

THE TREASURY DEPARTMENT



ADVISORY COMMITTEE ON THE AUDITING PROFESSION

DRAFT FINAL REPORT
SEPTEMBER 26, 2008



THE DEPARTMENT OF THE TREASURY

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

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

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I. TRANSMITTAL LETTER

ADVISORY COMMITTEE ON THE AUDITING PROFESSION

[September __, 2008]

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

Dear Secretary Paulson:

It is our pleasure and privilege to present to you on behalf of the Department's Advisory Committee on the Auditing Profession its Final Report and recommendations to enhance the sustainability of a strong and vibrant public company auditing profession.

The Advisory Committee has devoted twelve months to this effort, and we have on numerous occasions solicited public input at various meetings and through written commentary. We have provided a summary of the Advisory Committee's activities in the Co-Chairs' Statement, which is included in this Final Report.

We commend the Department for its initiative in creating the Advisory Committee, in shaping its broad charter, and in supporting its labors. You have been generous in furnishing staff and other resources. We trust that the Final Report and recommendations are worthy of the support and resources which you gave.

Each of the Advisory Committee members stands ready to lend whatever further assistance we may be able to render in carrying out the recommendations of this Final Report.

Respectfully submitted on behalf of the Advisory Committee,

Arthur Levitt, Jr.
Advisory Committee Co-Chair

Donald T. Nicolaisen
Advisory Committee Co-Chair

II: CO-CHAIRS' STATEMENT

The Advisory Committee on the Auditing Profession, appointed by the U.S. Treasury Secretary Henry M. Paulson, Jr., was asked to examine comprehensively the condition and future of the auditing profession, with emphasis on the sustainability of a strong and vibrant profession. In conducting its work, the Committee recognized that the prospects for the auditing profession are directly related to the quality and effectiveness, as well as the perceived value, of independent audits. Ultimately, it is a combination of transparency and trust that enables our financial markets to function efficiently. A strong and vibrant auditing profession is a critical element of that regime and especially important to the U.S. capital markets where more than 100 million people invest their savings and retirement assets.

While the focus was on the auditing profession in the United States and in particular on the audits of U.S. public companies, the Committee approached its work with the awareness that audits, especially of large capitalization companies, are global in nature and that auditing firms, both here and abroad, rely upon the quality and consistency of their global network firms. For that reason, we reached beyond our borders in seeking input from observers, witnesses, and others and in considering the future of the profession

The four largest firms audit approximately 98% of the market capitalization of U.S. public companies, a concentration generally comparable to their participation in other major capital markets. The auditing firms also examine and issue audit reports on privately owned entities, joint ventures, investment vehicles, employee benefit plans, and governmental and other entities. The requirements for such audits vary, but the objective is generally consistent, to provide an independent and objective test of the accounting policies, procedures, and judgment used by management in preparing the financial statements. In addition to audit and audit-related services, the largest auditing firms also provide a range of tax, advisory, and other professional services. In 2007, the four largest global network firms reported, in the aggregate, approximately \$90 billion in total revenues of which approximately \$11.8 billion (13.1%) was for audits of U.S. public companies. Total revenue reported by the U.S. affiliates of the four largest firms was \$31.2 billion.

This is the first major study of the U.S. auditing profession since enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and the Committee heard of many positive developments within the auditing profession in recent years and of a generally positive impact the Public Company Accounting Oversight Board (PCAOB) has had on audits. The Committee was also informed that actions have also been taken by foreign regulators and others to strengthen audits in other countries. The auditing profession has been studied extensively in the past, but was previously self-regulated and implementation of recommendations was not consistent. Under the oversight of the PCAOB, we are optimistic that recommendations of this Committee will receive appropriate attention.

We believe the U.S. standard setters and regulators, including the PCAOB should be involved on international matters, working to ensure a positive interchange and consideration of experience and expertise from within and outside the United States to help inform global de-

velopments, with the objective of strengthening financial reporting and auditing worldwide. Because a substantial portion of the audits of U.S. public companies occur outside the United States, our capital markets benefit when standard setters work with regulators in other countries and with international agencies. We believe that the United States should take a leadership role in ensuring the highest quality accounting and auditing standards.

An important requirement of Sarbanes-Oxley is that audits of U.S. public companies are to include evaluation by the independent auditor of the effectiveness of a company's system of internal control. While there were initial complications in implementing this requirement, it now seems to be working generally as intended and is a watershed event that has improved and will continue to improve financial reporting. An effective system of internal control is critical to the timely and accurate recording of transactions, to the safeguarding of assets, and ultimately to reliable financial reporting.

Due to Sarbanes-Oxley, independent audit committees in the United States now engage the independent auditor and manage the relationship. Audit scope under Sarbanes-Oxley has been expanded to include reporting on internal controls, and audit fees for U.S. public companies have increased significantly. At the same time, fees billed to audit clients for non-audit services have declined, a result generally appreciated by investors as strengthening auditor independence. Pre-Sarbanes-Oxley, audit fees were on average approximately only 50% of total fees charged to audit clients. That percentage increased dramatically to approximately 80% by 2006. We believe it important that audit fees continue to provide a fair return to auditors and we would not wish to see a return to the situation pre-Sarbanes-Oxley when audits were sometimes viewed as a commodity and priced accordingly. Now that evaluation of internal controls has been integrated into the audit, it appears that the scope of work and the resulting audit fees have generally stabilized and auditing firms are looking to areas beyond audit to profitably grow their practices. The rate of growth for non-audit services, especially advisory services offered to non-audit clients, now exceeds the rate of growth for audit services. We realize that the allocation of investment dollars and professional talent is in many cases interchangeable, and that some auditing firms are working a delicate balance in allocating resources amongst their various practices. As Co-Chairs of this Committee, we strongly believe that the audit practice should always be the highest priority.

This Report represents nearly one year's efforts of a philosophically diverse, talented, and committed group of investor, business, academic, and institutional leaders. Balance was a motivating force in creating a Committee that would be sensitive to the views of auditors (both large and small), public companies, investors, and the teaching profession. The Committee benefited from the input of observers who labored with the Committee in identifying and sorting through the issues. The level of commitment was high and the views received were often intense and passionate. The resulting Report of the Committee contains substantial information on the auditing profession and makes numerous recommendations that this remarkably collegial group of diverse interests embrace and support. All of the Committee members voted to issue the Committee report. (WE MAY NEED TO AMEND THIS SENTENCE IF ONE OR MORE COMMITTEE MEMBERS DO NOT SUPPORT THE REPORT)

We thank the Committee members and observers for their efforts, energy, intellectual input, and willingness to engage each other in exploring the broad range of issues. The Committee heard testimony from a large number of presenters and dealt with a tremendous volume of information, while identifying and debating the issues in a collegial and thoughtful manner.

We also wish to acknowledge the support and encouragement provided by our vice-chairman, Paul Volcker, and our Counsellor, Alan Beller. Paul supported us with his deep experience, intellect, and pragmatic thinking. Alan was involved in all our discussions and took the lead in assuring that the Report of the Committee was accurately communicated. The unwavering support and encouragement of both Paul and Alan were invaluable and we are deeply indebted to them. Finally, we wish to express our appreciation to Treasury staff, led by former Under Secretary Robert K. Steel and Assistant Secretary David G. Nason. This Report also would not have been possible without the tireless support of the other members of the staff, particularly Kristen E. Jaconi, Senior Policy Advisor to the Under Secretary, Kelly A. Ayers, Financial Economist, Gerry Hughes, Financial Analyst, and Timothy M. Hunt, Financial Analyst, who accumulated volumes of background information, arranged meetings, and provided support and assistance to the outstanding panels of experts that provided testimony to the Committee.

The Report of the Committee offers thirty-one recommendations derived from the deliberations of three Subcommittees each focused on one of three key areas—human capital, firm structure and finances, and concentration and competition.

The auditing firms are major employers, recruiting talent in competitive markets and offering exceptional training and diversity of experience. The largest firms are often included in leading publications of the “best places to work.” Recruiting, training, and retaining talent are critical to a strong and vibrant profession. The Subcommittee on Human Capital, chaired by Gary J. Previts, focused its efforts on accounting education, minority representation, and the supply and experience of accounting faculty. The Subcommittee focused time and effort on the adequate preparation of the accounting student and noted the need to increase the pace of curricular changes in college and university accounting programs to match more effectively the increasing pace of market developments. In order to accomplish this, the Subcommittee recommended that the accounting certification examinations, accounting curricula, and teaching materials should be continually updated to reflect changes in market developments.

At the same time, the Subcommittee on Human Capital noted the need for the profession to reflect the ethnic demographics of the global economy. Concerned about minority representation and retention in the profession, the Subcommittee recommended that the profession recruit minorities from other disciplines and careers as well as implement programs to increase minority retention. The Subcommittee also highlighted the role of community colleges in the recruitment process, stressing cross-sabbaticals and internships with faculty and students at Historically Black Colleges and Universities, and recommending increased funding for minority doctoral candidates. Finally, the Subcommittee noted the progress and the need for continued attention to the development of opportunities for women in the auditing profession.

Concerned about the shortage of accounting doctoral faculty, the Subcommittee on Human Capital recommended the following potential solutions: increasing public and private funding, increasing the number of professionally qualified faculty, stressing cross-sabbaticals, and creating incentives for the private sector to fund both accounting faculty and faculty research. In order to better assess the supply and demand of accounting personnel, the Subcommittee on Human Capital recommended the establishment of a committee to encourage the collection of demographic profile data of professional accountants and auditors.

Having noted the increasing complexity of financial reporting and auditing in a dynamic and global environment and the need to adequately prepare future professionals for such an environment, the Subcommittee on Human Capital recognized that changes in the accounting education structure might be warranted. Thus the Subcommittee developed a long-term recommendation to form a commission to study the future higher accounting education structure. Finally, some concern was expressed that the accounting profession needs to do more to strengthen its image as one of a handful of prominent professions.

How auditing firms are structured, their governance, their finances, and their reporting to the public and to investors affect not only how they function but also the market's perception and acceptance of the profession. The Subcommittee on Firm Structure and Finances, chaired by Robert R. Glauber, directed its efforts to a number of complicated issues. Realizing the importance of the reliability of financial statements to investor confidence, the Subcommittee focused on enhancing auditors' fraud detection capabilities. To further enhance those capabilities, the Subcommittee recommended the creation of a national center for market participants to share experiences and develop best practices relating to fraud prevention and detection.

As state boards of accountancy license public company auditors, the Subcommittee on Firm Structure and Finances developed several recommendations to make this regulation more effective and consistent across a national level: Congress should pass a federal provision requiring those states that do not voluntarily do so to adopt the Uniform Accountancy Act's mobility provisions. Federal and state regulators and enforcement bodies should meet in regular roundtables to reduce duplicative and potentially inconsistent enforcement regimes. States should ensure greater financial and operational independence of their state boards of accountancy.

Recognizing the recent improvements to public company corporate governance, the Subcommittee on Firm Structure and Finances recommended a series of initiatives to enhance transparency of the auditing profession. First, the Subcommittee recommended that the PCAOB and the Securities and Exchange Commission (SEC) consider the possibility of auditing firms' appointing independent members to firm boards or advisory boards. Second, the Subcommittee recommended that the SEC amend public company disclosure requirements to mandate disclosure of all public company auditor changes. Finally, the Subcommittee on Firm Structure and Finances recommended that the larger auditing firms produce a public annual report similar to the European Union's Eighth Directive, Article 40 Transparency Report and including audit quality indicators and also file on a confidential basis audited financial statements with the PCAOB.

The Subcommittee on Firm Structure and Finances also focused on improving the usefulness of the auditor's report, the auditor's primary means of communication with investors. The Subcommittee recommended that the PCAOB undertake standard-setting initiatives to consider improving the content of the auditor's report beyond its current pass/fail model and to require that the engagement partner sign the auditor's report.

As the result of mergers and the demise of Arthur Andersen, there are fewer large auditing firms with particular concentration amongst large global public companies. Audit committees and those who engage auditors desire choice and a competitive environment, which stimulates excellence and innovation. The Subcommittee on Concentration and Competition, chaired by Damon Silvers, directed its attention to the high degree of concentration in the public company audit market, particularly the larger public company audit market where four auditing firms dominate. The Subcommittee on Concentration and Competition did not consider any significant regulatory action to increase competition. However, in order to reduce the barriers to entry for smaller firms into the public company audit market, the Subcommittee recommended that public companies disclose in their SEC filings any agreements that limit audit choice. They also suggested that regulators and policy makers include smaller auditing firms on committees and public forums.

The Subcommittee on Concentration and Competition also examined the impact of catastrophic risk on this highly concentrated profession. The Subcommittee recognized that no auditing firm is too big to fail. However, it seems clear that the loss of one of the larger auditing firms would have systemic repercussions throughout the global capital markets. As a two-step solution to prevent and/or limit such repercussions, the Subcommittee recommended first that the PCAOB continuously monitor the sources of catastrophic risk to the profession. Second, the Subcommittee recommended a framework for a plan to rehabilitate and preserve a firm facing circumstances threatening its viability, thereby safeguarding its most critical assets: its partners and employees, its reputation, its client base.

At the same time, the Subcommittee on Concentration and Competition discussed enhancing audit quality as a key element in improving the viability and resilience of the auditing profession. The Subcommittee learned that auditing firms provide limited information on audit quality to the public, particularly to audit committees and investors. The Subcommittee recommended that the PCAOB consider the feasibility of developing and disclosing audit quality indicators so that more of such information can be developed and communicated.

The Subcommittee on Concentration and Competition focused considerable time and effort on auditor independence, critical to the credibility of the audit. The Subcommittee on Concentration and Competition recommended a greater understanding of independence by requiring that the public company auditor independence requirements be compiled into a single document and creating additional independence training materials for auditors.

To further enhance the accountability of audit committees, the Subcommittee on Concentration and Competition recommended that public companies adopt annual shareholder ratification of public company auditors, a practice common at over 70% of public companies today.

The Subcommittee on Concentration and Competition also noted the increasing globalization of the capital markets and the consequent increasing need for regulators and policy makers to collaborate at the global level to oversee auditing firms and monitor audit quality. The Subcommittee on Concentration and Competition recommended that the PCAOB continue to collaborate and cooperate with its foreign counterparts.

The work of the entire Committee was outstanding, but in spite of the earnest efforts of Subcommittee chairs working with extraordinarily well-informed and committed members we were unable to find common ground on one important issue the Committee faced from its inception- the question of the role of the civil litigation system in relation to public company audits. While consensus on this issue was not obtainable, the Committee nonetheless makes an important contribution by capturing the differing views that exist about private litigation involving auditing firms. As Co-Chairs we feel an obligation to express our own views.

While not all Committee members will share our views we wish to express our gratitude for the extensive efforts made by all members to carefully and openly examine every point of view. The effect of private litigation on auditing firms has been contentious for decades and it is not surprising that it continued to defy a consensus solution, but the Committee's dialogue nonetheless has laid the groundwork for continued and constructive effort in the future. It is in that spirit that we wish to define our perspectives on this issue. Similarly, we as Co-Chairs feel we need to amplify the conclusions of the Committee as a whole in the area of auditing firm transparency. The major auditing firms are key actors in the public securities markets. They must comply with the same principles of transparency that we ask of other major market actors, both for the sake of the credibility of the market system as a whole, and for the credibility and long-term health of the firms themselves. Below we outline specifically how we believe the Committee's recommendations should be implemented so as to accomplish this goal.

We accepted the challenge of chairing this Committee because we believed in the vital importance of auditing as a profession for the health of our markets and our economy, and, in a certain respect, the well-being of our society. The role of the auditor is noble. Yet, the prestige of the profession is understated. It is our sincere desire that the reputation of the profession will grow as recommendations made by this Committee are implemented and as the profession competes vigorously for a greater share of the best talent. Confidence in the content of information of all kinds is necessary for a complex society to function and many play a role. The rule of law, and a free and independent press are key structures in developing that confidence. So too is a strong and transparent auditing profession insofar as confidence in our economic enterprises and markets is concerned.

A desired outcome is an environment in which savings can be invested with confidence, but the more important outcome is that we can live our economic lives relatively free of suspicion and mistrust about the bedrock of our infrastructure of investor safeguards. Investment risk will always exist, and that is as it should be. The pursuit of higher returns involves greater risk and our markets consistently produce winners and losers. But, investors should have confidence that our infrastructure, including audits of public companies, is fundamentally fair and functioning effectively.

Considering the importance of the profession and its current concentration, during our work with the Committee we also closely examined the health of the auditing profession with particular emphasis on the largest firms. On many occasions we heard about the auditing firms' beliefs that their very survival is jeopardized as a result of their exposure to civil litigation brought by investors and the companies which they audit. As Co-Chairs, in reviewing the evidence, we came to the following conclusions.

- Litigation-related expenses are a significant component of auditing firms' cost structures. However, while significant and a concern, we do not believe the Committee was presented with evidence showing that ongoing litigation costs are at a level that significantly affects their ability to recruit talent or grow their practices.
- Audits of large public companies are concentrated amongst a limited number of auditing firms and the largest such firms are not able to use third party insurance in a cost-effective manner to manage the full range of their litigation costs. Some firms do use captive self-insurance in managing the costs of routine litigation but are unable to do so for damage claims in amounts that threaten survival of the firm. It is of course the case that a number of professions and industries are similarly unable to insure against catastrophic risks.
- The largest U.S. public companies have enormous market capitalization and, if a large cap company becomes insolvent or suffers a significant diminution in market value, such market loss often greatly exceeds the total capital of the auditing firm which audited that company. A suit for damages in the amount of that loss may be brought against the firm, which audited the public company. Similarly, while our focus was on audits of public companies, there are also significant claims against auditors arising out of audits of non-public entities. Such actions were generally referred to as "mega" or "catastrophic" claims in the Committee's deliberations. The auditing firms informed the Committee that they often feel pressured to settle such cases, even when they believe they have meritorious defenses, because taking such cases to judgment carries an unpredictable risk of loss in an amount that could threaten survival of the auditing firm.
- In addition to catastrophic threats to survival from private litigation, the firms are also at risk that a serious breach of professional audit duty, a criminal indictment, or other conduct that causes a mass loss of client, investor, employee and/or network firm confidence could threaten survival. These risks are inextricably intertwined with the use

of private firms to audit public companies and while they can be managed, they cannot be made to disappear completely, nor may they be fully insured against.

- Private litigation is an important supplement to regulatory activity in ensuring accountability and confidence in our financial markets.
- The range of issues identified by and the proposed solutions suggested to the Committee regarding private litigation were varied, some were exceedingly complex, and most could potentially affect many market participants both in the United States and abroad, not just the auditing firms who were the subject of the Committee's study.
- The U.S. auditing firms are private partnerships national in scope, but significantly dependent on the strength of their global networks. The largest such firms provide only limited information to the investing public about the sources of their revenue, their governance practices, the amount of their earnings, and their financial condition. The largest U.S. auditing firms informed us that they do not prepare financial statements using GAAP (Generally Accepted Accounting Principles) although in other regions of the world, some of their networked firms do provide such information.

Notwithstanding the Committee's inability to reach a recommendation as to private litigation, we believe that our responsibility as Co-Chairs is to lay out as clearly as feasible the considerations that should be considered in the future. There are strongly held views on both sides of the question as to whether adjustments in the system of private litigation are desirable, and as to the direction that those adjustments should take. It seems to us desirable to continue that debate, and it further seems to us unavoidable whatever our views.

Focusing more precisely on our Committee's mandate to consider the public company auditing profession, concerns about the potential effect on our capital markets from loss of one of the largest firms prompted a recommendation by the Committee that the PCAOB monitor auditor conduct that might present a risk to sustainability on an ongoing basis and that Congress establish a mechanism under which a firm could be rehabilitated. We strongly support this recommendation. Moreover, we believe it would be even more effective if the PCAOB were to on annual basis report its findings regarding the sustainability of the auditing profession to the Secretary of the Treasury or the President' Working Group.

Beyond this recommendation, with respect to private litigation against the auditing firms, we believe that the auditing of public companies is fundamentally a matter of national interest and concern. The steps taken under the Sarbanes-Oxley and the creation and operation of the PCAOB are two clear manifestations of that reality. Public company audits are conducted within the framework of a national securities market, and public company auditing standards are set nationally by the PCAOB. But the auditing of public companies can give rise to liability in state courts under differing substantive and procedural standards. This, in turn, creates a process that is costly, time consuming, and redundant. We therefore also believe that policy makers and the legal system should consider progressively moving towards a structure that at least for the most part embodies a common national set of standards. There are many complex issues that must be considered in moving further toward a national professional liability

regime for public company auditing firms, but clear national standards would seem consistent with the national perspective on public company auditing and the uniform national regulatory oversight system demonstrated by Sarbanes-Oxley and the PCAOB. We believe that while Congress and regulators and other policy makers all will have a role to play in the development of such a system, it must also be developed taking advantage of the best thinking of our most informed legal, economic, and other minds as to how such a system would be structured and implemented. We do believe that if done correctly, such a step has the potential to reduce cost and complexity, and can also be taken in a manner that does not lead to a reduction in accountability. If federal standards for professional conduct for public company auditors are eventually considered, they should reinforce the integrity of the auditing profession.

Fairness also dictates that auditing firms faced with litigation claims that threaten their survival, should have reasonable opportunity to litigate and appeal such matters. We believe the variations in state substantive and procedural law, when combined with the economics of actions arising out of matters involving major audit clients, can act to deny auditing firms a reasonable opportunity to litigate and appeal some cases.

Given the significant role auditing plays in our capital markets, as part of federalization of liability standards for public company auditors, Congress may in fact wish to consider the creation of a federally chartered audit structure for firms which choose to operate as such. It would require that the exclusive mission of such a firm be auditing and auditing-related matters. Characteristics of such a structure might include incorporation (with tax and financing advantages), requirements for capitalization, federal licensing, further clarity of PCAOB oversight, new governance structures with independent directors, limits on liability for audits of public companies, mandatory public reporting, including audited financial statements, and improvements to the auditor's report to investors. Additionally, Congress may in connection with creation of a federal charter, wish to consider the establishment of a federal insurance agency to provide coverage to investors in certain instances, funded by a portion of the audit fees charged to public companies. A federally chartered structure for auditing firms would have the advantage of maintaining independence and the focus on the audit as the principal product.

Any change enacted by Congress has the potential to affect other capital market participants in unintended ways and as noted above, ultimately policy makers and regulators must approach controversial issues from a perspective of basic fairness, informed by balanced expertise and supported by public exposure and input.

As Co-Chairs, we also have additional views in the area of transparency. We endorse the recommendation made by the Committee which calls for the PCAOB to develop standards of disclosure applicable to the auditing firms including a requirement that by 2011 the largest firms prepare and submit audited GAAP financial statements to the PCAOB. While we believe implementation of this recommendation would be a significant improvement in providing insights into the auditing profession, we also continue to believe that at least the largest auditing firms should make audited financial statements available, including to audit committees and the investing public. Issuance of audited financial statements provides greater

transparency and increases discipline and helps sharpen focus, accountability, and trust. The largest auditing firms play a vital role in ensuring the integrity of our capital markets and fairness requires that if a handful of these firms dominate the public company audit market, they should be transparent and provide a level of financial reporting that is generally comparable to that of the public companies they audit. We would encourage the largest firms to do so voluntarily, but if that step does not occur, we would have the PCAOB determine the effective date and precise content of such public reports and disclosures.

We hope our observations, as Co-Chairs of the Committee, will provide the starting point for a future consensus built around the principles of fairness to all participants in our public markets.

Arthur Levitt, Jr.

