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

November 30, 2007

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

Ladies and Gentlemen:

RE: Discussion Outline for Consideration by the Advisory Committee on the Auditing Profession

The Center for Audit Quality (CAQ) is an autonomous public policy organization serving investors, public company auditors and the capital markets and is affiliated with the American Institute of Certified Public Accountants (AICPA). The CAQ's mission is to foster confidence in the audit process and to aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Based in Washington, D.C., the CAQ has approximately 800 member firms representing tens of thousands of men and women dedicated to quality public company auditing.

OVERVIEW

The CAQ welcomes this opportunity to express our support for the important mission of the Department of the Treasury's Advisory Committee on the Auditing Profession.[1] As we noted in a press release issued when appointments to the Advisory Committee were announced, we share the panel's goal of ensuring that the auditing profession remains strong, vibrant and committed to quality.[2]

[1] This submission represents the observations of the Center for Audit Quality, but not the views of any specific firm or individual, including the two members of the CAQ's governing board appointed to serve on the Advisory Committee: KPMG Chairman and Chief Executive Tim Flynn and AICPA President and CEO Barry Melancon.

We support the five over-arching principles established to guide your efforts, chief among them that your work and recommendations should be designed “to promote and encourage prosperity and stability by both improving the quality of the audit process and audits and ensuring the viability and resilience of the public company auditing profession.”[3]

The past several years have been a period of enormous change in the U.S. and global capital markets and for the public company audit profession. The globalization of public company auditing has led firms to renew their commitment to seamless service that transcends borders and cultures. As part of a global network affiliate structure, firms stress local accountability, emphasize cross-border consistency and enhance audit quality. As an example of one firm’s approach, membership in the global organization comes with requirements that include granting oversight authority to global management, compliance with global quality, independence and risk management policies, and utilization of global training programs.

In a relatively short span of time, and in many parts of the world, the profession has gone from being partially self-regulated to being independently regulated. In the United States, the Public Company Accounting Oversight Board’s inspections and oversight regime provide it with access to every facet of public company audit practices. In addition, new corporate governance standards have been mandated for public companies. In particular, the renewed focus on the auditor’s primary responsibility to the audit committee, rather than company management, is a change that notably enhances auditor independence.

Taken together, these changes have created a platform for restoring investor confidence that had been shaken by the scandals at the beginning of the decade. There is evidence to suggest that progress is being made. In a survey conducted by the CAQ last July, 80 percent of investors expressed confidence in the audited financial information released by publicly traded U.S. companies. Further, six in ten investors said they have more confidence in audited financial information than they once did.[4] The public company audit profession is pleased to note these improvements.

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[2] “Center for Audit Quality Welcomes Appointments to Treasury Department Advisory Committee on the Auditing Profession,” Oct. 2, 2007; http://thecaq.org/newsroom/pdfs/release_10022007.pdf

[3] Working Discussion Outline, Advisory Committee on the Auditing Profession, Oct. 15, 2007. http://www.treas.gov/offices/domestic-finance/acap/agendas/outline-10-15-07.pdf

[4] Nationwide telephone survey of 1,001 investors related to investing, the capital markets and the Sarbanes-Oxley Act, conducted July 17-23, 2007 by the Glover Park Group. http://thecaq.org/events/sox/researchsummary.pdf

While such improvements are noteworthy, it is clear that significant work lies ahead to maintain investor confidence in a rapidly changing marketplace. Today, businesses are increasingly complex, contracts and transactions grow more complicated, and financial instruments are continually more sophisticated. Further, "intangible assets" like customer loyalty and brand names that are not easily measured or accounted for in financial statements are becoming an increasingly critical element of an enterprise's value.

Given these looming challenges, the public company auditing profession has an important role to play, and first hand experiences to share, in discussions aimed at ensuring the integrity and reliability of financial information and that financial reporting practices keep pace with changing market realities. In order to meet that obligation, it is vital that the profession not only be sustained but be able to evolve in a manner that will facilitate its participation in meeting these challenges. As was observed by the CEOs of the six leading global audit networks in a 2006 paper, "Audit networks cannot provide the services demanded without the requisite financial, technical and people resources."[5]

It is heartening to note that Secretary Henry M. Paulson, Jr. and Under Secretary for Domestic Finance Robert K. Steel have emphasized their recognition that a sustainable auditing profession is critical to the integrity of our nation's capital markets and the strength of the U.S. economy. We view the formation of the Advisory Committee on the Auditing Profession as a vital part of the ongoing dialogue about the measures needed to assure that the profession will have the resources, talent and expertise to continue to protect investors and facilitate the flow of capital and we are pleased to offer our support to these efforts.

