



June 20, 2008

To: Kristen E. Jaconi  
Senior Policy Advisor to the Under Secretary for Domestic Finance  
Department of the Treasury

From: Jean C. Bedard – Bentley College  
Joseph V. Carcello – University of Tennessee  
Dana R. Hermanson – Kennesaw State University

Re: **Responses to Questions Regarding Jean Bedard's Testimony on June 3, 2008**

***1. You indicated strong support for the formation of professional schools of accountancy. To what extent would they be associated with existing business schools and how would they be financed?***

Establishing professional schools of accountancy would be a complex undertaking and thus requires additional study, as recommended by the Advisory Committee in its preliminary recommendations. Funding for a professional school model is among the issues that need further study.

Notwithstanding this caveat, we envision professional schools of accounting as being independent from the business school, just as law and medical schools are independent. Such independence, however, would not preclude a professional school of accounting from working with the business school where such collaboration is jointly beneficial. The professional school would be funded just as any other unit of the university is funded, through tuition, state support, and private giving (assuming a public university). Consistent with other professional schools, many states would allow the university to charge premium tuition. In addition, if a separate license for auditing public companies were simultaneously adopted, and this license required graduation from a professional school (on a prospective basis), the professional school would be favorably positioned to secure adequate resources from the central university administration.

***2. You testified that the CPA exam should be based on 150 hours and not 120 hours. Do you have any empirical evidence that 150 hour candidates make better CPAs than those tested at 120 hours?***

The June 3<sup>rd</sup> testimony noted that because 18 states allow candidates to sit for the exam after 120 hours, the content of the exam is forced away from the kind of advanced level knowledge areas that the Committee notes are needed in today's professional environment. Jean Bedard suggested in her verbal comments that we consider a second "layer" of the exam for public company auditors, which could be taken after the Master's degree and several years of experience are completed. Thus, the current four parts could then continue to test the base level (undergraduate) education content. This is one possible way to address the issue.

Jean's comments on the CPA exam, and those in our May 15<sup>th</sup> response letter, were provided in an effort to be helpful to the Advisory Committee. The Committee recommends that recent capital market developments (e.g., IFRS, XBRL, internal control frameworks, ERM, etc.) be tested on the CPA exam beginning in 2011. The Committee suggests that testing these topics on the CPA exam would spur universities to include this material in the curriculum. However, the typical accounting undergraduate program only has six to seven courses above Accounting Principles (the introductory accounting course). Many of the recent developments in the capital markets will be covered in the 5<sup>th</sup> year, if they are covered at all. But if students can take the exam after 120 hours, the exam has to be written assuming this limited level of education. Therefore, the presumed effect of CPA exam content on university curricula will be lost.

To more specifically address your question, there is some evidence that students with 150 hours of education are better prepared for success in the profession than those with 120 hours. Raghunandan et al. (2003), after controlling for SAT scores, accounting credit hours, and enrollment in CPA exam preparation courses, find that students completing a 150-hour program have higher CPA exam pass rates. Allen and Woodland (2006) find that students with 150 hours of education are modestly more likely to pass the CPA exam. Cumming and Rankin (1999) study student preparedness for the CPA exam in Florida, among the first states to adopt a 150-hour requirement. Pass rates on the CPA exam approximately doubled from before to after the 150-hour requirement. Finally, Wier et al. (2005) find that the performance evaluations of those with an MBA or MAcc degree are higher than those holding only a baccalaureate degree, although they measured performance of management accountants, not of external auditors.

It is also important to recognize that the efficacy of 150-hour programs depends heavily on the content of the extra 30 hours. While some states permit 30 additional hours without requiring a Master's degree, we believe that a Master's degree should be the qualification for entry into the public accounting profession today. Finally, it is important to recognize that students entering public accounting with only 120 hours of education may be the most intrinsically gifted (e.g., they may have been heavily recruited by the firms after 120 hours of education). So, comparisons of success between students with 120 vs. 150 hours of education may be skewed by self-selection bias. For example, LeBron James successfully made the jump from high school to the NBA, but no one would argue that the optimal route to NBA success is to skip college basketball.

***3. You testified that you advocated the release of audited GAAP F/S by the large firms. The firms have indicated that they see that they could be at a disadvantage in the recruiting arena if this was required. Do you see any substance to that claim or related ramifications?***

We appreciate the opportunity to clarify the June 3<sup>rd</sup> testimony and the related points in our May 15<sup>th</sup> comment letter. We advocate greater transparency and governance improvements by the profession, in exchange for liability reforms. The transparency improvements that we favor most strongly are the development and public dissemination of a battery of audit quality indicators.

***4. To what extent are universities teaching IFRS? What plans are currently in place to begin such coverage and when is coverage at the level of U.S. GAAP anticipated?\****

Coverage of IFRS varies across universities. Some universities teach stand-alone courses (e.g., Kennesaw State has had a required course for many years, and Bentley College has an elective course), others integrate IFRS into existing financial accounting courses, and others have yet to modify their curriculum. Adoption by the SEC of a date certain for moving all U.S. filers to IFRS would speed academic adoption of IFRS. However, it will likely take some time before the coverage of IFRS is as advanced as the current coverage of U.S. GAAP (textbooks have to be rewritten, faculty retrained, and, unlike incentives that might exist in a professional school, the primary faculty incentive in today's business schools is publication in research journals). Also, there are significant constraints in terms of adding courses to the accounting major. Thus, if IFRS and U.S. GAAP are both taught (as they must be for the time being at least), then some part of U.S. GAAP must be taken out of the curriculum. This is a very difficult choice for accounting faculty to make.

***5. Would there be any value in revising CPA firm structures to provide for a separate subsidiary that would only provide audit services and that would include separate governance (i.e., include outside directors)? Would this structure provide adequate protection to the capital in the collective organization outside of the audit subsidiary?***

We believe there is some merit in considering audit-only firms or, as you suggest, audit-only subsidiaries (see the Hermanson letter of October 4, 2007 on the incompatibility of auditing and consulting services). We view it as unfortunate that this model, which we understand Arthur Andersen offered to the U.S. Justice Department with Paul Volcker as overseer, was not given a chance to demonstrate its efficacy. We do believe that there are great challenges to ensuring that the governance of such audit-only subsidiaries would be truly "separate" and not subject to the strong influence of those providing non-audit services. Also, we believe that including outside directors on firm governing boards is beneficial, just as it has been for U.S. public companies. However, anecdotal evidence suggests that margins on audit services are lower than those on non-audit services. Thus, it is an issue whether, in today's competitive environment, an auditing-only firm could obtain sufficient revenues to perform the work needed to reduce misstatement risk to target levels, and pay the salaries sufficient to attract and retain the best professional talent.

Your second question involves a legal determination. Many individuals are more qualified to answer this question than are we.

***6. Is there any research that indicates there would be adequate demand for the professional schools of auditing? What would be necessary for students to believe that there is a cost-benefit for additional education?***

Research typically requires data about the existing state of the world. Research cannot examine whether there would be adequate demand for professional schools of auditing since they don't currently exist – except if someone were to study market participants' perceptions, which has not been done to date. However, as discussed above, we believe that sufficient demand would exist (from both firms and students) if licensure for auditing public companies required graduation from a professional school.

***7. Many students of accounting programs end up in a career other than a public accounting firm. What can be done to improve accounting education for these students?***

We'd like to respond to this question in three ways. First, in the short run, we suggested in our comment letter that the Advisory Committee should recommend that MBA programs incorporate more content on ethics, controls, governance, and risk management. Graduates of MBA programs often end up as CEOs / CFOs and, in our view, would benefit from greater exposure to these topics. Second, the best option for improving accounting education for those students not entering public accounting is to partner with the American Accounting Association on needed changes. Prior efforts to force changes in the accounting curriculum from the outside have not worked well. Third, on a longer-term basis, if professional schools are developed, graduates of these programs may begin their careers in public accounting before moving to industry and elsewhere. To the extent that professional schools provide a better education, all segments of society that rely on the expertise of accountants will ultimately benefit.

***8. Should accounting programs be as focused as they are today on providing an education targeted to passing the CPA examination?***

The focus on the CPA exam varies widely across schools. Some schools choose to compete on this dimension to differentiate themselves, while others focus on other sources of differentiation. As discussed above, most five-year programs focus on much more than the CPA exam, as the exam as currently written is essentially a 120-hour exam.

***9. Is the majority of newer accounting department faculty advanced to full professorship at your institution without having published in one of the top three or four academic (journals)? Should that be a criteria for advancement in academic positions or as important a factor as the quality of one's teaching methods?***

Colleges and universities vary on the requirement for a “top four” journal publication for tenure or promotion to full professor. At most highly-ranked doctoral granting institutions, promotion to full professor without publishing in the top three or four journals is virtually impossible. For example, the two most recent promotions to full professor at the University of Tennessee had multiple publications in the top four research journals, and Tennessee’s promotion standards are higher now than they were previously. The ratcheting up of promotion standards, in terms of publication output, is endemic across accounting programs throughout the country.

Bentley College has traditionally been a Master’s-level school with a focus on applied research, but has recently begun a Ph.D. program. Bentley has several full professors who have not had a publication in one of the top four journals, but also has several others who have published in those outlets. Bentley has three tracks for post-tenure performance: scholarly, standard, and mixed. Tenured professors opt for one of those tracks, and promotion and merit decisions are made accordingly. Thus, there is a path at Bentley for individual faculty to be rewarded after tenure for focusing on high-quality teaching and contributing to pedagogical improvements. To be promoted to full professor, all faculty must maintain a consistent publication record, but thus far Bentley has not required a top four publication for promotion to full.

At Kennesaw State, there is no expectation of top-four publications for tenure or for promotion to full professor, although a few of our faculty have published at that level. Kennesaw State has a track system similar to the Bentley model and has a strong focus on applied research and contributions to accounting practice.

***10. Some doctoral programs now take 5-7 years to complete. What are the benefits and costs of such an extended period and should it be shortened and if so, how?***

The benefits are better research training and more research in progress before assuming the first job. We agree that the costs, both direct costs and opportunity costs, are significant. We personally believe that doctoral programs can be completed in 4-5 years, but unilaterally restricting program length for accounting Ph.D.s, but not for other Ph.D. programs in business schools, may be unrealistic.

***Question 4 Clarification***

\*\* We have one minor clarification of our response dated June 20, 2008. Question 4 asked about universities' current approaches to teaching IFRS. We described the variety of approaches, including Kennesaw State's required course and Bentley's elective course. We should clarify that the Kennesaw and Bentley courses address international accounting issues. Thus, these are not courses devoted to covering IFRS in tremendous detail. Rather, the courses cover a range of international accounting and business issues.

Answers to questions from the John H. Biggs presentation  
to the Treasury Advisory Committee Meeting, June 3, 2008  
Submitted: June 26, 2008

Following are my answers to the questions raised by three members of the Committee following my remarks on June 3, 2008.

Gaylen Hansen posed the following questions:

1. The large firms have indicated that they provide non-GAAP "financial information" to their partners but that they would have difficulty providing audited GAAP F/S to the public prior to 2011. To what extent do you give credence to that assertion?

Answer:

I think there may possibly be a technical difference between the financial information they give to their partners and the GAAP public statement that would be required for an audited statement. For instance, there would be at least three years of balance sheets prepared in accordance with GAAP and two years of earning statements in order to meet GAAP's requirements. Accordingly one could say that if they got started with a balance sheet on December 31, 2008, they would not be able to produce a financial statement until the end of 2010 or sometime in the first quarter of 2011.

I stand by my argument that this complete presentation, prepared with all the detailed requirements and disclosures of GAAP, would provide considerable information to the partners of the firms as well as to the public.

Since I have not seen, nor am I likely to see, the internal statements of any of the audit firms, I cannot really say how much information they convey.

2. To what extent do the public companies that you are associated with have plans in place to move to IFRS? How significant are the costs of conversion from U.S. GAAP? What additional resources are needed to make such conversion?

Answer:

The companies that I have been associated with do not have any specific plans to move to IFRS. There is speculation but I do not believe anyone is at work preparing careful analysis of what is involved. Certainly no company I am involved with has estimated the cost of conversion or what additional resources would be needed. Personally I suspect it will be a number of years before this happens.

Bill Travis posed the following questions:

3. You state that audit firm audited financial statements would be extremely useful to audit committees in making decisions about auditor selection and continuation. Can you be more specific about the critical information that audit committees would gain from a full set of audited financial statements from audit firms? You mentioned basic information such as capitalization, liquidity, litigation/insurance and % of audit revenues. Is there other information that would be beneficial? Is it possible that the information required could be more cost efficiently and concisely provided through other means, such as a summary report of critical information provided by the PCAOB from their inspection process? As an aside, I am concerned that the information that audit committees want will be very difficult to extract from what I expect to be very voluminous and complex financial statements and footnotes, keeping in mind that firms are involved in much more than public company audits...including private company audits, tax and consulting services.

Answer:

I think the information on “capitalization, liquidity, litigation/insurance and percentage of audit revenues” would be extremely valuable. I am also sure that there would be other information that would give audit committees an understanding of their audit firm that is not now available. For instance I would be quite interested in how post retirement liabilities are evaluated by our audit firm. A question I might ask in an audit committee meeting is “why do you use a higher assumption about future medical care costs than our company is using”. I would also be interested in the basic structure of how partners’ assets are distributed in retirement and what specific provisions are made for their retirement.

Other audit committee members would focus on other issues.

I would not be seeking more information than what is required under GAAP Accounting Principles. Footnote disclosures and a management discussion and analysis would bring out a lot of information.

I would think the PCAOB might be asking for other kinds of financial information that are not required by GAAP. It would then be a matter of judgment whether that information should be shared with audit committees. I come back to Mike Cook’s comment: “you at the PCAOB have lots of information that would be extremely valuable to audit committees. Can’t you find a way to share it.”

4. Can you further explain the value of information that you will garner from annual audited financial statements about the firm’s litigation status, insurance capacity and sustainability?

Answer:

In a typical GAAP public statement, there is a specific listing of all the litigation risks facing the company. The disclosure of those litigation risks is minutely managed by FASB positions on when it is a matter that must be disclosed. I think that detailed and disciplined discussion would be essential information for an audit committee. If it is done informally, there is no restriction on what must be said or what is material.

I think the insurance capacity would be shown and the specific MD&A discussion of litigation to the risk of losses in litigation.

Obviously the free capital of the firm and its ability to generate capital in the future would be a useful indication of the sustainability of the firm in the event of a major lawsuit, when combined especially with the litigation status

5. As an audit committee chairperson, what are your key decision criteria used in selecting an audit firm in a bid situation? Will the fact that mid-sized firms have smaller equity, smaller revenues and smaller insurance than the Big 4 impact your decision to select them?

Answer:

I think the key decision criteria in selecting an audit firm should be the quality of the audit proposed, the quality of the partners we will be dealing with, the quality of the technical and backup skills of the firm and perhaps most important, the reputation of the firm for audit integrity. I think smaller firms may have a harder time fielding high quality in a broad array of skills. But I think a reputation for integrity would trump a lot of other limitations.

A smaller firm might have a better financial position for dealing with litigation but probably the best defense against litigation is a sterling reputation for quality and integrity.

6. I have been told that in the UK, firms are now pushing average partner earnings because potential staff and clients are evaluating that measurement in making their decisions. Is that something that we should be concerned about? If so, how should we counter-balance that potential?

Answer:

I doubt seriously whether disclosure of average partner earnings should be a concern in evaluating a future audit relationship. Doubtless there will be narrow minded business leaders who do not value the high quality component to their



audits who will prefer a lower cost firm. That is a big mistake and one that I have used every occasion I have to speak against,

Ann Yerger posed the following question:

7. Do you believe audit firm legal liability would increase if the firms issued public audited financial statements? Should the audit profession have liability relief in exchange for the public issuance of audited financials? If so, what kind of relief would you recommend?

Answer:

I do not believe there should be a trade off between limiting audit firm legal liability and the desirability of their preparing public audited financial statements.

I think there has been substantial relief extended to audit firms in recent legislation and that the financial disasters of the early part of this century have had their impact on the carefulness of audit practices. I do agree with the larger view that we need a better system than state courts and juries for deciding complex financial issues. The ideas presented by Philip Howard in the Common Good for medical malpractice courts is an example of reform we desperately need. I think this also applies to accounting and all financial service companies who end up with totally unreasonable and inconsistent settlements. As a common matter, we do need a better system but I do not think we need it only for audit firms. In fact I think the dangers there are considerably less than they are in medicine and financial service companies.

Answers to Follow-Up Questions to the Center for Audit Quality from Lynn Turner

*“In its April 16, 2008 Second Supplement to the Report of the Major Public Company Audit Firms, it states “The firms welcome the Committee’s questions regarding the supplement submitted today, as well as the report and supplement submitted on March 5 . . .”*

*The Second supplement discloses the number of Private Actions Pending as of March 21, 2008 with Exposure Greater than \$100 Million, and a breakdown of that exposure by level and case type. In that regard, please provide the following information:*

- 1. The number of such actions broken down between those brought in state courts and those brought in federal courts, as well as whether they were brought in that particular court by (a) shareholders, (b) a company, or (c) a trustee.***

As described in the Second Supplement, the information in Appendix B is already broken out into claims brought by (a) shareholders, and (b) the company or its trustee. Presenting the data in this manner in the Second Supplement is appropriate because a trustee’s power to bring a claim on behalf of the company is premised on the basis that it is acting as management in the insolvency context. The data in the Second Supplement also reflects the *total* number of claims brought in federal and state courts, as the manner in which this information is compiled by each firm varies. For a discussion of our views regarding legislation that provides exclusive jurisdiction to federal courts over audit-related claims against auditors and/or audit firms, we refer you to pages 26 and 27 of our June 27, 2008 comment letter.

- 2. The range of length the cases pending in Appendix A have been outstanding as well as the average and median age.***

We refer you to Chart 12 of our January 23, 2008 submission. This chart provides detailed information with respect to the length of time that various claims against the audit firms have been pending. The chart illustrates that as of November 30, 2007, 33 private actions filed prior to 2003, 65 private actions filed in 2003 or 2004, and 49 private actions filed in 2005, 2006 or 2007 remained outstanding.

- 3. Since PSLRA was enacted, the average and median percentage of the claims that were actually paid in settlements, for each of the exposure levels set forth in Appendix B.***

We refer you to Chart 17 of our January 23, 2008 submission. This chart provides information with respect to the actual value of settlement payments made. This dataset begins in 1996, and thus largely covers the period of time since the enactment of PSLRA in 1995. The chart presents the precise figure for aggregate settlement amounts in each year—not just a trend line; in addition, settlement data for different types of cases are presented—i.e., public company audit, private company audit and all other services. Thus, Chart 17 allows the actual settlement data to be evaluated not just across varying periods, but also across different types of cases in one or more periods.

**4. Please identify whether any of the claims reflected in Appendix A or B included claims related to non public companies.**

The claims data presented in Appendix A and B include private actions brought against the firms by both public and non-public companies. Chart 6 in our January 23, 2008 submission provides data that is broken down by public company audit-related cases, private company audit-related cases, and all other cases.

**5. Please provide the list of the names of the companies involved for those claims in excess of \$500 million.**

As noted in our January 23, 2008 submission, “[i]nformation regarding litigation is highly sensitive, because of the risk that the data could be used unfairly against a firm in litigation.”<sup>1</sup> For this reason, the claims data submitted to the Committee has been aggregated to retain its anonymity and to prevent “reverse engineering” of the data. With this process, we have presented to the Committee an unprecedented compilation of information regarding the profession, including about litigation matters.

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*The March 5, 2008 supplement identifies 417 schools that one or more audit firms recruited at and states that on average, each firm recruits at approximately 250 colleges or universities. It also notes that at least one of the firms recruits at each of the 27 schools identified on Appendix B.*

**1. What was the median and average number of students each of the Big four firms hired from each of the 417 schools during the most recent, 2007-2008 recruiting season? What was the average and median salaries offered to these new hires?**

We refer you to the AICPA’s recent study, “2008 Trends in the Supply of Accounting Graduates and the Demand for Public Accounting Recruits,” which was provided to the Treasury Advisory Committee immediately after its release in early May 2008. (This study is also available on the AICPA’s website at <http://ceae.aicpa.org/Resources/Publications+Reports/2008+Trends+in+the+Supply+of+Accounting+Graduates+and+the+Demand+for+Public+Accounting+Recruits.htm>.) This study contains a comprehensive look at the trends affecting the accounting student pipeline, along with hiring trends for public accounting firms. For example, the study considers different aspects of hiring with respect to public accounting firms of different sizes, such as hiring of individuals with Bachelors’ and Masters’ degrees and hiring regarding gender, ethnicity, and region of the country. We think the study provides useful general information sought in this question.

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<sup>1</sup> January 23, 2008 CAQ Submission, at 35.

Our March 5, 2008 supplement included an aggregated list of schools at which one or more of the six (6) firms that provided information for the supplement recruited. We are concerned, however, that further data stratifications could be misinterpreted as rankings of the colleges and universities, which in turn could give rise to potentially harmful unintended consequences for both students and faculty and would not be in the best interests of the schools, the students or the profession. Such “rankings” could be casually extrapolated and could distract from the much more important fact that such a large number of schools was represented in the original submission. This large number of schools exemplifies the public company auditing profession’s success in reaching many qualified candidates from diverse geographical and demographic areas.

We also refer you to Appendix E of our January 23, 2008 submission regarding new hire salary information for recruits in New York, Chicago and Los Angeles. This salary information is also reported by practice area to provide additional information for the interested reader. Providing salary data by school would be subject to the same concerns as noted above, and would be unlikely to show any meaningful differentiation between schools.

**2. *What was the average number of scholarships offered by each of the major firms for the 2007-2008 school year to:***

- a. Minority students***
- b. Non minority students***

**3. *What was the average amount of the scholarships offered by each of the major firms for the 2007-2008 school year to:***

- a. Minority students***
- b. Non minority students***

We refer you to Appendix A of the February 4, 2008 written testimony of Barry Salzberg, Chief Executive Officer of Deloitte LLP, in which he enumerated an extensive list of the numerous avenues taken by the firms to provide support to accounting students. Scholarships, both minority and non-minority, are awarded through a wide array of methods within the largest firms including, but not limited to, contributions to endowment funds used by schools for student support, contributions made directly by partners and staff to school scholarship funds, contributions to state CPA societies’ scholarship funds, general scholarship gifts made by local firm offices to schools and accounting departments, Beta Alpha Psi contributions used for scholarships, and matching gift programs.