Donald T. Nicolaisen

III. Committee Members, Observers, and Staff of the Advisory Committee

Members:

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

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

Alan L. Beller, Counsellor to the Co-Chairs
Partner, Cleary Gottlieb Steen & Hamilton LLP

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

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

H. Rodgin Cohen
Chairman, Sullivan & Cromwell LLP
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Timothy P. Flynn
Chairman and Chief Executive Officer, KPMG LLP
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Ken Goldman
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Gaylen R. Hansen
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Paul A. Volcker, Vice-Chair
Former Chairman, Board of Governors, Federal Reserve System

Ann Yerger
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Mark W. Olson
Chairman, Public Company Accounting Oversight Board

Zoe-Vonna Palmrose (until July 2008)
Deputy Chief Accountant for Professional Practice, Office of the Chief Accountant, Securities and Exchange Commission

Michel Prada
Chairman, Autorité des Marchés Financiers

Sir David Tweedie
Chairman, International Accounting Standards Board

The Department of the Treasury:

Robert K. Steel (until July 2008)
Under Secretary for Domestic Finance

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

Kelly A. Ayers
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Michael Briskin
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Heidi Cohen
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Gerry Hughes
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Timothy M. Hunt
Financial Analyst
Office of Financial Institutions Policy

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

Steven D. Laughton
Senior Counsel
Office of the General Counsel

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

Jennifer Zuccarelli
Director
Office of Public Affairs

IV: COMMITTEE HISTORY

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

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

- 1 Treasury Secretary Henry M. Paulson, Jr., Remarks on the Competitiveness of U.S. Capital Markets at the Economic Club of New York (Nov. 20, 2006), *in* Press Release No. HP-174, U.S. Dep't of Treas. (Nov. 20, 2006) (included as Appendix C).
- 2 Treasury Secretary Henry M. Paulson, Jr., Opening Remarks at Treasury's Capital Markets Competitiveness Conference at Georgetown University (Mar. 13, 2007), *in* Press Release No. HP-306, U.S. Dep't of Treas. (Mar. 13, 2007) (included as Appendix D).
- 3 Press Release, U.S. Dep't of Treas., Paulson Announces First Stage of Capital Markets Action Plan (May 17, 2007) (included as Appendix E); Press Release, U.S. Dep't of Treas., Paulson: Financial Reporting Vital to US Market Integrity, Strong Economy (May 17, 2008) (included as Appendix F).
- 4 Notice of Intent to Establish; Request for Nominations, 72 Fed. Reg. 33560 (U.S. Dep't of Treas. June 18, 2007) (included as Appendix A).
- 5 Press Release, U.S. Dep't of Treas., Paulson Announces Auditing Committee Members to Make Recommendations for a More Sustainable, Transparent Industry (Oct. 2, 2007) (included as Appendix G). This press release describes the diverse backgrounds of the Committee members. For a list of Members, Observers, and Staff, see Chapter III.
- 6 See Committee Charter (included as Appendix B).

Committee Activities

The Committee held its initial meeting on October 15, 2007 in Washington, D.C.⁷ Then Under Secretary for Domestic Finance Robert K. Steel welcomed the Committee members and provided introductory remarks.⁸ Also on October 15, 2007, the Committee adopted its by-laws⁹ and considered a Working Discussion Outline to be published for public comment.¹⁰ The Working Discussion Outline identified in general terms issues for the Committee's consideration. A Working Bibliography, presented to the members prior to the initial meeting and updated intermittently throughout the course of the Committee's deliberations, provided the members with articles, reports, studies, and other written materials relating to the auditing profession.¹¹ All full Committee meetings were open to the public and conducted in accordance with the requirements of the Federal Advisory Committee Act.¹² The meetings of the full Committee were also Web or audio cast over the Internet.¹³

The Committee held its second meeting on December 3, 2007 in Washington, D.C. The agenda for this meeting consisted of hearing oral statements from witnesses and considering written submissions that those witnesses had filed with the Committee. The oral statements and written submissions focused on the issues impacting the sustainability of the auditing profession, including issues mentioned in the Working Discussion Outline. Nineteen witnesses testified at this meeting.¹⁴ The Committee held a subsequent meeting on February 4, 2008 in Los Angeles, California at the University of Southern California. The agenda for this meeting consisted of hearing oral statements from witnesses and considering written submissions that those witnesses had filed with the Committee. The oral statements and written submissions focused on the issues impacting the sustainability of the auditing profession, including issues mentioned in the Working Discussion Outline. Seventeen witnesses testified at this meeting.¹⁵ The Committee held additional meetings on March 13, 2008, April 1, 2008, May 5, 2008, June 3, 2008, July 22, 2008, and September 26, 2008. All were face-to-face meetings held at the Department in Washington, D.C., except for February 4, 2008, which was held in Los Angeles, California, and the meetings on April 1, 2008, and September 26, 2008, which were telephonic meetings. No witnesses testified at these additional meetings, except for the June 3, 2008 meeting. The agenda for the June 3, 2008 meeting consisted of hearing oral statements from witnesses and considering written submissions that those witnesses had

7 The Record of Proceedings of this and subsequent meetings of the Committee are available on the Department's website at <http://www.treas.gov/offices/domestic-finance//acac/press.shtml>. See Record of Proceedings, Meeting of the Committee (Oct. 15, 2007, Dec. 3, 2007, Feb. 4, 2008, Mar. 13, 2008, Apr. 1, 2008, May 5, 2008, June 3, 2008, July 22, 2008, and Sept. 26, 2008) [hereinafter Record of Proceedings (with appropriate date)] (on file in the Department's Library, Room 1428), available at <http://www.treas.gov/offices/domestic-finance/acac/press.shtml>.

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

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

10 The Working Discussion Outline is included as Appendix K.

11 The Working Bibliography is included as Appendix L. The Working Bibliography was subsequently updated in December 2007, February 2008, July 2008, and September 2008.

12 5 USC—App. 2 *et seq.*

13 See <http://www.treas.gov/offices/domestic-finance/acac/webcasts.shtml>.

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

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

filed with the Committee. The oral statements and written submissions focused on the issues mentioned in the Draft Report and Draft Report Addendum. Twenty-one witnesses testified at this meeting.¹⁶

The Committee, through the Department, published [four] releases in the *Federal Register* formally seeking public comment on issues under consideration. On October 31, 2007, the Committee published a release seeking comment on the Working Discussion Outline,¹⁷ in response to which the Committee received seventeen comment letters. On May 15, 2008 and on June 12, 2008, the Committee published releases seeking comment on the Draft Report¹⁸ and Draft Report Addendum,¹⁹ respectively, in response to which the Committee received [fifty-six] comment letters. On July 30, 2008, the Committee published a release seeking comment on the Second Draft Report,²⁰ in response to which the Committee received [seventeen] comment letters. In addition, the Department announced each meeting of the Committee in the *Federal Register*, and in each announcement notice included an invitation to submit written statements to be considered in connection with the meeting.²¹ In response to these meeting notices, the Committee received [nine] written submissions. In total, the Committee received [ninety-nine] written submissions in response to *Federal Register* releases.²² All of the submissions made to the Committee will be archived and available to the public through the Department's Library.

In addition to work carried out by the full Committee, fact finding and deliberations also took place within three Subcommittees appointed by the Co-Chairs. The Subcommittees were organized according to their principal areas of focus: Human Capital, Firm Structure and Finances, and Concentration and Competition.²³ Each of the Subcommittees prepared recommendations for consideration by the full Committee.

¹⁶Appendix J contains a list of witnesses who testified before the Committee.

¹⁷Request for Comments, 72 Fed. Reg. 61709 (U.S. Dep't of Treas. Oct. 31, 2007).

¹⁸Request for Comments, 73 Fed. Reg. 28190 (U.S. Dep't of Treas. May 15, 2008).

¹⁹Request for Comments, 73 Fed. Reg. 33487 (U.S. Dep't of Treas. June 12, 2008).

²⁰Request for Comments, 73 Fed. Reg. 44315 (U.S. Dep't of Treas. July 30, 2008).

²¹Notice of Meeting, 72 Fed. Reg. 55272 (U.S. Dep't of Treas. Sept. 28, 2007); Notice of Meeting, 72 Fed. Reg. 64283 (U.S. Dep't of Treas. Nov. 15, 2007); Notice of Meeting, 73 Fed. Reg. 2981 (U.S. Dep't of Treas. Jan. 16, 2008); Notice of Meeting, 73 Fed. Reg. 10511 (U.S. Dep't of Treas. Feb. 27, 2008); Notice of Meeting, 73 Fed. Reg. 13070 (U.S. Dep't of Treas. Mar. 11, 2008); Notice of Meeting, 73 Fed. Reg. 21016 (U.S. Dep't of Treas. Apr. 17, 2008); Notice of Meeting, 73 Fed. Reg. 28208 (U.S. Dep't of Treas. May 15, 2008); Notice of Meeting, 73 Fed. Reg. 39088 (U.S. Dep't of Treas. July 8, 2008); and Notice of Meeting, 73 Fed. Reg. 52080 (U.S. Dep't of Treas. Sept. 8, 2008).

²²All of the written submissions made to the Committee are available in the Department's Library, Room 1428 and on the Department's Committee's Web page at <http://www.treas.gov/offices/domestic-finance/acap/press.shtml>. To avoid duplicative material in footnotes, citations to the written submissions made to the Committee in this Final Report do not reference the Department's Library, Room 1428.

²³For a list of members and their Subcommittee assignments, see Chapter III.

V. BACKGROUND

The Department of the Treasury (Department) chartered the Advisory Committee on the Auditing Profession (Committee) to develop recommendations to ensure the “sustainability of a strong and vibrant public company auditing profession.” Auditors’ examination and testing of financial statements provide objective and independent assurance that a company’s financial statements follow generally accepted accounting principles. Auditors’ professional conduct requires an attitude of healthy skepticism in performing their work and their assurance is critical to investor confidence and, ultimately, the flow of capital. The auditor’s role in the effective functioning of the capital markets cannot be underestimated.

Prior Studies

Due to this important role, the auditing profession has been the subject of numerous studies. For example, the 1978 Report of the Commission on Auditors’ Responsibilities (Cohen Commission), studied independent auditors’ responsibilities and, primarily, the expectations gap—that gap between auditors’ performance and financial statement users’ expectations.¹ The Cohen Commission, established by the American Institute of Certified Public Accountants (AICPA), in response to the frauds at Equity Funding and National Student Marketing, recommended a series of initiatives to improve and clarify the auditor’s role in financial reporting, including enhancing auditor communications, fraud detection, and quality control mechanisms, improving accounting education, and strengthening auditor independence.² Each of these issues has been a focus of this Committee.

Again, less than a decade after the Cohen Commission, during a period of scrutiny of the auditing profession due to the failures of Drysdale Government Securities and E.S.M. Government Securities, the accounting profession—AICPA, American Accounting Association, Financial Executives Institute, Institute of Internal Auditors, and National Association of Accountants—convened the National Commission on Fraudulent Financial Reporting (Treadway Commission). The Treadway Commission focused on the failures causing fraudulent financial reporting and ways to reduce fraudulent reporting.³ Its 1987 recommendations relating to the independent auditor included enhancing the auditing standards regarding auditor’s responsibility for fraud detection, improving audit quality through strengthened peer review and concurring partner review, and a revised auditor’s report to clarify the auditor’s role and state whether the auditor has reviewed and evaluated the company’s internal control system.⁴ Again, upon many of these same issues, this Committee has deliberated.

In 1998, then Securities and Exchange Commission (SEC) Chairman Arthur Levitt, Jr., questioning financial reporting quality and auditors’ performance in the wake of accounting failures and a reporting environment increasingly focused on meeting earnings estimates,

1 COMMISSION ON AUDITORS’ RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS xi (1978) (Cohen Commission).

2 Cohen Commission xvii-xxxiv.

3 REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING 1 (Oct. 1987) (Treadway Commission).

4 Treadway Commission 11-16.

called upon the Public Oversight Board, at the time the monitor of the auditing profession's self-regulatory system, to create the Panel on Audit Effectiveness (O'Malley Panel) to evaluate auditor performance and assess the effects of recent trends in public company auditing.⁵ The O'Malley Panel noted the changing environment in which auditors conducted audits, including the impact of globalization, technological advances, and the growth of the firms' consulting practices upon auditor independence.⁶ The O'Malley Panel recommended, among other things, auditors' performance of "forensic-type" procedures on every audit to enhance fraud detection capabilities, audit committee pre-approval of independent auditors' non-audit services, and enhancement of audit methodologies.⁷

The Public Company Accounting Oversight Board

These three studies were all undertaken and issued during times of great change in the financial reporting environment and the auditing profession. So is this Committee's Report. The Department chartered this Committee almost exactly five years after the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Sarbanes-Oxley, borne out of a crisis in confidence in financial reporting and auditing, replaced voluntary public company auditor self-regulation with a new independent oversight system: The Public Company Accounting Oversight Board (PCAOB), a private, nonprofit corporation overseen by the SEC. Sarbanes-Oxley provided the PCAOB with registration, reporting, inspection, standard-setting, and enforcement authority over public company auditing firms.⁸

Now in its sixth year of operations, with a budget of \$145 million, mostly derived from fees charged to public companies, and nearly 500 employees, as of May 2008 the PCAOB has registered over 1853 auditing firms, 863 of which are domiciled outside the United States in eighty-five countries,⁹ not all of which issue public company audit reports. Registration involves, among other things, the firm's providing its public company audit client list, annual fees paid by public company audit clients for certain types of services, certain pending litigation, and quality control system description.

The PCAOB has promulgated a rule, currently pending SEC approval, to subject registered firms to annual and special reporting requirements. This rule requires annual reporting by auditing firms on such items as a public company audit client list and the percentage of the firm's total fees attributable to public company audit clients for each of the following categories of services: audit services, other accounting services, tax services, and non-audit services. The PCAOB rule also requires firms to file a "special" report, triggered by such events as the initiation of certain criminal or civil governmental proceedings against the firm or its personnel; a new relationship with a previously disciplined person or entity; or the firm becoming subject to bankruptcy or similar proceedings.¹⁰

5 Arthur Levitt, Jr., *The Numbers Game*, Remarks at the NYU Center for Law and Business, New York, NY (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>.

6 THE PANEL ON AUDIT EFFECTIVENESS REPORT AND RECOMMENDATIONS vii-viii (Aug. 31, 2000) (O'Malley Panel).

7 O'Malley Panel ix-xiv.

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

9 Public Company Accounting Oversight Board, *Board Actions to Date 1* (June 2008), available at http://www.pcaobus.org/About_the_PCAOB/PCAOB_Actions_to_Date_Update.pdf.

10 Public Company Accounting Oversight Board, *Rules on Periodic Reporting by Registered Public Accounting*

Beyond these disclosure requirements, registered auditing firms are subject to PCAOB inspections. The PCAOB inspection program is staffed with accountants with an average of twenty-five years of experience for the largest auditing firm inspections and fourteen years of experience for all other firm inspections and receives the greatest amount of PCAOB resources. The inspection program focuses on registered auditing firms' audit practices and compliance with auditing and professional standards, including fraud detection efforts and the adequacy of documentation.¹¹ In addition to being overseen by an independent regulator, the inspection program differs from the peer review program under the prior self-regulatory regime in its focus on the total audit environment, such as the auditing firm's "tone at the top," partner evaluation and compensation,¹² and the relationship between the firm's audit and non-audit practices.¹³

After the completion of each firm's inspection, the PCAOB issues a report of its key findings. Pursuant to Sarbanes-Oxley, the portions of the report focusing on criticisms and defects of the auditing firm's quality control systems are nonpublic, unless the firm fails to address sufficiently these defects within twelve months of the inspection report's issuance. Congress believed this mechanism would incentivize auditing firms to correct these defects. The public portions of the report may include descriptions of inspected matters and any significant deficiencies on inspected audit engagements.

In 2007, the PCAOB inspected 236 registered auditing firms and issued 170 reports on inspections conducted from 2004 through 2007.¹⁴ Ten U.S. firms and one Canadian firm are subject to annual inspections as they have over 100 public company audit clients. Currently, approximately 875 registered firms are subject to triennial PCAOB inspection; 230 of these firms are firms based in foreign jurisdictions.¹⁵

Under Sarbanes-Oxley, the PCAOB oversees all firms auditing public companies in the United States, which, as noted above, does include several auditing firms based in foreign jurisdictions. The PCAOB has entered or intends to enter into cooperative arrangements with foreign auditing regulators, many modeled similarly to the PCAOB, to inspect these foreign auditing firms. The PCAOB has promulgated a rule that allows it to rely on the work of foreign auditing regulators at a degree dependent on the independence and rigor of the foreign auditing regulatory system.¹⁶ In December 2007, the PCAOB also issued for comment a

Firms, PCAOB Release No. 2008-004, available at http://www.pcaobus.org/Rules/Docket_019/2008-06-10_Release_No_2008-004.pdf.

11 Public Company Accounting Oversight Board, *The Public Company Accounting Oversight Board 2-3* (June 2008), available at http://www.pcaobus.org/About_the_PCAOB/PCAOB_Overview.pdf.

12 Public Company Accounting Oversight Board, *2003 Annual Report 8*, available at http://www.pcaobus.org/About_the_PCAOB/Annual_Reports/2003.pdf.

13 Mark W. Olson, *Sarbanes-Oxley at Four: Protecting Investors and Strengthening the Markets*, H. Comm. on Financial Services (Sept. 19, 2006).

14 Public Company Accounting Oversight Board, *2007 Annual Report 10*, available at http://www.pcaobus.org/About_the_PCAOB/Annual_Reports/2007.pdf.

15 Mark W. Olson, *Remarks Before the AICPA National Conference on Current SEC and PCAOB Developments*, Washington, D.C. (Dec. 10, 2007), available at http://www.pcaobus.org/News_and_Events/Events/2007/Speech/12-10_Olson.aspx.

16 Public Company Accounting Oversight Board, *Bylaws and Rules, Section 4. Inspections, Rule 4012*, available

Policy Statement describing when the PCAOB would fully rely on qualified foreign regulatory regimes.¹⁷

Sarbanes-Oxley also provides the PCAOB with auditing, quality control, independence, and ethics standard setting authority. In its first year of operations, the PCAOB incorporated many of the AICPA's existing standards. The PCAOB focused most of its initial standard setting developing, promulgating, and revising the internal control auditing standard mandated under Sarbanes-Oxley. Initially proposed by the PCAOB in October 2003, and finalized and approved by the SEC in February 2004, *Auditing Standard 2: An Audit of Internal Control over Financial Reporting Performed in Conjunction with the Audit of Financial Statements* caused significant implementation challenges. Responding to these concerns, the PCAOB replaced *Auditing Standard No. 2* with *Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, approved by the SEC in July 2007. The PCAOB continues to work with auditors to implement appropriately this standard.

The PCAOB has also adopted or proposed a limited number of other new standards and rules, including those relating to audit documentation.

Finally, under its enforcement authority, the PCAOB can bar auditing firms from auditing public companies and levy fines up to \$15 million per offense. The PCAOB has launched numerous formal investigations, taken disciplinary actions against twelve registered firms, most of which were smaller firms, and nineteen individuals associated with registered firms.¹⁸

U.S. Auditing Firms

Today four auditing firms dominate the public company audit market in the United States. These four firms can trace their roots to European predecessors and most have a history of a century or more. Mergers over the past three decades and the demise of Arthur Andersen in 2002 have contributed to these four firms' dominance in the public company audit market.

Several mergers occurred among the largest twenty U.S. auditing firms in the 1970s: For example, Touche Ross & Co. merged with J.K. Lasser & Co., S.D. Leidesdorf & Co. merged with Ernst & Ernst, Niles & Niles merged with Haskins & Sells,¹⁹ and McGladrey, Hansen, Dunn & Company merged with Broeker Hendrickson & Co. to become McGladrey Hendrickson & Company.²⁰

Another wave of mergers occurred in the mid and late 1980s. In 1984, McGladrey Hendrick-

at http://www.pcaob.com/Rules/Rules_of_the_Board/Section_4.pdf.

17 Public Company Accounting Oversight Board, *Request for Public Comment on Proposed Policy Statement: Guidance Regarding Implementation of PCAOB Rule 4012* (Dec. 5, 2008), available at http://www.pcaobus.org/Inspections/Other/2007/12-05_Release_2007-011.pdf.

18 Public Company Accounting Oversight Board, *Board Actions to Date 2* (June 2008), available at http://www.pcaobus.org/About_the_PCAOB/PCAOB_Actions_to_Date_Update.pdf.

19 See Charles W. Wootton, Carel M. Wolk, and Carol Normand, *An Historical Perspective on Mergers and Acquisitions by Major US Accounting Firms*, ACCOUNTING HISTORY (May 2003), available at http://findarticles.com/p/articles/mi_qa3933/is_200305/ai_n9247219/print?tag=artBody;coll.

20 RSM McGLADREY, *Our History*, available at <http://www.rsmmcgladrey.com/About-Us/Our-History/>.

son & Company merged with A.M. Pullen and Company to become McGladrey Hendrickson & Pullen. In 1987, the merged firm changed its name to McGladrey & Pullen.²¹ In 1985, Alexander Grant & Co. merged with Fox & Co. to become the ninth largest accounting firm. The following year, the merged firm affiliated with the U.K. firm, Thornton Baker and changed its name to Grant Thornton.²² In 1987, Peat Marwick Mitchell, one of the largest eight firms, merged with KMG Main Hurdman, a smaller auditing firm affiliated with the European firm, Klynveld Main Goerdeler, to become KPMG Peat Marwick, becoming the second largest U.S. firm and the largest global firm.²³ In 1989, the fourth largest auditing firm Ernst & Whinney merged with the sixth largest firm Arthur Young to create Ernst & Young, then becoming the largest U.S. firm and the largest global firm.²⁴ Also in 1989, the seventh largest firm Deloitte Haskins & Sells merged with the eighth largest firm Touche Ross to form Deloitte & Touche, becoming the third largest U.S. firm and the third largest global firm.²⁵ Andersen and Price Waterhouse also contemplated merging in 1989, but called off the plan.²⁶ At the end of 1980s, six large firms dominated the auditing of public company revenues.

In 1998 the fifth largest firm Coopers & Lybrand merged with the six largest firm, Price Waterhouse, to become the second largest U.S. firm, PricewaterhouseCoopers. That same year, Ernst & Young and KPMG Peat Marwick announced their intention to merge, but later withdrew their proposal in the midst of merger reviews by the U.S. Department of Justice and the European Commission. At the end of the 1990s, five firms dominated the auditing of public company revenues.²⁷ Finally, further concentration occurred in 2002 with the dissolution of Andersen.

Compelling firm mergers was the desire to be able to service large public and multinational companies, have greater technical and industry-specific expertise, and capture the benefits from economies of scale. The need for a “global reach” persists with the globalization of the capital markets and the increasing size of multinational companies, pressuring continuing concentration in the largest public company audit market. In 2006, in the United States, the largest four auditing firms audited nearly 98% of total public company market capitalization, 98% of the largest public companies (those companies with over \$1 billion in annual revenues), 99% of total public company revenues, and 64% of all public companies. In 2006, they derived 94% of all public company audit and audit-related fees compared to 96% in 2004 and 2002. See Figure 1 below.

21 RSM MCGLADREY, *Our History*, available at <http://www.rsmmcgladrey.com/About-Us/Our-History/>.

22 GRANT THORNTON, *History of Grant Thornton*, available at <http://www.grantthornton.com/portal/site/gt-com/menuitem.91c078ed5c0ef4ca80cd8710033841ca/?vgnnextoid=75f52e5a13bc5010VgnVCM100000308314acRCRD&vgnnextfmt=default>.

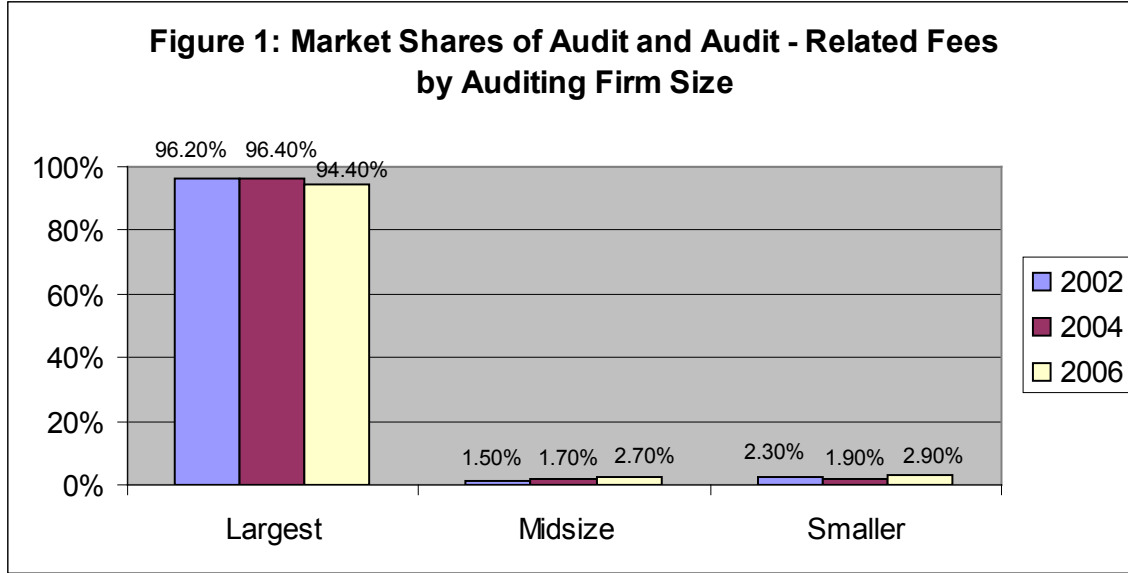
23 GAO, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION, GAO-03-864, 10-11 (July 2003) (2003 GAO REPORT).