Because we are preparing additional submissions related to specific areas that we believe will be of interest to the Advisory Committee, we will refrain from commenting on the scope and substance of the working discussion outline at this juncture. Instead, the goal of this particular submission is to offer what we view as necessary context for the Advisory Committee's current discussions. It comes in the form of a summary of the current professional environment, including regulatory experiences under the Sarbanes-Oxley Act and the programs administered by firms to meet our commitment to high audit quality.

THE REGULATORY SEA-CHANGE

The public company auditing profession has undergone tremendous change since enactment of the Sarbanes-Oxley Act of 2002 (SOX). Crafted in response to numerous corporate scandals, SOX established a comprehensive framework to reform and enhance oversight of the public company audit portion of the accounting profession, including:

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[5] "Serving Global Capital Markets and the Global Economy: A View from the CEOs of the International Audit Networks. November, 2006. http://www.deloitte.com/dtt/cda/doc/content/dtt_CEOVision110806(2).pdf

- Expanded oversight role of audit committees;
- Stricter rules regarding independence of the auditor;
- Partner rotation; and
- Creation of the Public Company Accounting Oversight Board (PCAOB).

This new era of regulatory oversight of public company auditors has stimulated a growing global recognition that our profession performs a critically important public service – one that is a key building block in maintaining investor confidence and strong capital markets.

Public Company Accounting Oversight Board

The PCAOB serves as the oversight authority for firms that audit issuers' financial statements filed with the Securities and Exchange Commission (SEC), as well as those firms that play a substantial role in the audits of SEC registrants. In this capacity, the PCAOB represents the public interest and has both broad investigative and disciplinary authority over registered public company audit firms and conducts a continuing program of inspections of public company audit firms to ensure compliance with SOX and the PCAOB's rules.[6] Inspections are conducted on a recurring basis (annually for firms that provide audit reports for more than 100 issuers, and every three years for most others). The PCAOB inspections are designed to determine the extent to which audit firms have, and adhere to, adequate quality control policies and procedures that address all significant aspects of public company auditing, as well as the effectiveness of performance on specific audit engagements. The PCAOB's regulatory oversight and ability to access comprehensive information about audit firms helps to ensure investor confidence in the quality and independence of the firms. For example, as part of its inspection process, the PCAOB reviews audit partner earnings information, internal quality measures of audit partners, accounting consultations with technical or national partners, human resources records of inspected engagement teams, and communications between the auditor and the audit committee. In addition, discussions are held with professional staff at the inspected office and, in many cases, the audit committee chair of the inspected audit client. In the final analysis, investors can trust that a regulator is deeply involved and committed to our audit quality.

Role of the Audit Committee

Prior to SOX, company management often controlled the process for the selection of auditors. The ability of management to control the employment of auditors could create doubts about the identity of the auditor's true clients – the issuer's shareholders and the investing public. To make this link stronger and more direct, SOX required that auditors be hired – and replaced – by the audit committee, not company management, and that the audit committee take direct responsibility for the

[6] PCAOB rules incorporate the professional standards for conducting audits of public companies' financial statements and internal control over financial reporting and the profession's ethics and independence rules.

appointment, compensation and oversight of the work of public company auditors – a change which notably enhances auditor independence from company management. In addition, the audit committee must pre-approve non-audit engagements to be performed by the audit firms. And to assure audit committees performing those functions represent shareholders first and foremost, SOX prohibits the inclusion of company officers and/or consultants on an audit committee of listed issuers and mandates that audit committee members be independent from management. Further, audit committees now invest more time to fulfill their responsibilities. During the period from 2002 to 2005, the average number of audit committee meetings nearly doubled – to 10. There was a large increase in the frequency of meetings over the four-year span as companies dealt with the new SOX regulations and increasingly complex accounting pronouncements. Additionally, the percentage of audit committee members who were identified as accountants more than doubled – from 5 percent in 2002 to 11 percent in 2005.[7]

Partner Rotation

SOX classifies partners into two categories:

- Lead and concurring audit partners; and
- All other audit partners.

Under SEC rules implementing the SOX provisions, lead and concurring partners must be rotated after five years and are subject to a "time-out" period of five years. All other partners involved with a registrant's audit must be rotated after seven years and are subject to a "time-out" period of two years.