As the term “scholarship” implies money specifically earmarked for tuition, we think that reviewing the broader kinds of educational support, as outlined by Mr. Salzberg, demonstrates the tremendous commitment made by the firms to the future of accounting education.

**4. *What was the number of, and average amount of, scholarships offered by each of the major audit firms to candidates in for PhD’s during the 2007-2008 school year?***

Funding for PhD students is rarely in the form of scholarships; instead, it comes from tuition waivers, remuneration for teaching assistant duties, grading, fellowships, and other

sources of support, including housing and living allowances. Similar to Questions 2 and 3 above, the support from the largest public company auditing firms takes many forms, and is often provided in a decentralized fashion and expended in a mostly university-controlled paradigm.

The profession's support of future PhDs is clear, as evidenced in part by its support for the unprecedented Accounting Doctoral Scholars Program, launched by the AICPA Foundation. The largest 80 firms and the state CPA societies are joining together to provide more than \$17 million in funding for a substantial increase in the number of PhDs to teach accounting, auditing and tax.

**RESPONSES TO TREASURY ADVISORY COMMITTEE MEMBERS'  
WRITTEN QUESTIONS POSED TO  
CHARLES W. GERDTS, III, GENERAL COUNSEL,  
PRICEWATERHOUSECOOPERS, LLP**

**Gaylen Hansen has posed the following questions:**

**1. You testified that the large audit firms are at risk of catastrophic litigation based on the existing outstanding claims. Since the firms have not provided settlement to claims data and other financial information requested by the Committee, what additional information could assist us in validating the firm's assertions that liability reforms are warranted?**

**Response:** The aggregate data submitted by the firms through the Center for Audit Quality demonstrate the threat posed to the audit profession and audit firms by catastrophic risk. As noted in the CAQ Supplement, as of March 21, 2008, the six largest auditing firms were named as defendants in 90 pending lawsuits that each presented potential claims in excess of \$100 million, 27 of which involved potential damages in excess of \$1 billion. The aggregate exposure in these 90 lawsuits totals over \$140 billion. This potential liability dwarfs audit firms' aggregate capital: the Center for Audit Quality reported that the total partner capital of the six audit firms for which claims data was supplied to the Committee was \$5.8 billion.

Audit firms' potential exposure in each of these large claims is principally a function of the market capitalization of their public-company clients rather than of audit-firms' alleged culpability in any supposed fraud. For that reason, specific details of past settlements would not be probative of any firm's ability to resolve *future* claims at an acceptable level. An assumption that history will continue to repeat itself in every future case does not go to the question whether the risk exists, but rather the probability that the risk will manifest itself in a catastrophic loss. To rely on the judgment and goodwill of claimants negotiating in a particular case would be a misguided approach to public policy. Finally, disclosure of details about prior settlements could harm the firm's efforts to resolve pending and future claims on fair and reasonable terms.

**2. With the advent of SOX, a regulated industry was created. In addition, audit firms enjoy exclusive right to the attest franchise. To what extent do you see that franchise and regulated firms as having a responsibility as "public interest entities" to provide information publicly? How would you distinguish any limitations with other regulated concerns such as utilities and insurance companies that are not SEC reporting concerns?**

**Response:** While there is no question that the audit profession has a public mandate to play a role in maintaining the soundness of capital markets, the profession is highly regulated at both state and federal levels. Unlike utility rates, audit fee levels are set by the market, and as our experience demonstrates -- and the Government Accountability Office report corroborates -- there is strong competition among audit firms for this business.

We strongly agree with the Committee that greater transparency in metrics of audit quality would greatly benefit capital markets. Providing market participants with more information on objective indicia of audit-firm quality would allow them to make better choices by facilitating comparability (and therefore competition) between audit firms -- just as public- registrant reporting requirements allow investors to compare public-company financial statements efficiently and accurately. Just as public companies seek to attract investors through strong financial results, audit firms should seek to distinguish themselves on the basis of measures of audit quality. For public registrants, financial disclosure is the principal means by which their owners -- public shareholders -- understand and monitor the companies' performance. Because the public interest in audit firms derive from those firms' public mandate to perform effective audits, the equivalent public disclosure would involve metrics by which the capital markets and relevant regulators could confirm that audit firms were providing trustworthy, high-quality audits.

In contrast, there is no evidence that disclosure of audit-firm financial results would improve price or service competition among audit firms. Indeed, no one has articulated a cognizable basis for the capital markets to need or desire proprietary firm financial information, and capital market participants have not demanded such information. Just as state regulators regularly evaluate the safety and soundness of insurance companies, to the extent capital markets need assurance that the larger audit firms remain secure, the PCAOB or the SEC can demand access to information by which they could gauge the firms' soundness and recommend any necessary mitigation.

**3. To what extent is your firm ready to provide IFRS services to all clients? Is a plan currently in place? If you are not fully prepared today – how long do you anticipate that it will take to become fully loaded at all levels of staffing?**

**Response:** We believe that we can be fully prepared to provide quality assurance services in an IFRS environment within any reasonable transition period that may be selected for the United States. At PricewaterhouseCoopers, we have already expended significant effort to prepare our firm for IFRS. In particular, we have numerous ongoing training and education initiatives -- both e-learning and classroom-based -- within our Firm to assist our partners and staff to prepare for the IFRS conversion process as well as for the ongoing, and increasing, need to perform quality audits of clients following IFRS. We have supplemented this training with a series of secondments of professional staff to and from other PricewaterhouseCoopers member firms in territories that have already adopted IFRS.

Having said this, regulators should understand that training would be more efficient if there were consensus on the timing transition to IFRS in the US. Training all audit professionals long before they may need to apply IFRS (by which time they may well have left the Firm or profession) is ineffective and may require re-training -- due to turnover, evolution in standards, and lack of practice in the interim period -- which results in increased costs being passed through to auditors, clients, and investors, alike.

**4. In your view should something similar to the SEC's Rule 102(e) be the basis for any clarification in the federal pleading standard related to litigation of audits of public companies?**

**Response:** We believe the heightened pleading standard enacted by Congress in the Private Securities Litigation Reform Act of 1995 (PSLRA) is the appropriate standard for scienter-based fraud claims brought under the federal securities laws. Imposing a lesser standard, such as the negligence-based standard of the SEC's Rule 102(e), would be inconsistent with Congress's thoughtful response to perceived excesses in securities litigation, as embodied in the PSLRA and Securities Litigation Uniform Standards Act of 1998 (SLUSA), and with the Supreme Court's decisions in the *Central Bank* and *Tellabs* cases. Indeed, it would contravene the present trend in federal litigation, which has been to require trial courts to act as more rigorous gatekeepers. Moreover, the effect of lowering the liability threshold for audit related claims would only exacerbate an already dangerous litigation environment.

If this question is directed to the pleading standards that should be applied if the federal courts were to have jurisdiction over non-scienter-based claims under the common law, we would support applying the modified negligence standard contained in SEC Rule 102(e) to claims brought by public companies against their auditors.

**Damon Silvers has posed the following questions:**

**5. What is the impact on audit market competition of internationalization in auditing and accounting, including but not limited to the potential convergence with International Financial Reporting Standards, the growth of global networks, and the Concentration and Competition Chapter's Recommendation 6 on enhancing global regulatory cooperation and coordination?**

**Response:** Globalization will undoubtedly have an impact on competition in the auditing profession -- as it will in most professions -- however we believe that the competition would have little to do with the underlying accounting standards being used. Indeed, convergence around IFRS may well permit local, regional, and national firms to participate in multi-jurisdictional audits that might otherwise have favored only the larger global networks. Thus, while we expect that the global networks will benefit from having a presence in their clients' locations around the globe, we anticipate that professionals in smaller accounting firms will successfully master IFRS and then compete vigorously for discrete parts of global engagements.

**6. What are the implications of these matters for the goals articulated in Recommendation 1 of the Subcommittee's section of the draft report (i.e. increased competition for audit services and encouraging the growth of firms beyond the four largest)?**

**Response:** Competition is likely to increase as the markets respond to and embrace a more globally consistent approach to accounting and auditing. Given that all firms around the globe will be applying the same standards, there should be more opportunities for smaller firms to serve global businesses.



**Bill Travis has posed the following questions:**

**7. The Advisory Committee is locked in a dispute over the question of whether there is significant risk of losing a large audit firm due to litigation risk. Some Advisory Committee members are insisting that audit firms provide detailed information about their litigation history. Other Advisory Committee members believe that information provided by Aon clearly indicates that audit firms do face significant risk of sustainability. Can you recommend an approach whereby PwC would submit the detailed litigation information the Advisory Committee originally requested, while retaining the confidentiality of the information?**

**Response:** As discussed in our response to Question 1, we believe that the aggregate data submitted by the firms through the Center for Audit Quality regarding pending claims demonstrate the threat posed to the health of the audit profession and audit firms by catastrophic risk. As we further noted in our response to Question 1, past settlement data will not predict firms' future ability to settle cases on reasonable terms, not least because exposure is driven by the market capitalization of the public company at issue, and market capitalization has increased significantly in recent years. If firm-specific settlement information -- which firms treat as competitively sensitive proprietary information -- were to be publicly disclosed, it would put audit firms at a significant disadvantage in negotiating fair and reasonable settlements in the future.

Finally, we would note that the PCAOB has broad, existing authority to gain access to audit firm proprietary information for purposes of carrying out its oversight functions. This is as it should be, as the PCAOB is the primary entity charged with maintaining the quality of audits performed by audit firms, which are private entities.

**8. Are litigation costs a significant deterrence factor as stated by some investor advocates? Why or why not?**

**Response:** We believe that the existing private civil litigation regime does little to deter negligence or wrongful conduct by auditors. The existing liability system severs the link between liability and fault, thereby undermining deterrence, especially for the largest public-company audits. In those cases, potential exposure is so massive that firms cannot choose to litigate such claims regardless of the merits of their position. For that reason, in most cases the resolution of private litigation has little to do with the quality of the audit.

What *is* deterred under the present system, to the detriment of U.S. capital markets, is public-company auditing by small and mid-sized firms. As representatives of such firms told this Committee, they are unlikely to take on clients with significant market capitalization, or even to expand their portfolio of smaller registrants, given the risk of commensurately greater liability. If competition among audit firms is quality-enhancing, and we believe it is, then the existing liability regime artificially depresses competition and actually diminishes quality rather than promoting it.

What we seek is a litigation regime that would allow us to bring *any* case to trial on the merits -- under the existing pleading and liability standards -- when we have valid bases to defend the quality of the audit and the reasonableness of its conclusions (a situation we believe will present itself in the vast majority of cases). The real problem, as described by several witnesses before the Committee, is that there are too many cases where the potential liability exposure -- not the merits of the case -- drives the decision to settle.

In general, damages in private securities aftermarket suits are calculated by a method widely known as the "out of pocket" formula, which extrapolates total damages from the difference between the price of securities on the affected trading days and an estimate of what the prices would have been but-for the misstated financials. As a result, the magnitude of the exposure for a particular case, and the degree of risk it represents, is for the most part not driven by the extent of the auditor's alleged culpability or the strength of the plaintiffs' case; rather, the magnitude of the liability is principally a function of the client's market capitalization. Using a very simple example, one would usually expect an audit firm to try a case where it had a 90 percent probability of winning. But, if the potential liability in the event of a loss is \$10 billion, even a 1 in 10 chance of losing results in \$1 billion in potential exposure. Unfortunately, a \$10 billion case is by no means unrealistic -- as the CAQ reported to the Committee there are currently 7 cases pending against audit firms each of which has the potential for \$10 billion damages or more.

Thus, the present litigation regime serves to significantly, and we believe artificially, exacerbate liability risk for large public clients, thereby creating a vulnerability for the firms that audit the financial statements of those companies and deterring competition for those audits by discouraging small and mid-sized accounting firms from seeking the work. Moreover, when weak claims are settled by auditor-defendants because the potential exposure is too large to be tried on the merits, liability and accountability are effectively uncoupled. This limits such suits' deterrent value and offends commonsense notions of justice. Finally, the current method of calculating damages leads only to wealth transfer between current and historical investors and does nothing to address the fraudulent misallocation of capital or to recover profit earned by those responsible for the fraud.

Adoption of a damages methodology more closely linked to compensating actual economic loss and eliminating ill-gotten profit would have several advantages over the current framework for all capital market participants, including investors. One result would be that more auditor liability cases will be tried and decided on the merits. This will better align accountability with actual wrongdoing or actionable negligence, thereby improving deterrence. That many non-catastrophic-sized cases are brought is evidence that sufficient incentives exist for claimants and the plaintiffs' bar to file and litigate such claims. We also believe that a broad solution is fairer, less prone to unintended consequences, and responds to many of the concerns voiced over imposing an auditor-only fix. Finally, reforming the damages calculus to reflect actual injury more accurately is the sort of fundamental change to the legal framework that Secretary Paulson and others have suggested would enhance the standing and competitiveness of U.S. capital markets.

**9. Can you recommend an approach to establishing litigation caps that would also be fair to investors?**

**Response:** As we noted in our responses to Questions 4 and 8, we believe that a more economically rational method of calculating damages in private securities cases would be pro-investor. It would eliminate the existing disincentive for small and mid-sized firms to “step up” and compete for more and larger public companies, and it would better sync liability with auditor conduct (as opposed to merely being a function of the size of the client), encouraging firms to take steps to improve audit rigor in an effort to avoid liability.

**10. Some say establishing liability cap protection for audit firms would unfairly protect one class of participant in the capital markets. You indicated other players in the markets do have such protections. Can you help me understand the realities and why audit firms should receive the benefit of liability caps?**

**Response:** While other capital market players are potential defendants in private securities suits, public-company auditors, and particularly the Big Four firms, arguably face far greater liability risks because of the combined effect of three factors: (i) given the concentration of public-company clients among the Big Four auditors, suits are numerous and constant; while a public company may face occasional shareholder suits, what is occasional for one public company becomes incessant for an auditor with hundreds or thousands of such clients; (ii) the magnitude of potential damages at issue are often debilitating for audit firms, because they are premised largely on drops in market capitalization; and (iii) auditors are named in complaints regardless of their actual roles in the alleged misconduct. For these reasons, audit firms have a particularly compelling interest in reform of the present litigation system.

We nevertheless believe that the Committee should take a broad view of the problem and not focus narrowly on fixes for auditing firms. As Dennis Nally observed in his testimony, “solutions aimed at insulating the auditing profession from some of the consequences of the U.S. litigation system miss the point that the system itself should be examined. ... [M]uch of the litigation risk for accounting firms stems from the firms’ reoccurring role as defendants in securities class action litigation.” As we noted above, we believe that a broad solution -- such as reform of the prevailing private securities litigation damages methodology -- is fairer, less prone to unintended consequences, and responds to many of the concerns voiced over imposing an auditor-only fix.

**11. Would there be any value in revising CPA firm structures to provide for a separate subsidiary that would only provide audit services and that would include separate governance (i.e. include outside directors)? Would this structure provide adequate protection to the capital in the collective organization outside of the audit subsidiary?**

**Response:** At PricewaterhouseCoopers, we do not support revising firm structures to provide for a separate “audit-only” subsidiary; in fact, we believe doing so would actually *diminish* audit quality. In our experience, a successful audit requires participation by experts with a variety of skills, including tax, valuation, internal control design, IT systems, internal audit, and forensic investigations, among others. We believe providing a broad scope of services is critical for audit quality. Ensuring that professionals with those specialized skills are not only willing to work at audit firms but keep their skill-set honed, we believe that they must be working in the field in their particular field of expertise. Efforts to create separate, audit-only subsidiaries, would likely harm the public interest, as firms would not be able to retain (and fully employ) the number and range of experts necessary to bring the highest quality and most appropriate experience to the audit.

Lynn Turner has posed the following questions:

**12. Does your firm currently provide its partners with quarterly and annual financial statements prepared in accordance with generally accepted accounting principles?**

**Response:** As I stated in my testimony at the Committee’s June 3, 2008 hearing, PricewaterhouseCoopers regularly provides information on firm financial performance and other metrics through various mechanisms to its owners, the firm’s partners. In addition, firm partners have direct access to the firm’s finance group, and the ability to obtain additional information of particular interest. The purpose of GAAP- or IFRS-compliant statements -- the ability of shareholders to compare public companies seeking investors in the capital markets -- simply is not relevant for our partners.

**13. Do you believe investors right of action of and accompanying liability damages should be limited for an auditor who was unable to detect massive fraud of a magnitude such as those that during the past decade ran into hundreds of millions and even billions of dollars; or against an auditor, or audit firm, that is found to have been aware of improper financial reporting by a public company and still issued an unqualified report?**

**Response:** As we indicated in our response to Question 8, we believe the key to fixing the existing liability regime is aligning damages calculations with actual harm and economic losses, not changing liability standards for auditors or other market actors.

**14. Do you believe there should be a private right of action against auditors when they knowingly provide substantial assistance to management or others in the commission of securities fraud?**

**Response:** We believe that the Supreme Court’s decisions in *Stoneridge Investment Partners, LLC*, 128 S. Ct. 761 (2008), and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), set out the correct standards for judging the liability of those accused in private suits of assisting in securities fraud.

In *Central Bank of Denver*, the Court held that the implied private right of action under Section 10(b) of the Securities Exchange Act of 1934 does not extend to aiders and abettors. In rejecting such an extension, the Court noted, as it has in the past, that “litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.” *Id.* at 189 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1958)). “Litigation under 10b-5 ... requires secondary actors to expend large sums even in pretrial defense and the negotiation of settlements.” *Id.* While private suits based on aiding and abetting liability are not authorized by the Act, the SEC has the authority to bring claims against aiders and abettors. *See* 15 U.S.C. § 78(t)e (“knowingly provides substantial assistance”).

More recently, in *Stoneridge Investment Partners*, the Court considered “when, if ever, an injured investor may rely upon § 10(b) to recover from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate § 10(b).” *Id.* at 767. The Court rejected any notion of general “scheme liability.” *Id.* at 770. Again, it noted that “extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies.” *Id.* at 772. At the same time, the Court reaffirmed that the “securities statutes provide an express right of action against accountants and underwriters ..., *see* 15 U.S.C. § 77k, and the implied private right of action in § 10(b) continues to cover secondary actors who commit primary violations.” *Id.* at 773-74. Given the concerns about the current securities litigation regime, including some of the abuses of that system that recently have come to light in federal prosecutions, we see no value in expanding the role of implied private rights of action.

**15. For each of the past ten years, what has the average settlement of claims against your audit firm been for audits of public companies in (please divide your responses between settlements involving companies with market capitalizations of less than \$1 billion and greater than \$1 billion):**

**a. State courts?**

**b. Federal courts?**

**Response:** As we discuss above in our response to Questions 1 and 7, to the extent the Committee is seeking to extrapolate from firm-specific data to assess the threat to the profession as a whole, we believe the aggregate data provided by the Center for Audit Quality best serves this purpose in light of competitiveness and litigation risk concerns. And, as discussed above, while PricewaterhouseCoopers historically has managed to resolve large claims at acceptable

levels, the aggregate data show that the frequency of large claims and the magnitude of the exposure have grown significantly in recent years as market capitalization has increased, exacerbating the risk of a catastrophic outcome. Specific details of past settlements would not be probative of the firm's ability to resolve future claims and firm-specific disclosure of details about prior settlements would compromise a firm's ability to resolve pending and future claims on fair and reasonable terms.

**16. What percentage of the amount claimed has been paid in the settlements in (15) above?**

**Response:** Our response is included above in our response to Question 15.

**17. How many claims against your firm were there in each of the past ten years in state courts? In federal courts? What were the nature of the claims and litigation that were filed in state courts?**

**Response:** As we discuss above in response to similar questions, PricewaterhouseCoopers provided detailed information about claims against the firm that were aggregated and provided to this Committee through the Center for Audit Quality. We believe this mechanism best balances the litigation and competitive risks posed by disclosing firm-specific data with the Committee's desire for information regarding the risks posed by the existing liability regime. As the data and other testimony before the Committee demonstrate, catastrophic liability risk is a significant problem for the profession, cannot be hedged by the commercial insurance markets, deters competition, and diminishes audit quality.

**18. What do you believe is an appropriate pleading standard if all claims are removed to exclusive jurisdiction of federal courts?**

**Response:** For claims brought under Section 10(b) of the 1934 Act or other scienter-based fraud claims, we believe the existing pleading standards, as defined by the Private Securities Litigation Reform Act of 1995 and the Supreme Court's decision in *Tellabs*, are appropriate. For other claims, we believe the standards set forth in Federal Rules of Civil Procedure should govern.

**19. Do you believe there should be a private right of action against auditors when they knowingly provide substantial assistance to management or others in the commission of securities fraud?**

**Response:** This question appears to be identical to Question 14. Thus our response is the same as our response to Question 14.

**20. How have or will the U.S. Supreme court decisions regarding *Dura Pharmaceuticals* or *Tellabs* likely affect the litigation outcome against the audit firms in the future?**

**Response:** While the effect of *Dura Pharmaceuticals* and *Tellabs* on securities class actions against auditors is still emerging, we anticipate that depending on how *Tellabs* is applied by district and appellate courts, it could result in more dismissals at the pleadings stage. Based on experience to date, the effect of *Dura Pharmaceuticals* on pretrial dispositions is much more difficult to predict.

**21. Are you aware of any caps placed on losses that investors may suffer when an audit is found to be negligent, reckless or fraudulent?**

**Response:** As discussed above in our response to Question 8, we believe that the current method of estimating damages does not accurately reflect actual economic losses to investors, but rather simply causes wealth transfer between buyers and sellers of securities at a different points in time. We believe that aligning damages with actual losses caused by each defendant's misconduct would have significant pro-investor benefits as detailed in our response to that question. We also are aware of liability caps in other jurisdictions, and of their active consideration in the European Union.