24 2003 GAO REPORT 10-11.

25 2003 GAO REPORT 10-11.

26 2003 GAO REPORT 10-11.

27 2003 GAO REPORT 21.



Source: U.S. GOVERNMENT ACCOUNTABILITY OFFICE, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION, GAO-08-163, 75 (Jan. 2008).

The largest four firms – Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers – each audited more than 1,000 public companies for 2006. The midsize firms – BDO Seidman, Crowe Chizek & Company, Grant Thornton, and McGladrey and Pullen – each audited more than 100 but fewer than 362 public companies. At the end of 2007, 480 registered firms reported one to five public company audit clients.²⁸ See Figure 2 below.

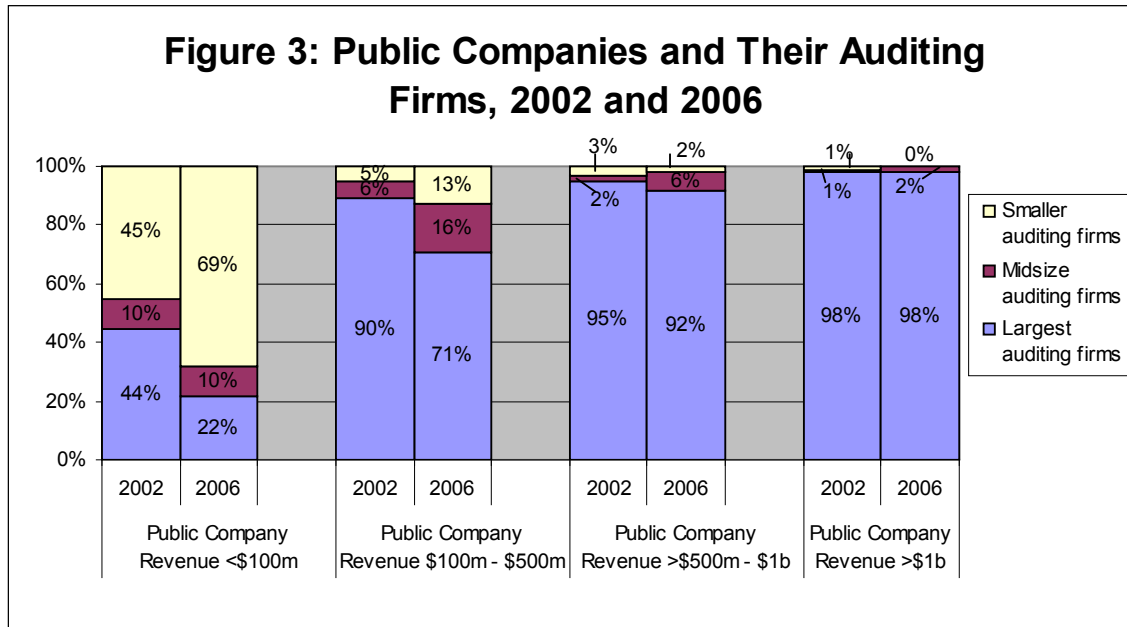
Figure 2: National Auditing Firms by Number of SEC Audit Clients

Firms	SEC Audit Clients
Ernst & Young LLP	1,652
Deloitte & Touche LLP	1,304
PricewaterhouseCoopers LLP	1,222
KPMG LLP	1,044
Grant Thornton LLP	362
BDO Seidman LLP	342
McGladrey & Pullen LLP	160
Crowe, Chizek and Company LLP	108

Source: Annual Survey of National Accounting Firms, *Public Accounting Report 4* (Apr. 15, 2008). Excludes public companies, including recent registrants, that, as of April 1, 2008, had not filed a periodic filing with the SEC for 12 months. Non-tickered subsidiaries and funds & trusts were filtered out. Registrants that filed a non-timely filing for a periodic filing in the six months preceding April 1, 2008 were added back into the registrant counts.

²⁸ Public Company Accounting Oversight Board, *2007 Annual Report 8*, available at http://www.pcaobus.org/About_the_PCAOB/Annual_Reports/2007.pdf.

Although the large public company audit market remains highly concentrated, concentration among the smaller public companies has eased since the implementation of Sarbanes-Oxley. For those public companies with under \$100 million in revenue, the shares of the largest auditing firms has decreased from 44% in 2002 to 22% in 2006; and for companies with revenues between \$100 million and \$500 million, the share has fallen from 90% in 2002 to 71% in 2006.²⁹ See Figure 3 below.



Source: U.S. GOVERNMENT ACCOUNTABILITY OFFICE, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION, GAO-08-163, 19 (Jan. 2008).

The four largest firms each generated U.S. revenues in 2007 of over \$5.4 billion, with the largest firm generating \$9.8 billion. The four largest firms each have over 1,715 partners, 15,200 nonprofessional staff, and 22,000 total staff, with the largest firm having 2,760 partners, 29,700 professional staff, and 41,000 total staff. The next four largest firms each generated U.S. revenues in 2007 of over \$480 million, with the largest of the midsize firms generating \$1.389 billion. These midsize firms each have over 200 partners, 1,500 nonprofessional staff, and 2,300 total staff, with the largest of the midsize firms having 700 partners, 5,900 nonprofessional staff, and 8,200 total staff.³⁰ See Figure 4 below.

²⁹ GAO, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION, GAO-08-163, 19 (Jan. 2008).

³⁰ *Annual Survey of National Accounting Firms*, PUBLIC ACCOUNTING REPORT 4 (Apr. 30, 2008).

Figure 4: Top Ten National Auditing Firms by Revenue and Staffing

Rank by U.S. Rev.	Firm	U.S. Net Revenue (\$ mil)	Rev. Growth Rate (%)	Ptnrs	Nonptnr. Prof'ls	Total Staff	No. Offices
1	Deloitte & Touche	9,849.0	12.3	2,758	29,725	40,998	101
2	PricewaterhouseCoopers	8,362.0	8.6	2,151	22,541	31,631	75
3	Ernst & Young	7,561.0	9.7	2,314	20,163	24,913	90
4	KPMG	5,357.0	11.6	1,715	15,164	22,003	89
5	RSM McGladrey	1,389.0	9.5	720	5,949	8,223	97
6	Grant Thornton	1,075.0	14.4	534	3,938	5,758	52
7	BDO Seidman	589.0	5.6	247	1,976	2,785	35
8	CBIZ & Mayer Hoffman McCann	500.7	12.8	243	2,086	4,722	33
9	Crowe	481.8	10.2	214	1,516	2,270	23
10	Reznick Group	216.7	14.8	40	967	1,240	10

Source: Annual Survey of National Accounting Firms, *Public Accounting Report 4* (Apr. 30, 2008).

U.S. Governance

Most auditing firms in the United States are organized as partnerships under state law. State law and partnership agreements determine the governance of U.S.-based auditing firms. Most state laws require that certified public accountants have the majority of voting rights and ownership interests.

Each of the largest six firms has governing bodies of eleven to twenty-one members, with most of the members elected by fellow partners.³¹ The governing bodies have various authorities, which may include setting long-term business strategy, admitting new partners, allocating income to partners, determining the amount of required capital, undertaking major transactions, such as acquisitions and mergers, and making borrowing decisions. Below is a description of the governance at the six largest auditing firms.

BDO Seidman's governing body, the Board of Directors, consists of ten elected partner directors, the chief executive officer, and up to two additional directors appointed by the Board. The Board elects the chairperson and selects candidates to serve as the chief executive officer, which the partners then select. The Board does not have to be comprised of any specific number of CPAs. The Board is authorized to "admit new partners, allocate income to partners, determine the amount of required capital, elect the chairperson of the Board, make acquisitions, and approve borrowings."³²

Deloitte & Touche USA's governing body, the Board of Directors, consists of twenty-one members and fourteen of those members must be CPAs. The partners elect eighteen mem-

31 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 2, 6, 9, 13, 16, and 19 (Jan. 23, 2008), available at <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

32 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 3 (Jan. 23, 2008), available at <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

bers and three are members due to their official position within the firm—the chief executive officer, the chairman of the Board, and the senior partner. The Board appoints the chairman and chief executive officer with partner approval. The Board’s powers include “admitting new partners with the approval of two-thirds of the active partners; approving significant management appointments; borrowing on behalf of the partnership; determining capital or capital loan requirements; approving the distribution of partnership units and additional amounts of net earnings; determining compensation for the chief executive officer, chairman, and senior partner; approving any appointment or removal of the chairman and chief executive officer of each Deloitte operating entity; and appointing interim Board members, including the chief executive officer, chairman, and senior partner.”³³

Ernst & Young has two Executive Boards: The Americas Executive Board is responsible for global strategy in the Americas area, which includes North America, South America, Central America, the Caribbean, and Israel. The United States Executive Board, made up of thirteen to twenty-one members, focuses on partner issues, and approves business transactions, such as mergers and acquisitions, partner admission and separation, profit allocation, and capital requirements. In addition, the Advisory Council, made up of twenty-one to twenty-four members, elected by firm partners, also approves business transactions, such as mergers and acquisitions, and other matters submitted to partner votes. The United States Executive Board appoints a CPA, subject to Advisory Council approval, to serve as both chairperson and chief executive.³⁴

The Partnership Board, comprised of eleven members, only three of which may be non-CPAs, governs Grant Thornton. The Board elects a chairperson and appoints a chief executive officer, whom the partners ratify. The Board approves strategy, annual budgets, and major business transactions. The Board also focuses on partner matters, including partner admission, capital requirements, and partner compensation.³⁵

KPMG’s Board of Directors is comprised of thirteen to eighteen members, with a majority being CPA members. The Board elects a chairperson of the firm, who also serves as chairperson of the Board and chief executive officer. The Board oversees the firm’s business matters, general management operations, and partner compensation and admits new partners.³⁶

PricewaterhouseCoopers’ Board of Partners and Principals is comprised of between twelve and eighteen members in addition to the firm’s Senior Partner, who is chief executive officer

33 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 6 (Jan. 23, 2008), *available at* <http://www.theqaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

34 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 9 (Jan. 23, 2008), *available at* <http://www.theqaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

35 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 13 (Jan. 23, 2008), *available at* <http://www.theqaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

36 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 16 (Jan. 23, 2008), *available at* <http://www.theqaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

and chairperson. Although there is no required number of CPAs, only partners oversee the public company audit practice. Principals are non-CPA firm members. The partners elect a Senior Partner, who serves as chief executive officer and chairperson of the Board. The Board oversees strategy, capital requirements, and partner admission and can make major financial transaction decisions.³⁷

Global Networks

The larger auditing firms are all members of global networks of affiliates. The creation of these networks, dating to the early twentieth century and increasing and growing into this century, was a response to a number of factors: the emergence of multi-national companies, and differing legal regulations, accounting and auditing standards, and cultural environment.³⁸ Firms found it necessary to provide auditing and other services in each jurisdiction of their clients' operations. And, the development of networks grew out of a need to comply with country-specific regulations, which then and now generally mandate that auditing firms be controlled and owned by locally licensed professionals. In addition, to effectively operate in foreign jurisdictions, auditing firms understood the need to employ individuals familiar with the accounting, legal, cultural, linguistic, and business practices of each relevant jurisdiction. Networking with auditing firms established in a relevant jurisdiction was a natural response to market reality.

Networks continue to evolve to serve their clients and for a variety of other reasons, including the ability both to use the networked firm name and reputation and share resources and expertise. A member of a network may be subject to quality assurance, risk management, and overall business operations reviews, codes of ethics, and professional conduct and practice rules.

Today's business enterprises and the capital markets are increasingly global and many firms make extensive use of their networks in performing audits of their respective clients. In doing so, the firms frequently share professional staff and transfers between member firms of a network are common. According to the *International Accounting Bulletin*, in 2006, the top fifteen auditing networks by revenue generated over a total of \$100.4 billion in revenue.³⁹ Each of the largest four networks, whose member firms include one of the four largest U.S. auditing firms by revenue, took in global revenues in 2007 in excess of \$19.8 billion, with the largest network taking in \$25.2 billion. These four networks each have over 7,200 partners, 92,000 non-partner professionals, and 123,000 total staff, with the largest network having 8,600 partners, 108,900 non-partner professional, and 147,000 total staff.⁴⁰ The next three largest networks, again each including as a member one of the next three largest U.S. auditing

37 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 19 (Jan. 23, 2008), available at <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

38 See Hansrudi Lenz and Marianne L. James, *International Audit Firms as Strategic Networks: The Evolution of Global Professional Service Firms* in Gérard Cliquet, George Hendrikse, Mike Tuunanen, and Josef Windsperger, *ECONOMICS AND MANAGEMENT OF NETWORKS: FRANCHISING, STRATEGIC ALLIANCES, AND COOPERATIVES* (New York: Physica-Verlag, 2007).

39 INTERNATIONAL ACCOUNTING BULLETIN, *Leading Global Accounting Networks – Full Member Fee Data: 2006*.

40 *Annual Survey of National Accounting Firms*, PUBLIC ACCOUNTING REPORT 7 (Apr. 30, 2008).

firms, took in global revenues in 2007 in excess of \$3.1 billion, with the largest of the midsize networks taking in \$4.7 billion. These three networks each have over 2,400 partners, 19,400 non-partner professionals, and 24,900 total staff, with the largest network having 2,500 partners, 23,700 nonprofessional staff, and 31,600 total staff.⁴¹ See Figure 5 below.

Figure 5: Largest Global Networks by Revenue and Staffing

Firm	FY 07 Global Net Revenue (\$ mil.)	Number of Partners	Nonpartner Professional Staff	Total Staff
PwC International	25,150	8,578	108,926	146,767
Deloitte Touche Tohmatsu	23,100	8,500	112,000	146,600
Ernst & Young Global Ltd.	21,104	8,173	110,439	130,993
KPMG International	19,810	7,159	92,924	123,322
BDO International	4,704	2,520	23,729	31,577
Grant Thornton International	3,500	2,423	19,418	27,277
RSM McGladrey International	3,060	2,411	22,482	24,893

Source: Annual Survey of National Accounting Firms, *Public Accounting Report 7* (Apr. 15, 2008).

Smaller auditing firms also belong to networks. Several firms auditing fifty to one hundred public company clients belong to Praxity, an international not-for-profit entity under Belgian law. The eighth largest network in terms of revenue launched in 2007 by the French-based auditing firm Mazars and former Moores Rowland International members, Praxity includes 101 independent firms in seventy-three countries with 23,258 personnel and global revenues of \$2.84 billion.⁴² Smaller U.S. auditing firms, such as BKD, LLP and Moss Adams LLP, are Praxity members. Smaller auditing firm, Crowe Horwath LLP, is a member of Horwath International, a Swiss verein and the ninth largest network in terms of revenue. With nearly 140 member firms with 19,127 personnel, Horwath generated \$2.53 billion in revenue in 2007.⁴³

Global revenue has doubled or nearly doubled at the largest four networks over the past five years. Note that the definition of the services provided, particularly “advisory services,” differs from network to network and may change from year to year in a single network. In fiscal year 2007, PricewaterhouseCoopers International Limited reported global revenues of \$25.1 billion, divided among assurance (\$13.1 billion or 52%), advisory (\$5.7 billion or 23%), and tax (\$6.3 billion or 25%).⁴⁴ See Figure 6. In fiscal year 2007, Deloitte Touche Tohmatsu reported \$23.1 billion global revenues, divided among audit (\$11.0 billion or 48%), financial advisory (\$1.9 billion or 8%), consulting (\$5.2 billion or 22%), and tax (\$5.0 billion or 22%).⁴⁵ See Fig-

41 *Annual Survey of National Accounting Firms*, PUBLIC ACCOUNTING REPORT 7 (Apr. 30, 2008).

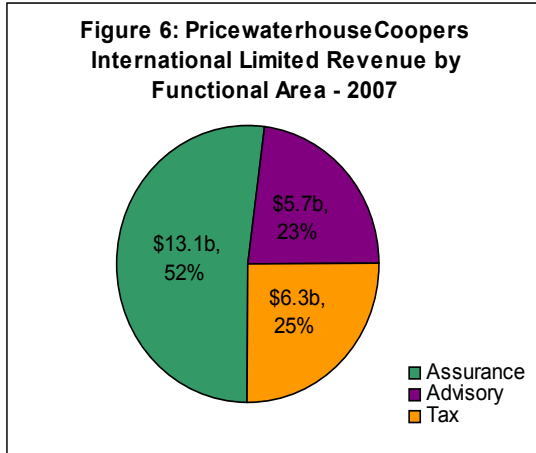
42 PRAXITY, *Profile*, available at <http://www.praxity.com/Membership>.

43 Horwath International, *Press Release: Horwath International is Number 9*, available at <http://www.horwath.com/hw/Publications/News/detail.cfm?id=51>.

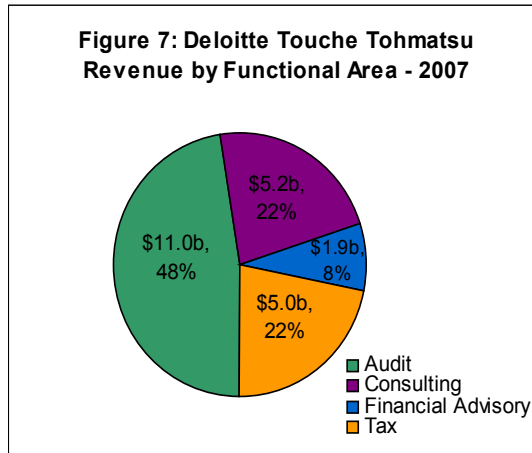
44 PRICEWATERHOUSECOOPERS INTERNATIONAL LIMITED, *07 Global Annual Review 34*, available at <http://www.pwc.com/extweb/home.nsf/docid/e32c41dba95f78b285257344004b111e>. PricewaterhouseCoopers International Limited defines advisory services as including transactions (e.g., valuation, merger and acquisitions, etc.), human resources (e.g., human resources management), and performance improvement (e.g., governance, IT effectiveness).

45 DELOITTE TOUCHE TOHMATSU, *Deloitte Touche Tohmatsu Worldwide Member Firms 2007 Review*, 60, available at <http://public.deloitte.com/media/0513/AnnualReview2007.pdf>. According to Deloitte Touche Tohmatsu, financial advisory services focus on corporate finance, forensic and dispute, merger and acquisition,

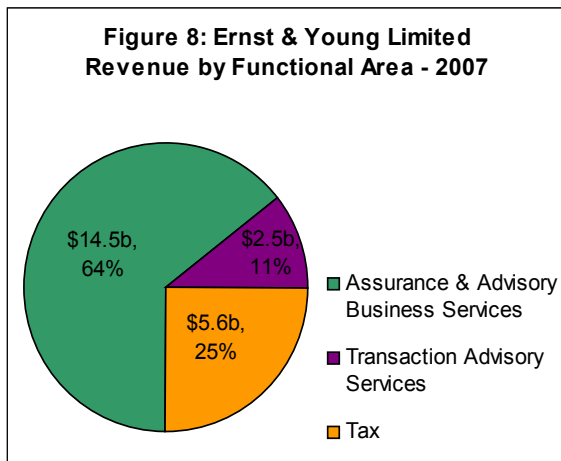
ure 7. In fiscal year 2007, Ernst & Young Global Limited reported \$21.1 billion in global revenues, divided among assurance and advisory (\$14.5 billion or 64%), tax (\$5.6 billion or 25%), and transaction advisory services (\$2.5 billion or 11%).⁴⁶ See Figure 8. In fiscal year 2007, KPMG International reported \$19.8 billion in global revenues, divided among audit (\$9.4 billion or 47%), tax (\$4.0 billion or 20%), and advisory (\$6.4 billion or 33%).⁴⁷ See Figure 9.



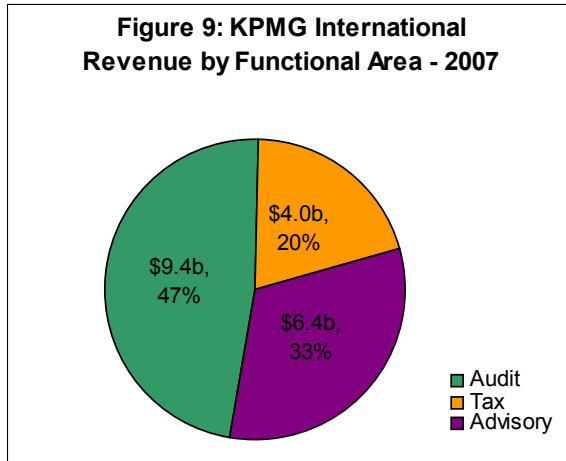
Source: 2007 Global Annual Review, 34.



Source: Deloitte Touche Tohmatsu 2007 Worldwide Member Firms Review, 60.



Source: Global Review 2007, 39.



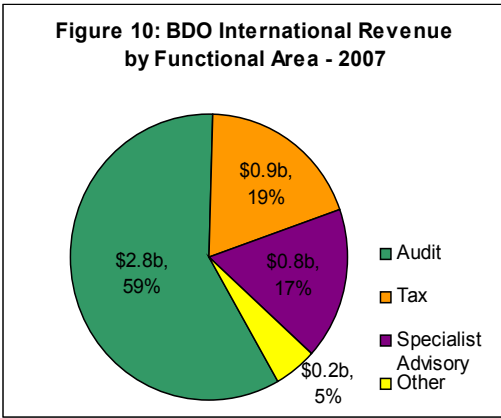
Source: KPMG International Annual Review 2007, 54.

reorganizations, and valuation, while consulting services focus on enterprise applications, human capital, outsourcing, strategy and operations, and technology integration.

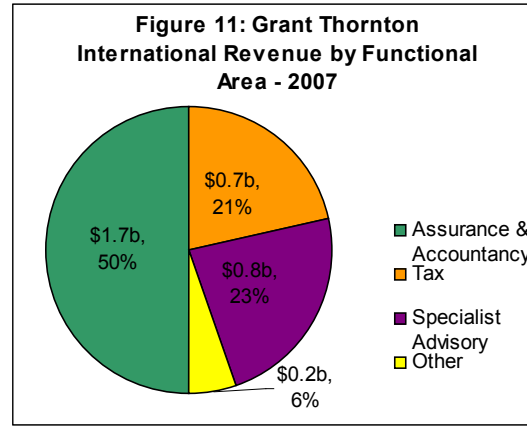
⁴⁶ ERNST & YOUNG GLOBAL LIMITED, Global Review 2007, 39, available at [http://www.ey.com/global/content.nsf/resources/Global_Review_07/\\$file/GR07_home.html](http://www.ey.com/global/content.nsf/resources/Global_Review_07/$file/GR07_home.html). According to Ernst & Young Global Limited, transaction advisory services include, among other things, mergers and acquisitions, restructurings, strategic finance, and valuation services. The auditing firm states: "For management reporting purposes certain revenues are included in multiple Service Lines and have been eliminated in presenting total revenue." Id.

⁴⁷ KPMG INTERNATIONAL, KPMG International Annual Review 2007, 54, available at <http://www.kpmg.com/SiteCollectionDocuments/IAR2007.pdf>. According to KPMG International, advisory services focus on issues, such as governances, mergers and acquisitions, regulatory environment, cost and risk optimization.