In developing regulations pertaining to SOX, the SEC acknowledged that its partner rotation requirements needed to strike a balance between the need to achieve a fresh look at the engagement and a need for the audit engagement team to be composed of competent accountants. Prior to SOX, lead partners typically worked on one account for seven or eight years, according to a 2006 poll of finance executives conducted by *CFO* magazine. While the new process has been effective in bringing a fresh approach to engagements every five years, more frequent rotation of partners would pose a significant logistical and human capital challenge for firms. It translates into at least one additional relocation during each partner's career and increased complexity in staffing audit engagements. Smaller firms, in particular, may not have another partner with sufficient industry expertise.

MAINTAINING QUALITY IN AUDIT SERVICES

Human Resources Management, Compensation and Rewards

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[7] 2006 Audit Committee Research Report, A Huron Consulting Group Report.

An audit firm's overall quality of service is a direct reflection of its workforce, as human talent is the first and strongest element of audit quality. Firms believe the true value of our profession lies in the good judgment of people – made possible by employing the best and the brightest and giving them the training, support and benefits they need to succeed.

The profession is looking to build a stronger – and more diverse – pipeline of talented individuals for the next generation of public company auditors. Persuading students to study accounting is a top priority. But success on that front calls attention to another pressing concern: the shortage of accounting faculty that hold Ph.Ds. In auditing, for example, less than a quarter of the doctorates needed to meet instructional demand will be awarded in the four-year period ending in 2008.

Additionally, the accounting and auditing curriculum must be updated to take into account increasingly sophisticated financial products and transactions and to include consideration of the increasing global framework, led by knowledge of International Financial Reporting Standards.[8]

The profession has a long-standing tradition of contributing to education, to ensure the curriculum addresses the complexity issues and the globalization of the business. Examples of these efforts include: a case study program which is currently in several schools and designed as an in-depth learning experience involving three modules (business analysis and review of past financial performance; accounting analysis; and responsive audit activities and judgments); an academic partnership program that teams a professor with a partner; professor residency programs, which give academics an insider's look at the profession; faculty training programs; and continued support of a Ph.D. project to boost the number of minority professors in business schools.

People who join audit firms are expected to adopt fundamental respect for independence and objectivity standards. The firms take responsibility for training very seriously in order to ensure a consistent approach to audit quality and the technical expertise necessary to effectively execute the work.

> **Hiring:** Audit firms maintain stringent hiring standards for both entry-level and experienced recruits, which include not only an assessment of academic records and relevant work experience, but also interviews and background and reference checks.
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> **Education, Licensure and Training:** Once hired, staff members participate in a variety of formal training courses with a curriculum that matches their respective roles and responsibilities as they progress in their careers. Both partners and staff receive regular training, and developmental and educational instruction. Underpinning an accounting firm's

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[8] The CAQ on Nov. 13 urged the U.S. Securities and Exchange Commission to develop a comprehensive plan, with appropriate timetables and a date certain, for moving all U.S. domestic registrants to International Financial Reporting Standards. http://thecaq.org/members/pdfs/CAQ_Comment_Letter_US_Co_Using_IFRS.pdf

competency requirements are the minimum academic, competency and ethics qualifications established by the standards of the PCAOB and the state boards of accountancy. The vast majority of state jurisdictions now impose additional academic coursework on candidates in the form of the 150-hour requirement to sit for the Uniform CPA Exam. Candidates from any educational discipline or major can be eligible to sit for the Uniform CPA Exam, as long as they have attained a threshold number of accounting course hours.

Profession mobility – in the U.S. and globally – is of heightened interest as firms look to staff audit engagements across state borders and seek to bolster the number of auditing professionals with highly qualified foreign students who meet the same professional criteria.

In addition to formal educational training, many audit firms take responsibility for significantly increasing the education of their professionals even after licensure as certified public accountants. As professionals, auditors must continue their training and meet minimum continuing professional education requirements on an ongoing basis.

Without question, today's business environment requires public company auditors to possess a broader and deeper range of skills. The firms have increased their technical training, with one introducing a mandatory three-day program for audit professionals from the manager to the partner level, with one day devoted exclusively to fraud detection.