**Ann Yerger has posed the following questions:**

**22. How many cases are currently pending against PwC in (1) federal court and (2) in state court? Please describe the plaintiffs and underlying issues in the state court cases. How, if at all, do the pleading standards differ in state courts and in federal courts? What do you believe is an appropriate pleading standard if all claims are removed from state courts to exclusive jurisdiction of federal courts?**

**Response:** As we discuss above in response to similar questions, PricewaterhouseCoopers provided detailed information about claims against our firm that were aggregated and provided to this Committee through the Center for Audit Quality. We believe this mechanism best balances the litigation and competitive risks posed by disclosing firm-specific data with the Committee's desire for information regarding the risks posed by the existing liability regime. As the data and other testimony before the Committee demonstrate, catastrophic liability risk is a significant problem for the profession, cannot be hedged by the commercial insurance markets, deters competition, and diminishes audit quality.

As indicated in our response to Question 18, for claims brought under Section 10(b) of the 1934 Act or other scienter-based fraud claims, we believe the existing pleading standards, as defined by the Private Securities Litigation Reform Act of 1995 and the Supreme Court's decision in *Tellabs*, are appropriate. For other claims, we believe the standards set forth in Federal Rules of Civil Procedure should govern.

**23. For each of the past 12 years\*, how many of the cases were filed against PwC in (1) state court; and (2) federal court? Of these cases (broken down by state and federal cases), how many were public v. private companies? Of these cases (broken down by state and federal cases), how many were brought by a (1) shareholder; (2) company; (3) trustee; and (4) other. Of these cases (broken down by state and federal cases), how many were settled, how many were dismissed by the courts, how many were tried and how many remain outstanding?**

**Response:** PricewaterhouseCoopers provided detailed information about claims against our firm that were aggregated and provided to this Committee through the Center for Audit Quality. We believe this mechanism best balances the litigation and competitive risks posed by disclosing firm-specific data, with the Committee's desire for information regarding the risks posed by the existing liability regime. As the data and other testimony before the Committee demonstrate,

catastrophic liability risk is a significant problem for the profession, cannot be hedged by the commercial insurance markets, deters competition, and diminishes audit quality.

**24. For each of the past 12 years\* (broken down by state and federal cases), of the settled cases filed against PwC, what were (1) aggregate claims; (2) average, high, low and median settlements; (3) average, high, low and median percentage payouts (settlement payment/claim)?**

**Response:** PricewaterhouseCoopers provided detailed information about claims against our firm that were aggregated and provided to this Committee through the Center for Audit Quality. We believe this mechanism best balances the litigation and competitive risks posed by disclosing firm-specific data, with the Committee's desire for information regarding the risks posed by the existing liability regime.

**25. For each of the past 12 years\*, of the tried cases filed against PwC, what were (1) aggregate, average, high, low and median claims; (2) aggregate, average, high, low and median verdicts against the firm?**

**Response:** PricewaterhouseCoopers provided detailed information about claims against our firm that were aggregated and provided to this Committee through the Center for Audit Quality. We believe this mechanism best balances the litigation and competitive risks posed by disclosing firm-specific data, with the Committee's desire for information regarding the risks posed by the existing liability regime.

**26. Please provide a detailed breakdown (by state and federal cases) of the 25 largest settlements and 25 largest judgments against PWC over the past 12 years.\* Please include name of case, description of case, plaintiff and amount of claim.**

**Response:** PricewaterhouseCoopers provided detailed information about claims against our firm that were aggregated and provided to this Committee through the Center for Audit Quality. We believe this mechanism best balances the litigation and competitive risks posed by disclosing firm-specific data, with the Committee's desire for information regarding the risks posed by the existing liability regime.

**27. How do you define catastrophic risk?**

**Response:** We define "catastrophic risk" as risk of an award of damages sufficiently large to imperil the firm's viability.



Addendum to Written Testimony of  
Kenneth Nielsen Goldmann, CPA  
Capital Markets and SEC Practice Director of  
JH Cohn LLP

Before  
The Department of the Treasury  
Advisory Committee on the Auditing Profession  
May 27, 2008

**Additional Questions June 30, 2008**

***Gaylen Hansen questions:***

***To what extent is your firm ready to provide IFRS services to all clients?***

Our firm is in favor of IFRS as a concept, we believe that financial statements from around the world should reflect a consistent set of accounting standards and principals. We believe, however, that the timing of the implementation of the conversion from US GAAP to IFRS is a significant issue as it appears that this conversion is gaining so much momentum that it will occur prior to a complete vetting of all of the inherent issues.

At the present time our firm, and likely other firms of our size, is not ready to provide IFRS services to all of our clients nor are we ready to provide such services to our public clients.

As I mentioned in my written testimony, one of the major hurdles that smaller CPA firms face in their efforts to expand the number of public companies they audit is the difficulty in establishing the internal infrastructure. Smaller firms, due to their size, cannot leverage economies of scale in certain areas. Establishing a critical mass of public company audit clients to support the internal compliance infrastructure for SEC independence tracking, SEC accounting and disclosure requirements in addition to GAAP, PCAOB inspections, and the administrative structures to develop new engagement and concurring partners to satisfy the rotation rules requires quite a bit of time and money. These investments in overhead infrastructure usually do not result directly in a revenue stream.

The switch from US GAAP to IFRS will provide a challenge to all firms with respect to the education and training of their public company auditing staff. The process of moving clients to IFRS will be demanding. Checklists, processes, consultations, quality control, etc., will have to be worked on before auditors are prepared to audit public clients. Having sufficient partners and staff trained in the new standards will be particularly difficult for smaller firms, by virtue of the fact that public company auditing is only a fraction of our audit business.



***Is a plan currently in place?***

Since the SEC has not set a date for adoption of IFRS, most firms, ours included, have not begun to train our staff on the new standards. We have begun to plan for how we will handle the transition internally, but we have not devoted resources to training just yet. And, unlike the top-tier and mid-tier firms that have vast international networks to draw upon for training and educational materials, the smaller CPA firms do not have such resources and are dependent on third parties for curriculum and training materials. Again, this goes back to not having sufficient infrastructure and overhead and economies of scale for a major undertaking such as this.

***If you are not fully prepared today – how long do you anticipate that it will take to become fully loaded at all levels of staffing?***

This is quite a difficult question to answer as we have never undertaken a project as massive as this type of “retooling” project. Entire systems will need to be revised including all of our checklists and audit programs as well as our quality control systems. On top of those changes we will need to train our entire professional staff in the IFRS standards. Inherent in that training will be an “unlearning” of our existing standards or at least those that will be affected. This, I believe, will be one of the most difficult tasks for all of us to accomplish. How does one “forget” what one has been trained over one’s entire career

Firms of our size will face some difficult decisions as concerns the change to IFRS if it is mandated by the SEC. What will private companies do? Will they still be reporting under US GAAP? If so, will our firms want to invest the needed amounts of resources to make the necessary changes to audit what amounts to a small percentage of our total audit practice?

If we had to take a guess at an appropriate length of time to make the transition we might suggest that anything less than five years would be too ambitious.

***In your view should something similar to the SEC’s Rule 102(e) be the basis for any clarification in the federal pleading standard related to litigation of audits of public companies?***

As an accountant I don’t feel prepared to answer this question. With that said, I would be in favor of strengthening the standards used in determining securities fraud claims and not in favor of weakening them.

***Damon Silvers questions:***

***What is the impact on audit market competition of internationalization in auditing and accounting, including but not limited to the potential convergence with International Financial Reporting Standards, the growth of global networks, and the Concentration and Competition Chapter's Recommendation 6 on enhancing global regulatory cooperation and coordination?***

As I mentioned in my written testimony, one of the major hurdles that smaller CPA firms face in their efforts to expand the number of public companies they audit is the difficulty in establishing the internal infrastructure. Smaller firms, due to their size, cannot leverage economies of scale in certain areas. Establishing a critical mass of public company audit clients to support the internal compliance infrastructure for SEC independence tracking, SEC accounting and disclosure requirements in addition to GAAP, PCAOB inspections, and the administrative structures to develop new engagement and concurring partners to satisfy the rotation rules requires quite a bit of time and money. These investments in overhead infrastructure usually do not result directly in a revenue stream.

The switch from US GAAP to IFRS will provide a challenge to all firms with respect to the education and training of their public company auditing staff. First of all, our public company clients will have to change their accounting systems to comply with IFRS. The process of moving clients to IFRS will be demanding. Checklists, processes, consultations, quality control, etc., will have to be worked on before auditors are prepared to audit corporate books. If public companies transition in slowly, all audit firms will be faced with having to conduct audits in IFRS for some clients, and US GAAP for others until such time that all public companies are using IFRS. Having sufficient staff trained in both standards will be particularly difficult for smaller firms, by virtue of the fact that public company auditing is only a fraction of our audit business.

Since the SEC has not set a date for adoption of IFRS, most firms, ours included, have not begun to train our staff on the new standards. We have begun to plan for how we will handle the transition internally, but we have not devoted resources to training just yet. And, unlike the top-tier and mid-tier firms that have vast international networks to draw upon for training and educational materials, the smaller CPA firms do not have such resources and are dependent on third parties for curriculum and training materials. Again, this goes back to not having sufficient infrastructure and overhead and economies of scale for a major undertaking such as this.

Firms of our size will face some difficult decisions as concerns the change to IFRS if it is mandated by the SEC. What will private companies do? Will they still be reporting under US GAAP? If so, will our firms want to invest the needed amounts of resources to make the necessary changes to audit what amounts to a small percentage of our total audit practice?

These challenges, and the others mentioned in your question – growth of global networks, enhancing global regulatory cooperation – may undoubtedly cause many small audit firms to rethink their business model and pull out of the public company audit market entirely. Firms may determine that the return on the investment does not warrant the expenditure. While this

will provide an opportunity for firms like JH Cohn, to grow through acquisition of new clients; it will have a negative impact on the concentration of audit firms.

As to the issue of the impact of enhancing global regulatory cooperation and coordination, the PCAOB recently requested comment on its proposed guidance that would allow it to place "full reliance" on an inspection of a PCAOB-registered non-U.S. firm conducted by the audit oversight entity located in the firm's home country. While this could be of benefit to all firms in an increasingly global economy, I agree with the comments submitted by the Center for Audit Quality to the PCAOB in March 2008:

"As reflected in the proposed guidance, many nations are enacting audit oversight entities that share the goals of the PCAOB, such as protecting investors, enhancing audit quality, and assuring public trust in public company audits and in the auditing profession. The willingness of the PCAOB to coordinate its inspection efforts with those oversight entities signals an appropriate level of respect for other nations' regulatory advancements. In that vein, we applaud your efforts to work with other audit regulators around the world. ... In general, the CAQ believes that determining the level of reliance on a non-U.S. audit oversight body based on adherence to important principles, assessed by reference to compliance with key criteria, is a reasonable approach. We note, however, that legal, regulatory, cultural and other differences among nations might cause audit oversight entities in different countries to follow somewhat different approaches to satisfy the underlying principles. Accordingly, strict adherence to a series of essential criteria might cause the PCAOB to place more or less reliance on a home country oversight entity than is warranted in the circumstances. We encourage the PCAOB to use the essential criteria as a general guide to assess the extent of compliance with the principles, rather than as a "checklist" of criteria that must be satisfied to grant full reliance."

***What are the implications of these matters for the goals articulated in Recommendation 1 of the Subcommittee's section of the draft report (i.e. increased competition for audit services and encouraging the growth of firms beyond the four largest)?***

In our opinion the change from US GAAP to IFRS will inhibit smaller firms from making the decision to enter into the market of auditing public companies and may cause some who are already auditing public companies to rethink their decision. The decision to change to IFRS will likely be made for public companies before it is made for private companies. Mid tier firms, with the vast amount of auditing revenue coming from private companies, will likely be precluded from making the necessary investment to "retool" their organizations to satisfy the small percentage of public company audits.

Inherent in that "retooling" will be an "unlearning" of our existing standards or at least those that will be affected. This, I believe, will be one of the most difficult tasks for all of us to accomplish. How does one "forget" what one has been trained over one's entire career?

**Bill Travis questions:**

***Do you believe that adding a requirement for small and mid-sized audit firms to provide audited financial statements to the public would cause your firm and other firms to exit the practice of auditing public companies? If the financial statement requirement was for firms with more than a specified number of public company audit clients, would your firm and other firms likely manage their client count to avoid the requirement?***

As I mentioned in my written testimony, one of the major hurdles that smaller CPA firms face in their efforts to expand the number of public companies they audit is the difficulty in establishing the internal infrastructure. Smaller firms, due to their size, cannot leverage economies of scale in certain areas. Establishing a critical mass of public company audit clients to support the internal compliance infrastructure for SEC independence tracking, SEC accounting and disclosure requirements in addition to GAAP, PCAOB inspections, and the administrative structures to develop new engagement and concurring partners to satisfy the rotation rules requires quite a bit of time and money. These investments in overhead infrastructure usually do not result directly in a revenue stream.

SEC audit clients for mid-tier firms usually represent a small percentage of their total revenue and usually are audited by a small percentage of the total number of partners. As a result, it is likely that while the SEC partners may want to provide the necessary audited financial statements, the non-SEC partners may overrule their desires. Should that occur, firms will pull away from auditing public companies thereby decreasing competition. At this point we have not had this discussion within my firm and therefore have not reached a conclusion.

Will firms "manage" the number of SEC registrants if there were a threshold above which audited financial statements would be required? Again, it is likely that the political pressure within a firm will cause some firms to "manage" the number of public company audits. As you know, currently there is a requirement for PCAOB inspections on an annual basis for firms with one hundred or more registrants and every three years for those with less than one hundred. If that threshold were to again be utilized for the audit requirement, the combination of the two changes would add considerable cost to firms and make it quite uneconomical to exceed the threshold. The additional cost of annual inspections combined with the cost of annual audits would be significant. In order to "break through" the threshold a firm would have to be quite confident of its ability to generate a significant number of public audit clients in a relatively short period of time to justify such additional costs.

***If larger firms were required to provide audited financial statements, would it be a competitive disadvantage for other firms who would not be required to provide audited financial statements? Would firms below the threshold be pressured to provide audited financials?***

The concept that providing audited financial statements of firms auditing public companies will somehow enhance the sustainability of the auditing profession escapes us. Auditing firms are private companies and as mentioned above are not exclusively devoted to auditing public companies. It is likely that many of our partners not associated with auditing public companies will object quite strenuously to the concept of our being required to incur the cost of obtaining an

audit as well as disclosing our financial information to the public. Smaller firms who have not yet achieved enough earnings to enhance their capital accounts could be placed at a competitive disadvantage.

If the larger firms were required to provide audited financial statements while mid-tier firms were not it might create an additional competitive disadvantage. The larger firms could claim that smaller ones are not as financially sound (even though they would not have an evidence of such) and therefore somehow inferior. These and other tactics could be used with potential clients as well as with recruiting new staff. It is also possible that audit committees when considering firms that disclosed and firms that did not disclose their financial information might request either financial statements or the disclosure of certain information that might be contained therein. In addition, mid-tier firms already have a difficult time with some investment banks in being recognized as competent enough to audit public companies for which they are underwriting new offerings. Disclosure or non-disclosure of financial statements could exacerbate that issue and again lead to a lack of competition rather than enhancing it.

Additionally, if smaller firms that conduct public company audits were required to disclose their audited financials, it would also put them at a competitive disadvantage for the larger segment of their business – private company audits. The non-disclosing, all-private company audit firms would have access to a considerable amount of financial data, and would be in the position to use these data when making their bids for new clients.

***Please expand on your views that audited financials would cause additional competitive challenges for mid-sized and smaller firms?***

As mentioned above, mid-sized firms will face internal issues related to the additional costs associated with audited financials as well as the concept of opening our finances to the public. Newer firms will have a more difficult time of competing while their capital is low and possibly their debt levels are high as potential clients or even potential employees may perceive them as weaker companies.

**Lynn Turner questions:**

**Does your firm currently provide its partners with quarterly and annual financial statements prepared in accordance with generally accepted accounting principles?**

Our firm is managed internally on the basis of cash basis financial statements. Our partners are provided, at monthly partners' meetings, with an overview of our financial performance on a cash and accrual basis. We are not provided with quarterly and annual financial statements prepared in accordance with GAAP. However, we do prepare such statements for our various banking relationships and those GAAP basis financial statements are available upon request by our partners.

**How many fellowship candidates has your firm put forward and supported to the FASB or SEC, such as the professional accounting fellows, in the past ten years?**

We have not put forward any professional accounting fellows in the past ten years.

**Do you oppose giving shareholders the right to ratify the auditor for the company they own?**

We are not opposed to giving shareholders the right to ratify the auditor for the company they own. However, with that said, there may be some practical implications if there was a requirement that such ratification be in place prior to the hiring of the auditor. Often annual meetings take place after the first quarter has concluded and the auditor has reviewed the financial statements. In addition, many companies change auditors during the year after shareholder ratification has taken place. If the ratification were a requirement, would the shareholders be required to ratify the new auditor before they could be hired? What would happen if an auditor resigned just after being ratified, would another ratification process then be required prior to hiring another firm?

We are of the opinion that a company's audit committee along with management are in the best position to make the decision on which firm to engage.

**For each of the past ten years, what has the average settlement of claims against your audit firm been for audits of public companies in (please divide your responses between settlements involving companies with market capitalizations of less than \$1 billion and greater than \$1 billion):**

a. State courts?

b. Federal courts?

We have not had any public company audit claim settlements against us in the past ten years.

***What percentage of the amount claimed has been paid in the settlements in (4) above?***

N/A

***How many claims against your firm were there in each of the past ten years in state courts? In federal courts? What were the nature of the claims and litigation that were filed in state courts?***

N/A

***What do you believe is an appropriate pleading standard if all claims are removed to exclusive jurisdiction of federal courts?***

We choose not to comment on this matter due to its legal nature.

***Do you believe giving federal courts exclusive jurisdiction over all claims involving audits of public companies is an adequate remedy for the potential exposure to catastrophic risk audit firms claim they face?***

The Committee's proposed recommendation concerning federal jurisdiction over claims involving audits of public companies, if adopted, would promote efficiency because all claims relating to a particular audit could be consolidated before a single judge. Consolidation or coordination of proceedings in individual and class action claims, however, is not a remedy for exposure to catastrophic risk that audit firms face.



HARVEY GOLDSCHMID, DWIGHT PROFESSOR OF LAW  
COLUMBIA LAW SCHOOL  
ADVISORY COMMITTEE ON THE AUDITING PROFESSION  
QUESTIONS FOR THE RECORD  
JUNE 3, 2008 MEETING  
SUBMITTED: JUNE 25, 2008

1. (Hansen) In your view should something similar to the SEC's Rule 102(e) be the basis for clarification in the federal pleading standards related to litigation of audits of public companies?

Yes, Rule 102(e) would provide a good basis for formulating a standard of care for auditors in federal courts. As I indicated during my testimony, however, the formulation of a standard of care should not change the current liability provisions under the federal securities laws (e.g., Sections 11 and 12 of the 1933 Securities Act and Sections 10(b) and 14(a) of the 1934 Securities Exchange Act).

2. (Hansen) What is your opinion of the so-called "scheme liability" as it has recently been argued in front of the Supreme Court in cases such as *Dura*, *Stoneridge* and *Tellabs*? Do you have any thoughts on what action is necessary to address scheme liability as it relates to audit firms giving "advice" to their clients?

In an amicus brief to the Supreme Court in the Stoneridge case, former SEC Chairmen Levitt and Donaldson and I said the following:

If allowed to stand, the decision below would make virtually invulnerable those who actively, purposely, and with market effect, engage in deceptive conduct and would cause grave harm. The decision conflicts with language and purposes of Section 10(b), the historical position of the Commission, and well-grounded judicial precedent.

The decision below immunizes non-issuers who commit securities fraud from private liability merely because they were cunning enough to avoid making a public statement. Those who – with purpose and effect – actively engage in fraudulent acts as part of a scheme with the issuer to defraud investors should be held primarily liable... Investors, both domestic and foreign, trust that fraud is not tolerated in our nation's securities markets and that strong remedies exist to deter and protect against fraud and to recompense investors when it occurs. The decision below, if left standing, would dramatically undermine private enforcement of our securities laws and investors confidence in our securities markets.

Unfortunately, our amicus brief was cited and quoted only by the dissenting justices in Stoneridge. New legislation will be needed to correct what I consider the Supreme Court's serious mistake.

3. (Hansen) Do you have an opinion as to whether all audit related issues of public companies should be moved from state to federal court?

This is a difficult and complex issue. A strong case can be made for such a move, but one must keep in mind that in recent years the federal courts have been less friendly to investor litigation than have some states. In the long run, as a matter of principle, as Congress implicitly recognized in the Sarbanes-Oxley Act, federalization makes sense. The auditing profession, when dealing with audits of public corporations, has large responsibilities for the health of our national financial markets, and providing a federal forum for related audit litigation would be constructive (e.g., in terms of uniformity and consistent judicial quality) if done in the following context: (i) no modification of liability provisions in force under the federal securities law is proposed; (ii) neither the SEC (or other governmental entities) nor the PCAOB is required to bring actions in federal district court; otherwise, substantial damage would be done to the federal administrative adjudication system; (iii) a care standard should be specified (see my answer to question 1); and (iv) the harm done to investors by the Supreme Court's Stoneridge decision should be remedied (see my answer to question 2).

4. (Hansen) You testified that the public has a right to know what is going on with large audit firms – e.g. they should release their financial statements. The firms argue that releasing their financials will only hurt them competitively and in litigation settlements. Could you share with us your feelings about the legitimacy of such assertions and whether it constitutes a real threat?

I see no reason why public disclosure by large audit firms would put them at a competitive disadvantage. Full transparency for large auditing firms would help to build public trust in our financial numbers (given the unique role auditors play in our financial markets), and reassure regulatory authorities, audit clients, and the public about the “public franchise” auditors have been given. Today, the auditors’ “public franchise” (created by statutes and SEC rules) conveys substantial market power, and the profitability, capitalization, sustainability, and effectiveness of large auditing firms is of legitimate public interest.

For smaller audit firms, I agree with the Advisory Committee's Addendum that the PCAOB should determine the disclosure requirements and which parts, if any, of the required disclosures should be made public. For smaller auditing firms, mandated full public disclosure might lead to exit from the market for the auditing of public corporations (because of cost and the diversified nature of small firm partnerships) and create entry barriers that the auditing market does not need.