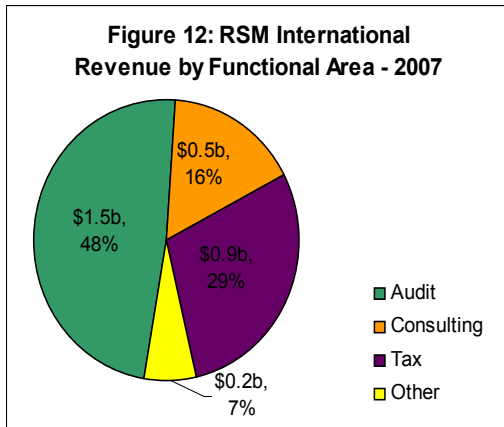
In fiscal year 2007, BDO International reported global revenues of \$4.7 billion, divided among audit (\$2.8 billion or 59%), tax (\$0.9 billion or 19%), specialist advisory (\$0.8 billion or 17%), and other (\$0.2 billion or 5%).⁴⁸ See Figure 10. In fiscal year 2007, Grant Thornton International reported global revenues of \$3.4 billion, divided among assurance and accountancy (\$1.7 billion or 50%), tax (\$0.7 billion or 21%), specialist advisory (\$0.8 billion or 23%), and other (\$0.2 billion or 6%).⁴⁹ See Figure 11. RSM International reported global revenues of \$3.1 billion, divided among audit (\$1.5 billion or 48%), tax (\$0.9 billion or 29%), consulting (\$0.5 billion or 16%), and other (\$0.2 billion or 7%).⁵⁰ See Figure 12.



Source: *BDO International Annual Statement Review 2007*, 4.



Source: *Grant Thornton International, Transparency Report 2008*.



Source: *RSM International 2007 Annual Report*, 24.

Although network member firms may be subject to internal quality reviews and share common methodologies, codes of conduct, and technical resources, for legal and other reasons the network agreements typically affirm the independence and autonomy of each of the mem-

⁴⁸BDO INTERNATIONAL, *Annual Statement 2007*, 4, available at [http://www.bdointernational.com/BDOGCO/website/BDOGCO/websiteContent.nsf/0/615eda8f40e40b2e802571c400360548/\\$FILE/AS07_layoutVsFINAL_250308.pdf](http://www.bdointernational.com/BDOGCO/website/BDOGCO/websiteContent.nsf/0/615eda8f40e40b2e802571c400360548/$FILE/AS07_layoutVsFINAL_250308.pdf).

⁴⁹GRANT THORNTON INTERNATIONAL, *Transparency Report 2008*, available at <http://www.gti.org/Transparency-report/Financial-information/Worldwide-fee-income.asp>.

⁵⁰RSM INTERNATIONAL, *2007 Annual Report*, 24, available at <http://www.rsmi.com/Website/web.nsf/pages/DOC882DB0AB65BED0348025740C00452DDF>.

ber firms. Often the network's website and annual reports reaffirm this independence. For instance, KPMG International's annual report states: "Each KPMG firm is separate and legally distinct."⁵¹ The annual report of Deloitte Touch Tohmatsu states: "As a Swiss Verein (association), neither Deloitte Touch Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names 'Deloitte,' 'Deloitte & Touche,' 'Deloitte Touche Tohmatsu,' or other related names."⁵²

Similarly, the PWC annual review: "PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity."⁵³ And Ernst and Young's global website: "Ernst & Young refers to one or more of the member firms of Ernst & Young Global Limited (EYG), a UK private company limited by guarantee...Each of EYG and its member firms is a separate legal entity and has no liability for another such entity's acts or omissions."⁵⁴ Driving the independence are often country-specific restrictions on outside ownership of auditing firms and the perceived need to limit liability of one network member firm from attaching to other network member firms.

While separate legal entities, the firms promote the globally integrated provision of these networks' services. KPMG International's website reports: "Global capability and consistency are central to the way we work. By providing global organizations with the same quality of service and behavior around the world, we can work with them wherever they choose to operate."⁵⁵ Deloitte Touche Tohmatsu's chairman commented on the development of this more integrated approach in the network's 2007 annual report: "In the old days, the Big Eight were a loose affiliation of local firms—every country had its own rules, organization, and name. A large reference book was the only evidence of an international network. Now Deloitte member firms *are* global businesses, under one brand, with shared methodologies and controls."⁵⁶

In the 2007 global network report, the Ernst & Young Global Limited Chairman stated: "We are aligning our infrastructure, streamlining our processes and programs and embracing a single global culture to create an integrated global organization that benefits our people, our clients and our wider stakeholders."⁵⁷ Likewise, the PricewaterhouseCoopers International Limited annual report states: "[O]ur people are connected across the globe through a handful of vital intangible assets and embody the very essence of the PwC global culture: the strength

51 KPMG INTERNATIONAL, *KPMG International Annual Review 2007*, 54, available at <http://www.kpmg.com/SiteCollectionDocuments/IAR2007.pdf>.

52 DELOITTE TOUCHE TOHMATSU, *Deloitte Touche Tohmatsu Worldwide Member Firms 2007 Review*, 2, available at <http://public.deloitte.com/media/0513/AnnualReview2007.pdf>.

53 PRICEWATERHOUSECOOPERS INTERNATIONAL LIMITED, *07 Global Annual Review 2*, available at <http://www.pwc.com/extweb/home.nsf/docid/e32c41dba95f78b285257344004b111e>.

54 ERNST & YOUNG, available at <http://www.ey.com/global/content.nsf/International/Home>.

55 KPMG INTERNATIONAL, available at <http://www.kpmg.com/Global/Pages/default.aspx>.

56 DELOITTE TOUCHE TOHMATSU, *Deloitte Touche Tohmatsu Worldwide Member Firms 2007 Review*, 6, available at <http://public.deloitte.com/media/0513/AnnualReview2007.pdf>.

57 ERNST & YOUNG GLOBAL LIMITED, *Global Review 2007*, 9, available at [http://www.ey.com/global/content.nsf/resources/Global_Review_07/\\$file/GR07_home.html](http://www.ey.com/global/content.nsf/resources/Global_Review_07/$file/GR07_home.html).

of our brand, the capabilities of our global network, our unrelenting commitment to quality and the power of our thinking...Every PwC firm is fully accountable and responsible to the entire PwC network of firms for the quality of its performance.”⁵⁸

Global Governance

Network governance also tends towards an integrated, “single-visioned” global network rather than a mere grouping of autonomous firms, although much of the specific governance and operating decisions of the member firms remain local. For example, a board, comprised of thirty-five members appointed by member firms and regions, governs and an Executive team, comprised of nineteen senior members, manages Deloitte Touche Tohmatsu, a Swiss *verein*. The Executive team establishes the vision and strategy of the Deloitte network. The board approves the network’s strategy, major transactions, and other significant initiatives and monitors ethical conduct. The board has a number of supporting committees: Governance; Risk Management: Audit and Finance; Membership Affairs; and CEO Evaluation and Compensation.⁵⁹

A twenty-member board governs KPMG International, a Swiss cooperative. KPMG International’s board reviews, endorses, and monitors the implementation of the KPMG network’s policies and procedures. An International Council, comprised of the KPMG Chairman, senior partners from the twenty-five largest member firms, and other Board- and Council-nominated members, approves common goals, direction, policies, membership matters, the annual international budget, and other financial decisions.⁶⁰

Three global bodies govern the Ernst & Young network, Ernst & Young Global Limited, a U.K. private company. The Global Advisory Council, comprised of forty-one member firm partners, provides governance oversight. The Global Executive, comprised of seventeen senior level executives, focuses on strategy, execution, and operations. Global Executive Committees—People; Quality and Risk Management; Operations and Finance; Client Service and Accounts; Assurance and Advisory Business Services; Tax and Transaction Advisory Services—have operational responsibilities and advise the Global Executive.⁶¹

A Global Board and Extended Leadership Team govern the PwC network, PricewaterhouseCoopers International Limited. PricewaterhouseCoopers International Limited develops strategies and oversees member firm compliance with risk management, quality control, and ethical standards.⁶²

In addition, a few of the largest networks have developed quality assurance and risk manage-

58 PRICEWATERHOUSECOOPERS INTERNATIONAL LIMITED, *07 Global Annual Review* 42, available at <http://www.pwc.com/extweb/home.nsf/docid/e32c41dba95f78b285257344004b111e>.

59 ERNST & YOUNG GLOBAL LIMITED, *Global Review 2007*, 4, available at [http://www.ey.com/global/content.nsf/resources/Global_Review_07/\\$file/GR07_home.html](http://www.ey.com/global/content.nsf/resources/Global_Review_07/$file/GR07_home.html).

60 KPMG INTERNATIONAL, *KPMG International Annual Review 2007*, 52, available at <http://www.kpmg.com/SiteCollectionDocuments/IAR2007.pdf>.

61 ERNST & YOUNG GLOBAL LIMITED, *Global Review 2007*, 12, available at [http://www.ey.com/global/content.nsf/resources/Global_Review_07/\\$file/GR07_home.html](http://www.ey.com/global/content.nsf/resources/Global_Review_07/$file/GR07_home.html).

62 PRICEWATERHOUSECOOPERS INTERNATIONAL LIMITED, *07 Global Annual Review* 42, available at <http://www.pwc.com/extweb/home.nsf/docid/e32c41dba95f78b285257344004b111e>.

ment monitoring of their member firms at a global level. For example, KPMG International has appointed a Global Head of Risk to oversee risk management and quality control practices across its member firms. Global Steering Groups within each KPMG practice area—audit, tax, and advisory—ensure consistent provision of quality services across member firms.⁶³ A Policy Board governs BDO Global Coordination BV, a Dutch company.⁶⁴ A Board of Governors governs and a Global Leadership Board manages Grant Thornton International Ltd., a private U.K. company. The Global Leadership Board oversees strategy and sets policies for human resources, information technology, marketing, quality control, and risk management.⁶⁵ A Board of Directors governs RSM International.⁶⁶ The Board is responsible for developing the network’s strategy.

Compelled by the increasing globalization of the capital markets and the disconnect between independent autonomous member firms and seamless provision of services, some auditing firms are moving to adopt an even more structurally integrated network. For instance, in 2007 KPMG integrated its practices in the United Kingdom, Germany, and Switzerland into a single entity, a U.K. registered LP, with a single management team, noting European regulatory standardization as facilitating this combination.⁶⁷

In addition, in April 2008 Ernst & Young announced its intention to consolidate practices in eighty-seven countries in Europe, the Middle East, India, and Africa into one unit led by one management team and a single profit-sharing scheme. The auditing firm explained the decision, labeled by the *Financial Times* as the “biggest shake-up of the professional services industry since the collapse of Arthur Andersen,” as an attempt to reflect its multinational clients’ global presence and service these clients accordingly.⁶⁸

In August 2008, PricewaterhouseCoopers announced its intention to reorganize its practices into three regions: China, United Kingdom, and United States.⁶⁹ The auditing firm noted that as a result of this reorganization, it will change the leadership model of its global network,⁷⁰ but maintain all its national partnerships, and increase the number of network standards each member firm must follow.

63 KPMG INTERNATIONAL, *KPMG International Annual Review 2007*, 8, available at <http://www.kpmg.com/SiteCollectionDocuments/IAR2007.pdf>.

64 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 5 (Jan. 23, 2008), available at <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

65 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 15 (Jan. 23, 2008), available at <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

66 RSM INTERNATIONAL, *Organizational Structure*, available at <http://www.rsmi.com/Website/web.nsf/pages/DOC4DC24A719D2B919D8025711B00502746>.

67 KPMG INTERNATIONAL, *KPMG Europe LLP - Proposal to Create Europes Largest Accountancy Firm* (June 10, 2006), available at <http://www.kpmg.eu/4885.htm>.

68 Jennifer Hughes, *Ernst & Young to Form Single Business Unit*, FINANCIAL TIMES, Apr. 20, 2008.

69 Jennifer Hughes, *PwC to Shake Up National Partnership Network*, FINANCIAL TIMES, Aug. 19, 2008.

70 PRICEWATERHOUSECOOPERS INTERNATIONAL LIMITED, *PwC Announces New Network Organisation to Build on Leading Position* (Aug. 20, 2008), available at <http://www.pwc.com/servlet/pwcPrintPreview?LNLoc=/extweb/ncpressrelease.nsf/docid/A1932CBD60C7CCD7852574AB004D416A>.

Non-Audit Services

Most auditing firms offer a range of services beyond auditing work, including tax and consulting and advisory services. Consulting services both to audit and non-audit clients became a greater and greater source of the largest U.S. firms' revenue from 1975 through the late 1990s. In 1975 at the largest eight auditing firms, consulting services revenues ranged from 5% to 16% of total revenues or 11% on average. In 1998, these services made up from 34% to 70% or an average of 45% of the largest five firms' revenues.⁷¹

By 2000, the revenue from these services had decreased to approximately 30% on average of total revenues for the largest five firms. By this time, firms had begun to sell off their information services consulting practices due to regulatory pressures as well as operational inefficiencies. Due to the partnership structure of auditing firms, the consulting arms were unable to seek outside capital and limited in their growth.⁷² In the late 1990s, the SEC had undertaken a review of the accounting firms and independence and noted the potential for conflicts of interest between the auditing and consulting units. In the midst of this debate, which included SEC consideration of restricting auditors' offering their clients financial information system design and implementation consulting, some of the firms began to sell off these consulting services.

In June 2000 Andersen Consulting split off from Andersen Worldwide and in January 2001 was renamed Accenture. In February 2001, Accenture raised \$1.7 billion in an initial public offering.⁷³ The roots of this spin off are much earlier and reflect more than a decade long battle: In 1989, Andersen Consulting had been spun off from Arthur Andersen into a legally separate partnership⁷⁴ and, after successfully seeking an SEC no-action letter, Andersen Consulting was able to operate without impairing Arthur Andersen's independence. Arthur Andersen and Andersen Consulting were coordinated only through their membership in the global network, Andersen Worldwide Organization.⁷⁵

For a number of years, Andersen Consulting campaigned aggressively for a more formal separation due primarily to the fact that Arthur Andersen had created internally a new consulting division, which often competed with Andersen Consulting, and that, Andersen Consulting with its more lucrative consulting practice, had to share profits with the other Arthur Andersen practices because of its member firm agreement with the Andersen Worldwide Organization.⁷⁶ An arbitration decision in 2001 finally ended the relationship, allowing Andersen

71 2003 GAO REPORT 8.

72 As then-Deloitte & Touche USA LLP Chief Executive Officer James E. Copeland, Jr. stated in 2000, "I could see us creating new businesses each year which we could sell off on a regular basis for extra capital for partners. So we would be both planting and harvesting high-value intellectual capital businesses on a regular basis." See Robert Bruce, *Big Five Reap Rewards by Selling Off the Consultants*, TIMES (U.K.), (Mar. 17, 2000).

73 Even prior to splitting off Andersen Consulting, Andersen had already begun to develop another consulting practice.

74 Preston Galla, *Conflicts of Interest: The Big Five Continue Their Restructuring to Separate Consulting from Accounting*, VARBUSINESS 57 (June 24, 2002).

75 Arthur Andersen and Company, SEC No-Action Letter, Fed. Sec. L. Rep. P 79,484 (June 20, 1990). See also Sean M. O'Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence* 45 B.C.L. REV. 741, 826-827 (2004).

76 Sean M. O'Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of*

Consulting to sever its ties by terminating its member firm agreement with the Andersen Worldwide Organization and complete its 2001 initial public offering.⁷⁷

In February 2000, Ernst & Young sold off its consulting arm to French computer services company, Cap Gemini Group S.A, for \$11.3 billion.⁷⁸ In 2001, KPMG spun off its consulting services, renamed Bearing Point, in an initial public offering for \$2 billion.⁷⁹ In 2002, having attempted to sell off its consulting practice for over two years, PricewaterhouseCoopers sold off its consulting services to International Business Machines Corp. for \$3.5 billion.⁸⁰ Although announcing in early 2002 its intention to “reluctantly” sell off its consulting practices,⁸¹ Deloitte never did. Once a management buy-out fell through in 2003, Deloitte announced it would retain its consulting arm.⁸²

Under Sarbanes-Oxley, Congress addressed certain auditor independence issues. Sarbanes-Oxley prohibited the offering of nine non-audit services to public company audit clients, including financial information system design and implementation, bookkeeping, actuarial services, appraisal or valuation services, internal audit outsourcing services, and legal and expert services unrelated to the audit. Sarbanes-Oxley subjected auditors’ permitted services to a few safeguards: the audit committee must approve all services provided by the auditor; and the public company must disclose its pre-approval policies and its audit and non-audit fees paid to the auditor.

Since Sarbanes-Oxley, the amount of non-audit fees⁸³ paid by the largest public companies⁸⁴ to their auditors has continued to drop. In 2002, non-audit fees comprised 50% of total fees paid by the largest public companies to their independent auditor. This figure fell to 27% in 2004 and further to under 20% in 2006. See Figure 13 below.

Auditor Independence 45 B.C.L. REV. 741, 826-827 (2004).

77 Final Award in ICC Case No. 9797/CK/AER/ACS, Andersen Consulting Business Unit Member Firms v. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative (July 28, 2000); Preston Galla, *Conflicts of Interest: The Big Five Continue Their Restructuring to Separate Consulting from Accounting*, VARBUSINESS 57 (June 24, 2002).

78 Ted Smalley Bowen, *Cap Gemini Inks Mega-Merger*, INFOWORLD (Mar. 6, 2000).

79 See J. Bonasia, *Enron Scandal Speeds Trend of Separating Big Five’s Businesses, Auditing, Consulting Bad Mix, Many Say the Accountant Should Not Be the Same Firm that Does Other Services*, INVESTOR’S BUSINESS DAILY (Mar. 25, 2002); see also 2003 GAO REPORT 9.

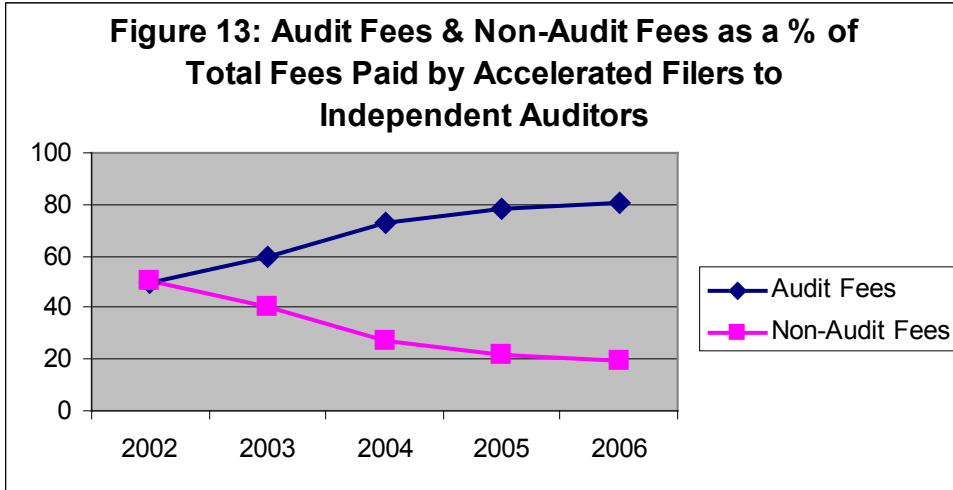
80 Melissa Klein, *It’s ‘Blue’ Skies for PwC Consulting: IBM Grabs Unit for \$3.5B*, ACCOUNTING TODAY (Aug. 19, 2002).

81 *Deloitte’s in ‘Split’ U-Turn*, ACCOUNTANCY AGE (Feb. 14, 2002).

82 Nanette Byrnes, *Why Deloitte Didn’t Divide*, BUSINESS WEEK ONLINE (Apr. 14, 2003), available at http://www.businessweek.com/magazine/content/03_15/b3828081_mz056.htm.

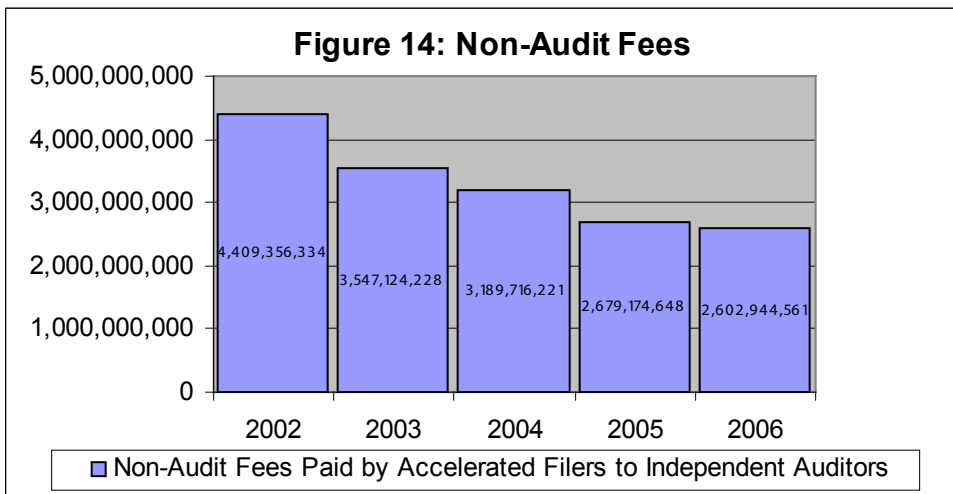
83 *Audit Analytics* defines non-audit fees as audit related fees, benefit plan related fees, FISDI fees, tax related fees, and other/miscellaneous fees.

84 3,667 accelerated filers.



Source: AUDIT ANALYTICS, NON-AUDIT FEES: A FIVE-YEAR TREND (March 2008) (Commissioned by the Center for Audit Quality).

Similarly, the total dollar amount of non-audit fees paid by the largest public companies to their independent auditor has decreased since 2002 from \$4.4 billion in 2002 to \$2.6 billion in 2006. See Figure 14 below.



Source: AUDIT ANALYTICS, NON-AUDIT FEES: A FIVE-YEAR TREND (March 2008) (Commissioned by the Center for Audit Quality).

The demand for advisory and consulting services remains strong and auditing firms continue to provide a variety of such services, but principally to their non-audit clients. Since the auditing firms generally do not break out their U.S. revenue by their consulting practices, the revenue growth rate is unknown. Today of the four largest firms only Deloitte reports U.S. revenue for management consulting services. Today management consulting services comprise 30% of Deloitte’s total revenues.

Only at the global network level are the largest firms' advisory services broken out (although the definition of these services differs for each firm). Advisory services are becoming a greater and greater percentage of total global revenue.⁸⁵

In fiscal year 2007, the Pricewaterhouse Coopers International network reported global revenues of \$25.1 billion, with \$5.7 billion or 23% making up advisory services.⁸⁶ In fiscal year 2007, the Deloitte network reported \$23.1 billion global revenues, with \$1.9 billion or 8% making up advisory services⁸⁷ and \$5.2 billion or 22% making up consulting services.⁸⁸ In fiscal year 2007, the Ernst & Young network reported \$21.1 billion in global revenues, with \$2.5 billion or 11% comprising transaction advisory services.⁸⁹ In fiscal year 2007, the KPMG International network reported \$19.8 billion in global revenues, with \$6.4 billion or 33% comprising advisory services.⁹⁰

The BDO International network reported \$4.7 billion in global revenue, \$0.8 billion or 17% comprising specialist advisory services.⁹¹ The Grant Thornton International network reported \$3.4 billion in global revenue, with \$0.8 billion or 23% comprising specialist advisory services.⁹² RSM International reported \$3.1 billion in global revenues with \$0.5 billion or 16% comprising consulting services.⁹³

85 Nanette Byrnes, *The Comeback of Consulting*, BUSINESS WEEK (Sept. 3, 2007), available at http://www.businessweek.com/magazine/content/07_36/b4048056.htm.

86 PRICEWATERHOUSECOOPERS INTERNATIONAL LIMITED, *07 Global Annual Review 34*, available at <http://www.pwc.com/extweb/home.nsf/docid/e32c41dba95f78b285257344004b111e>. Note that the definition of advisory services varies at each of the networks. PricewaterhouseCoopers International Limited defines advisory services to include transactions (e.g., valuation, merger and acquisitions, etc.), human resources (e.g., human resources management), and performance improvement (e.g., governance, IT effectiveness).

87 DELOITTE TOUCHE TOHMATSU, *Deloitte Touche Tohmatsu Worldwide Member Firms 2007 Review 60*, available at <http://public.deloitte.com/media/0513/AnnualReview2007.pdf>. According to Deloitte Touche Tohmatsu, financial advisory services focus on corporate finance, forensic and dispute, merger and acquisition, reorganizations, and valuation.

88 DELOITTE TOUCHE TOHMATSU, *Deloitte Touche Tohmatsu Worldwide Member Firms 2007 Review 60*, available at <http://public.deloitte.com/media/0513/AnnualReview2007.pdf>. According to Deloitte Touche Tohmatsu, consulting services focus on enterprise applications, human capital, outsourcing, strategy and operations, and technology integration.

