will be fewer Board members available to take leadership roles on standard setting projects and related research and technical activities, and (2) there will be fewer Board members to engage in external communications and dialogue with investors and other interested parties—important elements of a high quality standard setting process."²⁰

We are troubled by the Committee's apparent view that "capacity concerns" caused by fewer Board members "may be mitigated by more delegation of responsibilities to senior staff members and a possible increase in the size of the FASB staff."²¹ We believe that an important and unique feature of the FASB's due process, and one that we continue to support, is that FASB Board members actively deliberate and vote on all of the key issues in the development of a standard in open public meetings. In our view, those public deliberations—generally unscripted and not infrequently contentious—enhances the credibility of the standard setting process and the accountability of the individual Board members. Those deliberations should not be delegated to staff.

¹⁵ Letter from Richard C. Breeden, Chairman, SEC, to Shaun O'Malley, President, FAF 1 (Oct. 22, 1992) (on file with Council).

¹⁶ Letter from Jeff Mahoney, *supra* note 12, at 3 (footnote omitted).

¹⁷ Progress Report, *supra* note 1, at 34.

¹⁸ FAF Board of Trustees, *supra* note 13, at 3.

¹⁹ See, e.g., Andrew Osterland, *Despite Criticism, FASB Downsizes Itself*, Financial Week, Feb. 27, 2008, at 1, available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080227/REG/413651185> ("The vote to downsize came despite nearly unanimous disapproval expressed in 59 comment letters to the board").

²⁰ Letter from Jeff Mahoney, *supra* note 12, at 3.

²¹ Progress Report, *supra* note 1, at 35.

We certainly do not question the abilities and professionalism of the staff of the FASB. We, however, observe that few, if any FASB staff, have the depth of practical financial reporting experience and knowledge that historically has been, and in our view should continue to be, a key qualification for FASB Board members.²²

Developed Proposal 2.3: The SEC should encourage the FASB to further improve its standards-setting process and timeliness, as follows:

- ***Create a formal Agenda Advisory Group that includes strong representation from investors, the SEC, the PCAOB, and other constituents, such as preparers or auditors, to make recommendations for actively managing U.S. standards-setting priorities***
- ***Refine procedures for issuing new standards by: (1) implementing investor pre-reviews designed to assess perceived benefits to investors, (2) enhancing cost-benefit analyses, and (3) requiring improved field visits and field tests***
- ***Improve review processes for new standards by conducting post-adoption reviews of every significant new standard, generally within one to two years of its effective date, to address interpretive questions and reduce the diversity of practice in applying the standard, if needed***
- ***Improve processes to keep existing standards current and to reflect changes in the business environment by conducting periodic assessments of existing standards.***

The Council generally does not support the Committee's proposal to "[c]reate a formal Agenda Advisory Group." We note that the Committee views the creation of the Agenda Advisory Group as a complement to the "FAF's . . . changes to the FASB's agenda-setting process in which the FAF . . . [gave] the FASB Chairman control over the FASB's agenda."²³

²² See Rules of Procedure at 6 ("FASB members are required to have, in the judgment of the Board of Trustees, knowledge of accounting, finance, and business and a concern for the public interest in matters of accounting and financial reporting"). Of note, by our calculation the current seven FASB members have had on average approximately twenty-four years of practical financial reporting experience prior to joining the FASB. FASB, Facts about FASB (last visited Mar. 31, 2008), available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080227/REG/413651185>.

²³ *Progress Report*, supra note 1, at 38.

We publicly opposed the FAF's recent action "whereby the FASB Chair . . . [was] vested with the authority . . . to set the FASB's project plans, agenda, and project priorities."²⁴
We concluded that that action

. . . would appear to provide the FASB Chair the authority to remove a project from the FASB's agenda even if the project was supported by all of the other Board members or by all investors. Our concern is heightened by the numerous public reports over the past year of efforts by the SEC to exert more control over the FASB.

We, therefore, believe the existing agenda process should be maintained. We understand that the process includes solicitation of input from investors and other users of financial reports, and requires a majority vote of the Board to add or drop a project from the agenda. In our view, the existing thorough and public agenda process lessens the potential risk that FASB's independence might be impaired by the effects of self interested special interest groups to the likely detriment of investors and the capital markets.²⁵

We, therefore, would respectfully request that the Committee consider revising its proposal in its final report to recommend to the FAF that they reverse their recent decision and return the agenda setting decision making process back to a majority vote of the independent FASB Board members.

Although we do not have a view on the Committee's other related proposals about improving the "standards setting process and timeliness," we find it ironic that after describing in somewhat critical terms the existing "elaborate" and "time consuming" process of the FASB,²⁶ the Committee concludes the process "could be made more efficient" by adding more than two single-spaced pages of proposed procedures to the process.²⁷ Perhaps more ironic, the additional procedures include greater emphasis on a "cost-benefit analysis" notwithstanding that the Committee provides no solution for overcoming the acknowledged "difficulty in quantifying the benefits" of accounting standards.²⁸

²⁴ *FAF Board of Trustees, supra* note 13, at 4.