As I testified, I am very skeptical that releasing large auditing firm financials would significantly disadvantage large firms in the settlement of litigation.

Any marginal disadvantage, if one exists, is of little consequence compared to the public and audit client gains from full disclosure.

5. (Travis) What is the basis for your position that mid-sized and smaller firms will not lose competitive positioning with the disclosure of audited financial statements? Are you saying that audit committees won't evaluate the size of firm capital, audit revenues, insurance, partner income, etc. in their decision process? Alternatively, are you saying that the smaller firms are not as important to the capital markets?

I am only advocating the public disclosure of audited financial statements by large auditing firms. (Please see my answer to question 4 with respect to smaller firms.)

6. (Travis) You stated that the public has a right to know what is going on in large audit firms. What information (in addition to the audited financials, indicators of audit quality and the EU-related information) is needed by audit committees and the public?

I recommend that the following information be provided by large auditing firms:

- i. the disclosure now required by the E.U.'s Eight Directive, Art. 40, Transparency Report, as modified by the PCAOB to make Art. 40 appropriate for U.S. markets;
- ii. key indicators of audit quality and effectiveness, as determined by the PCAOB;
- iii. whatever the PCAOB determines should be added from its current and 2006 reporting proposals; and
- iv. audited financial statements prepared in accordance with GAAP (or IFRS as a successor system).

7. (Turner) Should a clear pleading standard in federal courts include not only fraud and recklessness, but also in some instances negligence such as when it is repetitive or involves items of heightened awareness?

I generally agree with this approach. (Please see my answers to questions 1 and 3).

8. (Turner) Do you believe liability should be limited for an auditor who is found to have been aware of improper financial reporting and still issued an unqualified

report or for an auditor who was unable to detect massive fraud such as those that during the past decade ran into billions of dollars?

(Please see my answers to questions 1-3).

9. (Turner) What do you believe is an appropriate pleading standard if all claims are removed to exclusive jurisdiction of federal courts?

As I indicated in my answer to question 1, the SEC's Rule 102(e) would provide an appropriate basis for formulating a standard of care for auditors in federal courts.

10. (Turner) How have or will the U.S. Supreme Court decisions regarding Dura Pharmaceuticals or Tellabs likely affect litigation against the audit firms?

Dura and Tellabs, on balance, are favorable decisions for defendants, but their long-term impact is now being played out in lower federal court decisions. Both Supreme Court decisions are defensible; it is the Supreme Court's 2008 Stoneridge decision that is indefensibly hostile to private actions and a serious mistake.

11. (Turner) Do you believe that any liability reform should include giving investors a right of action when a third party such as an auditor, knowingly provides substantial assistance (aiding and abetting) to a company or its management in the commission of securities fraud?

Yes. (Please also see my answer to question 2).

12. (Turner) What do you see as the implications of changing the pleading standard to a higher threshold from that today?

I would not change current liability standards under the federal securities laws. As to standard of care issues, see my answers to questions 1 and 3.

13. (Yerger) Would investors be disadvantaged in any way if all claims against auditors of public companies were required to be filed in federal court? Please explain.

As I indicated in my answer to questions 2, 3, and 10, the federal courts are less friendly to claims by investors than they were one or two decades ago. Recent decisions like Dura (on loss causation) and Tellabs (on "strong inference" pleading) are defensible. I believe that the Supreme Court's 2008 Stoneridge decision is indefensibly hostile to investors – indefensibly protective of intentional wrongdoing by so-called "gatekeepers" -- and a serious mistake.

14. (Yerger) Under what circumstances, if any, do you believe investors should support further limits on auditor liability?

Please see my answers to questions 1, 2, 3, 11, 12 and 13.

15. (Yerger) What types of claims, if any, should remain in state court? How, if at all, would plaintiffs' rights and remedies change if state-filed cases would go to federal court?

Please see my answers to questions 1-3, 10, and 11.

RESPONSES TO QUESTIONS POSTED ON JUNE 11, 2008  
FROM DAN M. GUY, Ph.D, CPA  
JUNE 22, 2008

From Gaylen Hansen

1. As I indicated in my written comments on June 3 before the Advisory Committee, the primary problem that causes auditors to fail to detect material fraud and error, which include direct effect illegal acts, is that they do not comply with existing auditing standards. Also, auditors fail to detect material misstatements when they lack the requisite independence/objectivity or otherwise have conflicts of interest as required by ethical standards established by the AICPA and the SEC. Although, I believe that minor changes in the auditor's standard report, such as a direct reference to fraud, error, including direct effect illegal acts, instead of using "material misstatements," will improve auditor communications, the real need is to improve auditor education at the university level and in CPA firms. By improving auditor education, the level of performance should rise and auditors, I believe, will do a better job in exercising professional skepticism and obtaining and evaluating audit evidence.
2. I believe that the auditor report is a symbol, and as stated above with minor modification, that symbol could be improved. I do not support long form reports – an issue that has long been debated and rejected – for two reasons: Such reports (A) will contain information that more appropriately belongs in financial statements, not audit reports, and (B) will decrease the value of the audit report as a symbol in conveying significant information about report modifications and will increase the amount of clutter, or noise, in audit reports. Finally, I believe that long form audit reports will increase auditor communication risks and related legal risks. Of course, if standard wording is used in long form reports, those risks should be minimized.
3. An expert opinion is the opinion of the individual giving the opinion, not the CPA firm from which the expert comes. In fact, Federal rules and most state rules applicable to experts prohibit an expert from signing in a firm name. For example, Federal Rule 26, "Duty to Disclose; General Provisions Governing Discovery," requires the expert to prepare and sign the report, not the firm that employs the expert.
4. I do not have expert knowledge about the conversion from US GAAP to IFRS. However, I have devoted a substantial part of my professional life, including writing a number of books on international auditing standards, to international GAAS. In fact, I was the US technical advisor to the IFAC on auditing matters for a number of years. Although I can't answer your question about IFRS, I must seize the opportunity to say that conversion of US GAAS to international GAAS would result in watered down auditing standards and less assurance being provided on US financial statements. Consequently, the PCAOB must make its own way in this area and not follow the AICPA in this direction.
5. My written comments were intended to state that PCAOB 3 has solved, at least for the present time, the acute documentation problems, or lack of documentation, that have plagued the accounting profession for years. PCAOB 3 is an excellent standard. In contrast, AU 722 in setting out performance and reporting requirements misses the mark. The performance standards,

which are driven by inquiry and analytical procedures and little more, do not recognize that when significant transactions occur in a given interim period those transactions must be audited in relation to the financial statements taken as a whole. In fact, that's what best practice is today, but the standard on interim financial information does not recognize or require that a substantive level of continuous auditing be applied to that information given its importance in the market place. In addition, AU 722 does not require the issuance of a review report. That issue should be restudied.

From Bill Travis

6. Auditors are not adequately trained and still all too frequently have a strong client service orientation (to management, not the audit committee) that results in extreme overreliance on client representations and sets of information prepared by clients. In addition, the lack of and deficiencies in training about ethical decision making is, in my opinion, extremely deficient in the universities and deficient in CPA firms.

From Lynn Turner

7. The top three changes that I believe are needed in the audit report are to:
  - A. Define the meaning of "material misstatement" in the standard audit report to explicitly state what that term encompasses (material fraud and material error, including material direct effect illegal acts).
  - B. Update the existing standard at AU 530 on dating the audit report to accord with the AICPA standard (SAS 103).
  - C. Determine whether the term "reasonable assurance" is appropriately understood.Finally, I also believe that the PCAOB should amend AU 508 to mandate that the audit report be addressed to the audit committee, among others.
8. In the Arizona Baptist case the auditing standards were right on point. As you know, this was a case about fraud and communications made about fraud to the auditors that the auditors simply ignored – well, they did obtain management representations to counter those communications. Thus, auditing standards were not followed. As indicated in my written statement, I frequently encounter bad audits (what I sometimes refer to as drive-by-audits). I also had been retained in a number of cases where the auditors were not independent; thus, no audit can be performed. These cases, some of which were audits of large public companies, sometimes involved situations where the foreign affiliate of a US CPA firm has prepared the financial statements of material investees or subsidiaries. The US firm has all-to-frequently not focused on the independence requirements and the foreign affiliate doesn't have a clue about what was required by US GAAS and independence rules.
9. For a long time the tone at the top in CPA firms and at the partner practice level was full speed ahead in terms of responding to client needs and selling services to clients. Not many people cared about ethics and independence, especially when ethical rules and concepts got in the way of making money. In 2001, I wrote (along with Doug Carmichael) a book on ethics, which was in large measure devoted to independence. That book, which was updated in 2003 after SOX, was the first ethics books to integrate the AICPA, SEC, PCAOB, DOL, and GAO rules on independence. I almost had to give the book to my publisher, because the publisher did a market survey of auditors and came back with the response: "No one really cares about ethics, and they are not

willing to buy a book on ethics." Of course, I thought that would change after Enron, but I got essentially the same reception from the publisher and the market place. Interesting, I have had a significant response from trial lawyers on both the plaintiff and defense sides in civil litigation.

10. I would not fall on my sword if a proposal came down that required *John Jones, CPA*, engagement partner, to add his signature to the firm signature on an audit report. Again, it would be a useless appendage in US practice. The requirement would add clutter; would not, in my opinion, have a behavioral impact on engagement partners in improving their performance; but given that the requirement has little or no cost associated with it, the requirement would not be harmful to US auditors. In other words, its little or no costs would not exceed the inconsequential benefit.
11. I absolutely believe that it makes no difference to an audit partner one way or the other whether he or she signs an audit opinion along with the firm signature. I also do not believe that it would have any effect on malpractice litigation. The duties and responsibilities of audit partners and other members of the audit team are clearly established in existing firm documentation requirements. PCAOB 2, to a small degree, improved the existing requirements; nothing more of substance is needed at this time.
12. I believe that the audit partner(s), along with the concurring partner(s), set the tone of the engagement. Consequently, those individuals have a major influence on the quality of audits. If they don't stress technical prowess, pledge allegiance to ethical decision making, and recognize the supremacy of the audit committee as the audit client, many audits will be substandard.
13. Please refer to the response for question 3 above.



Responses to questions of Advisory Committee members  
June 30, 2008

**Gaylen Hansen:**

1. You addressed the lack of Principles vs. Rules-Based Standards and implied that there is a dearth of research dealing with the new emphasis. Could you elaborate on the practical implications?

Relative to bright-line rules, principles-based standards allow management to exercise more judgment in choosing accounting methods and how methods are applied. Thus, whereas a particular number might be the “right” number under a rule, a range of numbers could be “right” under principles, depending on choices, assumptions, and point of view.

In applying judgment to financial statement items, management will almost certainly exhibit inherent as well as self-serving biases that will introduce more inherent variation in what can be considered as the “right” number. Furthermore, because auditors must make audit judgments *about* judgments of management, a management applying principles-based standards will have even more discretion to cast audited results in its favor.

In my view, independent research is needed to help predict the reliability of principles-based financial reporting and to assess what forms of accounting and auditing standards will best support reliable principles-based financial reporting.

2. To what extent are universities teaching IFRS? What plans are currently in place to begin such coverage and when is coverage at the level of U.S. GAAP anticipated?

As of fall 2007, very few American universities devoted more than one week of a four or five-year course of study to IFRS topics. By fall of 2009, there will be greatly expanded coverage and some schools will be offering full courses on IFRS.

Coverage of IFRS at the level of U.S. GAAP will require development of faculty expertise as well as textual materials for students. These activities will probably take three to five years. Perhaps more important, professors will have to (again) focus on developing student judgment and reasoning skills rather than memorization of specific rules.

Professors recognize that IFRS will replace U.S. GAAP in U.S. practice and the large registered accounting firms are working to expose faculty members to IFRS through workshops on the subject matter. For example, in June, professors at Texas and about a dozen other universities attended a two-day IFRS workshop conducted by KPMG.

**Bill Travis:**

3. Do you support the concept of professional schools of auditing? If so, what are the major hurdles to successfully implement this concept?

Professional schools of auditing *may* provide a framework within which professors would be rewarded for their expertise in public company auditing. Such schools might also be a vehicle for curriculum development by a consortium of universities, public company audit firms, and the PCAOB. However, it is not clear that specialization and isolation of auditing is desirable, viable, or economically feasible.

As a practical matter, it would be difficult to convince university administrators that substantial resources should be devoted to support specialization in public company audits as defined by PCAOB standards. In contrast to this compliance orientation, present-day education in *accounting* is much broader and involves measurement theories, decision making, governance, and the role of relevant and reliable information.

Despite the problems associated with professional schools of auditing, consideration of the possibilities by a broad audience may bring to light other useful ideas to achieve needs of the profession and society at large. In fact, prior testimony on the subject has substantially changed my own thinking about the possible alternative structures.

4. What can be done to better involve academia in the audit profession (in addition to providing access to audit firm information for research)? Will improved access to audit firm information for research, adding more Ph.D. slots in universities and more financial support for Ph.D. students help attract top talent into Ph.D. programs? Is there anything else that would help drive interest into this critically important career?

Access to the professional “laboratory” is essential to attracting young scholars to auditing because each professor must be able to show that he or she can expand knowledge as well as convey knowledge. More money for Ph.D. scholarships for audit specialization may attract more Ph.D. students, but keeping them requires the opportunity to succeed in auditing research when they graduate. More Ph.D. student slots would require more resources, and many business school deans see little need to devote more resources to prepare faculty to teach in five-year professional accounting programs for which graduates’ starting salaries are barely above those of undergraduates in fields such as finance.

5. The Advisory Committee is locked in a dispute over the question of whether there is significant risk of losing a large audit firm due to litigation risk. Some Advisory Committee members are insisting that audit firms provide detailed information about their litigation history. Other Advisory Committee members believe that information provided by Aon clearly indicates that audit firms do face significant risk of sustainability. Can you recommend an approach whereby academia could help objectively resolve this question?

In my written comments I stressed the need for independent research “in” auditing. More data about firms’ litigation costs and the context of alleged audit deficiencies and litigation

resolution would be useful. Such data would allow scholars to independently analyze the costs and risks of auditing today and to develop insights into the magnitude of the litigation problem and its potential importance to society.

To illustrate, large public company audit firms have more than once claimed that their “practice protection” costs (e.g., legal defense costs, settlements, and damages) average from about 16 percent to 20 percent of revenues—a rather astounding rate. The rate raises many questions that should be of interest to the Committee, prospective entrants to the profession, the profession itself, the PCAOB, and those concerned about the public interest.

What is behind this rate? How do practice protection costs in auditing compare with those of other industries? Is such a rate sustainable in the long term? Is it “good” for society to have such high practice protection costs? How do audit firm practice protection costs compare to what audit firms spend on research and development of better audit procedures, or quality control, or education and training? And how does practice protection cost compare to the cost of producing the audit itself?

As to the underlying litigation, is bad auditing involved, or is it bad accounting, bad accounting or auditing standards, bad decisions by investors, or merely bad outcomes for investors? Can Big Four firms with, say, *\$20 to 30 billion in capital* be expected to “insure” a *\$20 to 30 trillion economy* against bad outcomes for investors? There is, of course, no single answer because contextual variation. But the range of litigation possibilities is part of the firms’ cost management problem.

A large public company audit firm faces the prospect of litigation via at least 55 state, district, and territorial jurisdictions plus various federal statutes, the SEC, and the PCAOB that can result in multiple claims that are likely manageable in size plus mega suits of more than \$1 billion that are not. How should one analyze firm viability under such conditions?

With more information and data, independent scholarly researchers with expertise across multiple disciplines can directly address some of the question above and could help refine and frame others.

6. Are litigation costs a significant deterrence factor as stated by some investor advocates? Is there any research on this subject? Why or why not?

I am not aware of specific empirical research on deterrence although there is some analytical research using stylized mathematical models of various alternative legal regimes such as “loser pays court costs.” This is not to say that deterrence research isn’t needed.

To me, the question isn’t whether the potential for damages is a deterrence factor, clearly deterrence is important. Rather, the question is whether \$100 billion in potential damages provides substantially more deterrence than, say, \$100 million. Does *one thousand times greater* dollar exposure induce substantially more care in audit fieldworkers, managers, and partners as well as second partner reviewer and other monitors—especially when the subject matter is itself a matter of judgment? I doubt it.

7. Is there any research that supports or disputes the notion that adding the audit partner's signature to an audit report would enhance audit quality? If not, do you have any views on this subject?

I am not aware of specific "signature" research in auditing although there is behavioral research that supports accountability enhancement techniques such as adding one's signature. Personally, I am skeptical that manually signing one's name to an audit report would induce substantially more thought, effort, or care from an audit partner.

**Lynn Turner:**

8. Many students of accounting programs end up in a career other than a public accounting firm. What can or should be done to improve accounting education for these students?

At most top five-year accounting programs, about 90 percent of graduates are initially employed by large public company audit firms in audit, tax, or advisory positions. The remaining students are employed by corporations, Wall Street, government, or go to another graduate program. In my view, universities do a good job preparing students for careers in accounting and analysis positions outside of public company audit firms.

9. Should accounting programs be as focused as they are today on providing an education targeted to passing the CPA examination? If not, why not? If so, why?

To my knowledge, there is now much less emphasis on the CPA examination *per se*. Most universities have dropped "CPA review" as part of their curriculum.

10. Is the majority of newer faculty advanced to full professorship at your institution without having published in one of the top three or four academic [journals]? Should that be criteria for advancement in academic positions or as important a factor as the quality of one's teaching methods?

No one in my department has recently advanced to the rank of professor without multiple publications in the leading scholarly journals in accounting. Teaching is also important, but accounting professors must compete with finance, marketing, and management professors in increasing knowledge, and publication in leading scholarly journals is a primary metric by which performance is evaluated. As mentioned in my written comments, academic research can help inform practice and regulation and should be encouraged, in my view.

11. Some doctoral programs now take 5 to 7 years to complete. What are the benefits and costs of such an extended period and should it be shortened and if so, how?

Ph.D. programs have increased from 4 to 5 years to 5 to 6 years and might be shortened if more professors were available—but teaching budgets depend on the quality of scholarship within a discipline which, in turn, is reflected in publication in leading scholarly journals!

**Ann Yerger:**

12. Recent articles have reported that the Big Four are creating consortiums with colleges and universities to help develop college curricula on international financial reporting standards. How do these consortiums work; are these generally “exclusive” arrangements between a firm and a university?

I am not aware of “exclusive” arrangements between individual Big Four firms and individual universities regarding IFRS curriculum development. I am aware of short IFRS workshop programs offered to professors from multiple universities by KPMG and educational materials offered by all large firms.

13. Has this approach been used in the past on new accounting issues, and if so, what was the experience of these arrangements?

In the past, some individual Big Four firms have contracted with individual universities to meet short-term needs for personnel. These programs have had limited success due in part to the firms’ short-term interests—when a personnel crisis passes, so does the funding. Universities are naturally wary of making long-term commitments to curriculum revisions to meet short-term needs of private parties.

14. Are profession-university consortiums a beneficial approach for developing and maintaining dynamic curricula?

Perhaps. First, one should remember that most accounting professors view themselves as “scholars whose specialty is accounting” rather than as “public company audit professionals who specialize in training new entrants.” In addition, accounting professors have broader responsibilities than training for public company audit firms. These responsibilities color the effort that particular professors can devote to developing curricula to meet the immediate *specialized* needs of public company audit firms.

The nature of any such consortia also matters. On one hand (as mentioned above), past attempts to align particular firms’ interests in education and research tend to be short-term, while universities are interested in a discipline long-term and without regard to specific employer firms. By the time universities can respond to short-term needs of a particular firm, the firm has moved to some other critical need and funding of their special needs go with it. On the other hand, a broader consortium comprised of representatives from universities, public company audit firms, and the PCAOB might be a viable vehicle for economical development of relevant curricula.

Finally, although there are *many* reasons why professional schools of public company auditing are *not* a good idea, development of specialized curricula and support of independent, profession-specific research might be achieved through such a vehicle.

Respectfully,  
William Kinney

**Supplemental Written Testimony of Wayne Kolins  
National Director of Assurance of BDO Seidman, LLP**

Dear Members of the Committee:

I have been asked by a member of the Committee to respond to the following questions:

1. What is the impact on audit market competition of internationalization in auditing and accounting, including but not limited to the potential convergence with International Financial Reporting Standards, the growth of global networks, and the Concentration and Competition Chapter's Recommendation 6 on enhancing global regulatory cooperation and coordination?
2. What are the implications of these matters for the goals articulated in Recommendation 1 of the Subcommittee's section of the draft report (i.e., increased competition for audit services and encouraging the growth of firms beyond the four largest)?

I will respond to these questions on a combined basis because of their overlapping nature.

As I mentioned in my written testimony to the Committee on November 25, 2007, audit committees may review an array of factors in choosing an auditor that best matches the nature, location, and operations of the company. These factors include:

1. Accounting expertise/experience-Companies that frequently engage in complex transactions want to ensure that their auditor has the resources to analyze such transactions to ensure conformity with appropriate accounting rules and regulatory standards. In that regard, audit committees will likely want to be comfortable with the nature and accessibility of the firm's technical resources.
2. Industry expertise/experience-Some firms have extensive experience in certain industries. Audit committees want to deal with a firm that has demonstrated a deep understanding of the industry in question.
3. Experience in auditing public companies
4. Track record in adherence to professional accounting and auditing standards (e.g. PCAOB inspection results)
5. National and international reach-With the increasing expansion of business operations, accounting firms often need to have sufficient resources located in multiple states and countries
6. Quality of the firm's audit methodology and the consistency with which it is applied globally

7. The firm's client service model, including the extent and nature of partner involvement in the audit process and partner interaction with the company
8. Firm technology, including technical support provided to audit professionals
9. Composition of the engagement team, including technical and industry skills
10. Nature and extent of firm training programs
11. Quality of communications within the firm (e.g., between audit and tax professionals on the engagement teams and from the National office to the practice offices)
12. Firm culture and tone at the top (e.g., emphasis on audit quality and ethical standards)

Factors 1, 4, 5, 6, 8, 10, and 11 are particularly affected by the internationalization of auditing and accounting and the other circumstances mentioned in the Committee's questions. The expansion of these circumstances will require accounting firms to devote substantial funds and professional resources to training to understand new technical standards, particularly with respect to adapting to a principles-based approach requiring significant judgments. In that regard, as I also mentioned in my testimony, possible courses of action to help deal with this include:

1. Encouragement by regulators and exchanges of small-medium size firms to join a domestic alliance of independent firms to obtain services similar to that of a larger firm's National office-e.g., training; accounting and auditing updates; online professional literature resources; and access to accounting and auditing experts including industry experts (The BDO Seidman Alliance has functioned successfully in that regard.)
2. Enhancing the availability of specialized accounting and auditing training-e.g. from the AICPA or other professional bodies-to audit professionals from small-medium size firms
3. Renewal by the SEC Division of Corporation Finance of its practice fellow program. This program, as well as the existing program of the Office of the Chief Accountant, should provide opportunities for professionals from small-medium size firms.
4. Creation of a PCAOB practice fellow program, reaching out to professionals from firms of all sizes

I hope this is responsive to the questions.