Along with training, timely information and communication are essential. Information must be kept up-to-date and available to partners and staff regardless of their location. In larger firms this is generally accessed through a system of shared network databases and electronic information. Regular communications from the national office and practice units alert partners and staff to new standards and provide related guidance to assist them in understanding such changes and in providing high-quality service to clients. Access to current technical information is made available to employees of larger firms through an extensive investment in knowledge sharing and training systems. In smaller firms, current technical information is accessed through profession-based publishers, such as the AICPA, and through commercial providers, along with state CPA societies' extensive continuing education offerings.

Compensation and Rewards: Firms implement policies and procedures for evaluating, compensating, and otherwise rewarding partners and staff in a way that helps ensure the highest priority is given to performance of high quality audits and audit-related services in conformity with PCAOB standards and professional values, and the protection of investors. Generally, factors considered by firms when compensating and rewarding personnel include each person's demonstrated technical expertise, objectivity and professional skepticism in the performance of professional responsibilities, especially related to delivering quality audit services. The demonstrated ability to mentor and provide on-the-job training in the performance of a high quality audit is also an important factor. Consistent with SEC rules, audit firms are not permitted to compensate audit partners for selling non-audit services to their audit clients.

Firms generally provide consistent positive recognition for compliance with their quality control policies and procedures through methods that include partner and staff appraisals as well as promotion and remuneration policies. Though ultimately a matter of facts and circumstances, firms – as necessary and appropriate – maintain and clearly communicate a disciplinary framework for noncompliance that reflects clear penalties ranging from remedial actions to termination for instances of non-compliance or quality lapses. The firms also provide guidance on how and in what circumstances such penalties will be applied.

Basic Audit Quality Functions

One way that CPAs and public accounting firms meet their responsibility to the public is by continued focus on the systems of quality control that ensure conformity with applicable quality control standards, including those related to independence, objectivity and integrity. Audit firms have expanded the scope of their quality control standards, which include client acceptance and continuance, engagement performance processes, and engagement consultation and quality review. The quality control systems of the larger firms' public company audit practices are reviewed annually by the PCAOB as part of its inspection process, and of the smaller firms every three years.

Client Acceptance and Continuance: Controls regarding the acceptance and continuance of client relationships are important in a firm's system of quality control. The PCAOB inspections typically include an evaluation of the appropriateness of a firm's policies and procedures to ensure that the firm undertakes or continues to serve only those relationships and engagements in which the firm:

- Has considered the integrity of company management and does not believe that the client lacks integrity;
- Is competent to perform the engagement and has the resources to do so; and
- Can comply with all PCAOB standards in the conduct of the engagement.

Many accounting firms have developed enhanced risk management structures that include experienced partners who devote significant portions of their time to risk management activities. They play an integral part in the client acceptance and retention process. Importantly, clients are clients of the firm – not of the partners. As a result, the firms take a keen interest in all aspects of the audit engagement. For his/her part, the client engagement partner is responsible for bringing all appropriate resources to an engagement.

Engagement Performance Processes

Audit Methodology: Audit quality is often built on a comprehensive and consistently applied audit methodology. Accounting firms maintain comprehensive policies and procedures governing the accounting and auditing practice, updated to reflect new professional developments and to address emerging issues and needs. These policies and procedures cover professional and regulatory standards, as well as guidance about how best to implement the standards. Firms also drive consistency in the quality of engagement performance by written or electronic manuals, software tools, or other forms of standardized documentation, and industry or specific subject matter guidance materials.

Firms have generally adopted an enhanced framework of accountability for quality throughout the firm, from leadership to the engagement team level. The methodology framework is usually developed centrally and is supported by manuals and training. Compliance with the methodology is monitored by more senior partners designated to perform quality control functions. A firm may also designate individuals to have primary responsibility for monitoring and maintaining the firm's policies for the interpretation of accounting standards or auditing procedures. The common framework underpinning the audit methodology clarifies personal and collective responsibilities for high-quality work. Additionally, professionally-vetted and commonly accepted audit approaches and methodologies are commercially available in the marketplace, and are routinely accessed and implemented by smaller public company auditing firms.

Staffing of Engagement Teams: PCAOB standards require that the knowledge, skill and ability of personnel assigned significant engagement responsibilities be commensurate with the level of risk for the engagement. Ordinarily, higher risk engagements require more experienced personnel or more extensive supervision (or both) during the planning and conduct of the engagement. In building an engagement team, firms consider how to mobilize a knowledge-based, multi-disciplinary team that collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with the professional standards of the PCAOB. Firms also may involve industry, service line or functional specialists (*e.g.*, banking, income taxes, or information technology) generally based on an assessment of risk during the client acceptance and continuance process.