²⁵ *Letter from Jeff Mahoney, supra* note 12, at 4 (footnote omitted).

²⁶ *Progress Report, supra* note 1, at 39.

²⁷ *Id.* at 39-41.

²⁸ *Id.* at 40.

The Committee's more aptly named "cost-cost analysis" would likely simply delay or dilute necessary improvements to financial accounting and reporting. We, therefore, would respectfully request that the Committee consider applying some of the principles of its cost-benefit analysis to its own proposal before determining whether the proposal should be included as a recommendation in the Committee's final report.

Conceptual Approach 2.A.: *To further reduce interpretive implementation guidance associated with GAAP, we are considering proposing that the SEC further clarify its role vis-à-vis the FASB, as well as its internal roles and responsibilities, to mitigate the risk of its actions unintentionally driving behavior by market participants, as follows:*

- *The SEC should clarify that registrant specific matters are not authoritative forms of interpretive implementation guidance under GAAP and, accordingly, registrants other than the specific registrant in question are not required to take into account such registrant-specific matters.*
- *The SEC staff should refrain from informally communicating broadly applicable interpretive implementation guidance (e.g., staff speeches) that are likely to be perceived as changing the application of GAAP. Rather, such communications should be used to highlight authoritative interpretive implementation guidance that has already been issued.*
- *In instances in which the SEC staff identifies registrant-specific accounting matters that it believes may result in the need for broader interpretive implementation guidance or a clarification of an accounting standard under GAAP, the SEC staff should refer these items to the FASB as part of the Agenda Advisory Group.*
- *When it is necessary for the SEC or its staff to issue broadly applicable interpretive implementation guidance, it should try to provide such guidance: (1) in a clear communication identified as authoritative, (2) so that it can easily and immediately be integrated into a codification of SEC literature (as proposed in section V of this chapter), and (3) when expected to significantly change the application of GAAP, only after transparent due process and public comments to the extent practicable.*
- *The SEC staff should revisit internal procedures and take further steps necessary to improve the consistency of its views on the application of GAAP.*

The Council generally does not object to the Committee's potential proposal that the "SEC staff should refrain from informally communicating broadly applicable interpretive implementation guidance . . . that are likely to be perceived as changing the application of GAAP." As indicated in our policy on Independence of Accounting and Auditing Standard Setting, previously described, we believe that investors generally are not well served when the SEC interferes with or overrides the decisions and judgments of the FASB. The following recent example illustrates the basis for our view.

On January 8, 2008, the SEC Chief Accountant issued a letter to the Financial Executives International and the Center for Audit Quality about the application of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (“Statement 140”).²⁹ Many financial reporting experts agree that the Chief Accountant’s letter, which was not subject to any public due process, provides an implicit exemption from the requirements of Statement 140.³⁰ As a result of that exemption many financial enterprises are permitted to keep problem subprime mortgages off of their balance sheets, making those reports less credible and less transparent to many investors and other market participants.³¹ As one commentator observed:

Freezing subprime mortgage rates as a way to limit foreclosures may be a wonderful idea. Yet lenders shouldn’t need the promise of accounting freebies to do this. If the SEC is going to dangle exemptions anyway, it should at least say so. *Its mission is to protect investors, not the banking industry.*³²

If, therefore, the Committee ultimately decides to include in its final report a recommendation that the SEC further clarify the SEC/FASB relationship regarding interpretative implementation guidance, we would respectfully request that the Committee include as a central component of any clarification a statement reemphasizing the importance of respecting and supporting the FASB’s independence in performing its important standard setting role.³³

Developed Proposal 3.1: The FASB or the SEC, as appropriate, should issue guidance reinforcing the following concepts:

- ***Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor.***
- ***Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor.***

²⁹ Letter from Conrad W. Hewitt, Chief Accountant, SEC, to Arnold Hanish, Chairman, Committee on Corporate Reporting, Financial Executives International and Sam Ranzilla, Chairman, Professional Practice Executive Committee, The Center for Audit Quality (Jan. 8, 2008), *available at* <http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf>.

³⁰ *See, e.g.,* Jonathan Weil, *Morgan Stanley Cries Mommy, SEC Comes Running*, Bloomberg.Com, Feb. 6, 2008, at 1, *available at* http://www.cii.org/UserFiles/file/about/general_members_list_1-18-2008.pdf.

³¹ *Id.* at 2.

³² *Id.* (emphasis added).