Very truly yours,  
Wayne Kolins  
National Director of Assurance



**RESPONSES TO QUESTIONS FROM THE  
FEDERAL ADVISORY COMMITTEE ON THE AUDITING PROFESSION  
UNITED STATES DEPARTMENT OF THE TREASURY**

**ANNE M. LANG**  
**CHIEF HUMAN RESOURCES OFFICER OF GRANT THORNTON LLP**  
**June 27, 2008**

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- 1. To what extent is your firm ready to provide IFRS services to all clients? Is a plan currently in place? If you are not fully prepared today – how long do you anticipate that it will take to become fully loaded at all levels of staffing?**

We recognize the accelerating pace of global acceptance of IFRS and the need for the U.S. firm to master and apply IFRS in the very near future.

Today, Grant Thornton LLP is readily meeting the need for IFRS services from our clients and we will be ahead of future demand. Our plans call for preparedness scaled to meet demand and we will have sufficient personnel to handle our clients' IFRS-related needs when they are needed. We initiated IFRS training two years ago and continue to keep our key people abreast of developments. We have dedicated resources in our National Professional Standards Group and continue to publish material, including periodic newsletters, related to IFRS for both internal and external use.

Grant Thornton International Ltd, our global network, has a full-time International Financial Reporting Standards team that is responsible for promoting high quality, consistent application of IFRS throughout the global organization. The IFRS team is advised and supported by member firm IFRS experts, including an IFRS interpretations group. The IFRS team promotes consistency through an international training program, operating an IFRS helpdesk service and by publishing extensive technical and interpretative guidance, newsletters and other tools and resources. These materials, along with other IFRS developments, are communicated through a network of designated IFRS leaders in member firms, including our U.S. firm.

- 2. What does Grant Thornton do to help improve the retention of women in the firm?**

Retaining and *advancing* women is a Grant Thornton business imperative. For our firm to continue to be a strong organization, we need to keep and move up our top talent, as women comprise a very significant portion of the top talent pool. We have found that the Grant Thornton culture that favors flexibility and rejects a one-size-fits-all approach to career development makes us a very attractive workplace for both women and men.

Grant Thornton has made the firm an exciting career choice for women and working mothers in particular. Since 2004, the number of female partners at Grant Thornton LLP has increased by 145 percent. Thirty percent of our female partners hold leadership positions in our firm. Women represent some 47 percent of Grant Thornton's personnel.



RESPONSES TO QUESTIONS FROM THE TREASURY ADVISORY COMMITTEE ON  
THE AUDITING PROFESSION BY ANNE M. LANG, CHIEF HUMAN RESOURCES  
OFFICER OF GRANT THORNTON LLP (CONTINUED)

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Grant Thornton LLP was named a 2006 and 2007 Working Mother 100 Best Company by *Working Mother* magazine. *PINK* magazine's inaugural list of the Top Companies for Women included Grant Thornton LLP in its Elite Eight. For the third consecutive year, Grant Thornton LLP was named to the "Companies That Care" honor role.

Much of our recent success is a result of our Women @ Grant Thornton initiative, which specifically addresses the factors that encourage women to stay with the firm and advance. The initiative is run by a national managing partner who reports directly to our CEO, and is also guided by an active advisory board of men and women across the firm. We have found that Women @ Grant Thornton is successful because it embraces three essential elements: training, coaching and mentoring, and workplace flexibility. The initiative delivers these elements through national and local office programs including:

- Executive Presence – a training program that teaches women at Grant Thornton how to project confidence and their best professional image
- Growing Grant Thornton: Men and Women Succeeding Together – a training program focused on breaking through gender stereotypes
- Leading Women's Mentoring Program – an initiative specifically designed to address advancement issues. The program pairs our top female senior management with high performing female senior managers. Global research indicates that one of the top three barriers to women's advancement is lack of female role models. This program, currently in roll-out, is designed to overcome this barrier, while developing the executive potential of high performing women who can become the firm's future leaders.
- Off Ramping/On Ramping Program – an initiative developed to provide the opportunity for women to take time off for a couple of years, while remaining connected to the firm in anticipation of returning to Grant Thornton. Research shows that 37 percent of professional women voluntarily leave the workforce at some point in their career, on average for 2.2 years. After this brief break, some 93 percent try to re-enter, but less than 5 percent are interested in joining the companies they left. We want our best and brightest women to come back to Grant Thornton. Our program is designed to encourage qualified employees who leave the firm and workforce for some time to consider returning to Grant Thornton as their natural choice. We work to maintain a connection with these qualified professionals through periodic contact, supplying laptops and other facilitating technology, offering CPE training to help them uphold their professional status, providing networking opportunities and offering access to coaches, among other connective mechanisms.

A new program launched in 2007, called Grant Thornton – At Your Service, is available to all Grant Thornton people, but has been particularly popular with women. It is a free virtual concierge service that helps busy working parents find backup childcare, research schools and plan family vacations, among other activities.

**3. What specific recommendations do you have for providing additional and adequate funding for Ph.D. programs?**

We have seen that many schools do not have the resources to provide adequate funding for the length of time it currently takes a student to complete a Ph.D. in accounting – usually around five years beyond a Masters Degree. Two potential solutions worthy of consideration include providing direct scholarships to universities that would cover all the years necessary to complete a Ph.D. program or augmenting current scholarships that do not fund education for extended periods. The Advisory Committee may also wish to explore ways in which completion of Ph.D. requirements can be accomplished more efficiently and in less time, while upholding quality, as the current commitment is a deterrent both in terms of time and

**RESPONSES TO QUESTIONS FROM THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION BY ANNE M. LANG, CHIEF HUMAN RESOURCES OFFICER OF GRANT THORNTON LLP (CONTINUED)**

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cost. We ask that you place specific emphasis on evaluating how the dissertation process can be streamlined so that students do not languish unnecessarily while preparing their dissertations. As you look at changes in the undergraduate accounting curriculum, an evaluation of the Ph.D. track would be beneficial as well.

We also suggest that the Advisory Committee evaluate ways of supporting faculty who work with Ph.D. students. In many universities, advising and mentoring Ph.D. students does not count as part of a professor's teaching load, so faculty are often reluctant to take on this added responsibility. Financial incentives may be helpful. We note that spending more time advising and mentoring students is often difficult for faculty members with a heavy teaching load, intensive research underway or significant service-related responsibilities. Universities should be encouraged to find ways to identify their most gifted mentors and re-allocate faculty responsibilities to enable effective student mentoring.

**4. What can be done to improve retention of staff of CPA firms when the very successful ones have opportunities to take other positions that pay substantially more?**

We have found that the most important factors in keeping talented professionals within our firm are the opportunity for challenging and meaningful work, as well as the opportunity to grow and advance. These factors work either for or against retention. Top-caliber professionals at Grant Thornton like the intellectual challenge, engaging in a collective effort with other smart and interesting people, and having the chance to make a difference. Only very rarely does someone leave the firm – or choose another career – because of compensation alone.

**5. How would you envision using a faculty member on sabbatical at your firm?**

Grant Thornton's Academic Fellow program is based on the notion that the faculty member must have an experience that will make him or her a better teacher and researcher, and that Grant Thornton must benefit from the meaningful contribution of the resident faculty member.

The firm provides the faculty member with:

- The opportunity to take a real role in his or her area of interest, and participate in training, planning meetings, client service and appropriate management conferences and retreats,
- The opportunity to work with at least one national group within the firm in order to understand the infrastructure of the firm, how quality is controlled and ways in which individual offices and partners are connected through common methodologies, cultures and commitments,
- The opportunity to meet the firm's leaders and see them in action, and
- The opportunity to work on a significant research project to advance the firm's understanding of an issue, its professional practice or the quality of work performed.

The faculty member provides the firm with the following important contributions:

- Working in areas where his or her expertise would benefit the firm
- Identifying emerging areas that would benefit from additional research and academic pursuit
- Enhancing interactions between the firm and faculty members
- Participating in firm activities and providing an "educated outsider's" view
- Participating in AAA events as a representative of the firm
- Providing insights to the firm on recruitment of new entrants and training

BARRY MATHEWS, DEPUTY CHAIRMAN, AON CORPORATION  
ADVISORY COMMITTEE ON THE AUDITING PROFESSION  
QUESTIONS FOR THE RECORD  
JUNE 3, 2008 MEETING  
SUBMITTED: JUNE 30, 2008

Gaylen Hansen has posed the following questions:

1. In your view should something similar to the SEC's Rule 102(e) be the basis for clarification in the federal pleading standard related to litigation of audits of public companies?

Our expertise relates to the estimation of and the financing of the risks to professional organizations. We would suggest that this question is best posed to the attorneys who testified before the Committee.

2. Do you have an opinion as to whether all audit related issues of public companies should be moved from state to federal court?

Our expertise relates to the estimation of and the financing of the risks to professional organizations. We would suggest that this question is best posed to the attorneys who testified before the Committee.

3. You testified that the large audit firms are at risk of catastrophic litigation based on the existing outstanding claims. Since the firms have not provided settlement to claims data and other financial information requested by the Committee, what additional information could assist us in validating the firm's assertions that liability reforms are warranted?

Just on a point of clarification, what I said in my testimony was that at no time have we encountered a situation in which there existed as substantial a threat to the sustainability of audit firms as that created today by the potential for mega professional liability claims brought in US courts. So I am looking not just at the threat posed by existing outstanding claims but also at that posed by the potential for very large claims in the current risk environment.

In regard to what information we can provide, Aon works with its clients under various confidentiality and non-disclosure agreements that limit the amount of information that we gain from our clients that we can then pass on to third parties. I am sure that you understand why such agreements are a necessary aspect of our business relationships. Obviously, we can, and are willing to, provide publicly available information to the Advisory Committee relating to both auditors' historical claims experience and outstanding claims against the audit profession. Subject to agreement as to the time frames in which the information would be required to be produced, we could also provide comparative information to the Advisory Committee - perhaps based on current versus older claims made against the accounting firms, to evidence the growth in quantum of demands, or the relative size of claims brought against auditors versus those brought against other professional firms. The latter

information will require some research on our part and we are uncertain as to the depth of information that may be available in the public domain.

Bill Travis has posed the following questions:

4. The Advisory Committee is locked in a dispute over the question of whether there is significant risk of losing a large audit firm due to litigation risk. Some Advisory Committee members are insisting that audit firms provide detailed information about their litigation history. Other Advisory Committee members believe that information provided by Aon clearly indicates that audit firms do face significant risk of sustainability. Can you provide any additional factual support that can help us break this deadlock?

We are not aware as to the extent of information that has been made available to the Advisory Committee by the audit firms or what the points in dispute are. As noted in the response to Mr. Hansen's questions, we tend to work with our clients under various confidentiality and non-disclosure agreements that define the information that we receive from our clients that can be provided to third parties. As you can appreciate, those agreements preclude us from providing the statistics relating to professional liability claims that were notified to us by the firms themselves. However, we do undertake a significant amount of research and mine publicly available claim related information, which you may find useful in your deliberations and we could make available to you.

We are also cognizant that the factual support that may assist you in your discussions is not necessarily just claims or settlement data. It may include facts about the current risk environment, i.e., the key drivers of risk, as we see them and upon which we provide advice to our clients. Whilst we believe the Committee has signaled that it is looking for background data that is largely based on settlement values rather than the quantum of claims made, perhaps because the Andersen claims in particular were settled for relatively low values, we believe that additional detail as to these drivers may give the Committee insight into the relationship between the claims and subsequent settlement levels. We could provide a review of some of the recent extremely large settlements (from publicly available sources) look at the underlying factors that drove these high settlements, and test whether these factors remain strong, are weakening or may be intensifying.

We would be happy to have a conversation with you and other members of the Committee regarding the type of information that you would find to be helpful in breaking this deadlock, and whether such information can be provided.

5. Would it make sense for large firms to separate their audit practices into separate legal entities that would be part of a larger complex of entities with a holding company? Would this structure help contain the financial risk of auditing public companies?

On the face of it we do not see how a reorganization of the accounting firms would reduce the risk to the auditors.

Separating the audit practice from the remainder of the firm would obviously reduce the risk to the partners in other practice areas, where contractual limitations of liability may be commonplace and where the risk resulting from potential malpractice claims is generally more limited. However, it would not seem to provide any additional protection for the auditors themselves. From a risk financing perspective, as the separation may require that insurance policies be underwritten separately for the audit and non-audit practices, the firms may actually have to put more capital at risk in their captives and underwrite additional insurance limits through their captive insurance companies. All in all, providing insurance to the separate entities could increase the costs to the firms.

Lynn Turner has posed the following questions:

6. Do you believe liability should be limited for an auditor who is found to have been aware of improper financial reporting and still issued an unqualified report or for an auditor who was unable to detect massive fraud such as those that during the past decade ran into billions of dollars?

Mr. Turner poses an interesting question. I would like to answer it in two parts - first, with a personal opinion; and second, by referring to approaches undertaken elsewhere.

#### Personal Opinion

It is my opinion that liability caps should be enforced in all circumstances except those in which the firm, as defined by the executive management of the firm, is deemed to have acted fraudulently or criminally in the attestation process. In such a situation, the value of the firm to the financial community is suspect at best and I would question its continuing worth to the general commercial process.

However, I would view the fraudulent or criminal actions of a partner, manager or of a limited group of partners and managers in the falsification of a financial report to be as much a defrauding of the audit firm (his or her partners and employees) as it is the defrauding of investors, creditors and others. In these circumstances I believe that a liability cap should be enforced to protect the firm as a whole, but there should be no limitation of liability against the purveyors and abettors of the fraud. In these circumstances, it seems to me that the audit firm continues to provide significant value to the financial community, and its ability to continue in business should be protected. The pain inflicted by a significant settlement or judgment on an audit firm within the liability cap would seem to me to be a sufficient penalty.

#### Other Approaches

As you know, some jurisdictions have employed liability caps on claims arising against auditors on statutory audits for many years. Germany is an excellent example

of such a liability regime. In most cases such caps may not apply in the cases where fraud or gross negligence on the part of the auditor is proven in court. However, it should also be noted that such jurisdictions also tend to have cultures that are substantially less litigious than the US, where any such determination would be made by a judge whose specialty is commercial law. In these cases the laws are in harmony with the general outlook as to compensation and the role of the courts in the settlement of disputes.

7. For each of the past ten years, what has the average settlement of claims against auditors been for audits of public companies in (please divide your responses between settlements involving companies with market capitalizations of less than \$1 billion and greater than \$1 billion):

We are unable to answer questions 7 and 8 because our settlement data, though very extensive, does not cover all settlements by all audit firms in the US over the period in question

a. State courts?

b. Federal courts?

8. What percentage of the amount claimed has been paid in the settlements in (1) above?

9. What do you believe is an appropriate pleading standard if all claims are removed from state courts to exclusive jurisdiction of federal courts?

Our expertise relates to the estimation of and the financing of the risks to professional organizations. We would suggest that this question is best posed to the attorneys who testified before the Committee.

10. Do you believe investors right of action of and accompanying liability damages should be limited for an auditor who was unable to detect massive fraud such as those that during the past decade ran into hundreds of millions and even billions of dollars; or against an auditor, or audit firm, that is found to have been aware of improper financial reporting by a public company and still issued an unqualified report?

This question has been responded to above.

11. How have or will the U.S. Supreme court decisions regarding Dura Pharmaceuticals or Tellabs likely affect litigation against the audit firms?

Our expertise relates to the estimation of and the financing of the risks to professional organizations. We would suggest that this question is best posed to the attorneys who testified before the Committee.

12. Are you aware of any caps placed on losses that investors may suffer when an audit is found to be negligent, reckless or fraudulent?

We are not aware of any circumstances where an auditor in the United States is able to limit liability on an engagement for a publicly held client.

13. You testified that bonding for an appeal is a problem. However, in the BDO Seidman case in Florida the CEO of the firm in the case publicly stated they did not have a problem providing sufficient bonding. What cases are you aware of in the past decade where the firm was unable to obtain bonding and was it in a federal or state court?

We are familiar with both the BDO case to which Mr. Turner refers and the bonding issues facing the accounting profession.

First, it is important to note that the CEO of BDO Seidman (BDOS) has also said that if the judgment is affirmed, that BDO Seidman would be unable to respond to it because of its quantum and would be forced out of business. We mention this because an appeal bond is, for all intents and purposes, a security rather than an insurance policy. The surety rents its capital to the purchaser of the bond rather than "bets" its capital as in an insurance policy. The surety expects that the principal (the party who contracts for the bond) will make it whole in the event the obligee draws down the bond. As such, the surety would expect the principal to fully collateralize the bond. As you can appreciate, if BDOS would have been forced to procure a bond of a quantum equivalent to the judgment, given the statement of the BDOS CEO, no surety would have provided it. However, BDOS was fortunate in the sense that the judgment was brought in Florida, a state which imposes a \$50,000,000 cap on the size of appeal bonds required to appeal a financial judgment. A surety cap is a feature of a minority of states and not applicable to federal court. It is worthwhile to note that subsequent to the judgment the plaintiffs tested the constitutionality of the surety cap to put additional pressure on BDOS.

Surety bond capacity is a major issue for auditors in the US and has been for some time. It is the knowledge the accounting profession has of this problem that tends to lead audit firms away from the courts to the settling of cases that they may have preferred to defend, but are unable to because of the potential downside of losing a court case at first instance.

14. In how many cases or what percent of cases have plaintiffs been able to discover the amount of insurance coverage the audit firm has?

It is generally accepted that in US courts plaintiffs can force the production of the defendant's insurance policy during the discovery phase of a trial. This is true for a small number of other countries as well. We would defer to the attorneys on the panel to offer a fuller explanation of the discovery process.

**Results from McGladrey & Pullen LLP's Survey of Mid-Size and Smaller Auditing Firms  
Concerning Questions Posed by Damon Silvers at the June 3, 2008 Meeting of the Advisory  
Committee on the Auditing Profession**

**Question 1**

What is the impact on audit market competition of internationalization in auditing and accounting, including but not limited to the potential convergence with International Financial Reporting Standards, the growth of global networks, and the Concentration and Competition Chapter's *Recommendation 6* on enhancing global regulatory cooperation and coordination?

**Firms' Responses**

**Firm 1.** *Recommendation 6* discusses audits of public companies that we currently are not auditing. A potential convergence with IFRS would require firm-wide training and obviously cost a significant amount of money. The Big 4 firms already have specialists in IFRS and would have even a greater advantage on winning larger clients and retaining them.

**Firm 2.** For auditing firms that are currently in the public company audit market, internationalization in accounting and auditing improves the competitive position of small and mid-sized auditing firms, as compared to the largest four firms. However, we believe the impact on audit market competition for larger public companies to be constrained by other barriers (as discussed in our response to Question 2 below).

Geographical limitations in terms of physical presence to provide audit assistance and knowledge of foreign/International generally accepted accounting principles (GAAP), as well as foreign tax laws, is becoming less of an issue for smaller and mid-sized auditing firms due to the growth of global networks. The development of technology and the expansion U.S. companies (both private and publicly owned) into overseas markets have necessitated small and mid-sized auditing firms to work more closely with each other around the world. The growth of these global networks has increased the willingness of public companies to work with small and mid-sized auditing firms, and has already increased competition in the audit market, mainly amongst small and mid-sized public companies. *Recommendation 6* to enhance regulatory collaboration and coordination between the PCAOB and its foreign counterparts would provide an additional stimulus to the growth of global networks.

The primary issue facing small and mid-sized U.S. auditing firms is the control of audit quality in the global networks, and the differences between U.S. and foreign/International generally accepted auditing standards (GAAS). U.S. member firms normally lack the ability to monitor the methodology or quality of the work performed overseas, making it difficult for a U.S. firm to rely upon the audit work performed by a foreign affiliate. Internationalization of auditing standards that would allow a U.S. firm to rely upon the work performed by an overseas affiliate with minimal monitoring could result in small and mid-sized auditing firms being able to further expand their presence in the public company audit market.



**Firm 3.** Once public companies begin reporting under IFRS, market pressures will not support 2 sets of reporting standards for public and private companies and GAAP will no longer be the “gold standard”. As such, private companies may be forced to report under IFRS by users of financial statements. From an audit perspective, there are a lot of small public accounting companies that will struggle with learning and applying an entirely new set of financial reporting standards. There will be a significant period of time where financial statements will more than likely not be in full compliance with IFRS and will be confusing to users.

Under the new QC standards issued by the AICPA, many smaller audit firms will more than likely receive “Fail” reports as they struggle to properly apply IFRS.

Because of the significant change and internationalization, smaller public accounting firms will not be able to compete with bigger firms that have the resources and time to properly apply the changes.

**Firm 4.** The continued complexity of new accounting and auditing standards will eventually drive many firms out of the audit business. We are seeing many small firms in our markets deciding to stop doing audits. I think this will continue to happen and start moving to mid size firms in the future. There needs to be recognition that privately owned companies gain little value from the majority of this stuff.

**Firm 5.** Convergence with IFRS will initially favor larger firms that have existing global networks. However, as global standards become THE standard, market competition will be diminished.

## **Question 2**

What are the implications of these matters for the goals articulated in *Recommendation 1* of the Concentration and Competition Subcommittee's section of the draft report (i.e. increased competition for audit services and encouraging the growth of firms beyond the four largest)?