Supervision and Quality Review: A number of internal quality control procedures are performed at an engagement level. For example, the work performed by staff would be reviewed by more experienced engagement management team members, including the lead engagement partner, complemented with internal quality reviews. In addition, an accounting firm's public audit clients have an engagement quality control review partner (also known as a concurring partner or a quality review partner) assigned who is responsible for reviewing the key risks identified by the engagement team and responses to those risks, significant engagement team judgments, the audit plan and its execution, the resolution of significant issues, the financial statements, disclosures and the appropriateness of the audit report. The engagement quality control review partner for public company audits is generally experienced in the industry and provides additional expertise with respect to accounting, auditing, financial reporting, compliance with SEC regulations and capital markets activities.

Engagement Consultation: The very largest of firms typically have a national office, which is a separate unit within the accounting and auditing practice, and independent from those responsible for revenue generation or management. Members of the national office may have a seat on the leadership team that sets strategic direction for the accounting and auditing practice, and drives major practice initiatives and decisions. The national office typically consists of partners and managers who are specialists in accounting and auditing standards and their application. They review and advise on matters involving significant, unusual or complex accounting or auditing issues and SEC regulations, as well as set policies, positions and audit methodology. Smaller firms often replicate some or all of the functions of a national office through designation of special review and consultation partners.

In the event of a disagreement relating to a significant accounting or auditing decision within an engagement team, a resolution process provides guidance for escalating the discussion through the firm's technical chain-of-command until the matter is satisfactorily resolved. In their pursuit of quality, some firms have adopted what one refers to as "safety valves," which include an ethics hotline for 24/7 confidentiality, a dispute resolution process to resolve disagreements with superiors' conclusions, and a quality mailbox to solicit ideas for continuous improvement.

Quality Control Risk Assessment

Continuing or periodic assessment of potentially significant risks of violation of PCAOB standards or professional values is important. Firms analyze and implement action plans related to how significant risks to quality can be better controlled. As a complement, firms also maintain internal monitoring and inspection processes to help ensure that the policies and procedures relating to the system of quality control are relevant, adequate, appropriately updated, adapted to changing conditions, and operating effectively.

Internal and External Inspections

The public company auditing profession is closely monitored by the PCAOB through the inspection of the firms' public company audit practices, which, when coupled with a firm's internal quality inspection program, provides a quality control framework and helps to ensure that firms consistently conduct high quality audits. The purpose of the monitoring and inspection functions is to provide reasonable assurance that the quality control policies and procedures are appropriately designed, operating effectively, complied with in practice, and sufficient to achieve the overall quality control objective that the firm and its personnel comply with professional standards, standards of the accounting oversight body and the firm's own internal quality standards. Monitoring and internal inspection include the ongoing evaluation of all of the elements of quality control and periodic inspections of completed engagements and of various aspects of the quality control system. The monitoring and internal inspection functions evaluate quality control deficiencies and identify systemic or repetitive deficiencies that require timely corrective action. Remediation of deficiencies is accomplished through the development and implementation of action plans, including firm-wide training when appropriate.

Internal Inspection Programs: As mentioned above and in addition to the PCAOB inspection process, many of the large audit firms conduct their own internal inspection programs which include an annual review of the firms' systems of quality controls for the accounting and auditing practice. Inspection teams primarily are composed of partners and senior staff who review compliance with elements of the quality control systems. Most firms strive to ensure that every audit partner is reviewed at least once every three years, but any partner may be reviewed more frequently. The results of these inspections are available to be shared with the PCAOB.

PCAOB Inspection: As noted before, the PCAOB conducts regular inspections of the procedures and practices of the public company audit practices of PCAOB-registered firms. The reviews are designed to determine the extent to which audit firms have and adhere to adequate quality control policies and procedures that address all significant aspects of public company auditing, as well as the effectiveness of performance on specific audit engagements.

Firm Structure and Networks

Accounting firms in the U.S. are generally organized as limited liability partnerships under state law. State law generally requires firms to be owned by individuals that actively participate in the practice. Professional codes of conduct/ethics are imposed on partners and staff by the PCAOB, the AICPA, and by state boards of accountancy. Firms also install codes of conduct/ethics that employees are required to meet, and those codes vary based on the size and complexity of the firm. The codes are enforced by the firms' own policies and disciplinary procedures. These firm codes and standards often exceed those imposed by the regulators and professional standards.