³³ *See* Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 8,221, Exchange Act Release No. 47,743, Investment Company Act 26, 028, at 5 (Apr. 25, 2003), *available at* <http://www.sec.gov/rules/policy/33-8221.htm> (“ . . . [W]e recognize the importance of the FASB’s independence”).

- ***Just as qualitative factors may lead to a conclusion that a quantitatively small error is material, qualitative factors also may lead to a conclusion that a quantitatively large error is not material. The evaluation of errors should be on a “sliding scale.”***

The FASB or the SEC, as appropriate, should also conduct both education sessions internally and outreach efforts to financial statement preparers and auditors to raise awareness of these issues and to promote more consistent application of the concept of materiality.

The Council generally does not support the Committee’s proposal to modify “the assessment of the materiality of errors to financial statements”³⁴ We believe that investors are best served by the existing qualitative approach to assessing materiality and that the Committee has failed to provide a sufficient basis for modifying that approach.³⁵

The Committee’s proposal appears to be premised on the view that there is a growing number of unnecessary restatements and that one of the chief causes of those restatements is “an overly broad application of the concept of materiality”³⁶ We are not convinced that that premise is accurate.

While there clearly had been a growing number of restatements following the initial passage and ongoing implementation of the Sarbanes-Oxley Act of 2002, recent evidence indicates that the number of restatements is now declining.³⁷ During 2007, there were a total of 1237 restatements representing a 31% drop from the 1801 restatements in 2006.³⁸

³⁴ *Progress Report*, *supra* note 1, at 55.

³⁵ See Letter from Jeff Mahoney, General Counsel, Council, to Office of Secretary, PCAOB 4 (Feb. 13, 2007), available at http://www.cii.org/UserFiles/file/resource%20center/correspondence/2007/February%2013%202007%20PCAOB%20Comment%20Letter%20_Final_.pdf (“We note that the SEC, the Financial Accounting Standards Board, and the US Supreme Court have all reached generally consistent conclusions indicating that investors are best served by a qualitative principles-based approach to materiality”).

³⁶ *Progress Report*, *supra* note 1, at 53.

³⁷ Audit Analytics, 2007 Financial Restatements, A Seven Year Comparison 2 (Feb. 2008) (on file with Council).

³⁸ *Id.*

The 2007 restatement statistics are viewed by many as the beginning of a downward trend.³⁹ As one analysis concluded:

This *trend* appears to indicate that publicly traded companies are adapting to the more rigorous conventions, with respect to financial reporting, adopted in response to, and in conjunction with, the Sarbanes Oxley Act of 2002 and other rules adopted to improve the accuracy and reliability of corporate financial disclosures since the collapse of Enron and Worldcom.⁴⁰

Similarly, another commentator has recently observed:

There's no mystery why restatements initially soared. Sarbanes-Oxley began requiring auditors to attest to whether their clients' internal controls over financial reporting are effective. In performing those reviews, auditors found many weak accounting systems and lots more errors.

. . . .

Fixing those controls has amounted to a major capital investment by public companies. And now we're starting to see the payoff: Restatements are declining, because companies are making fewer mistakes, though still way too many.⁴¹

In addition, although there is some evidence that the application of professional judgment to the assessment of the materiality of errors may have an impact on the number of restatements,⁴² materiality does not appear to be a chief cause of restatements.⁴³

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ Jonathan Weil, *Audit Brothel's Grand Re-Opening May Come Soon*, Bloomberg.Com, Mar. 27, 2008, at 1, available at http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_weil&sid=a5yp1RD709jM.

⁴² See Marlene Plumlee & Teri Lombardi Yohn, *An Analysis of the Underlying Causes of Restatements 7* (Mar. 1, 2008), available at <http://ssrn.com/abstract+1104189> (“ . . . the decrease in the materiality of the net income effect of restatements over the years examined provides support for the notion that auditors are becoming more conservative or that alternative materiality thresholds are being used to determine whether an error exists that needs to be restated”).

⁴³ *Id.* at 5.

More specifically, a recent academic study found that “the majority of restatements (57%) filed from 2003 to 2006 were caused by basic internal company errors, inconsistent with the conventional wisdom that the complexity of the accounting standards drives most of the restatements.”⁴⁴

Finally, we note that the Committee acknowledges that the “Treasury Department has recently selected University of Kansas Professor Susan Scholz to conduct an examination of the . . . reasons for restatements of public company financial statements.”⁴⁵ In light of the pending Professor Scholz study, and the evidence referenced above, we would respectfully request that the Committee consider omitting or deferring any final report recommendations about materiality and restatements.

Developed Proposal 3.4: The SEC should adopt a judgment framework for accounting judgments. The PCAOB should also adopt a similar framework with respect to auditing judgments. Careful consideration should be given in implementing any framework to ensure that the framework does not limit the ability of auditors and regulators to ask appropriate questions regarding judgments and take actions to require correction of unreasonable judgments.