## **Firms' Responses**

**Firm 1.** This is something our firm is already in process of accomplishing. Instead of having generalist accountants we are moving towards specialists.

**Firm 2.** *Recommendation 1* states that barriers to the growth of smaller auditing firms need to be removed to increase competition in the audit market for public companies. We believe that it will be challenging to increase the amount of competition in the audit market for larger public entities (annual revenues over \$500 million). However, the recommendations contained within Section VII. Concentration and Competition of the Advisory Committee's report are likely to increase competition in the audit market for small and mid-sized public companies (less than \$500 million in annual revenues).

Since the passage of the Sarbanes-Oxley Act of 2002 and the creation of the Public Company Accounting and Oversight Board (PCAOB) many small and mid-sized auditing firms have

elected not to audit public companies. The decision was based almost exclusively on the actual and perceived costs of continuing to operate in the public company audit market. Experience among many regional and local firms has shown that a public company audit practice in the current regulatory environment requires a substantial investment of time, effort, resources and money. Differences between U.S. and foreign/International GAAP and GAAS, and the firms' lack of knowledge of those differences, likely had minimal impact on the decision. The internationalization of accounting and auditing standards, the growth of global networks, or *Recommendation 6* to enhance global regulatory cooperation and coordination, is unlikely to result in these firms returning to the public company audit market.

As noted above, internationalization in accounting and auditing improves the competitive position of small and mid-sized auditing firms, as compared to the largest four firms. However, other barriers to auditing larger public companies (annual revenues over \$500 million) present more difficult hurdles for these small and mid-sized auditing firms to overcome.

Small and mid-sized auditing firms have structures in place to provide efficient and effective audits for small and mid-sized companies, whether they are public or privately owned. This strategic advantage over the four largest auditing firms is the most likely reason why 78% of small (annual revenues less than \$100 million) and 29% of mid-sized (annual revenues of \$100 to \$500 million) public companies in 2006 were audited by small and mid-sized auditing firms, as opposed to only 2% of the 1500 largest public entities. Small and mid-sized auditing firms are likely to be more interested in expanding their public audit practice in the small and mid-sized public company audit market, rather than expanding into auditing of larger public entities.

We consider the following reasons to be most important as to why small and mid-sized auditing firms are likely to be unwilling to audit large public companies:

- Many of the small and mid-size auditing firms do not have the detailed, specialized knowledge, or practice aids, to be able to effectively and efficiently respond to complex accounting and auditing situations of larger public companies.
- Smaller and mid-sized firms frequently do not have the staff and other resources available that are required to audit larger public companies.
- Increased risk of catastrophic loss from litigation (the Committee's *Recommendation 2*, to help protect auditing firms from catastrophic loss, may lessen this issue).
- Limited access to appropriately priced professional indemnity insurance.
- Increased business risk resulting from a few very large clients, in comparison to the remainder of their client base.

The majority of small and mid-sized auditing firms in the U.S. have designed their business model and structure to provide effective and efficient audits for middle-market clients (annual revenues of approximately \$10 million to \$100 million). These models and structures are normally scalable to larger clients up to approximately \$500 million. Removing barriers such as restrictions from members of capital markets, homogenization of U.S. and International GAAP and GAAS, harmonization between the PCAOB and its foreign counterparts, will provide small and mid-sized auditing firms more access to audit public companies. However, we do not consider the removal of these barriers likely to incentivize the small and mid-sized auditing firms

to change or adapt their business models and firm structures in order to audit larger public companies.

The following barriers to small and mid-sized auditing firms auditing large public firms are considered more important than the issue of internationalization of accounting and auditing in preventing small and mid-sized auditing firms from auditing large public companies:

- Members of audit committees of large public companies are reticent to look beyond the four largest auditing firms for their audit.
- Restrictions on auditor selection from providers of funding and other members of the capital markets.

The Committee's recommendations designed to improve the profile and name recognition of small and mid-sized auditing firms is likely to help with these barriers. Requirements to disclose provisions within agreements that limit auditor choice will add pressure for members of capital markets to take a more expansive view of the audit market. However, currently held biases within audit committees and capital markets of "bigger is better" with regards to auditing firms is likely to persist without an initiative such as *Recommendation 3*, the development of publicly disclosed indicators of an auditing firm's audit quality. The development of audit quality indicators (calculated consistently between different auditing firms) will allow audit committees and stakeholders to make informed qualitative decisions with regards to auditor selection.

In conclusion, we consider that the internationalization in accounting and auditing is facilitating the increased competition in the audit market for public companies. However, other barriers need to be addressed before any real changes in the audit market for larger public companies are realized, most noticeably, the risk of catastrophic loss. Additionally, we believe that it is possible, even in the long term, that there will not be noticeable changes in audit market competition for larger public companies due to the organizational structure of the largest four to six auditing firms being more suited to produce an effective and efficient audit for larger public companies than that of the small and mid-sized auditing firms.

**Firm 3.** Many of the barriers to that keep smaller auditing firms from being unable or unwilling to enter the large public company audit market cannot be effectively removed.

The most significant barriers deal with legal exposure and business models/firm structures that do not support serving large public companies.

Although representation of smaller auditing firms in committees, fellowships, etc. would be beneficial, it would only give that public accounting firm a marketing point to talk about. It does not remove the legal exposure barriers or solve inadequate business models.

For small regional auditing firms, being able to be part of a "network" to a larger mid-tier auditing firm does provide more flexibility and ability to effectively serve larger public companies. It also allows regional firms to have access to technical support, international firms, etc. necessary in order to do that.

**Firm 4.** The complexities are going to reduce, not increase, future competition.

**Firm 5.** Very little short term implications, and potential barriers with financial market recognizing smaller firms as adequate "insurance" will cause further delay in acceptance of smaller audit firms beyond largest firms.

NELL MINOW, EDITOR & CO-FOUNDER, THE CORPORATE LIBRARY  
ADVISORY COMMITTEE ON THE AUDITING PROFESSION  
QUESTIONS FOR THE RECORD  
JUNE 3, 2008 MEETING  
SUBMITTED: JUNE 11, 2008

Gaylen Hansen has posed the following question:

1. You testified that the expectations of auditors should not be lowered but rather raised. What mechanisms do you see as appropriate to accomplish such a change most effectively?

This should be done through the PCAOB and AICPA.

Zoe-Vonna Palmrose has posed the following question:

2. You mentioned that the Arthur Andersen Public Review Board of which your father was a member, disbanded soon after Andersen issued its 1980 Annual Report (with audited GAAP financial statements). What is your understanding of (1) when and why the Public Review Board was disbanded and (2) when and why Andersen ceased issuing GAAP financials?

Those questions have to be asked of the people who made those decisions; I was not party to them.

Bill Travis has posed the following questions:

3. Can you provide further explanation of why the Advisory Committee should not ask the PCAOB to determine whether to provide audit firm audited financials to the public? You state that this would provide significant pressure on the PCAOB.

I have the highest regard for the independence and integrity and ability of the PCAOB but my experience is that when advisory groups call on regulatory bodies to make such decisions are subjected to enormous pressure from the regulated bodies, especially when they are as controversial as this issue has been. As I said in my testimony, I prefer that they be encouraged to explore ways to encourage innovation and competition in financial disclosure.

4. You mentioned innovation in the audit profession should be encouraged. Can you clarify what areas the profession should focus its attention towards?

I was speaking specifically about the recommendations before us but also more generally about the perverse consequences of command-and-control regulatory structures.

Lynn Turner has posed the following questions:

5. Do you believe the level of transparency of audit firms is currently acceptable?

I believe that more disclosure of items like litigation reserves would be of use to audit committees establishing their levels of confidence in audit firms.

6. You testified that “market forces” should be used to obtain greater transparency from the audit firms. Yet the firms have refused to provide information to audit committee chairs such as the non public portion of their PCAOB inspection reports. In addition, during the 1970’s Congress urged the firms to provide greater transparency through the submission of financial reports yet all but Arthur Andersen declined to do so, and at a later date, Andersen also ceased providing transparent financial statements to the public as well. What evidence do you have that you can share with the committee that market forces will result in actually achieving the transparency suggested in the addendum to the Treasury committee report? What specific type of market based approaches would you recommend be taken with respect to improving the information provided to investors to be used as a basis for their vote on the ratification of auditors, and the auditors financial stability, capital and liquidity?

The difficulty here is in the small number of firms available to do the work required by large and complex public companies. But I believe that if audit committees said they would not retain the firms unless they provided the level of information required to give them confidence, they would have to do so. I do not believe that they should be required to do GAAP accounting. No one understands the benefits and limitations of GAAP accounting better than they do and if they do not believe it is appropriate for an enterprise whose assets are almost exclusively human and intellectual, that is understandable.

7. Do you believe investors private rights of action of and accompanying liability damages should be limited for an auditor who was unable to detect massive fraud of the magnitude such as those that during the past decade ran into hundreds of millions and even billions of dollars; or against an auditor, or audit firm, that is found to have been aware of improper financial reporting by a public company and still issued an unqualified report?

I can see both sides of this one as well as the side that supports some formula of proportionate liability. Fairness argues against a liability cap for anyone who was aware of improper financial reporting. But without one it just moves the rulemaking over to the insurance providers and that system has no accountability whatsoever.

JULES MUIS, FORMER VICE PRESIDENT AND CONTROLLER,  
WORLD BANK  
ADVISORY COMMITTEE ON THE AUDITING PROFESSION  
QUESTIONS FOR THE RECORD  
JUNE 3, 2008 MEETING  
SUBMITTED: JUNE 30, 2008

Q 1) IS THERE ANY EVIDENCE THAT SUPPORTS THE POSITION THAT  
ADDING AN INDIVIDUAL PARTNER'S SIGNATURE TO AUDIT OPINIONS WILL  
IMPROVE AUDIT QUALITY? (Bill Travis question)

ANSWER JWM:

I am not aware of any persuasive empirical research undertaken and/or concluding either way, in favor or against. Having said that, I think any such research when undertaken would be severely handicapped by an inherent inability to audit trail conclusively the real thought process that goes into audit sign offs. This tentative observation is also manifested by audit oversight bodies (such as the PCAOB) own reporting, never giving systemic positive assurance on the results of audit firm reviews, their conclusions mostly being piecemeal or couched in (open-ended) negative assurance terms ("..nothing has come to our attention...")

It is tempting to think that because none of the major financial calamities we have seen were preceded by timely audit warnings in the form of audit qualifications -on both sides of the Atlantic- points in the direction of a systemically failing audit profession. It is even more tempting to think that because we have seen many more re-statements of financial statements in the US than in Europe -where numerous countries already required individual sign offs prior to its introduction in the EC 8th Directive- that Europe would have an edge in claiming audit effectiveness compared to the US. However, the latter would be jumping to conclusions- ignoring the differences in extant US/EU regulation and (rigor in) audit and accounting traditions. And the former - judging a profession by its error rate only - whatever instinctively appealing, would be premature. It would ignore the fact that in order to assess an audit profession's effectiveness/added value one would have to consider the whole universe, i.e. all audit opinions expressed, both when things went visibly wrong; as well as when things appear to be right. What is missing in this equation is the question HOW MUCH PAIN/AUDIT EFFORT IT TOOK THE AUDITORS TO TO CONVINCING ITS CLIENT TO GET IT RIGHT, PRIOR TO EXPRESSING AN OPINION ON THE ACCOUNTS. Empirical research into a profession which failures become (selectively) manifest, and with not all failures necessarily surfacing; but its professional astute good efforts in arm-twisting clients in doing the right thing never surfacing, runs a real risk in misjudging same profession's (in)effectiveness.

In order to establish the overall performance of the audit profession by empirical research, one would need access to a representative sample of the whole audit universe,

be (made) privy to the judgmental issues and how they have been resolved, witness audit judgment in action from bottom-top, top-down and sideways, including getting hold of all relevant and substantive reasons why an audit opinion call was made one way or another, and establish possible co-mingling of competing professional and client relation decision drivers. In short it would basically require, against the background of a potential litigation perspective prevalent in many grey situations, audit firms to put the Fifth Amendment on hold, dramatically change their audit paper documentation and retention policies, and convince them, indeed, "to be so open-minded that their brains pop out". This is unlikely to happen any time soon.

Hence the decision to add an individual partners' signature will have to be based on common sense, precedence and deduction, like many macro and micro controls we introduce. Common sense and experience tell us that a double lock system will give us more protection than a single lock. It will also increase the chance of being locked out occasionally from consensus within the firm, sometimes for the right, sometimes for the wrong reasons. Calling for extra due caution prior to sign off, not an excessive luxury in the public interest setting of the audit profession. Whether in balance it is worth the (limited) hassle will depend on the circumstances. The prevailing circumstances in the profession are that the double lock system already exists firm-internally. The audit process involving a multiple lock system of cascading sign offs in any audit setting, including sign off for the whole by the engagement partner. In short the audit profession has already concluded that multiple sign offs are definitely good for internal quality assurance purposes. The question then remains why what is good for firm-internal purposes should not be good enough for external purposes, limited to disclosure of the concurrence of both the ultimately responsible engagement partner and his firm with the audit opinion expressed, for the world to see.

Needless to say that it will not be very attractive for a firm, or the engagement partner for that matter, to add an extra individualized signature for external purposes, since it complicates legal liability questions and gives some extra weight to the opinion of the individual engagement partner, at the possible expense of the firm's (also commercial) interest as a whole; and/or vice versa. And some engagement partner's may not like the reputational risk that goes with a visible identification. But from a user perspective it can be seen as a useful manifestation of a profession living by its credo of individual professional responsibility within the quality assurance framework/brand management policies of the audit firm involved. I personally think the visible joint and several impact of dual sign off is a useful, painless and near-gratis improvement in audit accountability. A low hanging fruit immediately within the Committee's reach.

For the doubters among the Committee members I recommend to also go for 'precedence' or example as a supporting argument. From individualized dual sign offs on joint tax filings, CFO/CEO's SOx inspired sign offs, till any other individualized sign off required by custom, law or regulation. Or to imagine what would happen if we would, across the board, do away with individualized sign offs in favor of institutionalized sign offs only. From that it is clear that adding one's individual name and signature to any institutional assertion helps beef up credibility, exposure and due diligence of all involved. In



particular for a profession that has individual professional responsibility as its professed core accountability mantra; to be of equal weight with the firm's responsibility. This issue calls for and/or thinking; rather than either/or.

Finally, may I refer those who prefer to first see empirical research (to effectively do the impossible, see above) on the subject to the observation of a 19th Century Prussian General: "The Romans would have never conquered the world, had their soldiers been obliged to learn Latin first".

Q. 2: IN YOUR TESTIMONY YOU ADVISED THE COMMITTEE TO PAY ATTENTION THE RE-GROWTH OF THE CONSULTING PRACTICE WITHIN AUDIT FIRMS AND THE DANGER THIS BECOMING A MAJOR FIRM DISTRACTION. ARE YOU SEEING ISSUES OF INDEPENDENCE THAT RAISE CONCERNS? DO YOU ADVOCATE AN AUDIT-ONLY FIRM AND IF SO WOULD YOU PRECLUDE FIRMS FROM PERFORMING TAX SERVICES? (Lynn Turner question))

ANSWER JWM:

I strongly believed for the first 30 years of my career that the audit profession could deal with the challenges and temptations that go with offering both audit and consulting services at the same time. Enron/dot.com changed all that and I belatedly and reluctantly concluded that the profession had not lived up to its own expectations. I have since supported the prohibition of consulting services to audit clients. My present position is that I am (still) giving the benefit of my ever increasing doubt to the fall back position as is, i.e. allowing for providing consulting services next to audit services, for non-audit clients only that is. Frankly admitting that also that position has eroded in my own mind in the wake of the aggressive tax advisory scandals; and the reemergence of audit firms as robust consulting firms. In particular when systemic positions are being taken, be it on accounting standards, tax, regulatory arbitration, HR, all areas that may effect the interest of individual audit clients, extant and potential, hence audit judgment.

At this juncture I am not ready to make a new move next station, i.e. to-wards recommending a mandatory audit-only business model. But I wanted to signal in my submission of May 23,2008 that it would not hurt if the Committee would make clear that the option of a designated audit-only firm is real and is there; that the Committee sees it as viable (which it is); and should be introduced if once again the profession fails to meet expectations on its public interest inspired audit role. As a shot in front of the bow of a profession that too often suggests that, having shrunk to 4 players, each and any of the 4 is too crucial a link in the fragile chain hence too big to fall in the present audit landscape. This having been born out in, and reinforced by the recent tax advisory scandals, which was resolved at the expense of introducing 'moral hazard', aggravating an already fragile situation.

A Committee view to the effect that it sees an audit-only designated firm construct as a viable option for the future - but one it is not recommending as yet - would be a salutary

and responsible comment for all concerned. And pave the way for extra due caution in audit firms' behavior, safeguarding its privileged position. I realize such forewarning would still not address the distractions that go with allowing a public function to be carried out in a for profit setting, inevitably introducing trade offs between the professionally required and the commercially desirable. But time has come to address the distractions and temptations that go with branching out into other professional areas (including tax services), inevitably causing crosswinds effecting the dedication and integrity that go with the audit role. I have come to conclude that we should do away with the notion that tinkering with the present business model is going to be disastrous for quality audit delivery; or the recruitment of state of the art professionals by audit firms. There are plenty of government agencies, including the GAO's of this world, that prove differently and actually demonstrate a real skill and professional astuteness in when and how to express other than clean opinions.

Our present macro audit business model boils down to rainmakers having been granted a state sanctioned monopoly in running the umbrella manufacturing industry. They are understandably keen to expand their activities to also include making thunder and lightning and windstorms. The embedded conflicts can just be too much for public comfort.

In sum, making clear up front there are other, more penetrating but viable, options available beyond the Committee's extant recommendations, cannot hurt.

## Treasury Committee Questions for Kathryn A. Oberly

From Gaylen Hansen:

**“1. You testified that the large audit firms are at risk of catastrophic litigation based on the existing outstanding claims. Since the firms have not provided settlement to claims data and other financial information requested by the Committee, what additional information could assist us in validating the firm’s assertions that liability reforms are warranted?”**

The six largest U.S. audit firms have provided to the Committee an unprecedented view of heretofore private information about their internal workings and finances, as well as the litigation risks that threaten the profession. I urge the Committee to review carefully the January 23, 2008 submission from the Center for Audit Quality (“CAQ”), along with its supplements on March 5 and April 16, 2008. The European Commission also has recently acknowledged the magnitude of this risk to the profession.<sup>1</sup> I also recommend to the Committee the comment letter from Ernst & Young, dated June 27, 2008, in which we present the numerous authorities that have identified the risk of catastrophic litigation. Indeed, citing the collapses of Laventhol & Horwath and Arthur Andersen and the \$521 million state court judgment against BDO Seidman that is currently on appeal, the Committee itself has identified the risk of catastrophic litigation as “real.”<sup>2</sup> In short, there is ample and compelling evidence before the Committee to support the conclusion that the catastrophic litigation risk to the profession and the resultant risk to market stability and investor interests are real and significant.

Fundamentally, too, the provision of additional data relating to past settlements would not help to establish the nature of catastrophic litigation risk. That our firm and others have been able to achieve outcomes short of the demise of a large firm in the past is not a reliable indicator of what may happen in the future. So long as the current system, which has indisputably brought down at least two audit firms and is threatening another, remains unreformed, catastrophic litigation could strike at any time.

**“2. With the advent of SOX, a regulated industry was created. In addition, audit firms enjoy exclusive right to the attest franchise. To what extent do you see that franchise and regulated firms as having a responsibility as ‘public interest entities’ to provide information publicly? How would you distinguish any limitations with other regulated concerns such as utilities and insurance companies that are not SEC reporting concerns?”**

I would refer you to EY’s comment letter of June 27 and focus your attention on the transparency section of the letter in which we express support for enhancing

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<sup>1</sup> See *Commission Recommendation of 5/VI/2008 concerning the limitation of the civil liability of statutory auditors and audit firms* (2008), at 2.

<sup>2</sup> Draft Report of the Advisory Committee on the Auditing Profession (May 5, 2008) at VII:6 [hereinafter “Draft Report”]; 73 Fed. Reg. 28,190, 28,204-05 (May 15, 2008).

transparency of audit firms to the public, audit committees, and regulatory authorities as is relevant and appropriate.

**“3. To what extent is your firm ready to provide IFRS services to all clients? Is a plan currently in place? If you are not fully prepared today – how long do you anticipate that it will take to become fully loaded at all levels of staffing?”**

Given the global movement toward IFRS, regulators, preparers, audit firms, analysts, and others are consciously increasing their investments in preparing for what we believe to be an inevitable shift in the U.S. to IFRS. The U.S. accounting profession has responded to previous changes, and there is no reason to believe that its professionals will not respond to this newest change in timely fashion. To ensure that the profession and others will be prepared is part of the reason why EY has advocated establishing a future date-certain for adoption of IFRS, not only to provide a clear deadline by which the preparers, auditors, other market participants, and academics should prepare for the switch, but also to encourage the legal and regulatory changes that would be necessary to facilitate a full move away from U.S. GAAP and to IFRS.

**“4. In your view should something similar to the SEC’s Rule 102(e) be the basis for any clarification in the federal pleading standard related to litigation of audits of public companies?”**

Rule 102(e) of the SEC’s Rules of Practice is not a pleading standard. Rather, it represents a substantive regulatory standard to be applied by the SEC in administrative actions, not by courts presiding over private litigation. Rule 102(e) is confined to situations in which the SEC, acting as a regulator and in the interest of the investing public, uses its significant authority to determine who can and cannot practice before it. The SEC’s power under this provision is expansive, and even includes the ability to impose sanctions for two types of negligent conduct.

Private litigation presents a very different context than the regulatory setting in which Rule 102(e) is applied. In particular, pleading standards are used in private litigation to set the minimum threshold for evidence and presentation in order to survive a motion to dismiss. Rule 102(e) simply would not translate well into a pleading standard, and it would be inappropriate to try to force Rule 102(e) into this framework. In addition, I believe it would be inappropriate to incorporate Rule 102(e) into a substantive liability standard in the context of private securities litigation. As I stated before the Committee, “[a]n actual knowledge standard would be a huge improvement” over the current recklessness standard in actions brought under the federal antifraud provisions.<sup>3</sup>

From Bill Travis:

**“5. The Advisory Committee is locked in a dispute over the question of whether there is significant risk of losing a large audit firm due to litigation risk. Some Advisory Committee members are insisting that audit firms provide detailed**

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<sup>3</sup> Written Submission of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, June 3, 2008, at 11.