89 ERNST & YOUNG GLOBAL LIMITED, *Global Review 2007*, 39, available at [http://www.ey.com/global/content.nsf/resources/Global_Review_07/\\$file/GR07_home.html](http://www.ey.com/global/content.nsf/resources/Global_Review_07/$file/GR07_home.html). According to Ernst & Young Global Limited, transaction advisory services include, among other things, mergers and acquisitions, restructurings, strategic finance, and valuation services.

90 KPMG INTERNATIONAL, *KPMG International Annual Review 2007*, 54, available at <http://www.kpmg.com/SiteCollectionDocuments/IAR2007.pdf>. According to KPMG International, advisory services focus on issues, such as governances, mergers and acquisitions, regulatory environment, cost and risk optimization.

91 BDO INTERNATIONAL, *Annual Statement 2007*, 4, available at [http://www.bdointernational.com/BDOGCO/website/BDOGCO/websiteContent.nsf/0/615eda8f40e40b2e802571c400360548/\\$FILE/AS07_layoutVsFINAL_250308.pdf](http://www.bdointernational.com/BDOGCO/website/BDOGCO/websiteContent.nsf/0/615eda8f40e40b2e802571c400360548/$FILE/AS07_layoutVsFINAL_250308.pdf). According to BDO International, specialist advisory services focus on business advisory, corporate finance, corporate recovery, forensic accounting, and risk advisory.

92 GRANT THORNTON INTERNATIONAL, *Transparency Report 2008*, available at <http://www.gti.org/Transparency-report/Financial-information/index.asp>. According to Grant Thornton International, specialist advisory services include specialist advisory services, including, but not limited to, business risk services, forensic and investigation services, recovery and reorganization and transaction advisory services.

93 RSM INTERNATIONAL, *2007 Annual Report 24*, available at <http://www.rsmi.com/Website/web.nsf/pages/DOC882DB0AB65BED0348025740C00452DDF>.

VI. HUMAN CAPITAL

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

The Committee recognizes the profession's commitment to human capital issues, and commends it for the varied initiatives undertaken in recent years that encourage recruitment and retention, so that the "best people stay in the profession."¹ The Committee acknowledges the profession's progress in its ability to lower its attrition rate,² especially among females in the profession,³ and its strong commitment to increasing Americans' financial literacy.⁴ The Committee also notes that the largest auditing firms are regularly included in leading publications' lists of the "best places to work."⁵ The Committee applauds public accounting firms for

- 1 Record of Proceedings (Dec. 3, 2007) (Written Submission of Julie K. Wood, Chief People Officer, Crowe Chizek and Company LLC, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Wood120307.pdf>. *See also* Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Second Draft Report 6 (Aug. 29, 2008), *available at* http://comments.treas.gov/_files/82908ACAPcommentletterFINAL.pdf ("A number of firms have implemented progressive programs to improve their recruitment and retention of minorities in the profession.").
- 2 *See* Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Timothy P. Flynn, Chairman and Chief Executive Officer, KPMG LLP, 107), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf> (highlighting auditing firms' recent successful efforts in stemming attrition rates).
- 3 *See* Record of Proceedings (June 3, 2008) (Questions for the Record of Anne M. Lang, Chief Human Resources Officer, Grant Thornton LLP, 1), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-6-3-08.pdf> ("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.").
- 4 *See* Record of Proceedings (July 22, 2008) (Oral Remarks of Barry C. Melancon, President and Chief Executive Officer, American Institute of Certified Public Accountants, 35), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-07-22-08.pdf> (noting the profession's involvement with "360 Degrees of Financial Literacy," which is a national effort by CPAs to help teach others about financial literacy).
- 5 *See, e.g., Best Places to Launch a Career 2008*, BUSINESS WEEK (Sept. 15, 2008), *available at* <http://bwnt>.

offering a broad set of tangible and intangible benefits that support and motivate employees, including a flexible and inclusive work environment, competitive compensation packages, mentoring programs, career development, and community service opportunities.⁶

Concurrent with its many human capital and workplace successes, however, is the acknowledgement by the profession and others that there “is still room for improvement.”⁷ After receiving testimony from witnesses and from comment letters, the Committee identified specific areas where the Committee believed it could develop recommendations to be implemented in the relatively short term to enhance the sustainability of the auditing profession. These specific areas include accounting curricula, accounting faculty, minority representation and retention, and development and maintenance of human capital data. The Committee has also developed a recommendation to study the possible future of higher accounting education’s institutional structure.

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

Recommendation 1. Implement market-driven, dynamic curricula and content for accounting students that continuously evolve to meet the needs of the auditing profession and help prepare new entrants to the profession to perform high quality audits.

The Committee considered the views of all witnesses who provided input regarding accounting curricula at educational institutions.⁸ The Committee believes that the account-

businessweek.com/interactive_reports/career_launch_2008/index.asp (showing that auditing firms Ernst & Young LLP, Deloitte LLP, PricewaterhouseCoopers LLP, KMPG LLP, Grant Thornton LLP, and McGladrey & Pullen LLP rank nos. 1, 2, 3, 5, 76, and 104, respectively, in a survey of best places to start a career); *100 Best Companies to Work For, 2008*, FORTUNE (Feb. 4, 2008), available at http://money.cnn.com/magazines/fortune/bestcompanies/2008/full_list/index.html (showing that auditing firms Ernst & Young LLP, KPMG LLP, PricewaterhouseCoopers LLP, and Deloitte LLP rank nos. 57, 71, 90, and 95, respectively, in a survey on best places to work); *2007 100 Best Companies*, WORKING MOTHER (2007), available at <http://www.workingmother.com/?service=vpage/859> (showing that auditing firms Deloitte LLP, Ernst & Young LLP, Grant Thornton LLP, KPMG LLP, and PricewaterhouseCoopers LLP made the top 100 best companies to work at list); *The 2008 Top 50 Companies for Diversity*, DIVERSITYINC (June 2008), available at <http://www.diversityinc.com/public/3272.cfm> (showing that auditing firms PricewaterhouseCoopers LLP, Deloitte LLP, Ernst & Young LLP, and KPMG LLP rank nos. 4, 16, 17, and 49, respectively, in a survey on most diverse places to work).

6 See, e.g., Record of Proceedings (Dec. 3, 2007) (Questions for the Record of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 2-3 (Feb. 1, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-07.pdf>; Record of Proceedings (Feb. 4, 2008) (Written Submission of Barry Salzberg, Chief Executive Officer, Deloitte LLP, 9), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Salzberg020408.pdf>.

7 Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Second Draft Report 6 (Aug. 29, 2008), available at http://comments.treas.gov/_files/82908ACAPcommentletterFINA.L.pdf. See also Record of Proceedings (Feb. 4, 2008) (Written Submission of Gilbert R. Vasquez, Managing Partner, Vasquez & Company LLP, 6), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Vasquez02042008.pdf> (“[The profession has] made some progress but more much remains to be done.”).

8 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Joseph V. Carcello, Director of Research, Corporate Governance Center, University of Tennessee, 8), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Carcello120307.pdf> (noting the market’s expectations that university accounting curricula will expose students to recent financial reporting developments, such as

ing curricula in higher education are critical to ensuring that individuals have the necessary knowledge, mindset, skills, and abilities to perform quality public company audits. In order to graduate from an educational institution with an accounting degree, students must have completed a certain number of hours in accounting and business courses. Accounting curricula typically include courses in auditing, financial accounting, cost accounting, and U.S. federal income taxation. Business curricula typically include courses in ethics, information systems and controls, finance, economics, management, marketing, oral and written communication, statistics, and U.S. business law.⁹ Since the 1950s, several private sector groups have studied and recommended changes to the accounting curricula,¹⁰ but notwithstanding these

international financial reporting standards and eXtensible Business Reporting Language); Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (stating the need to “[d]edicate funds and people to work with accounting professors to ensure that the curriculum is keeping pace with developments in business transactions, international economics and financial reporting” and specifying the need to focus on ethical standards and international accounting and auditing standards); Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (stating the need to “[m]odernize and enhance the university accounting curriculum, which should include consideration of other global curriculum models to increase knowledge of International Financial Reporting Standards (IFRS), finance and economics, and process controls”).

9 Record of Proceedings (Feb. 4, 2008) (Written Submission of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 13), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (commenting that business students typically take two sophomore-level introductory accounting classes and accounting majors take six additional accounting courses in their final two years of schooling).

10 *See, e.g.*, FRANKLIN PIERSON, ET AL., *THE EDUCATION OF AMERICAN BUSINESSMEN* (1959) (noting that the main goal of a business education should be the development of an individual with broad training in both the humanities and principles of business); ROBERT A. GORDON AND JAMES E. HOWELL, *HIGHER EDUCATION FOR BUSINESS* (1959) (suggesting that accounting curriculum abandon its emphasis on financial accounting and auditing while emphasizing humanities); ROBERT H. ROY AND JAMES H. MACNEILL, *HORIZONS FOR A PROFESSION* (1967) (emphasizing the importance of a humanities background for accountants and recommending accounting graduate study); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, COMMITTEE ON EDUCATION AND EXPERIENCE REQUIREMENTS FOR CPAs, *REPORT OF THE COMMITTEE ON EDUCATION AND EXPERIENCE REQUIREMENTS FOR CPAs* (Mar. 1969) (recommending, among other things, a five-year education requirement to be adopted by states by 1975); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, *EDUCATION REQUIREMENTS FOR ENTRY INTO THE ACCOUNTING PROFESSION: A STATEMENT OF AICPA POLICIES* (May 1978) (preferring a 150 semester-hour education requirement rather than a five-year education requirement to acquire the common body of knowledge and sit for the CPA examination); American Accounting Association, Committee on the Future Structure, Content, and Scope of Accounting Education, *Future Accounting Education: Preparing for the Expanding Profession*, 1 *ISSUES IN ACCOUNTING EDUCATION*, No. 1, 168-95 (Spring 1986) (examining accounting education and accounting practice since 1925 and concluding that, among other things, the current state of accounting education is inadequate to meet the dynamic needs of the profession and accounting education must be reassessed to meet these needs); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, *EDUCATION REQUIREMENTS FOR ENTRY INTO THE ACCOUNTING PROFESSION: A STATEMENT OF AICPA POLICIES*, 2ND ED., REVISED (Feb. 1988) (reaffirming the 150 semester-hour requirement); ARTHUR ANDERSEN & CO., ARTHUR YOUNG, COOPERS & LYBRAND, DELOITTE HASKINS & SELLS, ERNST & WHINNEY, PEAT MARWICK MAIN & CO., PRICE WATERHOUSE, AND TOUCHE ROSS, *PERSPECTIVES ON EDUCATION: CAPABILITIES FOR SUCCESS IN THE ACCOUNTING PROFESSION* (1989), *available at* <http://aaahq.org/aecc/big8/cover.htm> (stating that the chief executive officers of the eight largest public accounting firms believe that graduates entering public accounting need to have greater interpersonal, communication, and thinking skills as well as greater business

pleas for reform, curricula are characteristically slow to change.¹¹

In this regard, the Committee makes the following recommendations:

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

Accounting and auditing professionals commonly complete the requirements of professional examinations in order to comply with legal or professional association requirements. To become licensed at the state level as a certified public accountant, an individual must, among other things, pass the Uniform CPA Examination. Professional examinations, such as the Uniform CPA Examination, influence the content of the technical, ethical, and professional materials comprising the accounting curricula.¹²

The Committee believes that evolution of professional examination content serves as an important catalyst for curricular changes to reflect the dynamism and complexity of auditing public companies in global capital markets. The American Institute of Certified Public Accountants (AICPA) already regularly analyzes and updates its examination content, through practice content analysis and in conjunction with the AICPA Board of Examiners, which comprises members from the profession and state boards of accountancy. The Committee recommends that such changes remain a focus to ensure that both the 150 semester hour curriculum¹³ as well as examination content reflect in a timely manner important ongoing

knowledge and that the accounting curriculum must be a dynamic experience); and Accounting Education Change Commission, *Objectives of Education for Accountants: Position Statement Number One*, 6 ISSUES IN ACCOUNTING EDUCATION, No. 2, 307-12 (Fall 1990) (describing the education objectives for accountants in an environment where accounting education has not kept pace with the changing demands upon the accounting profession).

11 Record of Proceedings (Dec. 3, 2007) (Written Submission of Ira Solomon, R.C. Evans Distinguished Professor, and Head, Department of Accountancy, University of Illinois, 14-15), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Solomon120307.pdf> (lamenting the slow pace of change in accounting curricula and education).

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

13 *See, e.g.*, Record of Proceedings (Written Submission of Jean C. Bedard, Timothy B. Harbert Professor of Accounting, Department of Accountancy, Bentley College, 1), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Bedard060308.pdf> (observing that using the CPA Examination as a catalyst for curricula change will only be effective if the CPA Examination is written assuming completion of 150 hours); Record of Proceedings (June 3, 2008) (Questions for the Record of Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, 2 (June 20, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-6-3-08.pdf> (noting that recent developments suggest a trend away from requiring 150 hours to sit for the CPA examination since eighteen states allow candidates to sit for the exam after 120 hours); Edward P. Howard, Senior Counsel, and Julianne D’Angelo Fellmeth, Administrative Director, Center for Public Interest Law, Comment Letter Regarding Draft Report and Draft Report Addendum 2-4 (June 13, 2008), *available at* http://comments.treas.gov/_files/ACAP_Draft_Report_Comments.pdf (providing background on the issue

market developments and investor needs, such as the increasing use of international financial reporting standards (IFRS),¹⁴ expanded fair value measurement and reporting, increasingly complex transactions, new Public Company Accounting Oversight Board (PCAOB) auditing and professional standards,¹⁵ risk-based business judgment, and technological innovations in financial reporting.

Moreover, the Committee believes that professional¹⁶ and ethical standards,¹⁷ fraud examination and forensic auditing, financial risk management, and valuation, and subject matter relating to their application, are an essential component of the accounting and auditing curricula and accordingly should be reflected in the professional examinations and throughout business and accounting coursework.¹⁸

Finally, the Committee recommends that the market developments outlined in this section be reflected in professional examination content as soon as practicable, but not later than 2011.¹⁹

of requiring 150-hours for licensure while allowing 120-hours to sit for the CPA Examination in California); Record of Proceedings (June 3, 2008) (Oral Remarks of Anne M. Mulcahy, Chairman and Chief Executive Officer, Xerox Corporation, and Alan L. Beller, Partner, Cleary Gottlieb Steen & Hamilton LLP, 70-71, 77), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-06-03-08.pdf> (noting the tension between updating the curricula in order to keep current with the changing environment and fitting these changes into a four-year program).

14 Samuel K. Cotterell, Chair, National Association of State Boards of Accountancy, and David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Comment Letter Regarding Draft Report and Draft Report Addendum 1 (June 29, 2008), *available at* http://comments.treas.gov/_files/June2908LetterheadTreasuryAdvisoryCommitteeontheAuditingProfession.pdf (agreeing that IFRS should be reflected in the CPA examination); Arnold C. Hanish, Chair, Committee on Corporate Reporting, Financial Executives International, Comment Letter Regarding Draft Report and Draft Report Addendum 2 (July 3, 2008), *available at* http://comments.treas.gov/_files/FEICCRTreasuryACAPCommentLetter-Filed73080.pdf (suggesting a greater emphasis of IFRS in the accounting curriculum).

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

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

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

18 *See, e.g.*, Samuel K. Cotterell, Chair, National Association of State Boards of Accountancy, and David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Comment Letter Regarding Draft Report and Draft Report Addendum 1 (June 29, 2008), *available at* http://comments.treas.gov/_files/June2908LetterheadTreasuryAdvisoryCommitteeontheAuditingProfession.pdf (agreeing that ethics should be included in the accounting curriculum); Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 9 (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf (recommending that the Committee state that the following courses should be included in the curricula: ethics, fraud examination and forensic auditing, problem solving, finance, negotiation and communication skills, financial risk management, global business, taxation, and valuation); Record of Proceedings (Written Submission of Anne M. Lang, Chief Human Resources Officer, Grant Thornton LLP, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Lang060308.pdf> (asking the Committee to specifically cite the need for curricula that teach specialized knowledge, such as risk management, computational finance, valuation theory, and sophisticated modeling techniques).

19 *See, e.g.*, Samuel K. Cotterell, Chair, National Association of State Boards of Accountancy, and David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Comment Letter Regarding Draft Report and Draft Report Addendum 1 (June 29, 2008), *available at* http://comments.treas.gov/_files/June2908LetterheadTreasuryAdvisoryCommitteeontheAuditingProfession.pdf.

In particular, the CPA examination should test a candidate's knowledge consistent with practice needs and the highest contemporary level of education required based on those practice needs. In addition, the Committee recommends that new evolving examination content be widely and promptly communicated to college and university faculty and administrators so that corresponding curricular changes in educational institutions can continually occur on a timely basis.

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

Students are expected to use a variety of sources, such as textbooks and online materials, to learn. Such materials are an important element of higher education. The Committee learned that these commercial materials are generally conservatively managed and follow rather than lead recent market developments.²⁰ Because developing accounting materials involves a significant investment of time and resources, commercial content providers carefully consider the potential risks and rewards before publishing new materials, even where a more prompt response to new developments might be beneficial to students.

The Committee believes that accounting educational materials can contribute to inducing curricular changes that reflect the dynamism and complexity of the global capital markets and that commercial content providers should recognize the importance of capturing recent developments in their published materials. Specifically, the Committee recommends that organizations, such as the AICPA and the American Accounting Association (AAA), meet with commercial content providers and encourage them to update their materials promptly to reflect recent developments such as the increasing use of IFRS, new PCAOB auditing and professional standards, risk-based business judgment, and expanded fair value reporting, as well as technological developments in financial reporting and auditing such as eXtensible Business Reporting Language (XBRL).²¹

Further, in order to ensure access to such materials and recognizing the benefits of technological innovations,²² the Committee recommends that authoritative bodies and agencies should

treas.gov/_files/June2908LetterheadTreasuryAdvisoryCommitteeontheAuditingProfession.pdf (agreeing with the Recommendation to keep the CPA examination current).

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

21 See, e.g., Aram Kostoglian, Eastern Region Attest Practice Leader, and Ernest Baugh, National Director of Professional Standards, Mayer Hoffman McCann P.C., Comment Letter Regarding Draft Report and Draft Report Addendum 1 (June 13, 2008), *available at* http://comments.treas.gov/_files/MayerHoffmanMcCannCommentLetter.pdf (noting that textbooks lack a thorough discussion of current market developments); PricewaterhouseCoopers LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 4 (June 30, 2008), *available at* http://comments.treas.gov/_files/PwCCommentLtrTreasCmtDraftandAddendum63008.pdf (noting support for updating teaching materials promptly to reflect recent developments such as the increasing use of IFRS).

22 See Stephanie Woodruff, Chief Revenue Officer, AverQ, Inc, Comment Letter Regarding Draft Report and Draft Report Addendum (June 2, 2008), *available at* http://comments.treas.gov/index.cfm?FuseAction=Home.ViewPopup&Topic_id=9&FellowType_id=1&Reply_id=95&SuppressLayouts=True (suggesting the use or study of "technology" to address auditing profession challenges).

be encouraged to provide low-cost, affordable access to digitized searchable authoritative literature and materials, such as Financial Accounting Standards Board (FASB) codification and eIFRS, to students and faculty members. Moreover, since the content of professional examinations, such as the Uniform CPA Examination, is based upon research using digitized materials, students need to have access to, among other things, searchable accounting standards.²³ The Committee believes that low-cost affordable access to such primary materials would thus enhance student learning and performance and technical research.

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

A common theme of our first set of recommendations is that accounting curricula should reflect recent developments, including globalization and evolving market factors. As a further catalyst to curricula development and evolution by educational institutions, the Committee recommends ongoing attention to responsiveness to recent developments by the bodies that accredit educational institutions. Accrediting agencies review institutions of higher education and their programs and establish that overall resources and strategies are conformed to the mission of the institutions. For example, the Association to Advance Collegiate Schools of Business (AACSB) and the Association of Collegiate Business Schools and Programs (ACBSP) accredit business administration and accounting programs. Since 1919, the AACSB has accredited business administration programs and, since 1980, accounting programs offering undergraduate and graduate degrees. The AACSB has accredited over 450 U.S. business programs and over 150 U.S. accounting programs. Since 1988, the ACBSP has accredited business programs offering associate, baccalaureate, and graduate degrees. As of February 2008, over 400 educational institutions have achieved ACBSP accreditation. The accreditation standards at both accrediting agencies relate to, among other things, curricula, program and faculty resources, and faculty development.

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

Recommendation 2. Improve the representation and retention of minorities in the auditing profession so as to enrich the pool of human capital in the profession.

The auditing profession presents challenging and rewarding opportunities for those who pur-

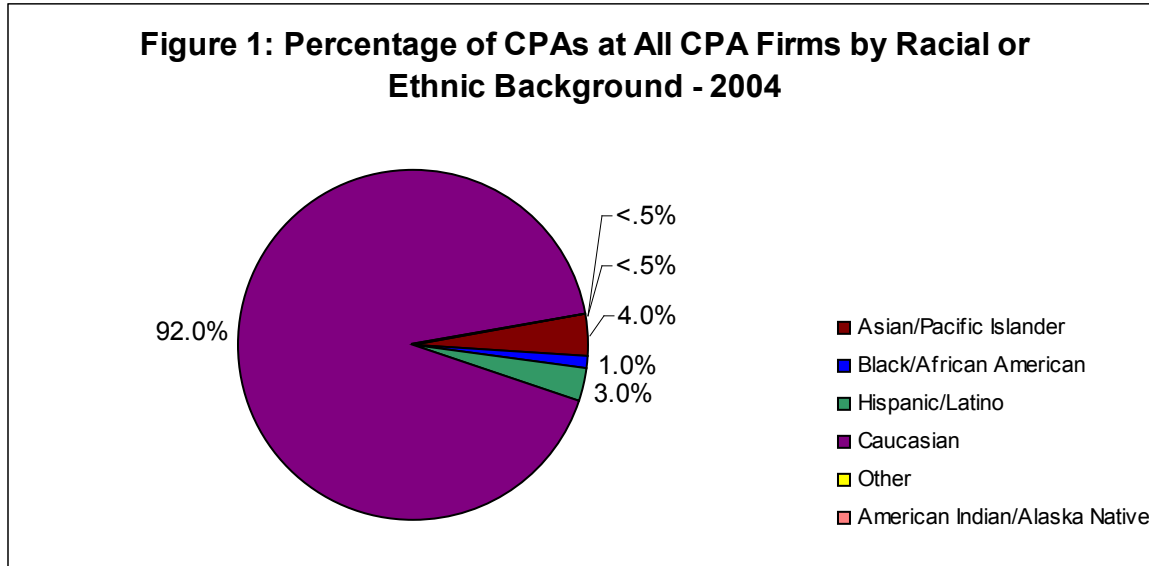
²³See Record of Proceedings (Feb. 4, 2008) (Written Submission of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 14), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (affirming the need for student access to digitized searchable accounting and auditing materials).

sue a career in auditing and the profession actively recruits talent from all backgrounds.²⁴ Yet, the Committee was concerned by what it heard from individuals with various backgrounds about minority representation and retention in the auditing profession.²⁵ In 2004, minorities accounted for 22% of all bachelor's and masters' degrees awarded in accounting, while

²⁴The Committee discussed the issue of representation and retention of females in the profession and the Committee found that the profession is undertaking significant efforts to hire and retain females and notes that these issues are being much better managed today. See, e.g., Record of Proceedings (June 3, 2008) (Oral Remarks of Amy Woods Brinkley, Global Risk Executive, Bank of America Corporation, 57), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-06-03-08.pdf> (noting that the Committee spent considerable time discussing this issue of female representation in the profession); Record of Proceedings (June 3, 2008) (Written Submission of Kayla J. Gillan, Chief Administrative Officer, RiskMetrics Group, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Gillan060308.pdf> (urging the Committee to examine the issue of female representation in the profession); Record of Proceedings (June 3, 2008) (Oral Remarks of Anne M. Lang, Chief Human Resources Officer, Grant Thornton LLP, 100-101), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-06-03-08.pdf> (stating that "...certainly recruiting women into the profession is something that [Grant Thornton LLP has] done extremely well for the last several years... [the] advancement of ... women is something that [Grant Thornton LLP] still need[s] to pay attention to"). The Committee notes the following statistics: In 2007, at the partner level, females represented 23% of partners on average, while in 2004 they were 19% and in 1994 they were just 12% of all partners. American Institute of Certified Public Accountants, *A Decade of Changes in The Accounting Profession: Workforce Trends and Human Capital Practices* 5 (Feb. 2006); DENNIS R. REIGLE, HEATHER L. BUNNING AND DANIELLE GRANT, 2008 TRENDS IN THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS 60 (2008), available at http://ceae.aicpa.org/NR/rdonlyres/C1E23302-17D3-4ED5-AE81-B274D9CD7812/0/AICPA_Trends_Reports_2008.pdf. According to *Public Accounting Report* surveys, the percentage of female professionals at the largest firms was 47.3% in 2007 and 44.2% in 2004. *Women at Big Four Gain Ground in Partnership Percentage*, PUBLIC ACCOUNTING REPORT 6 (Oct. 31, 2004) and *Women Post Gains in Partnership Percentage*, PUBLIC ACCOUNTING REPORT 11 (Jan. 31, 2008). From 2005 to 2007, women represented about half of the new hires at the six largest firms. CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 58 (Jan. 23, 2008). The Committee also considered the effects of workload compression on retention in the profession. Some Committee members believe that auditing firms and their clients could benefit from flexibility in fiscal year-end date choices for companies, thereby spreading audit work throughout the year, and reducing workload overlap with the tax filing season. Record of Proceedings (Oct. 15, 2007) (Oral Remarks of William D. Travis, Director and Former Managing Partner, McGladrey & Pullen LLP, 71), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-10-15-07.pdf> (noting that "[a] significant challenge for retention of personnel in mid-size and small audit firms is the extreme seasonality ... during the winter season. This reality places enormous pressure on audit quality and balanced lives of ... professionals"); Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Barry C. Melancon, President and Chief Executive Officer, American Institute of Certified Public Accountants, 118), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf> (noting that the Human Capital Subcommittee discussed workload compression issues).