In most parts of the world, the right to practice accountancy is granted only to firms in which locally qualified professionals have majority or full ownership. Most, if not all, accounting firms that serve multi-national enterprises are by necessity members of regional or global networks with affiliates that operate locally and are subject to local regulatory regimes. The network structure is used for a number of reasons, including national restrictions that limit equity ownership in CPA firms to local licensees.

Global networks of firms emerged in the late 1800s (generally via contractual arrangements among firms) and grew in size and scope through the second half of the 20th century. Firm networks continue to serve a critical need to meet the increasing globalization of business and the capital markets. Over time and in response to a business climate that features both cross-border opportunities and cross-border risk, the global networks have increased their oversight and compliance monitoring over their member firms.

Member firms typically execute a membership agreement with the network organization to spell out the rights and obligations of the respective parties, and the networks typically adopt (and member firms ratify) policies and requirements to provide greater detail about how those obligations are carried out. The rights and obligations cover matters such as compliance with the common standards, policies and methodologies of the network, participation in quality assurance programs, sharing of information, agreement on a common and collaborative business strategy, rights to use the network name and other trademarks, conditions for continued membership in the network, processes and penalties for withdrawal from the network, sharing of common costs and/or payment of network membership fees, voting rights, and other rights to participate in network governance. These agreements typically prohibit the network organization from providing services to clients – limiting that function to the member firms themselves.

The concept of a network is used by many firms, from the largest to the smallest of firms. Networks operate in two basic styles. In the first model, a firm joins and identifies with a global network to reference and identify with that network and to create a presence similar to the six largest firms. In the second model, a firm joins and identifies with a global network but keeps its firm or local name and acknowledges its affiliation with an international network by including all or part of the network name in its firm name. Also, some firms align internationally, but are not members of a network, rather are organized as an association of like-minded firms. These firms reference the association membership, but do not include the association name in their firm name.

Audit Firm Governance

Each network has its own organization and structure, and with respect to firms that are associated with international organizations, the ability of the international organization to affect each national or regional firm's operations varies from network to network. The discussion in this section represents a synthesis of structures and should not be read as representing the governance for any particular network.

At the global level, membership agreements and network policies typically set forth terms of reference for firms' governing bodies and their composition. Firm governance structures at the network level typically include a chairman and chief executive (who may or may not hold executive position(s) in one of the member firms), a leadership team of partners with various functional and geographic responsibilities, and an oversight board, typically made up of partners in the firm. For the largest of firms and networks, the management team and oversight board are responsible for monitoring compliance with firm policies and procedures and have the authority to impose sanctions against member firms. Although the preference is certainly to impose sanctions designed to ensure compliance with and education about global standards, sanctions ultimately can include withdrawal of the member firm's rights to use the network name and trademarks, and expulsion of the member firm. For smaller firm networks, membership in a global network is more related to the ability to call upon a member firm to assist with work in another country and may have somewhat less structure and oversight than for larger firm networks.

Firms that are actively engaged globally have adopted new structures to help provide the level of service their clients demand, whenever they demand it. As an example, one firm several years ago reorganized 140 country practices into seven aligned global areas. In uniting its people and its market-facing activities on every continent, the firm has underlined its worldwide commitment to consistency and quality.

Governance structures help to ensure high quality, competent professionals, make the best use of the firm's intellectual capital, and create an environment where professional risks are anticipated and addressed. Audit firm governance processes and the allocation of power, authority, and responsibility within the firm are based on the recognition of the ultimate importance of high quality professional work, quality control standards, and professional values.

> **Firm Management and Election of Leadership:** There are various ways in which public company audit firms approach the election, evaluation and removal of their leadership. Typically, the largest audit firms in the U.S. are run by senior management – usually an elected or appointed chief executive officer and/or senior partner, along with other executives who constitute a management team. Senior management often includes leaders of the various service lines, a risk management or professional practice leader, a general counsel and/or director of compliance, an operating and administrative leader, and a business strategy leader, among others. Oversight of management's strategy and performance is typically provided by a supervisory board (sometimes referred to as a "board of partners"). Typically, a super majority of board members are CPAs not serving on the management committee who represent the interests of the partnership as a whole.
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> One of the critical elements of governance in firms that perform audits of public companies is that the decision making authority of the professionals who are trained in auditing and licensed as CPAs may not be over-ridden by non-CPAs in the firm. Accordingly, there are limits on the number of non-CPAs in a firm's ownership and in positions of decision making authority as to the application of professional judgment regarding the application of accounting principles and audit standards. Outside influences driven by factors other than professional responsibilities are a threat to the sound exercise of professional judgment.