**information about their litigation history. Other Advisory Committee members believe that information provided by Aon clearly indicates that audit firms do face significant risk of sustainability. Can you recommend an approach whereby E&Y would submit the detailed litigation information the Advisory Committee originally requested, while retaining the confidentiality of the information?"**

The six largest U.S. audit firms have provided to the Committee an unprecedented view of heretofore private information about their internal workings and finances, as well as the litigation risks that threaten the profession. I urge the Committee to review carefully the January 23, 2008 submission from the Center for Audit Quality ("CAQ"), along with its supplements on March 5 and April 16, 2008.

As for maintaining confidentiality of information provided to the Committee, the answer to this question depends, among other things, on a legal determination whether the Committee is subject to the Federal Advisory Committee Act ("FACA"). This question thus should be directed to Committee staff for an opinion on whether the Committee can maintain the confidentiality of information submitted. Nevertheless, it is my understanding that the information would be subject to FACA, and therefore, any information submitted to the Committee would not be confidential.

**"6. Are litigation costs a significant deterrence factor as stated by some investor advocates? Why or why not?"**

I would refer you to EY's recent comment letter in which we stated our belief that needed liability reforms do not run counter to the deterrence goals that underlie the antifraud provisions of the federal securities laws or similar state laws. We agree with investor advocates and others who argue that private enforcement of the securities laws can have a salutary effect on accountants in the performance of their professional duties, and we are not advocating that private plaintiffs be denied access to the courts. But, given the strengthened regulatory and inspection regime created by the Sarbanes-Oxley Act and similar measures in other countries, the imposition of catastrophic risk on the profession is simply not needed in order to achieve appropriate deterrence. Even assuming that litigation risks constitute a "significant deterrence factor," there is no reason to believe that liability must reach catastrophic levels to influence auditor behavior. As I expressed in my testimony, "[t]he question is whether any deterrence is added by keeping a nuclear bomb in the arsenal."<sup>4</sup> Instead, and as the European Commission recently commented, "[a]udit quality should be driven more by sound regular inspections whilst liability should complement such efforts but not make the audit business unattractive."<sup>5</sup> With the independent regulatory and inspection regime now in effect, the current private enforcement rules in the U.S. need substantial reform.

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<sup>4</sup> *Id.* at 7-8.

<sup>5</sup> The European Commission, Commission Recommendation on limitation of auditors' liability: Frequently Asked Questions (6 June 2008), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/366&format=HTML&aged=0&language=EN&guiLanguage=fr>.

**“7. Can you recommend an approach to establishing litigation caps that would also be fair to investors?”**

There are numerous ways in which liability caps could be structured to mitigate the threat of catastrophic liability while still being fair to investors. Capping damages does not mean denying plaintiffs all avenues to recovery, but it does mean that the interests of the opposing parties (the investor-plaintiffs and the audit firm-defendant) as well as unrepresented third parties, such as other investors in the market, be considered and balanced. That is, any damage cap system should recognize the legitimate interests of investor-plaintiffs to receive compensation for wrongs done to them. But it should also reflect the relative culpability of the audit firm-defendant and its ability to pay damages. The current system of liability for audit firms can result in an audit firm paying substantially more than what is properly attributable to its wrongdoing. Also, the interests of third parties should not be omitted: because the capital markets rely heavily on the audit profession, a windfall recovery for investor-plaintiffs that results in the loss of another audit firm likely would reduce the availability of services for some issuers and increase prices for audit services for the rest of the market. The increased price and reduced availability of audit services will ultimately redound to the detriment of all investors. As I stated before the Committee, “you have to balance how much [investors] should be able to recover from the firm if it’s going to put the firm out of business; meaning . . . is it a bad thing for investors that one more major audit firm disappear from the face of the earth? . . . I don’t think they’re well-served in the long term by losing another audit firm.”<sup>6</sup>

Although this necessary balancing act is complex, there are many options for the creation of a liability cap, an appropriate combination of which will hopefully result in a liability system that is workable for all parties. For example, liability caps can be tiered, they can vary based on the size of the audit firm or the client or both, they can be combined with government-sponsored insurance programs to cover excess losses, as well as government power to seek disgorgement and penalties. Fortunately, this is the type of complex balancing that policymakers take on every day, and there is no reason to suspect that a solution cannot be reached. I refer you to EY’s June 27<sup>th</sup> comment letter for additional discussion of this issue.

**“8. Some say establishing liability cap protection for audit firms would unfairly protect one class of participant in the capital markets. You indicated other players in the markets do have such protections. Can you help me understand the realities and why audit firms should receive the benefit of liability caps?”**

In my testimony, I suggested that other market participants are able to shield themselves from catastrophic liability in ways that auditors cannot. Specifically, I noted

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<sup>6</sup> Statement of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, June 3, 2008 Advisory Committee on the Auditing Profession Webcast, *available at* <http://www.treas.gov/offices/domestic-finance/acap/webcasts.html> (3:41:46-3:42:17, 3:43:01-3:43:14).

that underwriters can cap their “liability through indemnification agreements or other limits on liability.”<sup>7</sup> Similarly, lawyers “avoid liability on the ground that no statement is made to investors.”<sup>8</sup> These mechanisms to limit liability are unavailable to the auditing profession.

As detailed in my testimony and in EY’s June 27<sup>th</sup> comment letter, it is my belief that this current framework is unfair and unwise, and that auditors should have protection from the persistent threat of catastrophic liability. Audit firms are in a unique position as financial market “gatekeepers.” The firms are heavily regulated (unlike lawyers, for example), are required to be private partnerships (unlike underwriters, for example), and perform activities that subject them routinely to potential liability under the securities laws. As a result, the liability exposure for the firms that audit public companies dwarfs the exposure for other securities market participants. Audit firms serve a vital public function and ensuring the sustainability of the profession is an irrefutable imperative for the security of our capital markets.

**“9. Would there be any value in revising CPA firm structures to provide for a separate subsidiary that would only provide audit services and that would include separate governance (i.e. include outside directors)? Would this structure provide adequate protection to the capital in the collective organization outside of the audit subsidiary?”**

Although an “audit only” firm is an interesting proposal, I believe that such a model is not in the best interest of investors. The model would not produce a viable firm that is able to deliver high quality audit services.

An audit-only firm would have to overcome several significant obstacles to its success. First, the performance of a successful audit requires that a firm bring together individuals in multiple specific areas of expertise, such as tax, internal controls, IT, and forensic skills. These individuals’ skills are honed while providing other services for non-audit clients. An audit-only firm would either have experts with less cutting-edge skills in these key areas, or would have to hire that capacity from somewhere else, risking lapses in quality control. Second, the audit firm would have trouble recruiting and retaining subject-area experts if there were no non-audit work available. Non-audit work not only sharpens the expert’s skills, but also provides the expert with varied types of work that are of a less cyclical nature than audits, creating both greater professional satisfaction and opportunities for growth, diversification, and advancement. In sum, the audit activities of a firm must be closely integrated with the other services provided by the firm in order to provide the audit firm with the skills and personnel demanded by audits of large multinational companies.

From Lynn Turner:

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<sup>7</sup> *Id.* at 4.

<sup>8</sup> *Id.*

**“10. For each of the past ten years, what has the average settlement of claims against your audit firm been for audits of public companies in (please divide your responses between settlements involving companies with market capitalizations of less than \$1 billion and greater than \$1 billion)?”**

**“11. What percentage of the amount claimed has been paid in the settlements in (10) above?”**

**“12. How many claims were there in each of the past ten years in state courts? In federal courts? What were the nature of the claims and litigation that were filed in state courts?”**

In response to the above questions, I note that EY has entered into a number of settlement agreements whose key terms are publicly available, ranging from the Cendant settlement to the recent American Italian Pasta Co. settlement. Many other settlements, however, contain confidentiality terms that prohibit the disclosure of specific information. For this reason, among others, providing additional data with respect to settlement agreements, including data about the amount asserted in the complaint, the amount realistically claimed later in the proceedings or in settlement negotiations, and the amount of the ultimate settlement, would be extremely difficult.

In any event, as stated in my response to Question 1 above, data about past settlements and claims is a poor predictor of future settlement amounts and, indeed, of the ability to settle at all. The inability to settle just one mega-claim could have devastating ramifications for an audit firm and, consequently, for the profession as a whole.

**“13. Does your firm provide its partners GAAP basis financial statements on a quarterly and annual basis?”**

As I stated in my oral testimony before the Committee, EY does not prepare GAAP basis financial statements.<sup>9</sup>

**“14. Do you believe investors['] right of action of and accompanying liability damages should be limited for an auditor who was unable to detect massive fraud of a magnitude such as those that during the past decade ran into hundreds of millions and even billions of dollars; or against an auditor, or audit firm, that is found to have been aware of improper financial reporting by a public company and still issued an unqualified report?”**

On June 5, 2008, the European Commission issued a Commission Recommendation concerning a limitation of auditors' civil liability. The EC stated that the Commission Recommendation “aims to protect European capital markets by ensuring

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<sup>9</sup> See Statement of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, June 3, 2008 Advisory Committee on the Auditing Profession Webcast, *available at* <http://www.treas.gov/offices/domestic-finance/acap/webcasts.html> (2:59:06-31).



that audit firms remain available to carry out audits on companies listed in the EU.”<sup>10</sup> In the course of its commentary, the EC made an astute observation regarding the fact that practical limits on liability exist today, based on a firm’s ability to pay. The EC noted, “[e]ven without any existing method of limiting liability, the expectations of third parties to obtain compensation face practical limits, corresponding to the financial capacities of the audit firms.”

The overriding public policy issue is a question as to how investors and the public interest are best served. Is the public interest best served by the current unlimited liability system wherein a single class of investor plaintiffs can maximize their recovery, but by doing so cause the permanent loss of an audit firm which provides valuable services to the public? Or is the public interest best served by imposing a liability limit which allows a particular class of investors to obtain substantial recovery but in an amount that allows the audit firm to continue its provision of services upon which the public and the markets, rely? What may be in the peculiar interests of a limited number of individuals may not protect the broader interests of the general public. We believe remedying this situation as it relates to the US liability system and the auditing profession is the overriding public policy challenge before the Committee and one it is insufficiently confronting

Additionally, I understand this question to be asking whether there should be a carefully constructed liability cap. As I have stated, I think that there are numerous ways in which liability caps could be structured to mitigate the threat of catastrophic liability while still being fair to investor plaintiffs. Capping damages does not mean denying plaintiffs all avenues of recovery. Among other things, a cap would not affect fines or penalties that could be sought by government regulators. Any damage cap system should recognize the legitimate interests of investors, just as it reflects the relative culpability of audit firms and their ability to pay damages.

**“15. What do you believe is an appropriate pleading standard if all claims are removed to exclusive jurisdiction of federal courts?”**

I note that the Supreme Court’s recent decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 853 (2007)—requiring that plaintiffs show “strong” evidence of the defendant’s intent to deceive, manipulate, or defraud—moves in the right direction in this respect. More can and should be done, however, to clarify the pleading standard to ensure that only meritorious litigation can survive a motion to dismiss.

**“16. Do you believe there should be a private right of action against auditors when they knowingly provide substantial assistance to management or others in the commission of securities fraud?”**

This question has been litigated most recently in the *Stoneridge* case<sup>11</sup> in the Supreme Court, and the profession submitted a brief regarding the proper scope of a

<sup>10</sup> Press Release, The European Commission, Auditing: Commission issues Recommendation on limiting auditing firms’ liability (6 June 2008), available at [http://ec.europa.eu/internal\\_market/auditing/liability/index\\_en.htm#recommendation](http://ec.europa.eu/internal_market/auditing/liability/index_en.htm#recommendation).

<sup>11</sup> *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

private right of action. See Amicus Brief of American Institute for Certified Public Accountants in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 2007 WL 2363263 (Aug. 15, 2007).

**“17. How have or will the U.S. Supreme Court decisions regarding *Dura Pharmaceuticals* or *Tellabs* likely affect the litigation outcome against the audit firms in the future?”**

It is very difficult to know how these cases will be applied and how they will affect the profession in the future. Each case features its own special circumstances and often cases are not litigated to conclusion, but rather settle in advance of judgment. Although I think it is unclear how these decisions will affect the settlement calculus of the parties, I believe it is unlikely that either case will result in a meaningful reduction in the catastrophic liability risk facing the profession.

**“18. You recommended that a cap be placed on auditors’ liability? What in your professional opinion is a fair amount for a liability cap?”**

I refer you to EY’s written comment letter of June 27<sup>th</sup> and to my answer to question 7 above.

**“19. Are you aware of any caps placed on losses that investors may suffer when an audit is found to be negligent, reckless or fraudulent?”**

We have previously heard arguments that question why it would be appropriate to limit the liability of audit firms if investors do not have limits on the losses they may incur if an audit is found to have been deficient. This raises the larger, overriding public policy question about how the public interest is best served, and we would refer you to our responses to question 7 and 14.

From Ann Yerger:

**S1. “How many cases are currently pending against Ernst & Young in (1) federal court and (2) in state court? Please describe the plaintiffs and underlying issues in the state court cases. How, if at all, do the pleading standards differ in state courts and in federal courts? What do you believe is an appropriate pleading standard if all claims are removed from state courts to exclusive jurisdiction of federal courts?”**

**S2. “For each of the past 12 years, how many of the cases were filed against E&Y in (1) state court; and (2) federal court? Of these cases (broken down by state and federal cases), how many were public v. private companies? Of these cases (broken down by state and federal cases), how many were brought by a (1) shareholder; (2) company; (3) trustee; and (4) other. Of these cases (broken down by state and federal cases), how many were settled, how many were dismissed by the courts, how many were tried and how many remain outstanding?”**

**S3. “For each of the past 12 years (broken down by state and federal cases), of the settled cases filed against E&Y, what were (1) aggregate claims; (2) average, high,**

**low and median settlements; (3) average, high, low and median percentage payouts (settlement payment/claim)?”**

**S4. “For each of the past 12 years, of the tried cases filed against E&Y, what were (1) aggregate, average, high, low and median claims; (2) aggregate, average, high, low and median verdicts against the firm?”**

**S5. “Please provide a detailed breakdown (by state and federal cases) of the 25 largest settlements and 25 largest judgments against E&Y over the past 12 years. Please include name of case, description of case, plaintiff and amount of claim.”**

As stated above, providing detailed data with respect to either pending or settled litigation is made difficult, if not impossible, by the confidentiality issues surrounding the litigation and settlement process. Although EY obviously settles many of the cases brought against it, its ability to do so in the past is not a guarantee of the firm’s ability to settle future claims that could cause the demise of the firm. Some incremental liability reforms, such as the clarification of the standard for liability discussed above, could assist in lessening that risk, but these are not individually sufficient answers to the problem.

**S6. “How do you define catastrophic risk?”**

Simply put, it is the risk, posed by either private litigation or government action, that an auditing firm will cease to be a viable ongoing concern, and thus will no longer be able to provide services to the markets and investors.

Brian O'Malley, SVP & General Auditor  
The NASDAQ OMX Group, Inc.  
One Liberty Plaza  
New York, NY 10006

Mr. Arthur Levitt, Jr., Committee Co-Chair  
Mr. Donald T. Nicolaisen, Committee Co-Chair  
Advisory Committee on the Accounting Profession  
Office of Financial Institutions Policy, Room 1418  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Dear Chairman Levitt and Chairman Nicolaisen,

Thank you for the opportunity to address the Committee and for your work to improve our nation's important competitive landscape in the auditing arena. Below is my response to questions submitted to me following testimony before the Advisory Committee on June 3, 2008.

**Question 1 submitted by Damon Silvers:** *What is the impact on audit market competition of internationalization in auditing and accounting, including but not limited to the potential convergence with International Financial Reporting Standards, the growth of global networks, and the Concentration and Competition Chapter's Recommendation 6 on enhancing global regulatory cooperation and coordination?*

In most marketplaces, global growth results in enhanced competition. However, as companies increasingly become global and more complex in nature, in terms of legal structures, transnational currency flows and other dynamics that accompany global growth, they require the services of larger and more international auditing firms. At the present time, few firms are available to do this and it may take some time for other firms to grow into this enhanced role.

With the approaching full recognition of IFRS accounting rules and the shift to IFRS by many U.S. companies being evaluated by the SEC, the largest accounting firms will be best suited to respond, due to their having the most experienced employee base with using IFRS. As such, at least initially, the audits of IFRS reporting companies may be limited to the largest accounting firms.

We believe that it is feasible for more accounting firms to join this rank. In that regard, Recommendation 6, which relates to global regulatory cooperation, is crucial to the development of more competition. Global regulators must ensure that any competitive vacuum is of the shortest possible duration by allowing market forces to provide opportunities for other firms to build themselves up into viable global competitors to the established big firms.

**Question 2 submitted by Damon Silvers:** *What are the implications of these matters for the goals articulated in Recommendation 1 of the Subcommittee's section of the draft report (i.e. increased competition for audit services and encouraging the growth of firms beyond the four largest)?*

, Recommendation 1 suggests that smaller firms can be "incubated" towards joining the big four as globally staffed experienced firms that can handle the demands of the most

complicated audit clients. As the Advisory Committee wisely acknowledges, this recommendation has a long-term timeline, but success is possible, and will require time and active management by policy-makers, the SEC and PCAOB.

**Question 3 submitted by Lynn Turner:** *Does NASDAQ have a formal policy against limiting the selection of auditors to the Big 4 firms? If not, has it considered such a policy and what would be the pros and cons of such a proposal?*

NASDAQ requires that our listed companies have an auditor that is subject to PCAOB oversight. Similarly, before the Sarbanes-Oxley Act created the PCAOB, we required that a NASDAQ-listed company's auditor be subject to peer review. We do not believe that these requirements limit a company's choice of auditor in any significant way. Moreover, this assures adequate regulatory oversight of auditing firms. .

**Question 4 submitted by Lynn Turner:** *Do you support or oppose giving shareholders the right to ratify the auditor for the company they own?*

Shareholder approval of auditors is a very common and accepted practice. NASDAQ OMX, on our own accord, submits its auditor to the shareholders for approval. While we have not yet fully considered this idea, we believe that if adopted there would need to be a uniform standard across all listed markets in the United States and the requirement should be carefully structured so that a company could, if it felt the need, make a change in its auditors between annual meetings.

It has been suggested that this recommendation may provide a benefit beyond that discussed in the Draft Report in that requiring a vote on auditor selection may benefit, in particular, smaller public companies that may experience difficulty in otherwise achieving a quorum at their annual meetings -- particularly in the context of some recent actions to limit broker held share voting. We suggest that the Advisory Committee submit this recommendation to the SEC for their review and that they convene all U.S. markets to review its appropriateness.

Thank you again for your interest in having NASDAQ OMX comment on these important issues. I wish you much success with the final report of the Advisory Committee.

Sincerely,



Brian O'Malley

**Response of Frank Ross, CPA to Written Questions  
From Members of the U.S. Treasury Advisory Panel on the Audit Profession**

Question 1 – What is the single most important step in your view that the profession could take to recruit and retain African-American males in as accounting students? Into audit firms? As doctoral candidates?

*Answer 1 – In terms of recruitment, I think we need to aggressively work within minority communities to raise awareness of the accounting profession as an attractive career option that wins respect from members of the community. If an African American earns a law degree or a medical degree, he or she knows they will be seen by the community as somebody who has reached the top rung of American society. Becoming a CPA does not have the same cachet yet, in the African-American community.*

*Importantly, outreach to the African American community, especially to young men, must reach beyond the schools. I believe the profession must engage on a continuous, ongoing basis with local grassroots organizations such as 100 Black Men, local Boule, fraternity activities, etc. that focus their energy on young men. We probably need to engage with the churches as well.*

*Let me emphasize, we must work with local organizations. Working with national groups has its place, but the most effective grassroots outreach will involve the individuals at the local level who have personal connections and credibility with the young men they see every day. By doing this work locally, effective outreach will eventually target hundreds of separate local programs and groups. This of course will require a commitment to spending dollars over several years.*

*Once we have recruited young African Americans, male or female, into the profession, the focus shifts to retention. In my view, keeping African Americans and others in the profession largely involves building confidence and nurturing young workers' belief that they can succeed and advance. I think non-minorities do not understand how fragile self-confidence is for many young minorities – even those who have graduated from top colleges and universities.*

*And, I think the biggest single greatest source of confidence is a good mentor – not just somebody the young professional can talk to, but somebody who will actively work to advance the younger person's career by helping them get challenging assignments and also serving as a role model. I believe audit firms must challenge their partners and senior managers to take personal responsibility for helping new minority professionals.*

*I think the best way to expand the number of African-American doctoral candidates is to beef up the existing PhD Project, which has a good track record of expanding the number of minority professors at U.S. business schools. In this area, I think we have a program that works pretty well, but, again, we need to commit additional resources.*

**Response of Frank Ross, CPA to Written Questions  
From Members of the U.S. Treasury Advisory Panel on the Audit Profession**

Question 2 – What can the profession do to improve retention of staff of CPA firms now in the near term – when the very successful ones have opportunities to take positions that pay substantially more?