²⁵See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Ira Solomon, R.C. Evans Distinguished Professor, and Head, Department of Accountancy, University of Illinois, 13), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Solomon120307.pdf>; Record of Proceedings (Dec. 3, 2007) (Questions for the Record of George S. Willie, Managing Partner, Bert Smith & Co., 2 (Jan. 30, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-12-3-2007.pdf>; Record of Proceedings (Dec. 3, 2007) (Written Submission of Julie K. Wood, Chief People Officer, Crowe Chizek and Company LLC, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Wood120307.pdf>.

in 2007, minorities accounted for 21%.²⁶ In 2004, African Americans represented 1% of all CPAs, Hispanic/Latino, 3%, and Asian/Pacific Islander, 4%.²⁷ See Figure 1. These percentages changed very little in 2007 when African Americans represented 1% of all CPAs, Hispanic/Latino, 2%, and Asian/Pacific Islander, 4%.²⁸ See Figure 2.



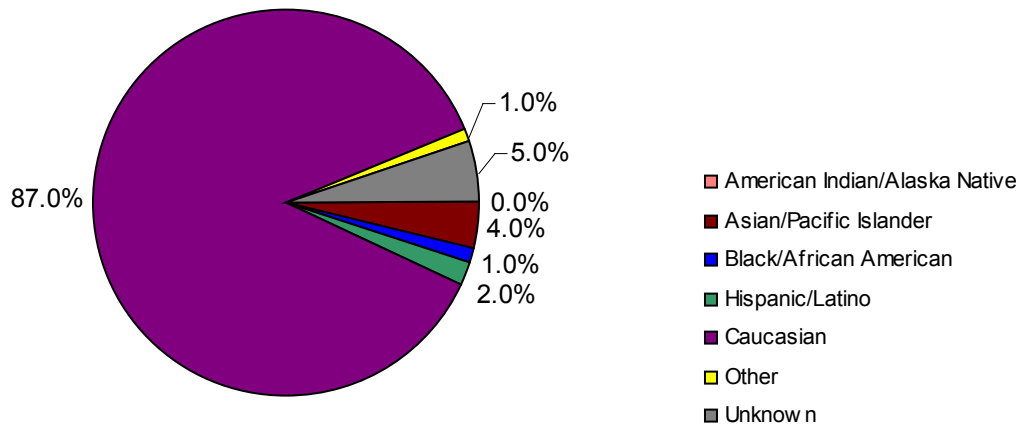
Source: BEATRICE SANDERS AND LETICIA B. ROMEO, THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS-2005: FOR ACADEMIC YEAR 2003-2004 35 (2005).

26 DENNIS R. REIGLE, HEATHER L. BUNNING AND DANIELLE GRANT, 2008 TRENDS IN THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS 30 (2008), available at http://ceae.aicpa.org/NR/ronlyres/C1E23302-17D3-4ED5-AE81-B274D9CD7812/0/AICPA_Trends_Reports_2008.pdf.

27 BEATRICE SANDERS AND LETICIA B. ROMEO, THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS-2005: FOR ACADEMIC YEAR 2003-2004 35 (2005), available at http://ceae.aicpa.org/NR/ronlyres/11715FC6-F0A7-4AD6-8D28-6285CBE77315/0/Supply_DemandReport_2005.pdf.

28 DENNIS R. REIGLE, HEATHER L. BUNNING AND DANIELLE GRANT, 2008 TRENDS IN THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS 61 (2008), available at http://ceae.aicpa.org/NR/ronlyres/C1E23302-17D3-4ED5-AE81-B274D9CD7812/0/AICPA_Trends_Reports_2008.pdf.

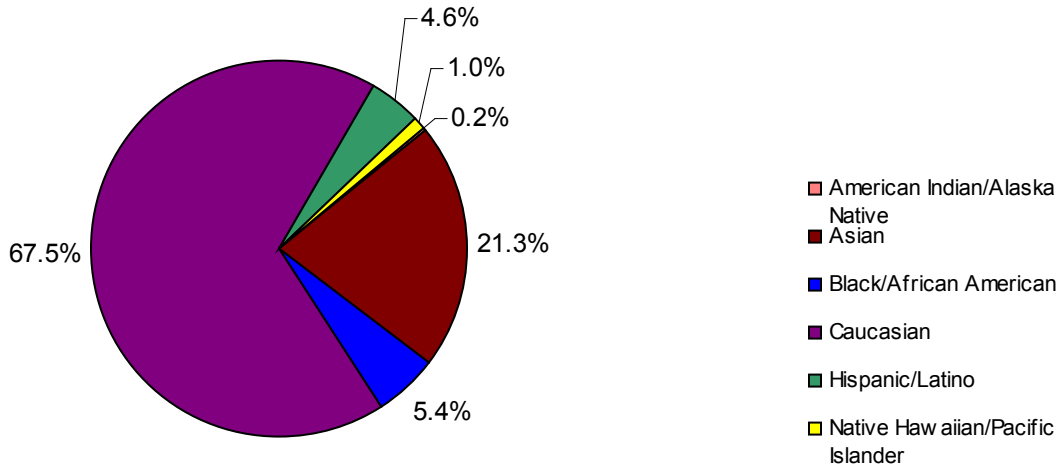
Figure 2: Percentage of CPAs at All CPA Firms by Racial or Ethnic Background - 2007



Source: DENNIS R. REIGLE, HEATHER L. BUNNING AND DANIELLE GRANT, 2008 TRENDS IN THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS 61 (2008).

African Americans accounted for 5.4% of new hires in 2007 at the largest six accounting firms, Hispanics, 4.6%, and Asians, 21.3%.²⁹ See Figure 3.

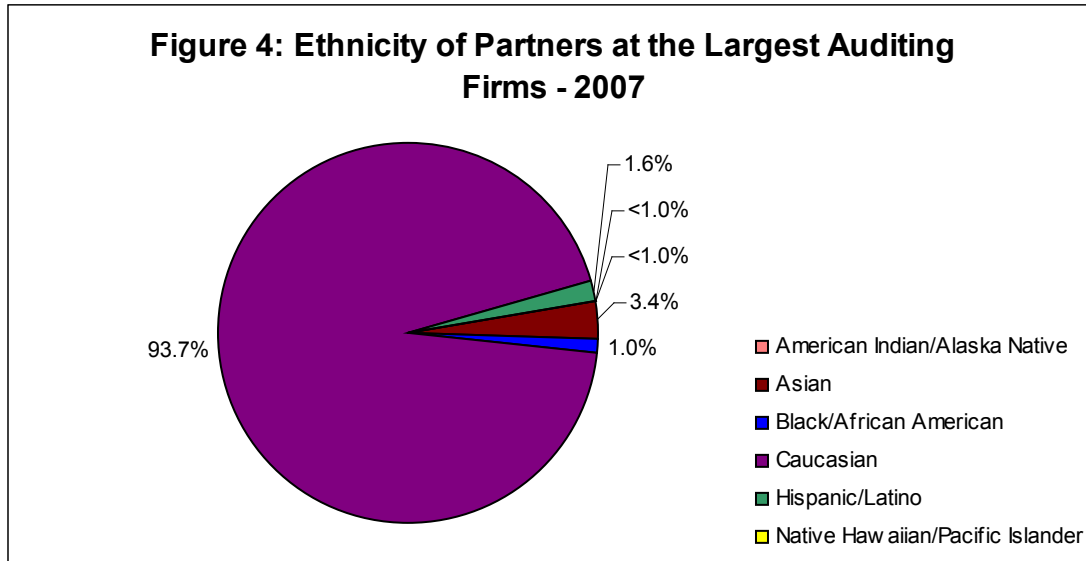
Figure 3: Ethnicity of New Hires at the Largest Auditing Firms - 2007



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

²⁹CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 59 (Jan. 23, 2008), available at <http://www.theqaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

In 2007, 1.0% of the partners in the six largest accounting firms were African American, 1.6% were Hispanic/Latino, 3.4% were Asian, and less than 1.0% were Native Hawaiian/Pacific Islander or American Indian/Alaska Native, aggregating less than 7% of the total partners.³⁰ See Figure 4.



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

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

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

³⁰CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 60 (Jan. 23, 2008), available at <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

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

The Committee heard from witnesses that the auditing profession has “fallen short” on its minority recruitment goals.³¹ Accordingly, the Committee recommends that auditing firms actively market to and recruit from minority non-accounting graduate populations, both at the entry and experienced hire level, utilizing cooperative efforts by academics and firm-based training programs to assist in this process.³² Generally, auditing firms hire individuals for the audit practice who are qualified to sit for the Uniform CPA Examination.³³

Further, the Committee recommends that auditing firms expand their recruitment initiatives at historically black colleges and universities (HBCUs), and explore the use of proprietary schools as another way to recruit minorities into the profession.³⁴ Currently over 100 educational institutions established before 1964 to serve the African American community are designated as HBCUs and over fifty of these HBCUs maintain accounting programs. Approximately 290,000 students are enrolled in HBCUs³⁵ and HBCUs enroll 14% of all African American students in higher education.³⁶ Twenty-seven HBCUs have one or more of the six largest accounting firms recruiting professional staff on their campus.³⁷ Both the number of these schools visited by the largest firms and the number of firms recruiting at these schools should increase. Proprietary schools are for-profit businesses that teach vocational or occupational skills and there are over 2,000 proprietary schools in the United States.³⁸ In 2005, these schools enrolled over 1 million students: African Americans accounted for 23% of these students, Hispanics, 13%, and Asian/Pacific Islander, 4%.³⁹

31 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Julie K. Wood, Chief People Officer, Crowe Chizek and Company LLC, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Wood120307.pdf>.

32 See Ernst & Young LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 22 (June 27, 2008), *available at* http://comments.treas.gov/_files/EYACAPCommentLetterFINAL2.pdf (supporting this Recommendation).

33 See Record of Proceedings (Dec. 3, 2007) (Questions for the Record of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 4 (Feb. 1, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-07.pdf> (noting that since 1997, Ernst & Young LLP has typically hired individuals qualified to sit for the Uniform CPA Examination).

34 See Record of Proceedings (June 3, 2008) (Written Submission of Frank K. Ross, Director, Center for Accounting Education, Howard University School of Business, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Ross060308.pdf> (agreeing that this Recommendation will help increase minority recruitment).

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

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

37 CENTER FOR AUDIT QUALITY, SUPPLEMENT TO REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 1 (Mar. 5, 2008), *available at* <http://www.thecaq.org/publicpolicy/data/TRData2008-03-05-Supplement1.pdf>.

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

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

(b) Institute initiatives to increase the retention of minorities in the profession.

The Committee considered testimony on the retention of minorities in the profession.⁴⁰ As discussed above, minorities are significantly under-represented in leadership and partnership positions within the profession. The Committee recognizes the lack of minority mentors and role models⁴¹ in the profession and the profession's awareness of this situation.⁴² In a 2006 National Association of Black Accountants (NABA) survey, almost 60% of African American respondents stated that their mentors come from outside of the profession and almost 55% of respondents stated that they had been with their current employer for three years or less.⁴³ The Committee considered testimony that African Americans leave the profession for other careers or do not wish to become managers or partners because they see that there are few African Americans in leadership positions within the firms.⁴⁴ The Committee also heard testimony that the retention rate for Hispanics "is low."⁴⁵ In 2004, Hispanics represented 3% of the professional staff at all CPA firms⁴⁶ and this percentage did not change in 2007.⁴⁷

40 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of George S. Willie, Managing Partner, Bert Smith & Co., 3), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Willie120307.pdf> (noting that "firms must do more to retain and promote minority professionals"); Record of Proceedings (June 3, 2008) (Written Submission of Frank K. Ross, Director, Center for Accounting Education, Howard University School of Business, 8), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Ross060308.pdf> (noting that "auditing firms need to establish aggressive retention programs that focus on retention").

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

42 See Record of Proceedings (July 12, 2006) (Written Testimony of Manuel Fernandez, National Managing Partner—Campus Recruiting, KPMG LLP, to the Subcommittee on Oversight and Investigations of the House Financial Services Committee, 5), available at <http://financialservices.house.gov/media/pdf/071206mf.pdf> (identifying the lack of minority faculty mentors and role models and noting "[w]hen students of color do not see professors of their own ethnic background on the accounting faculty, they are less apt to consider the option of a career in accountancy"); Record of Proceedings (Dec. 3, 2007) (Questions for the Record of George S. Willie, Managing Partner, Bert Smith & Co., 1 (Jan. 30, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-12-3-2007.pdf> (recommending the establishment of a mentor program for minority accounting students).

43 THE CENTER FOR ACCOUNTING EDUCATION, HOWARD UNIVERSITY SCHOOL OF BUSINESS, NABA MEMBERSHIP SURVEY, *Analysis of Work Experience of NABA Members* Table 23 and 5 (Sept. 15, 2006), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/NABAMembershipSurvey.pdf>.

44 Record of Proceedings (June 3, 2008) (Written Submission of Frank K. Ross, Director, Center for Accounting Education, Howard University School of Business, 5), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Ross060308.pdf>.

45 Record of Proceedings (Feb. 4, 2008) (Written Submission of Gilbert R. Vasquez, Managing Partner, Vasquez & Company LLP, 4), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Vasquez02042008.pdf>.

46 BEATRICE SANDERS AND LETICIA B. ROMEO, THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS-2005: FOR ACADEMIC YEAR 2003-2004 32 (2005), available at http://ceae.aicpa.org/NR/rdonlyres/11715FC6-F0A7-4AD6-8D28-6285CBE77315/0/Supply_DemandReport_2005.pdf.

47 DENNIS R. REIGLE, HEATHER L. BUNNING AND DANIELLE GRANT, 2008 TRENDS IN THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS 59 (2008), available at http://ceae.aicpa.org/NR/rdonlyres/C1E23302-17D3-4ED5-AE81-B274D9CD7812/0/AICPA_Trends_Reports_2008.pdf.

The Committee believes that firms must continue to find ways to retain minorities in the profession in order to ensure the profession's long-term viability. The Committee believes the need to instill confidence is critical to an individual's career as is the need for mentors, especially at the start of an individual's career.⁴⁸ The Committee also recognizes that auditing firms must continue to give challenging assignments so that individuals have the motivation to stay in the profession.⁴⁹ Thus, the Committee recommends that public company auditing firms intensify their efforts to create and maintain retention programs, including mentoring programs, for their employees as a means to provide these individuals with guidance, career coaching, and networking. Further, the Committee recommends that the profession compile and issue best practices related to minority recruitment and retention.⁵⁰

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

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

As of January 2008, approximately 11.5 million students were enrolled in the 1,200 community colleges in the United States: African Americans accounted for 13% of these students, Hispanics, 15%, and Asian/Pacific Islander, 6%.⁵¹

In August 1992, the Accounting Education Change Commission (AECC), created in the late 1980s by the academic community to examine potential changes to accounting education, recognized the importance of two-year colleges in accounting education. The AECC noted that over half of all students taking their first course in accounting do so at two-year colleges and that approximately one-fourth of the students entering the accounting profession take their initial accounting coursework at two-year colleges. The AECC called for "greater rec-

48 See Record of Proceedings (June 3, 2008) (Written Submission of Frank K. Ross, Director, Center for Accounting Education, Howard University School of Business, 8), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Ross060308.pdf> (noting that "auditing firms need to establish aggressive retention programs that focus on confidence... the single greatest source of confidence is a good mentor. Unless [an individual has] been blessed with a truly strong mentor, it may be hard to understand how beneficial it is").

49 See Record of Proceedings (June 3, 2008) (Oral Remarks of Anne M. Lang, Chief Human Resources Officer, Grant Thornton LLP, 83), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-06-03-08.pdf> (stating that "... what [Grant Thornton] find[s], at least in the research that we've done with people coming into the organization and staying in public accounting, is that meaningful and challenging work and the opportunity to advance, based on an individual's career aspirations, is really what keeps our people longer").

50 See PricewaterhouseCoopers LLP, Comment Letter Regarding the Draft Report and Draft Report Addendum 5 (June 30, 2008), *available at* http://comments.treas.gov/_files/PwCCommentLtrTreasCmtDraftandAddendum63008.pdf.

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

ognition within the academic and professional communities of the efforts and importance of two-year accounting programs.”⁵²

The Committee also heard from witnesses emphasizing the need to expand minority recruitment initiatives at community colleges.⁵³

The Committee believes that more attention to community colleges may provide, in addition to an increase in the overall supply of students, another avenue for minorities to become familiar with and attracted to the auditing profession. Currently none of the largest auditing firms recruits at community colleges because “individuals who only have associate degrees typically will not have sufficient qualifications to satisfy state licensing requirements.”⁵⁴ The Committee recommends that accreditation of two-year college accounting programs at community colleges be explored and implemented when viable, so that these programs can be relied upon as one of the requisite steps toward fulfilling undergraduate educational requirements.⁵⁵ Further, the Committee recommends that auditing firms and educational institutions at all levels support and cooperate in building strong fundamental academic accounting programs at community colleges, including providing internships or financial support for students who begin their studies in two-year programs and may be seeking careers in the auditing profession. The Committee also recommends that auditing firms and four-year colleges and universities and their faculty focus on outreach to community college students in order to support students’ transition from community colleges to four-year educational institutions.⁵⁶

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

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

⁵²ACCOUNTING EDUCATION CHANGE COMMISSION, ISSUES STATEMENT NUMBER 3: THE IMPORTANCE OF TWO-YEAR COLLEGES FOR ACCOUNTING EDUCATION (Aug. 1992), *available at* <http://aaahq.org/aecc/PositionsandIssues/issues3.htm>.

⁵³*See, e.g.*, Record of Proceedings (Feb. 4, 2008) (Written Submission of Gilbert R. Vasquez, Managing Partner, Vasquez & Company LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Vasquez02042008.pdf> (noting that auditing firms overlook community colleges where minorities, and specifically Latinos, represent a large student population); Record of Proceedings (Dec. 3, 2007) (Questions for the Record of George S. Willie, Managing Partner, Bert Smith & Co., 2 (Jan. 30, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-07.pdf> (recommending that the auditing profession increase its visibility at community colleges).

⁵⁴CENTER FOR AUDIT QUALITY, SUPPLEMENT TO REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 1 (Mar. 5, 2008), *available at* <http://www.theqaq.org/publicpolicy/data/TRData2008-03-05-Supplement1.pdf>.

⁵⁵*See* Record of Proceedings (June 3, 2008) (Written Submission of Anne M. Lang, Chief Human Resources Officer, Grant Thornton LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Lang060308.pdf> (supporting the accreditation of community colleges).

⁵⁶*See, e.g.*, Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 8 (June 26, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (stating that outreach programs to community colleges could be effective); PricewaterhouseCoopers LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 5 (June 30, 2008), *available at* http://comments.treas.gov/_files/PwCCommentLtrTreasCmtDraftandAddendum63008.pdf (suggesting that the Committee recommend steps to transition students from community colleges to four-year colleges and universities).

The Committee recommends encouraging a concerted effort to increase the focus upon HBCUs in order to raise the number of African Americans in the auditing profession and urging the HBCUs, auditing firms, corporations, federal and state governments, and other entities to emphasize the use of cross-sabbaticals.⁵⁷ Cross-sabbaticals are interactive relationships where faculty and seasoned professionals are regularly represented in the practice and academic environments through exchanges. Evidence suggests that such exchanges can be beneficial, and continued development of such exchanges is expected to provide substantial benefits for all parties.⁵⁸ Cross-sabbaticals present an opportunity for “reflective thinking” for seasoned professionals.⁵⁹

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

The Committee received testimony regarding the lack of minority mentors and role models⁶⁰ and notes that the profession has recognized this situation.⁶¹ Thus, the Committee also rec-

⁵⁷ See Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 8 (June 26, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (agreeing with this Recommendation).

⁵⁸ See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (recommending encouraging sabbaticals, internships, and fellowship opportunities, structured to give faculty opportunities to conduct research for promotion and tenure); Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 68), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-2-4-08.pdf> (stating that sabbaticals deliver professors “a wealth of knowledge they could bring back in the classroom”).

⁵⁹ Record of Proceedings (Mar. 13, 2008) (Oral Remarks of H. Rodgin Cohen, Chairman, Sullivan & Cromwell LLP, 69), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf> (noting that spending time in the classroom should “give the [practicing accountant] the time to do the reflective thinking”); Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Zoe-Vonna Palmrose, Deputy Chief Accountant, SEC), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf> (commenting that sabbaticals provide the “opportunity for reflective thinking”).

⁶⁰ See, e.g., Record of Proceedings (June 3, 2008) (Written Submission of Frank K. Ross, Director, Center for Accounting Education, Howard University School of Business, 9), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Ross060308.pdf> (highlighting that a 2006 NABA survey revealed that almost 60% of African American respondents stated that their mentors come from outside of the profession); Record of Proceedings (Feb. 4, 2008) (Written Submission of Gilbert R. Vasquez, Managing Partner, Vasquez & Company LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Vasquez02042008.pdf> (highlighting the lack of Hispanic role models and mentors in the accounting profession).

⁶¹ See, e.g., Record of Proceedings (July 12, 2006) (Written Testimony of Manuel Fernandez, National Managing Partner—Campus Recruiting, KPMG LLP, to the Subcommittee on Oversight and Investigations of the House Financial Services Committee, 5), *available at* <http://financialservices.house.gov/media/pdf/071206mf.pdf> (identifying the lack of minority faculty mentors and role models and noting “[w]hen students of color do not see professors of their own ethnic background on the accounting faculty, they are less apt to consider the option of a career in accountancy”); Record of Proceedings (Dec. 3, 2007) (Questions for the Record of George

ommends that public company auditing firms intensify their efforts to create internships and mentoring programs for students in accounting and other complementary disciplines, including those from HBCUs and community colleges, as a means to increase the awareness of the accounting profession and its attractiveness among minority students.

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

Some dedicated programs have succeeded in attracting minorities to enter and complete accounting doctoral studies.⁶² In particular, the PhD Project, an effort of the KPMG Foundation, has worked to increase the diversity of business school faculty.⁶³ The PhD Project focuses on attracting minorities to business doctoral programs, and provides a network of peer support. Since the PhD Project's establishment in 1994, the number of minority professors at U.S. business schools has increased from 294 to 889.⁶⁴ Ninety percent who enter the PhD Project earn their doctorates, and 99% of those who complete their doctorates go on to teach.⁶⁵ The PhD Project has received over \$17.5 million⁶⁶ in funding since 1994 from corporations, foundations, universities, and other interested parties.⁶⁷

The Committee believes that programs such as these can successfully recruit minorities to accounting doctoral studies. The Committee recommends that auditing firms, corporations, and other interested parties advertise existing and successful efforts to increase the number of minority doctorates by developing further dedicated programs.⁶⁸ Additionally, the Committee recommends that auditing firms, corporations, and other interested parties maintain and increase the funding of these programs.