"Tone at the top" – the ethical atmosphere created in the workplace by an organization's leadership – is a key ingredient to firm management and election of leadership for firms of all sizes. As a result of the significant changes that have taken place within the accounting profession in recent years, firms as a general matter have implemented more comprehensive, systematic processes for managing risk, monitoring compliance with risk management policies and procedures and ensuring audit quality. While the regulatory and oversight regimes currently in place have been critical to helping the profession ensure greater independence and objectivity, they are even more effective when firms commit to a “tone at the top” that complements the efforts of regulators by reflecting greater emphasis on governance that, by implication, encourages professionals to take greater responsibility for their actions and those of their peers.

> **Accountability through Partnership Agreements:** Generally, firms hold their partners accountable through partnership agreements. Partners have no inherent right to continued employment. Their continued association is contingent upon full compliance with their undertakings pursuant to those agreements.
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> Partner obligations are spelled out in partnership agreements. Those obligations bind the partner on matters such as compliance with policies and standards, contribution of capital, behavior in the workplace and otherwise, mandatory retirement age, return of shares upon separation, and processes of removal whether or not for cause. Partners’ performance is generally evaluated based on specific measures (both quantitative and qualitative) to assess performance, demonstrated technical competence and personal character, as well as compliance with applicable firm policies and professional standards.

ETHICS AND COMPLIANCE

Independence, Integrity and Objectivity

Independence – objective, impartial judgment – forms the bedrock of credibility in the auditing profession, and is essential to the profession’s primary function in the capital markets. Congress recognized the importance of auditor independence when it passed the Sarbanes-Oxley Act by codifying certain pre-existing professional and regulatory requirements into the Act, and also strengthening those requirements.

Great emphasis is placed within each firm, as it should be, on ethical conduct and compliance with SEC, PCAOB and firm independence standards. Over the last several years, those systems have been expanded and are now ingrained in the planning and performance of every audit. Public company audit firms have extensive checks and balance systems and processes to monitor firm and individual professional independence. Beyond communicating detailed independence policies to partners and staff, audit firms generally have implemented procedures and policies including: a system of listing clients and restricted investments; a process where professionals (and, in the case of networks, member firms) must report details of all investment transactions; timely monitoring of investments held; and individual systems designed to evaluate whether non-audit services are permissible and submitted in a timely manner for audit committee pre-approval. Typical compliance tools include systems and processes to pre-clear and subsequently monitor the firm’s business relationships and alliances; periodic communication to partners and staff about changes to client relationships; annual confirmation of compliance with restrictions; training; designated independence experts that are available for consultations when questions arise; and compliance monitoring and testing of individual compliance. Independence monitoring systems are more extensive and elaborate in larger firms, due to the breadth of their public company audit practices and the large volume of professionals within the firm.

As noted before, lead audit partners and engagement quality control review partners on SEC audit clients can not serve in those capacities for more than five consecutive years. There are additional rotation requirements applicable to other partners who play a significant role in firm audits.[9] Professional standards and SEC interpretations prohibit circumstances in which an audit client constitutes an unduly large portion of a firm's revenue.[10] These safeguards help to ensure that familiarity, financial dependence and other threats do not impair a firm's independence, integrity and objectivity.

The heightened focus on auditor independence is a positive development for investor assurance and confidence. However, to gain the maximum benefit from increased investor confidence, the auditor independence regulations and requirements supporting that confidence must be robust, conceptually sound, and well understood. The independence rules are also most effective when risk-based to ensure that the rules remain in step with increasingly complex, global markets. Inconsistencies among jurisdictions or regulations, such as standards that differ because of different oversight bodies or regulations that differ by country, increase complexity and create difficulties in monitoring compliance. In the last five years, audit firms have made substantial investments in resources and systems related to both personal and firm-level audit independence. As an example, one firm has over 20 partners and professionals dedicated to this effort in order to conduct independence audits of all partners at least once every three years.

To make certain their people understand the rules, policies and their personal responsibility and role in safeguarding independence, firms throughout the profession have increased the hours and depth of their training on independence, including tailoring the training specifically to the roles of partners, service-line professionals, procurement personnel, and newly-hired employees. In 2004-2005, for example, nearly 18,000 client service professionals completed one firm's mandatory, four-hour independence and integrity training, which also is required of new hires. Another 500 business development and procurement professionals completed the same training.