*Answer 2 – We need to work as hard on retention as we do on recruitment. I think there is a tendency to think that once we get an African American or other minority to join an accounting firm that the work is over. But that's not true. As I've noted previously, I believe we lose African Americans to other professions because they believe they have better opportunities in other professions. I believe that African Americans and other minorities leave our profession primarily because they are not satisfied with the firm they've joined and/or the work experience they've been given. In short, they do not see a path to success. Therefore, they leave to take the first offer they receive for more than they are currently earning without regards to the long term dollars that they could earn if they remained to become managers or partners with their current auditing firm.*

*The profession needs to show these young people that they are welcomed and that they have a genuine opportunity to move to the highest echelon of the firm. To do that, we have to begin by helping build young professionals' self-confidence as they transition into a more competitive environment. As I've said before, I think the biggest single boost to confidence is a good mentor – not just somebody to talk to once in a while, but somebody who takes responsibility for helping a young person get the job opportunities to advance his or her career. I had mentors who did that for me, and I am convinced it made all the difference in the world. When I talk to young people who have left the profession, their reasons tend to center on job experience and a lack of confidence about their career path rather than the need to make more money.*

*In addition, we need to show African Americans that they if they stay the course, they will be rewarded financially. For a variety of reasons, I think the profession has been a bit shy to talk about the financial rewards of becoming a manager or a partner. I believe compensation at the partner level is competitive with other professions, but we don't do enough to impress that fact on younger professionals. To the extent that concern about compensation is a factor in leaving the profession, I think we can counter that with some self-promotion about the rewards on behalf of the profession. I also believe that higher starting salaries would help us keep more of the most promising people in the early years. While I do not believe money is necessarily the controlling factor in career decisions, I do believe that people are more likely to stay if they feel they are well compensated.*

**Response of Frank Ross, CPA to Written Questions  
From Members of the U.S. Treasury Advisory Panel on the Audit Profession**

Question 3 – Minorities have aspired to become other professionals such as lawyers or doctors. What impact would making schools of accountancy professional schools similar to law or medical programs have on enhancing the recruitment of minorities?

Answer 3 – *I don't believe African Americans choose medicine or law over accounting because of differences in the educational structures of the three careers. If anything, I think requiring an additional two or three years of schooling might make accounting less attractive to some minorities.*

*Changing the education model as suggested would impose a significant additional financial burden. In addition to paying for more schooling, young people also would have to defer for several years the chance to earn a full time salary. In terms of minority recruitment, I think this type of change is more likely to be a disincentive than an incentive to enter accounting. Of course, this was similar to the argument used against the 150 hour rule. To date I have not seen any empirical studies to support this argument. I believe that before moving forward with the idea of a school of accountancy similar to law or medicine such a study should be done.*

*That's not to say that I necessarily oppose the concept of additional professional schooling similar to law and medical programs. If there are specific objectives that can only be achieved by changing the education model, we should consider those on their own merits.*

*But I would have to know a lot more before I take a position. For example, I would want to know the objectives of that type of change and what problems we are aiming to fix. If the idea is just to give them more technical training, I want to know 1) if that is truly necessary, and 2) is this the most effective way to achieve the goal? Also, I would want to know whether modifying the 150 hour requirement to add more specific requirements for the additional 30 hours would enhance the students' education. I think that's a step we can take first, long before we add extra time and costs to entering the accounting profession.*

*As I said in my written testimony, it is important to keep an open mind and constantly review the way we prepare new entrants. But I confess that I think there comes a point when you need to get out of the classroom and begin to learn from real life experience on the job. I really think the best way to learn how to be an auditor is to start auditing under the direction of experienced auditors.*



**Response of Frank Ross, CPA to Written Questions  
From Members of the U.S. Treasury Advisory Panel on the Audit Profession**

Question 4 - Recent articles have reported that the Big Four are creating consortiums with colleges and universities to help develop college curricula on international financial reporting standards. How do these consortiums work; are these generally “exclusive” arrangements between a firm and a university? Has this approach been used in the past on new accounting issues, and if so, what was the experience of these arrangements? Are profession-university consortiums a beneficial approach for developing and maintaining dynamic curricula?

***Answer 4** – I am not personally familiar with the specific arrangements described, so I cannot say exactly how they work or whether they are exclusive. However, as somebody who has drawn from the profession for both lecturers and case material in my auditing and ethics courses at Howard University, I generally believe that profession-university consortiums are a beneficial approach for developing and maintaining dynamic curricula.*

*In my experience, such collaboration between the profession and universities, provide students with up to date material and personal insight from the perspective of practitioners. It makes the course material more dynamic and interesting. In my experience, the students are generally very engaged because they like to learn about auditors’ real-life experience.*

*I realize that the benefits are limited to the specific school or schools involved in a particular relationship. However, most of the firms that participate in these types of partnerships attempt to extend the benefits by posting materials on their web sites and/or providing them directly to all accounting faculty at schools that they recruit from.*

KURT N. SCHACHT, MANAGING DIRECTOR,  
CENTRE FOR FINANCIAL MARKET INTEGRITY, CFA INSTITUTE  
ADVISORY COMMITTEE ON THE AUDITING PROFESSION  
QUESTIONS FOR THE RECORD  
JUNE 3, 2008 MEETING  
SUBMITTED: JUNE 30, 2008

Gaylen Hansen has posed the following questions:

1. You testified that there are instances where predecessor firms may be charging excessive fees to reissue audit reports. Could you elaborate with any specific examples and also indicate what steps that the PCAOB and/or SEC might take to address such situations?

We hear comments (no specifics), both now and back when the SEC smaller company advisory committee looked at this audit capacity issue. It was a particular concern with finding enough capacity to do SOX related work. The top audit firms make it hard for a small public company to make a cost effective switch to a second tier firm. These small public companies face challenges, where it has decided to change auditors to reduce costs and receive more attention/service. Their big audit firms treat them as less important engagements, tend to charge them as if they were big public companies and over charge on SOX related matters in particular. As the small public company then moves to switch, the former large audit firm charges a high fee to reconfirm or reissue the previous opinions as a sort of exit penalty. The former auditors have also been known to play games with the newly appointed auditors by delaying access to audit information and last minute scheduling changes for the new audit firm.

Damon Silvers has posed the following questions:

2. What is the impact on audit market competition of internationalization in auditing and accounting, including but not limited to the potential convergence with International Financial Reporting Standards, the growth of global networks, and the Concentration and Competition Chapter's Recommendation 6 on enhancing global regulatory cooperation and coordination?

We are concerned that the quality of audit work done under global financial reporting standards will be an increasing challenge. The level and quality of audit practice is quite diverse under existing standards. First, although a single international auditing standard has been promulgated, (IAASB) IAS, the standards are applied and enforced at the national level, and the views regarding oversight and enforcement as well as the infrastructures tasked with the responsibility vary widely across jurisdictions. Second, the level of both preparer and auditor skill and experience varies across stated national adopters of IFRS from nonexistent to highly competent and the learning curve is steep. Third, although we expect to converge to a single global IFRS standard eventually, in the interim, auditors must maintain competence in two mutually recognized standards (IFRS and US GAAP) as well as local/national standards. This diversity in

requirements creates serious challenges. Fourth, the learning curve for auditors is very steep and efforts are only beginning in many jurisdictions, including many firms in the U.S., to plan for the transition to IFRS and IAS. For example, a comprehensive text on IFRS suitable for university accounting programs is not yet available. In addition, the Uniform CPA Examination in the U.S. does not yet cover IFRS or IAS.

Of particular concern are 1) whether the level of familiarity and experience with IFRS standards in the US creates another default to the top tier firms, and 2) whether non-U.S. audit firms auditing financial statements prepared in accordance with IFRS for public companies listed and trading in the US are of high quality and subject to PCAOB – equivalent oversight. Your recommendations six is critical to ensuring that public company auditing firms are contributing effectively to audit quality.

3. What are the implications of these matters for the goals articulated in Recommendation 1 of the Subcommittee's section of the draft report (i.e. increased competition for audit services and encouraging the growth of firms beyond the four largest)?

Obviously where the audit expertise required to service the big public companies now requires full IFRS fluency, the resource is further constrained.

Lynn Turner has posed the following questions:

4. You testified the CFA Institute supports achieving a single set of independence standards. In doing so, would you support permitting any of the services currently prohibited by the Sarbanes-Oxley Act of 2002 or water down independence rules for public companies by adopting less rigorous rules available currently applicable only to private or governmental entities that permit such services by the auditor such as broader business affiliations between the audit firm and a company the CPA firm audits?

Rigorous independence standards should be consolidated and coordinated to achieve on single standard of independence. The standards would apply to audits of both public and non-public entities. Any application of the single, uniform standard of independence should begin with the highest and most rigorous rules applicable to public company audits. Within those standards, certain aspects may be waived or otherwise determined to be not applicable to non-public company audits. This is a means of establishing a single set of standards with variable applications rather than having multiple standards.

5. If a single set of auditor independence rules could be achieved only by reducing the level of independence required for public companies, would you still support adoption of a single set of independence rules?

No. As indicated in our response above, we believe that high and rigorous standards currently applicable to public companies should be the base-line.

6. Do you believe the financial stability of a CPA firm, can be reasonably assessed by an audit committee, investor, analyst or regulators, if they are unable to obtain the firm's financial statements prepared in accordance with generally accepted accounting principles, assuming other data currently publicly available for the firms is the other data one would have to work with?

We think we should this transition in the audit industry with having audit firms provide at least enough financial information which would allow an audit committee to make a credible determination of the audit firm's financial viability. We would certainly hold as a goal, that this information over time would include GAAP financial statements. Financial statements prepared in accordance with GAAP would allow audit committees and other users to compare audit firms on a consistent basis in those cases where they are choosing among competing firms.

**Department of the Treasury  
Advisory Committee on the Auditing Profession  
Responses of  
Michael R. Young  
Willkie Farr & Gallagher LLP  
Following Testimony of  
June 3, 2008**

Gaylen Hansen has posed the following questions:

- 1. In your view should something similar to the SEC's Rule 102(e) be the basis for any clarification in the federal pleading standard related to litigation of audits of public companies?**

No. Rule 102(e) in substance puts in place a negligence-based standard that would, in my view, be a step in the wrong direction. The problem is that a plaintiff can allege some form of "negligence" with regard to virtually any audit. The allegation can be as simple as an assertion that an auditor: (1) didn't do something; and (2) should have. Since an auditor never tests 100%, virtually every audit is susceptible to such an allegation of a 102(e) violation.

- 2. You testified that the large audit firms are at risk of catastrophic litigation based on the existing outstanding claims. Since the firms have not provided settlement to claims data and other financial information requested by the Committee, what additional information could assist us in validating the firm's assertions that liability reforms are warranted?**

I don't know that anyone can pin down the exact "tipping point" for each of the major firms – that is, the monetary judgment or settlement that begins the downward spiral into bankruptcy. I do, though, believe that the available information gives us a pretty good sense of the neighborhood.

In my own analysis, I have come to think of \$500 million as the amount that places an accounting firm in jeopardy. A payout of that amount could be expected to deprive each partner of a significant percentage of his or her net income. For example, I estimate that a \$500 million payment out of \$5.5 billion of revenue (average revenue for the six largest firms) would be expected to deprive an average partner of 40% of that partner's otherwise-expected earnings.

The question then becomes: What happens to an accounting firm when its partners' earnings decline by 40%? Since most of us don't live with a 40% cushion in our household cash flow, I presume that the partners of such a firm would no longer be able to meet their everyday expenses, such as home mortgages and loan repayments for the money borrowed to contribute to the firm's capital base. It is true, some level of partnership capital might be available in the short run but, on the other hand, I presume that that capital would be necessary to run the firm and therefore need to be replenished resulting in the same basic shortfall. Given the highly attractive employment alternatives available to the upper-tier partners (alternatives that may include not only higher salary but the diminished personal risk of disconnecting from a public accounting firm), it is logical to believe that the key partners under such circumstances would leave the firm.

As a result of the inevitable press attention, key clients would presumably leave as well and the risk to the firm would take on the momentum of a self-fulfilling prophecy. It is this kind of scenario, for example, that resulted in the bankruptcy of Laventhol & Horwath.

An even less forgiving scenario would involve the need for an immediate cash payment by the firm – such as might occur, for example, if it suffered an adverse judgment and needed to post a bond pending appeal or needed to make good on the judgment in cash. I’m not sure a prudent lender would be willing to lend under such circumstances, and I question whether the money could be raised through a capital call quickly or at all. I’m not sure how a firm would deal with that.

Bill Travis has posed the following questions:

- 3. The Advisory Committee is locked in a dispute over the question of whether there is significant risk of losing a large audit firm due to litigation risk. Some Advisory Committee members are insisting that audit firms provide detailed information about their litigation history. Other Advisory Committee members believe that information provided by Aon clearly indicates that audit firms do face significant risk of sustainability. Can you recommend an approach whereby audit would submit the detailed litigation information the Advisory Committee originally requested, while retaining the confidentiality of the information?**

I wonder whether an acceptable approach might involve the submission of the information to the PCAOB for some kind of economic analysis which then could be transmitted to the Advisory Committee.

- 4. Are litigation costs a significant deterrence factor as stated by some investor advocates? Why or why not?**

I don’t believe they are, though to understand the reason requires a more in-depth understanding of the dynamics of litigation and audit risk management than is often available through public sources.

The main point here is that, in my view, an accounting firm cannot effectively manage its risk through the quality of its audits. In other words, litigation costs are not a significant deterrence because they cannot be effectively avoided through enhanced audit quality.

Granted, this did not appear to be the view of the profession a few years ago (and, at some firms, may not even be the view today). The thinking several years ago seemed to be that audit risk could be managed through the enhancement of audit quality. The approach was to: (1) identify above-average risk clients; and (2) increase the level of audit testing commensurate with the risk. The approach was logical and well reasoned. There was only one problem. It didn’t work.

The problem I saw was that, no matter how much more an auditor would dig into the books and records of a company presenting above-average risk, determined executives could take a fraud one level deeper. That is, of course, to be expected at a company with a corrupt “tone at the top.” True, the accounting firms could adopt a 100% “forensic” approach to an audit and more effectively manage risk that way. But such an approach is economically infeasible. For

example, one of my most recent forensic investigations took more than a year and cost more than \$100 million.

Indeed, it is an irony of the present litigation environment that enhanced audit quality can actually serve to *increase* the litigation risk. When an auditor uncovers fraud, a foreseeable consequence is that the auditor will get sued for not discovering it earlier – a contention to which the auditor will typically be vulnerable because fraud can almost never be detected at the outset through a normal GAAS audit. The problem is exacerbated by the lack of clarity regarding the point at which ostensibly poor management judgments or errors mutate into what, in hindsight, might be characterized as fraud. The reality, therefore, is precisely the opposite of the conventional expectation. The conventional expectation is that enhanced fraud detection reduces the risk of litigation. My own view is that the opposite can be true.

It is my view, therefore, that the most effective risk management is the separation of the firms from those clients that present above-average risk. I should reiterate that I don't know that this view is shared within the firms themselves.

**5. Can you recommend an approach to establishing litigation caps that would also be fair to investors?**

When I was asked that question at the American Assembly conference of Columbia University, I suggested a \$100 million liability cap. The basis, I said, would simply be a societal determination that that was the most a single firm should pay based on the action or inaction of an individual partner. My thinking was that, as long as investors knew the rules before hand, they could make their investment decisions accordingly.

I understand that the profession does not favor this approach, and I understand why. While a \$100 million liability cap might be of benefit to the largest firms, it would do little for those firms below, say, the Big Four. At the same time, such an approach would probably further concentrate public company audits at the big-firm level given their enhanced ability to survive compared to the smaller firms.

That being the case, one might naturally gravitate to an approach involving some multiple of audit fees. For some of the largest audits, that could result in caps that would exceed the \$100 million cap I mentioned at the American Assembly.

**6. Some say establishing liability cap protection for audit firms would unfairly protect one class of participant in the capital markets. You indicated other players in the markets do have such protections. Can you help me understand the realities and why audit firms should receive the benefit of liability caps?**

It was actually Kathryn Oberly who made the point about the liability protections available to professionals other than auditors, though I agree completely with her observations. Her point was that underwriters can limit their liability through indemnification agreements, but auditors (owing to SEC independence rules) cannot. Attorneys can limit their liability through the avoidance of statements to the public, but auditors (who issue public audit reports) cannot. And credit rating agencies enjoy the benefit of First Amendment protection, but auditors (owing to

the peculiar way the law has developed) do not. It is hardly surprising, therefore, that auditors are the deep pocket of choice.

- 7. Would there be any value in revising CPA firm structures to provide for a separate subsidiary that would only provide audit services and that would include separate governance (i.e. include outside directors)? Would this structure provide adequate protection to the capital in the collective organization outside of the audit subsidiary?**

I don't see why a separate audit subsidiary would be better positioned to withstand a large judgment, and I don't believe improved governance would make any difference at all unless the improved governance resulted in a determination to more aggressively weed out those audit clients presenting above-average risk. Indeed, absent increased aggressiveness in separating the firm from potentially risky clients, I would expect an audit-only subsidiary to be *more* vulnerable to litigation insofar as its capital base and cash flow would be smaller.

Lynn Turner has posed the following questions:

- 8. Do you believe there should be a private right of action against auditors when they knowingly provide substantial assistance to management or others in the commission of securities fraud?**

Balancing all of the considerations, I accept the resolution of this issue by the Supreme Court in *Central Bank*. I do believe that, when such participation results in a deliberately false audit report, there should be a private cause of action, a view that is consistent with the Supreme Court's holding. While I have answered the question as posed, I am obliged to add the observation that, in my experience, auditors almost never knowingly seek to assist fraud. Rather, they are accused of doing so based on acquiescence to a client position that seems plausible at the time of the audit.

- 9. How many and which CPA firms are you aware of that have failed in the past two decades as a result of claims by investors? Were those audits involved found to have complied with Generally Accepted Auditing Standards in courts?**

The only one of which I'm aware is Laventhol & Horwath. I don't know whether the audits were found to have complied with GAAS, though to my mind it doesn't make much difference. A GAAS violation can be demonstrated simply through the poor exercise of judgment so, to my mind, the elimination of a firm because of a GAAS violation seems disproportionate.

- 10. What do you believe is an appropriate pleading standard if all claims are removed from state courts to exclusive jurisdiction of federal courts?**

That's a tough one. A strong argument can be made for the "scienter" standard now used under section 10(b), but the problem is that that standard can be satisfied even when an auditor believes he or she has acted in good faith. To illustrate, sometimes an engagement partner will, in complete good faith, sign an audit report unaware of the fact that, for example, an outside vendor of the audit client has provided the auditor with a false receivable confirmation. If the auditor has not detected the falsity where detection was arguably possible, the auditor may be



susceptible to a contention of fraud – notwithstanding a genuine belief that the audit procedures complied with GAAS. An attempt to address that scenario would cause one to head in the direction of a standard requiring “intent.” This is, of course, precisely the issue left unaddressed by the United States Supreme Court in *Ernst & Ernst v. Hochfelder*.

**11. Do you believe investors right of action of and accompanying liability damages should be limited for an auditor who was unable to detect massive fraud of a magnitude such as those that during the past decade ran into hundreds of millions and even billions of dollars; or against an auditor, or audit firm, that is found to have been aware of improper financial reporting by a public company and still issued an unqualified report?**

It would depend. Among other things, I would be interested in knowing whether the failure of detection was the result of a level of collusion that made detection all but impossible. For example, I have seen frauds where all of the participants in the transaction at issue lied and 100% of the documentation given to the auditor was falsified. I don't know how an auditor could be expected to detect such a thing.

On the other hand, there are certainly instances in which an auditor could have followed up and didn't. The question then becomes whether such a circumstance should, depending on the capitalization of the audit client, result in the elimination of the engagement partner's firm. Perhaps one approach would be to limit the liability of the firm but decline to limit the liability of the individual engagement partner. That way, the wrongdoing partner is penalized but the innocent partners – not to mention the innocent audit clients – are not.

**12. You testified that the current litigation system needs to be fair. What amount of a cap on auditors' liability would be fair in your professional opinion?**

I mentioned above \$100 million, though I reiterate my understanding that none of the firms favor that approach. To my way of thinking, the issue of fairness does not turn on any particular number or approach but on awareness by investors that a particular number or approach is in place. As long as investors are so aware, they can make their investment decisions accordingly.

**13. You testified that auditors have claims against them of approximately \$140 billion. In the past ten years, what has been the average and median amount of settlement as a percentage of amounts claimed?**

In my experience, the settlements have been way below the amount claimed. I should add that that is completely unsurprising to me. Plaintiffs' damages theories tend to be wild exaggerations of true investor losses and, often, deserve to be rejected out of hand as a starting point for settlement discussions. I only wish that juries would have the same reaction. Unfortunately, the mathematics can be so utterly confusing that a jury may accept a plaintiff's estimate as credible when, in my view, it is nothing of the kind. The result, of course, is the dynamic depriving the accounting firm of its day in court and the need to pay settlements to avoid the risk of firm-debilitating verdicts at trial based on exaggerated damages theories.

I hasten to add that that is not to suggest the resulting settlements are necessarily insignificant. I still recall the \$400 million settlement by Ernst & Young arising from civil litigation involving

bank failures. Other significant settlements include E&Y's \$335 million settlement in Cendant, Deloitte's \$312 million settlement in connection with failed banks, and PwC's \$225 million settlement in connection with Tyco. The list is obviously much longer than that. I mention these simply to illustrate that large settlements do in fact occur.

The key point, though, is not the extent to which the firms (with only limited exception) have been able to survive through acceptable settlements. The key point is their inability to actually have their day in court in a large-scale case.

**14. How have or will the U.S. Supreme Court decisions regarding *Dura Pharmaceuticals* or *Tellabs* likely affect the litigation outcome against the audit firms in the future?**

Both *Dura Pharmaceuticals* and *Tellabs* should help the firms. *Dura Pharmaceuticals* puts the weight of the Supreme Court behind the general rule requiring proof of loss resulting from a misrepresentation. *Tellabs* allows the federal courts to consider not only the inferences from the plaintiffs' pleadings, but also the inferences from the accounting firm's defenses as well.

I should add, though, that, while both decisions may cause unwarranted complaints to be judicially dismissed as a threshold matter, if a complaint survives the dismissal stage neither case will address the problem of an accounting firm's inability to take a large-scale case to trial.

**15. For each of the past ten years, what has the average and median settlement of claims against your audit firm been for audits of public companies in (please divide your responses between settlements involving companies with market capitalizations of less than \$1 billion and greater than \$1 billion):**

**a. State courts?**

**b. Federal courts?**

Here I need to defer to the experience of the accounting firms themselves.

**16. What percentage of the amount claimed has been paid in the settlements in (15) above?**

Again, I defer to the experience of the firms.

**17. How many claims were there in each of the past ten years in state courts? In federal courts? What were the nature of the claims and litigation that were filed in state courts?**

I'm afraid I don't track this data. Potential sources might be NERA or Cornerstone.

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