The proposed framework applicable to accounting-related judgments would include the choice and application of accounting principles, as well as the estimates and evaluation of evidence related to the application of an accounting principle. We believe that a framework that is consistent with the principles outlined in this developed proposal to cover judgments made by auditors based on the application of PCAOB auditing standards would be very important and would be beneficial to investors, preparers, and auditors. Therefore, we propose the PCAOB develop a professional judgment framework for the application and evaluations of judgments made based on PCAOB auditing standards.

The Council generally does not support the Committee’s proposal to establish a framework “to cover judgments made by auditors based on the application of PCAOB auditing standards” We are particularly concerned that the proposal leaves open the possibility that the framework would be “implemented through a safe harbor”⁴⁶ We believe, in contrast to the apparent view of the Committee,⁴⁷ that a judgment framework for auditors implemented as a safe harbor, or other limitation on auditor liability, *would not* be beneficial to investors because it may reduce the quality and reliability of audits.

⁴⁴ *Id.* (footnote omitted).

⁴⁵ *Progress Report, supra* note 1, at 54.

⁴⁶ *Id.* at 66.

⁴⁷ *Id.* at 67.

As background, for a number of years the Council has been closely following issues relating to auditor liability.⁴⁸ In 2006, after months of research, discussion, and consideration, the Council's General Members unanimously approved the following Council policy on the "Liability of Outside Auditors":

Companies should not agree to limit the liability of
outside auditors.⁴⁹

The Council's policy on the Liability of Outside Auditors was based, in part, on our conclusion that companies that agree to limit their auditor's legal liability may be reducing audit quality and reliability and, thus, potentially placing themselves, their shareowners, and the capital markets at risk. That conclusion appears to be generally consistent with the views of the staff of the Commission⁵⁰ and the U.S. federal banking agencies.⁵¹

The Council's conclusion on the potential negative impact to investors of further limits on auditor's legal liability also appears to be generally consistent with the results of a recent independent study commissioned by the European Union.⁵² That study found that

. . . the majority of institutional investors . . . are
concerned that a limitation of auditors' liability will affect
audit quality negatively⁵³

⁴⁸ See, e.g., An Advisory to Financial Institutions on Auditor Independence, 10 Council Research Service Alert 93, 95 (May 31, 2005) (on file with Council).

⁴⁹ Council, Corporate Governance Policies, 2.10e **Liability of Outside Auditors** 5 (updated Sept. 18, 2007), available at [http://www.cii.org/UserFiles/file/council%20policies/Redesigned%20CII%20Corp%20Gov%20Policies%201-29-08\(1\).pdf](http://www.cii.org/UserFiles/file/council%20policies/Redesigned%20CII%20Corp%20Gov%20Policies%201-29-08(1).pdf).

⁵⁰ See, e.g., SEC's Codification of Financial Reporting Policies, Section 602.02.f.i—indemnification by Client, 3 Fed. Sec. L. (CCH) Section 38,335 (2003), available at <http://www.fdic.gov/regulations/laws/rules/5000-3100.html>.

⁵¹ See, e.g., Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 Fed. Reg. 6847 (Feb. 9, 2006), available at <http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-1189.pdf>.

⁵² London Economics in association with Ralf Ewert, Study on the Economic Impact of Auditors' Liability Regimes *xlii* (Sept. 2006), available at http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf.

⁵³ *Id.* '.

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Our conclusion also appears to be generally consistent with the results of a recent report by the U.S. Government Accountability Office (“GAO”) on audit concentration.⁵⁴ In that report, the GAO considered and rejected a number of different proposals that have been set forth by various parties to reduce the risk of further concentration in the audit market, including proposals to further limit auditor liability.⁵⁵ In rejecting proposals to further limit auditor liability, the GAO report notes that “[s]ome of the former regulators and a representative of investors we spoke with were concerned that having less potential liability would limit the extent to which audit firms were held responsible for their work and could lead to lower audit quality.”⁵⁶

We, therefore, would respectfully request that, if the Committee ultimately concludes that its final report should include a recommendation supporting a “professional judgment framework” for auditors, the recommendation explicitly oppose the implementation of the framework as a “safe harbor” or other limitation on auditor liability.⁵⁷

* * * *

The Council appreciates the opportunity to express its views on the Progress Report. Please do not hesitate to contact me if you have any questions or if you would like any additional information.

Sincerely,



Jeff Mahoney
General Counsel

⁵⁴ Audits of Public Companies, Continued Concentration in Audit Market for Large Public Companies Does not Call for Immediate Action, GAO-08-163, at 6 (Jan. 2008).

⁵⁵ *See id.* at 4-6.

⁵⁶ *Id.* at 56.

⁵⁷ *Progress Report, supra* note 1, at 66.