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[9] Under the SEC's auditor independence rules, accounting firms with fewer than five public company audit clients and less than ten partners are exempt from the partner rotation requirements provided the PCAOB conducts a review of each public company audit client engagement at least once every three years.

[10] According to a Staff Report on Auditor Independence prepared by the SEC's Office of the Chief Accountant in March 1994, "The Commission's published requirements do not specifically address this issue; however, the Commission's staff raises questions regarding the independence of accountants who derive more than 15% of their total revenues from one client or group of related clients…"

Interpretations, Investigations and Enforcement

While accounting firms conduct their business within the framework of applicable professional standards, laws, regulations and internal policies, firms also acknowledge that these standards, laws, regulations and policies do not govern all types of behavior. Knowing that a firm's culture and values are of utmost importance to the effective functioning of its quality control system, most accounting firms reinforce their commitment to high standards for quality and integrity by publishing a code of conduct for all of their people and member firms.

Codes of conduct established by the profession, accounting firms and their networks (as well as the code established by the AICPA and incorporated into regulations by state boards of accountancy) supply a framework for resolving possible ethical issues, which is further strengthened and complemented by the oversight and enforcement capabilities of the SEC and PCAOB. It is the responsibility of professionals in the accounting firm to follow firm policies and applicable codes of conduct, regulations and professional standards. Recognizing that non-compliance with a code of conduct could indicate, or result in, a lax compliance environment, accounting firms or boards of accountancy (or both) take steps to investigate suspected code violations and, if appropriate, remedy the situation.

In addition, the PCAOB's regulation of the audit profession provides oversight for the firm's efforts. In order to ensure that auditors comply with certain fundamental principles of integrity and to eliminate or reduce threats to objectivity, safeguards are implemented to help ensure objectivity, professional competence and due care, confidentiality, and professional behavior. The PCAOB's oversight further supports such efforts.

THE GLOBAL VIEW

From a global perspective, there is considerable diversity in the ways in which countries have responded to the issues of audit quality, education and training, audit standard setting, and oversight. However, there appears to be growing consensus that regulators on every continent would be well served by working more closely together in the interest of improving worldwide audit quality.

The establishment of the Public Interest Oversight Board (PIOB) in March 2005 was the result of a collaborative effort by the international financial regulatory community, working with the International Federation of Accountants, to ensure that auditing and assurance, ethics and educational standards for the accounting profession are set in a transparent manner that reflects the public interest. According to the Madrid-based organization, "It was mutually recognized that high quality, transparent standard-setting processes with public and regulatory input, together with regulatory monitoring and public interest oversight, are necessary to enhance the quality of external audits of entities. For this reason, the PIOB also maintains active liaison with independent audit regulators around the world."

Last year, 18 independent audit regulatory organizations from around the world created the International Forum of Independent Audit Regulators (IFIAR). IFIAR's purpose is to share knowledge of the audit market environment and practical experience of independent audit regulatory activity; to promote collaboration in regulatory activity; and to provide a focus for contacts with other organizations interested in audit quality.

Noting that an increasing number of countries are taking steps to enhance auditor oversight, PCAOB Chairman Mark Olson has said, "The PCAOB strongly believes that dialogue and cooperation among auditor regulators are critical to every regulator's ability to meet the challenges that come with the increasingly complicated and global capital markets."[11]

CONCLUSION

In conclusion, it is our hope that this synopsis of the current public company audit environment will be useful to the Advisory Committee as it considers options to strengthen the profession's financial soundness and its ability to attract and retain qualified personnel. As noted before, the profession looks forward to sharing our views with you in the weeks to come.

Five years after the first of SOX's reforms, public company auditors are more committed than ever to the highest standards of quality and ethical service. In working to make public company audits more reliable and relevant to investors, the CAQ views the deliberations of the Advisory Committee as an extraordinary opportunity to identify rational and realistic approaches that will result in a more sustainable auditing profession for decades to come.

Sincerely,

James S. Turley
Chair, Governing Board
Center for Audit Quality
Chairman and CEO, Ernst & Young LLP

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

[11] "PCAOB Meets with Asian Counterparts to Discuss Cooperation on Auditor Oversight," March 23, 2007. http://www.pcaobus.org/News_and_Events/News/2007/03-23.aspx