S. Willie, Managing Partner, Bert Smith & Co., 1 (Jan. 30, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-12-3-2007.pdf> (recommending the establishment of a mentor program for minority accounting students).

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

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

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

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

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

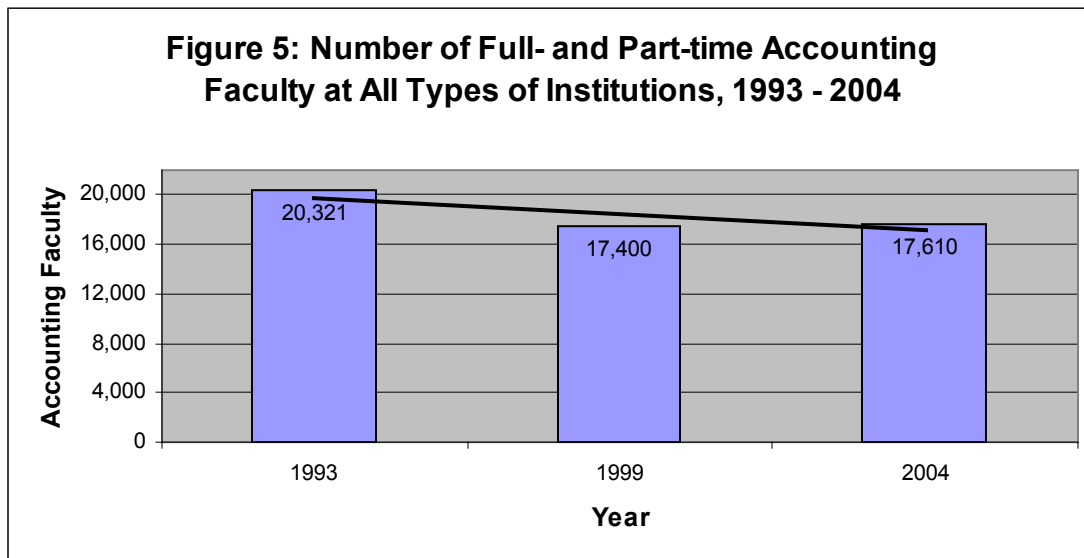
67 For further information on the PhD Project, see http://www.phdproject.org/corp_sponsors.html.

68 See, e.g., Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 9 (June 26, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (stating that this Recommendation could lead to an increase in the number of minority accounting doctorates); Record of Proceedings (June 3, 2008) (Written Submission of Frank K. Ross, Director, Center for Accounting Education, Howard University School of Business, 11), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Ross060308.pdf> (noting the need to expand support for the PhD Project and similar initiatives).

Recommendation 3. Ensure a sufficiently robust supply of qualified accounting faculty to meet demand for the future and help prepare new entrants to the profession to perform high quality audits.

The Committee heard testimony from individuals regarding the need to have an adequate supply of faculty with the knowledge and experience to develop qualified professionals for the increasingly complex and global auditing profession.⁶⁹

The Committee recognizes that there is a high level of concern about the adequacy of both the near- and the long-term supply of doctoral faculty, especially given the anticipated pace of faculty retirements. According to National Study of Postsecondary Faculty data, the number of full- and part-time accounting faculty at all types of educational institutions fell by 13.3% from 20,321 in 1993 to 17,610 in 2004, while student (undergraduate) enrollment increased by 12.3% over the same period.⁷⁰ See Figure 5.



Source: ADVISORY COMMITTEE ON THE AUDITING PROFESSION, RECORD OF PROCEEDINGS (DEC. 3, 2007) (WRITTEN SUBMISSION OF DAVID W. LESLIE, CHANCELLOR PROFESSOR OF EDUCATION, COLLEGE OF WILLIAM AND MARY, 5).

⁶⁹ See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of David W. Leslie, Chancellor Professor of Education, College of William and Mary, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Leslie120307.pdf> (noting a 13.3% decline in accounting faculty from 1988 to 2004); Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (stating that “recent years have seen a reduction in accounting faculty, based on a wave of retirements and lack of accounting Ph.D.s coming into the system”); Record of Proceedings (Dec. 3, 2007) (Written Submission of Ira Solomon, R.C. Evans Distinguished Professor, and Head, Department of Accountancy, University of Illinois, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Solomon120307.pdf> (stating that “the number of persons entering accountancy doctoral programs is too low to sustain the accountancy professoriate”).

⁷⁰ Record of Proceedings (Dec. 3, 2007) (Written Submission of David W. Leslie, Chancellor Professor of Education, College of William and Mary, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Leslie120307.pdf>.

Moreover, the current pipeline of doctoral faculty is not keeping pace with anticipated retirements. In November 2006, it was estimated that one-third of the approximately 4,000 accounting doctoral faculty in the United States were 60 years old or older, and one-half were 55 years old or older.⁷¹ The average retirement age of accounting faculty was 62.4 years.

In terms of specialization within the accounting discipline, an AAA study concluded that only 22% and 27% of the projected demand for doctoral faculty in auditing and tax, respectively, will be met by expected graduations in the coming years.⁷² However, 91% and 79% of the projected demand for doctoral faculty in financial accounting and managerial accounting, respectively, will be met.⁷³

In addition to the accounting faculty supply issues, the Committee heard testimony from witnesses on the need to ensure faculty are qualified and able to teach students the latest market developments, such as fair value accounting, IFRS, and XBRL. The Committee learned that often new accounting faculty may have little practical experience.⁷⁴ Witnesses testified to the difficulty of academics' acquiring "practice-oriented" knowledge as the bond between the profession and academia is underdeveloped. Witnesses did suggest improving these relationships with incentives for sabbaticals and sharing practice experience.⁷⁵

In this regard, the Committee makes the following recommendations:

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

The Committee recognizes that ensuring an adequate supply of doctoral accounting faculty in higher education is crucial to both retaining the academic standing of the discipline on campus and developing well-prepared and educated entry-level professionals. The resource represented by these professionals is essential for high quality audits. The Committee believes that high quality audits are critical to well-functioning capital markets, and therefore

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

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

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

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

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

the funding necessary to supply the healthy pipeline of doctoral accounting faculty to assist in providing these human capital resources must be made available.⁷⁶ The Committee therefore recommends expanding government funding, at both the federal and state level, for accounting doctoral candidates. The Committee also recommends that private sources (including corporations, institutional investors, and foundations as well as auditing firms) continue to be encouraged to fund accounting doctoral candidates.⁷⁷ The Committee recognizes and commends the auditing firms' support of doctoral candidates.⁷⁸

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

⁷⁶ See Record of Proceedings (June 3, 2008) (Written Submission of Jean C. Bedard, Timothy B. Harbert Professor of Accounting, Department of Accountancy, Bentley College, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Bedard060308.pdf> (noting that “[f]unding for doctoral study is absolutely critical”).

⁷⁷ See, e.g., Record of Proceedings (June 3, 2008) (Written Submission of Kayla J. Gillan, Chief Administrative Officer, RiskMetrics Group, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Gillan060308.pdf> (noting that Sarbanes-Oxley Act Section 109(c)(2) states that monetary penalties assessed by the PCAOB against registered firms and individuals are to be used exclusively to fund merit-based scholarships for accounting undergraduate and graduate students and that Section 109(c)(2) also includes certain procedural requirements for the funds' release, such as Congressional approval, and recommending the Committee suggest eliminating the unnecessary procedural obstacles contained in the statute); PricewaterhouseCoopers LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 6 (June 30, 2008), *available at* http://comments.treas.gov/_files/PwCCommentLtrTreasCmtDraftandAddendum63008.pdf (noting that the profession provides funding for faculty, but other private sector participants as well as Congress and state and local officials could contribute funding).

⁷⁸ See Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf>. Other commenters have suggested another method to increase the number of faculty and professionals as well as potentially expand diversity within the profession is by increasing the current H-1B quota of 65,000. Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 9 (June 26, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (noting the need to increase the quota for H-1B visas to help increase the number of faculty and the number of professionals knowledgeable of international issues); PricewaterhouseCoopers LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 7 (June 30, 2008), *available at* http://comments.treas.gov/_files/PwCCommentLtrTreasCmtDraftandAddendum63008.pdf (recommending immigration reform, such as expansion of H-1B visa program, to increase supply of accounting faculty, international experience, and diversity). *But cf.* Carl Olson, California National University, Comment Letter Regarding Draft Report and Draft Report Addendum 31-32 (June 6, 2008), *available at* http://comments.treas.gov/_files/OlsonCommentLetter0606082.pdf (opposing the use of H-1B visas by accounting firms to recruit employees).

have underscored the benefits of professionally qualified and experienced faculty.⁷⁹ Therefore, the Committee recommends that accrediting agencies continue to actively support faculty composed of academically and professionally qualified and experienced faculty.

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

As discussed above, cross-sabbaticals are interactive relationships where faculty and seasoned professionals are regularly represented in the practice and academic environments through exchanges. For example, currently, the Securities and Exchange Commission (SEC) and the FASB offer fellowship programs for professional accountants and accounting academics. Evidence suggests that such exchanges can be beneficial, and continued development of such exchanges is expected to provide substantial benefits for all parties.⁸⁰ Cross-sabbaticals present an opportunity for “reflective thinking” for seasoned professionals.⁸¹ Academics often face the disincentive of being forced to forgo their full salaries in order to engage in such sabbaticals,⁸² and colleges and universities may not encourage professional practice sabbaticals, preferring that the focus of faculty be directed exclusively toward academic research and the number and placement of scholarly articles. The Committee believes that changing both the academic and practice culture will require a plan and commitment of support at the highest institutional levels.

⁷⁹ See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy-Emeritus, University of Illinois, Comment Letter Regarding Discussion Outline 19 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008.doc (stating that “[t]here are clearly practice professionals that make excellent contributions to some of the most highly rated accounting programs in the country”); Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (stating that accreditation bodies “revise accreditation standards to allow the employment of more audit professionals, either active or retired, as adjunct professors”).

⁸⁰ See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fornelli020408.pdf> (recommending encouraging sabbaticals, internships, and fellowship opportunities, structured to give faculty opportunities to conduct research for promotion and tenure); Record of Proceedings (June 3, 2008) (Written Submission of William Kinney, Charles & Elizabeth Prothro Regents Chair in Business and Price Waterhouse Fellow in Auditing, University of Texas, Austin, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Kinney060308.pdf> (noting the completion of an August 2007 to February 2008 assignment as an academic fellow in the Professional Practice Group of Office of Chief Accountant at the SEC, and stating that the experience provided a greater understanding of the regulatory process and that “my students have already benefited through more relevant classes”); Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 68), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (stating that sabbaticals deliver professors “a wealth of knowledge they could bring back in the classroom”).

⁸¹ Record of Proceedings (Mar. 13, 2008) (Oral Remarks of H. Rodgin Cohen, Chairman, Sullivan & Cromwell LLP, 69), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf>; Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Zoe-Vonna Palmrose, Deputy Chief Accountant, SEC, 67), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf>.

⁸² Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 67-69), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (noting the financial disincentives associated with sabbaticals).

Specifically, the Committee recommends that educational institutions, auditing firms, corporations, federal and state regulators, and others engage in a two-fold strategy to both encourage cross-sabbaticals and eliminate financial or career disincentives for participating in such experiences.⁸³ Further, the Committee recommends that university administrators place as high a value on professional sabbaticals for purposes of promotion and tenure as they do for research and scholarly publication.⁸⁴

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

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

As discussed above, there are concerns about the adequate supply of accounting faculty and about the need to have faculty who can inject more practical experience into classroom learning. Currently, there are few specific financial incentives encouraging private sector funding of accounting doctoral faculty or sponsoring of professional accountants to teach at educational institutions. Nonetheless, the Committee notes that the profession recognizes the need to support initiatives to increase faculty and is currently directing its efforts to raise funds for such a new initiative.⁸⁵

⁸³See, e.g., Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 11 (June 27, 2008), available at http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf (noting the formation of a task force on cross-sabbaticals with accounting faculty, including those at HBCUs); Record of Proceedings (June 3, 2008) (Written Submission of William Kinney, Charles & Elizabeth Prothro Regents Chair in Business and Price Waterhouse Fellow in Auditing, University of Texas, Austin, 5), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Kinney060308.pdf> (supporting the idea of allowing professors to take sabbaticals and providing direct evidence by describing a recent assignment as an academic fellow in the Professional Practice Group of the SEC's Office of Chief Accountant).

⁸⁴See Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft Report Addendum 4 (May 15, 2008), available at http://comments.treas.gov/_files/ACAPCommentLetter-May152008.pdf (noting the need to “[p]lace equal emphasis on completing a sabbatical with a private sector institution or government entity as with publishing one ‘tier A’ paper”).

⁸⁵See Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia M. Fornelli, Executive Di-

The Committee also heard from several witnesses regarding the unavailability of data relating to auditing practice and the impact this lack of data has on research and potentially on the profession's sustainability. In particular, witnesses stated that the decline in auditing research materials, including archival or experimental data, will lead to a further decline in faculty and doctoral students specializing in auditing.⁸⁶ Since educational institutions normally require publications in top tier journals for promotion or tenure, faculty and doctoral students will conduct research in accounting areas where data are prevalent.

The Committee also heard that encouraging more professionally qualified and experienced faculty will foster a stronger relationship between academia and the profession.⁸⁷ Currently, there exists a need for more interaction between academia and the profession.⁸⁸ Encouraging practicing accountants to pursue careers as academically and professionally qualified faculty would bring practical business experience to classrooms so that students are better prepared to perform quality audits in the dynamic business environment.

Finally, the Committee recommends that Congress pass legislation creating a variety of tangible incentives for private sector institutions to establish support for accounting and auditing faculty and faculty research, to facilitate access to research data and individuals,⁸⁹ and to

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

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

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

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

89 *See, e.g.*, Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft

sponsor transition of professional accountants from practice to teaching positions. These incentives must be sufficiently attractive to companies and auditing firms to effect rapid behavioral change, and should avoid cumbersome levels of administration. The Committee believes that these incentives would provide the necessary impetus to private sector institutions to help increase the number of accounting faculty as well as faculty with significant practical experience.

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

The Committee heard testimony regarding the lack of consistent demographic and higher education program profile data concerning the profession.⁹⁰ The need for comparable, consistent, periodic information regarding the demographic profile of professional accountants and auditors, related higher education program capacity, entry-level supply and demand of personnel, accounting firm retention and compensation practices, and similar particulars are fundamental to a meaningful understanding of the human capital circumstances impacting the public company auditing profession and its future and sustainability.

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

Report Addendum 2 (May 15, 2008), *available at* http://comments.treas.gov/_files/ACAPCommentLetter-May152008.pdf (recommending that auditing firms and regulators assist academic researchers with access to data relating to the auditing practice); Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 11-12 (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf (noting the attempt to actively work with academia to find ways to overcome confidentiality issues concerning auditing practice data); Record of Proceedings (June 3, 2008) (Written Submission of Kayla J. Gillan, Chief Administrative Officer, RiskMetrics Group, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Gillan060308.pdf> (recommending that everyone have access to PCAOB inspection data and suggesting the Committee seek legislative amendments to allow this access); Record of Proceedings (June 3, 2008) (Written Submission of William Kinney, Charles & Elizabeth Prothro Regents Chair in Business and Price Waterhouse Fellow in Auditing, University of Texas, Austin, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Kinney060308.pdf> (suggesting legislation encouraging access to data).

⁹⁰Record of Proceedings (Dec. 3, 2007) (Questions for the Record of David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, 2-4 (Feb. 6, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-07.pdf> (stating that “[s]ince 1970, ... NASBA and the AICPA have recognized the need for a national database for Certified Public Accountants and have taken steps leading to the development of the database... [c]urrently, NASBA is not aware of a mechanism or database which would provide an accurate count of CPAs, without the effect of ‘double counting’”); Julia Grant, *Demographic Challenges Facing the CPA Profession*, 20 RESEARCH IN ACCOUNTING REGULATION (2008); Record of Proceedings (Dec. 3, 2007) (Written Submission of Ira Solomon, R.C. Evans Distinguished Professor, and Head, Department of Accountancy, University of Illinois, 13), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Solomon120307.pdf> (noting the lack of comprehensive accounting profession supply and demand data and recommending the “establishment of a continuous and comprehensive system that produces more timely and reliable supply and demand data”).

Materials such as those supplied by the Center for Audit Quality to the Committee,⁹¹ previous AICPA Supply and Demand studies,⁹² and AAA-commissioned demographic research⁹³ provide examples of the necessary information. In addition, AICPA membership trends, augmented by data available from state boards of accountancy regarding numbers of licensees, may be useful data.

Therefore, the Committee recommends the establishment of a national cooperative committee, comprised of organizations such as the AICPA and the AAA, to encourage periodic consistent demographic and higher education program profile data.⁹⁴ The Committee believes that having such data available will increase the ability of auditing firms, corporations, investors, academics, policy makers, and others to understand more fully, monitor and evaluate, and take necessary or desirable actions with respect to the human capital in the auditing profession and its future and sustainability.

Recommendation 5. Encourage the AICPA and the AAA jointly to form a commission to provide a timely study of the possible future structure of higher education for the accounting profession.

The Committee heard testimony regarding the feasibility of establishing a free-standing, post-graduate professional educational structure.⁹⁵ Currently, there is no post-graduate insti-

91 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Jan. 23, 2008), *available at* <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

92 DENNIS R. REIGLE, HEATHER L. BUNNING AND DANIELLE GRANT, 2008 TRENDS IN THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS (2008), *available at* http://ceae.aicpa.org/NR/ronlyres/C1E23302-17D3-4ED5-AE81-B274D9CD7812/0/AICPA_Trends_Reports_2008.pdf.

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

94 *See, e.g.*, Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft Report Addendum 2 (May 15, 2008), *available at* http://comments.treas.gov/_files/ACAPCommentLetter-May152008.pdf (supporting this Recommendation); Ernst & Young LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 23 (June 27, 2008), *available at* http://comments.treas.gov/_files/EYACAPCommentLetterFINAL2.pdf (supporting this Recommendation); Record of Proceedings (June 3, 2008) (Written Submission of Anne M. Lang, Chief Human Resources Officer, Grant Thornton LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Lang060308.pdf> (supporting this Recommendation).

95 Record of Proceedings (Dec. 3, 2007) (Oral Submission of Joseph V. Carcello, Director of Research, Corporate Governance Center, University of Tennessee, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/CarcelloOralStatement120307.pdf> (recommending that “the Advisory Committee consider a different model – an education model involving professional schools of auditing...”); Record of Proceedings (June 3, 2008) (Written Submission of Anne M. Lang, Chief Human Resources Officer, Grant Thornton LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Lang060308.pdf> (noting that the establishment of a commission to study a higher education structure for the accounting profession “is a very sound” recommendation). *But cf.* Record of Proceedings (Feb. 4, 2008) (Written Submission of Phillip M.J. Reckers, Professor of Accountancy, Arizona State University, 3), *available at*

tutional arrangement dedicated to accounting and auditing. Graduate programs in accounting are generally housed within business schools and linked with undergraduate accounting programs.

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

In a November 2006 Vision Statement, the chief executive officers of the principal international auditing networks noted the challenges in educating future auditing professionals, including the sheer quantity and complexity of accounting and auditing standards, rapid technological advancements, and the need for specialized industry knowledge.⁹⁶ This development in the market leads to a clear need to anticipate and enhance the human capital elements of the auditing profession. As such, this vision statement provides the impetus to commission a group to study and propose a long-term institutional arrangement for accounting and auditing education.

As in the past, in the face of challenges of the changing environment for the profession, the Committee believes that the educational system should thoughtfully consider the feasibility of a visionary educational model. Therefore, the Committee recommends that the AICPA and the AAA jointly form a body to provide a timely study of the possible future of the higher education structure for the accounting profession.⁹⁷ This commission may include representation from higher education, practitioners from the wide spectrum of the accounting and auditing profession, regulators, preparers, users of the profession's services, and others. The

<http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Reckers020408.pdf> (discounting the feasibility of free-standing professional schools).

96GLOBAL CAPITAL MARKETS AND THE GLOBAL ECONOMY: A VISION FROM THE CEOs OF THE INTERNATIONAL AUDIT NETWORKS 15 (Nov. 2006).

97See, e.g., Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft Report Addendum 5 (May 15, 2008), *available at* http://comments.treas.gov/_files/ACAPCommentLetter-May152008.pdf (supporting this Recommendation and noting the need for these schools to be well-funded and be independent from business schools with control over tenure and promotion); Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 23 (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf (supporting this Recommendation and noting the commission should consider other human capital issues including financial and time concerns as well as recruiting individuals from other disciplines); Record of Proceedings (June 3, 2008) (Written Submission of Anne M. Lang, Chief Human Resources Officer, Grant Thornton LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Lang060308.pdf> (agreeing with this Recommendation). *But cf.* Record of Proceedings (June 3, 2008) (Written Submission of Frank K. Ross, Director, Center for Accounting Education, Howard University School of Business, 11), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Ross060308.pdf> (noting the financial concerns that an extra year of schooling would have on the less affluent, which includes a "disproportionate number" of minorities).

commission would consider the potential role of a postgraduate professional school model to enhance the quality and sustainability of a vibrant accounting and auditing profession. The commission should consider developments in accounting standards and their application, auditing needs, regulatory framework, globalization, the international pool of candidates, and technology. Finally, a blueprint for this sort of enhanced professional educational structure would also require the consideration of long-term market circumstances, academic governance, operations, programs, funding and resources, the role of accreditation, and experiential learning processes.

VII. FIRM STRUCTURE AND FINANCES

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

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

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

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

Recommendation 1. Urge the Securities and Exchange Commission (SEC), and Congress as appropriate, to provide for the creation by the Public Company Accounting Oversight Board (PCAOB) of a national center to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies, and commission research and other fact-finding regarding fraud prevention and detection, and further, the development of best practices regarding fraud prevention and detection.

PCAOB standards currently require auditors to plan and perform audits to obtain reasonable assurance whether financial statements are free of material misstatement, including those caused by fraud.² The Committee considered testimony and commentary regarding auditing

1 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Jan. 23, 2008); CENTER FOR AUDIT QUALITY, SECOND SUPPLEMENT TO REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Apr. 16, 2008).

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

firms' responsibilities and practices relating to fraud prevention and detection.³ The auditing profession itself has recognized the significance of its duties with respect to fraud: "Perhaps no single issue is the subject of more confusion, yet is more important, than the nature of the obligation of auditors to detect fraud—or *intentional material misstatement* of financial information by public companies."⁴

No formal forum currently exists where auditors and other market participants regularly share their views and experiences relating to fraud prevention and detection in the context of fraudulent financial reporting. The Committee received testimony that it would improve audit quality and benefit the capital markets and investors and other financial statement users for auditing firms to share their fraud detection experiences⁵ and to develop best practices relating to fraud prevention and detection.⁶ The Committee received testimony and comment letters from entities volunteering to host such a forum.⁷

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

3 See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy-Emeritus, University of Illinois, Comment Letter Regarding Discussion Outline 4 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008.doc; Record of Proceedings (Feb. 4, 2008) (Written Submission of Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf>.

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

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

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

7 See, e.g., David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Comment Letter Regarding Second Draft Report 1 (Aug. 15, 2008), *available at* http://comments.treas.gov/_files/NASBA081508CommentLetter.doc (suggesting the the National Association of State Boards of Accountancy Center for the Public Trust as host of a national fraud center); Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Second Draft Report 4 (Aug. 29, 2008), *available at* http://comments.treas.gov/_files/82908ACAPcommentletterFINAL.pdf (suggesting the Center for Audit Quality as the host of a national fraud center); Larry E. Rittenberg, Chair, The Committee of Sponsoring Organizations of the Treadway Commission, Comment Letter Regarding the Second Draft Report 2 (Aug. 19, 2008), *available at* http://comments.treas.gov/_files/COSOLettertoACAP8_19_08.pdf (suggesting a willingness to consider hosting a national fraud center).

The Committee recommends that the SEC, and Congress as appropriate, provide for the creation by the PCAOB of a national center both to facilitate auditing firms' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies and to commission research and other fact-finding regarding fraud prevention and detection.⁸ The Committee also recommends that the auditing firms, forensic accounting firms, certified fraud examiners, investors, other financial statement users, public companies, and academics develop, in consultation with the PCAOB, the SEC, international regulators, and the National Association of State Boards of Accountancy (NASBA), best practices regarding fraud prevention and detection.⁹ The Committee also recognizes that a national center and best practices will have greater impact if these concepts are ultimately extended and embraced internationally.

Recommendation 2. Encourage greater regulatory cooperation and oversight of the public company auditing profession to improve the quality of the audit process and enhance confidence in the auditing profession and financial reporting.

The SEC, the PCAOB, and individual state boards of accountancy regulate the auditing profession. The SEC and the PCAOB enforce the securities laws and regulations addressing public company audits. Individual state accountancy laws in fifty-five jurisdictions in the United States govern the licensing and regulation of both individuals and firms who practice as certified public accountants.¹⁰ State boards of accountancy enforce these laws and also administer

8 See, e.g., Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft Report Addendum 6 (May 15, 2008), *available at* http://comments.treas.gov/_files/ACAPCommentLetter-May152008.pdf (supporting this Recommendation); Samuel K. Cotterell, Chair, National Association of State Boards of Accountancy, and David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Comment Letter Regarding Draft Report and Draft Report Addendum 2 (June 27, 2008), *available at* http://comments.treas.gov/_files/June2908LetterheadTreasuryAdvisoryCommitteeontheAuditingProfession.pdf ("Conclusions from, or approaches discussed during, Center deliberations could have an immediate effect on the way accounting practitioners approach the performance of audits and would likely form the basis for consideration of changes in auditing standards."); Record of Proceedings (June 3, 2008) (Written Submission of Kenneth Nielsen Goldmann, Capital Markets and SEC Practice Director, J.H. Cohn LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Goldmann060308.pdf> (noting how useful such a center would be to smaller firm auditors in detecting and preventing fraud.); Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 10-11 (June 26, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (agreeing with this Recommendation and volunteering the Center for Audit Quality to house this center). *But cf.* Jim Wanserski, Businessman, Comment Letter Regarding Draft Report and Draft Report Addendum (June 3, 2008), *available at* http://comments.treas.gov/_files/ACAPDraftReportcommentsJune22008.doc (stating that public company management is key in fraud prevention and detection efforts more so than the external auditor and notes the small percentage of frauds uncovered by public company auditors).

9 See also Dave Richards, Institute of Internal Auditors, Comment Letter Regarding Draft Report and Draft Report Addendum 3 (June 13, 2008), *available at* http://comments.treas.gov/_files/IIARESPONSETREASURYADVISORYCOMMITTEEONAUDITING061308.doc (suggesting the Institute of Internal Auditors be included in the listing of organizations providing best practices).

10 Record of Proceedings (Dec. 3, 2007) (Written Submission of David A. Costello, President and Chief Execu-

the Uniform CPA Examination. NASBA serves as a forum for these boards to enhance their regulatory effectiveness and communication.

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

(a) Institute the following mechanism to encourage the states to substantially adopt the mobility provisions of the Uniform Accountancy Act, Fifth Edition (UAA)¹¹: If states have failed to adopt the mobility provisions of the UAA by December 31, 2010, Congress should pass a federal provision requiring those states to adopt these provisions.

The American Institute of Certified Public Accountants (AICPA) and NASBA jointly author the UAA, a model bill which focuses on the education, examination, and experience requirements for certified public accountants. As the name of the bill suggests, the UAA advances the goal of uniformity, in addition to protecting the public interest and promoting high professional standards. In 2006 and 2007, recognizing the changing global economy and the impact of electronic commerce, the AICPA and NASBA proposed amendments to the UAA to allow for a streamlined framework for CPA “mobility” of practice among the states; that is, a CPA’s practice privileges would be valid and portable across all state jurisdictions beyond that of the CPA’s resident state.¹²

According to NASBA, to date thirty-one states have passed mobility legislation. Two other states currently have mobility legislation introduced and other bills are anticipated in the 2009 legislative session. Almost every state is now discussing or considering mobility, and a number of other state boards of accountancy have voted to support and move forward with mobility.

The Committee considered testimony and commentary on the importance to auditing firms’ multi-state practices of the adoption of the UAA’s mobility provisions.¹³ A NASBA repre-

presentative Officer, National Association of State Boards of Accountancy, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Costello120307.pdf>.

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

12 Record of Proceedings (Dec. 3, 2007) (Questions for the Record of David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, 1 (Feb. 6, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-2007.pdf> (“As the global business community continues to expand, CPAs will be required to practice beyond the state in which they reside. Inefficiencies are created when those individuals are required to complete paperwork and submit a fee for every state in which they perform professional services.”). Note that the UAA does require notification or “permitting” for out-of-state firms performing attest services for audit clients headquartered in another state, but not for individual CPAs. *See* UAA, §§ 7(a)(1), 7(c)(1), and 23(a)(4) (Fifth Ed. July 2007).

13 *See, e.g.*, Amper, Politziner and Mattia, P.C., Comment Letter Regarding Discussion Outline 2 (Nov. 14, 2007), *available at* http://comments.treas.gov/_files/AmperPolitzinerMattia.pdf (noting that “[t]he ease of performing audits in any state by a valid CPA ... without requiring to be licensed by each state would be beneficial.”); Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 5) (Dec. 3, 2008), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (noting that a number of states are cooperating and working

sentative testified, “In order for our capital market system to continue to prosper and grow, NASBA recognized the need to ensure that an efficient, effective mobility system is in place that will allow CPAs and their firms, as professional service providers, to serve the needs of American businesses, where ever they are located.”¹⁴

The Committee believes that, given the multi-state operations of many public companies and the multi-state practices of many auditing firms, practice mobility will foster a more efficient operation of the capital markets. The Committee recommends the following mechanism to encourage the states to adopt the UAA’s mobility provisions: If states have failed to adopt the mobility provisions of the UAA by December 31, 2010, Congress should pass a federal provision requiring those states to adopt these provisions.¹⁵ The Committee recognizes that some state legislatures meet biannually, and for such legislatures this deadline poses a challenge.¹⁶

towards adopting uniform mobility requirements); Record of Proceedings (Dec. 3, 2007) (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf> (“The Treasury Committee should suggest that the states eliminate barriers to interstate practice by universal adoption of the mobility provisions of the Uniform Accountancy Act.”).

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

15 *See, e.g.*, Ernst & Young LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 24-25 (June 27, 2008), *available at* http://comments.treas.gov/_files/EYACAPCommentLetterFINAL.pdf (agreeing with this Recommendation); Mayer Hoffman McCann P.C., Comment Letter Regarding Draft Report and Draft Report Addendum 2 (June 17, 2008), *available at* http://comments.treas.gov/_files/MayerHoffmanMcCannCommentLetter.pdf (noting that the lack of mobility impairs firms from assigning the best people to engagements and uses important resources to establish and comply with multiple state licensure); PricewaterhouseCoopers LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 9 (June 30, 2008), *available at* http://comments.treas.gov/_files/PwCCommentLtrTreasCmtDraftandAddendum63008.pdf; Bruce Rosen, Eisner LLP, Comment Letter Regarding Draft Report and Draft Report Addendum (May 23, 2008), *available at* http://comments.treas.gov/index.cfm?FuseAction=Home.View&Topic_id=9&FellowType_id=1&CurrentPage=1 (noting the importance of putting the right resources in the right place without the needless complexity of differing state requirements). *But cf.* Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft Report Addendum 6 (May 15, 2008), *available at* http://comments.treas.gov/_files/ACAPCommentLetterMay152008.pdf (recommending that while there does need to be increased mobility, it could be achieved by a national license for public company audits in addition to state licensing.); William Hermann, Managing Partner, and Gregory Coursen, Director of Professional Standards, Plante & Moran, PLLC Comment Letter Regarding Draft Report and Draft Report Addendum 2 (June 12, 2008), *available at* http://comments.treas.gov/_files/Commentletter61208.pdf (noting the AICPA’s success in driving the adoption of the UAA’s mobility provision).

16 *See, e.g.*, Samuel K. Cotterell, Chair, National Association of State Boards of Accountancy, and David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Comment Letter Regarding Draft Report and Draft Report Addendum 3 (June 27, 2008), *available at* http://comments.treas.gov/_files/June2908LetterheadTreasuryAdvisoryCommitteeontheAuditingProfession.pdf (recommending a later due date because some states may not be able to meet the 2010 deadline due to their legislative calendars); Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 14-15 (June 26, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (suggesting delaying federal action as states may adopt the provisions

However, such a deadline should be attainable and will encourage such legislatures to place this issue high on their agenda. The Committee also recommends that the states participate in NASBA's Accountancy Licensee Database (ALD) as a mechanism to assist in maintaining appropriate oversight of CPAs throughout the country regardless of where they practice and that appropriate authorities interpret federal and state privacy regulations to facilitate implementation of the ALD.

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

Under the federal securities laws, the SEC has enforcement authority over public company auditing firms and oversight authority over the PCAOB under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Sarbanes-Oxley provides the PCAOB with registration, reporting, inspection, standard-setting, and enforcement authority over public company auditing firms.¹⁷ In addition, the fifty-five boards of accountancy license, regulate, and enforce state accountancy laws pertaining to certified public accountants and their firms. In addition, the Department of Justice (DOJ) and state attorneys general can bring enforcement actions against auditing firms and their employees.

The Committee considered testimony from auditing firms on the duplicative and sometimes inconsistent federal and state oversight of the profession.¹⁸ The Committee does recognize that both federal and state regulators have made attempts to coordinate better their enforcement activities.¹⁹ One witness suggested the possible formation of a commission to help improve regulatory effectiveness.²⁰ Another witness urged state and federal regulatory coop-

on their own or, at the least, moving the deadline to December 31, 2011 to allow states adequate time to adopt the provisions).

¹⁷ Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7211-7219.

¹⁸ See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf>; Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf>; Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Barry Salzberg, Chief Executive Officer, Deloitte LLP, App. A 4 (Mar. 31, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> (criticizing duplicative auditing firm investigations by states with no nexus to alleged conduct).

¹⁹ See, e.g., Record of Proceedings (Dec. 3, 2007) (Oral Remarks of David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, 98), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-12-3-07.pdf> (noting that “[the National Association of State Boards of Accountancy] has been working with the PCAOB very closely coordinating efforts, trying to diminish as much as possible the redundancy in enforcement”); Record of Proceedings (Dec. 3, 2007) (Written Submission of David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Costello120307.pdf> (stating that the National Association of State Boards of Accountancy is assisting state boards in enforcement cases involving multi-state activities).

²⁰ Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (noting

eration to ensure harmonized regulation and licensure.²¹

The Committee recommends mandating regular and formal roundtables of the PCAOB, the SEC, the DOJ, the state boards of accountancy, and the state attorneys general, to periodically review the overall enforcement regimes applicable to the public company auditing profession.²² These roundtables also should focus on regulatory coordination, improvement, and consistent approaches to enforcement to minimize duplicative efforts. Because of the difficulty and cost of bringing together many different state agencies on a regular basis, the Committee recommends that NASBA assist states by taking a leadership role in coordinating their responsibilities and interests.²³

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

The Committee is concerned about the financial and operational independence of state boards of accountancy from outside influences, such as other state agencies, and the possible effect on the regulation and oversight of the accounting profession. A number of state boards are under-funded²⁴ and lack the wherewithal to incur the cost of investigations lead-

that, “it would be useful to evaluate the possibility of an interstate commission for the whole of the audit profession. Such a commission would bring together state licensing authorities, the PCAOB, and appropriate professional organizations. It would be the means to rationalize existing disparities in licensing qualifications, continuing education requirements and peer review for non-public company audit practices. It would also enable enforcement of common regulations and license discipline across state and federal jurisdictions.”)

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

22 *See e.g.*, Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft Report Addendum 6 (May 15, 2008), *available at* http://comments.treas.gov/_files/ACAPCommentLetter-May152008.pdf (supporting this Recommendation); Samuel K. Cotterell, Chair, National Association of State Boards of Accountancy, and David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Comment Letter Regarding Draft Report and Draft Report Addendum 3 (June 27, 2008), *available at* http://comments.treas.gov/_files/June2908LetterheadTreasuryAdvisoryCommitteetheAuditingProfession.pdf (supporting this Recommendation); Mayer Hoffman McCann P.C., Comment Letter Regarding Draft Report and Draft Report Addendum 2 (June 13, 2008), *available at* http://comments.treas.gov/_files/MayerHoffmanMcCannCommentLetter.pdf (suggesting that all meetings be made public); *but cf.* Frank Frankowski, Chief Financial Officer, Airborne Systems, Comment Letter Regarding Draft Report and Draft Report Addendum 1 (June 2, 2008), *available at* http://comments.treas.gov/_files/FrankowskiLetter.pdf (stating that the Recommendation “will only add to the confusion and lack of focus on the underlying issues”).

23 Samuel K. Cotterell, Chair, National Association of State Boards of Accountancy, and David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Comment Letter Regarding Draft Report and Draft Report Addendum 3 (June 27, 2008), *available at* http://comments.treas.gov/_files/June2908LetterheadTreasuryAdvisoryCommitteetheAuditingProfession.pdf (supporting this Recommendation).

24 NATIONAL ASSOCIATION OF STATE BOARDS OF ACCOUNTANCY, SUBMISSION IN CONNECTION WITH THE DECEMBER 3, 2007 MEETING OF THE ADVISORY COMMITTEE ON THE AUDITING PROFESSION (Jan. 2008)

ing to enforcement. In addition, some state boards fall under the centralized administrative “umbrella” of other state agencies and lack control of financial resources and/or operational independence necessary to carry out their mandate of public protection.²⁵ In some cases, board members are nominated by private associations whose constituencies are not necessarily focused on the protection of the public.

The Committee believes that greater independence of state boards of accountancy would enhance their regulatory effectiveness. The Committee recommends that, working with NASBA, states evaluate and develop means to make their respective state boards of accountancy more operationally and financially independent of outside influences.²⁶ The Committee notes that this Recommendation to ensure the independence of state boards of accountancy is not meant to limit in any way the efforts of regulators and other governmental enforcement bodies to coordinate their regulatory and enforcement activities as recommended in Recommendation 2(b).

Recommendation 3. Urge the PCAOB and the SEC, in consultation with other federal and state regulators, auditing firms, investors, other financial statement users, and public companies, to analyze, explore, and enable, as appropriate, the possibility and feasibility of firms appointing independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency of auditing firms.

In response to the recent corporate accounting scandals, related legislative and regulatory requirements and best practices, public companies enhanced their corporate governance. One of the most prominent alterations to the corporate governance scheme was the increased representation and strengthening of independent members of boards of directors. The New York Stock Exchange and the Nasdaq enhanced their public company listing standards to call for a majority of independent board members.²⁷ Best practices have gone even further, calling for a “substantial majority” of independent directors.²⁸

(documenting the wide spectrum of funding for individual state boards of accountancy and noting the number of full-time staff per state boards of accountancy office).

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

26 See Samuel K. Cotterell, Chair, National Association of State Boards of Accountancy, and David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Comment Letter Regarding Draft Report and Draft Report Addendum 3 (June 27, 2008), available at http://comments.treas.gov/_files/June2908LetterheadTreasuryAdvisoryCommitteeontheAuditingProfession.pdf (“There is a need to ensure all State Boards of Accountancy have adequate funding to maintain a healthy regulatory environment, which includes the ability to fund the costs of investigations and disciplinary enforcement.”); Ernst & Young LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 25 (June 27, 2008), available at http://comments.treas.gov/_files/EYACAPCommentLetterFINAL.pdf (agreeing that appropriate operational support is needed to allow regulators the resources to monitor the profession).

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

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

A combination of Sarbanes-Oxley provisions and exchange listing standards mandate fully independent audit committees, nominating/corporate governance, and compensation committees.²⁹ In addition, independent directors' responsibilities have increased. For example, the independent audit committee now appoints, oversees, and compensates the auditor.³⁰ Although difficult to quantify the benefits of these enhancements, many have extolled these reforms as improving the quality of board oversight, reducing conflicts of interest, and enhancing investor confidence in public company operations and financial reporting.³¹

Public company auditing firms as private partnerships are not subject to these requirements. Instead, state laws and partnership agreements determine the governance of auditing firms.³² Often a firm's governing body is comprised of elected firm partners.³³ Some firms are currently using advisory boards, although these may not be well-publicized or transparent.

Several witnesses testified to the benefits of improving auditing firm governance and suggested the addition of independent members to the boards of directors.³⁴ One witness called

majority of independent directors and regular executive sessions of the independent directors).

29 Sarbanes-Oxley Act, 15 U.S.C. § 78-j (2002) (mandating audit committees comprised solely of independent directors); New York Stock Exchange, Listed Company Manual § 303A.04 (2004) (requiring nominating/corporate governance committees comprised solely of independent directors); New York Stock Exchange, Listed Company Manual § 303A.05 (2004) (requiring compensation committees comprised solely of independent directors); New York Stock Exchange, Listed Company Manual § 303A.06 (2003) (mandating compliance with SEC rules requiring audit committees comprised solely of independent directors); Nasdaq, Manual, Rule 4350(d) (mandating compliance with SEC rules requiring audit committees comprised solely of independent directors). Nasdaq, Manual, Rule 4350(c)(3) (requiring independent directors to determine, or recommend to the full Board for determination, the compensation of all executive officers). Nasdaq, Manual, Rule 4350(c)(4) (requiring independent directors to determine, or recommend to the full Board for determination, director nominees.).

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

31 For example, see the commentary accompanying New York Stock Exchange, Listed Company Manual § 303A.01 ("Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.") and the interpretive material accompanying Nasdaq Rule 4350, IM-4350-4 ("Independent directors ... play an important role in assuring investor confidence. Through the exercise of independent judgment, they act on behalf of investors to maximize shareholder value in the companies they oversee and guard against conflicts of interest. Requiring that the board be comprised of a majority of independent directors empowers such directors to carry out more effectively these responsibilities.").

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

33 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 2-22 (Jan. 23, 2008) (detailing the various governance structures of the largest six auditing firms); Cynthia M. Fornelli, Executive Director, Center for Audit Quality, and James S. Turley, Chair, Governing Board, Center for Audit Quality, and Chairman and Chief Executive Officer, Ernst & Young LLP, Comment Letter Regarding Discussion Outline 13 (Nov. 30, 2007), *available at* http://comments.treas.gov/_files/Treasurycommentletterfinal11302007.pdf (noting the largest auditing firms have supervisory boards overseeing management).

34 See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy-Emeritus, University of Illinois, Comment Letter Regarding Discussion Outline 12 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008 ("[I]ndependent board members similar to those found on public company boards would be a good governance practice and would signal the markets about the firms' positive commitment to the public good."); Record of Proceedings

for an entirely independent board with enhanced responsibilities, including chief executive officer selection, determining partner compensation, and monitoring potential conflicts of interest and audit quality.³⁵ An auditing firm representative noted that his firm was considering adding independent members on its international governing board.³⁶

The Committee believes that enhancing corporate governance of auditing firms through the appointment of independent board members, whose duties run to the auditing firm and its partners/owners, to advisory boards with meaningful governance responsibilities (possible under the current business model), and/or to firm boards could be particularly beneficial to auditing firm management and governance.³⁷ The Committee also believes that such advisory boards and independent board members could improve investor protection through enhanced audit quality and firm transparency. The Committee is particularly intrigued by the idea of independent board members with duties and responsibilities similar to those of public company non-executive board members.

The Committee recognizes the multiple challenges that instituting a governance structure with independent board members might entail, including compliance with state partnership laws and independence requirements, insurance availability for such directors, and liability concerns.³⁸ Accordingly, the Committee recommends that the PCAOB and the SEC, in consultation with federal and state regulators, auditing firms, investors, other financial statement users, and public companies, analyze, explore, and enable, as appropriate, the possibility

(Feb. 4, 2008) (Written Submission of Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf> (stating that independent board of directors could possibly decrease potential conflicts of interest).

35 Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga Jr., Vice Chairman, Capital Research and Management Company, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf>.

36 Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf>.

37 Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> ("Such a change in the governance model may be one way to strengthen our ability to serve market participants and reinforce independence.").

38 Several witnesses commented on these difficulties. *See, e.g.*, Ernst & Young LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 25-26 (June 27, 2008), *available at* http://comments.treas.gov/_files/EYACAPCommentLetterFINAL.pdf; Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 17-19 (June 26, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf; William Hermann, Managing Partner, and Gregory Coursen, Director of Professional Standards, Plante & Moran, PLLC, Comment Letter Regarding Draft Report and Draft Report Addendum 1-2 (June 13, 2008), *available at* http://comments.treas.gov/_files/Commentletter61208.pdf; Record of Proceedings (June 3, 2008) (Written Submission of Barry Mathews, Deputy Chairman, Aon Corporation, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Mathews060308.pdf>; David McDonnell, Chief Executive Officer, Grant Thornton International Ltd, and Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Ltd Board of Governors, Comment Letter Regarding Draft Report and Draft Report Addendum 4 (June 27, 2008), *available at* http://comments.treas.gov/_files/GTCommentlettertoACAPJune2008_FINAL.pdf.

and feasibility of firms' appointing independent board members and advisory boards.³⁹ The Committee notes that the PCAOB and the SEC should consider the size of auditing firms in analyzing and developing any governance proposals.⁴⁰

Recommendation 4. Urge the SEC to amend Form 8-K disclosure requirements to characterize appropriately and report every public company auditor change and to require auditing firms to notify the PCAOB of any premature engagement partner changes on public company audit clients.

In 2006, over 1,300 public companies changed their auditor and from 2002 to 2006 over 6,500 public companies changed their auditor.⁴¹ Under current SEC regulations, a public company must disclose any auditor change on Form 8-K.⁴² SEC regulations require disclosure of any disagreements on financial disclosures during the preceding two years prior to a resignation or termination and whether some issue, such as the auditor's inability to rely on management's representations, may put into question financial disclosure reliability. SEC regulations also allow a public company to request that the auditor respond with a letter addressed to the SEC stating whether it agrees with the company's disclosure and, if it does not agree, stating why.

While the SEC does attempt to uncover through its rules whether the auditor change relates to disagreements over accounting and reporting matters, the SEC rules do not require a public company to provide a reason for the auditor's departure in the vast majority of cases. The limitations of the existing disclosure requirements have resulted in companies failing to disclose any reason for their auditor changes in approximately 70% of the more than 1,300 auditor changes occurring in 2006.⁴³

The Committee considered testimony and commentary regarding the lack of clear disclosure surrounding auditor changes. Testimony and commentary viewed the lack of transparency surrounding auditor changes as detrimental to investor confidence in financial reporting.⁴⁴

39 See Record of Proceedings (June 3, 2008) (Written Submission of Nell Minow, Editor and Co-Founder, The Corporate Library, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Minow060308.pdf>. *But cf.* Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 3-4 (June 27, 2008), *available at* http://comments.treas.gov/_files/ResponsetoAdvisoryCommittee0627final.PDF (advising the Committee to keep in mind the fact that accounting firms operate differently than public companies and that the PCAOB currently reviews information that would concern independent board members); Paul Lee, Director, Hermes Equity Ownership Services Limited, Comment Letter Regarding Draft Report and Draft Report Addendum 3 (June 13, 2008), *available at* http://comments.treas.gov/_files/ACAPresponse13Jun08.pdf.

40 See Record of Proceedings (June 3, 2008) (Written Submission of Kenneth Nielsen Goldmann, Capital Markets and SEC Practice Director, J.H. Cohn LLP, 4-5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Goldmann060308.pdf> (noting that smaller firms do not have large public company audit practices so the concept of public board members may be difficult).

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

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

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

44 See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy-Emeritus, University of Illinois, Comment Letter Regarding Discussion Outline 4 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008.doc (recommend-

Testimony and commentary suggested greater transparency regarding auditor changes would compel audit committees to more closely evaluate auditor selection decisions and lead to greater competition in the audit market.⁴⁵

The Committee believes that explicitly stating the reason for an auditor change will assist investors in determining the quality of financial reporting and subsequent investment decisions. The Committee recommends that the SEC amend its Form 8-K disclosure on auditor changes by providing for the following mechanism:⁴⁶ The public company would file within four days of an auditor change a Form 8-K disclosing that an auditor had resigned, was terminated, or did not seek reappointment; the company would appropriately characterize and state in all cases in plain English the reason or reasons for the change. The company would also disclose whether its audit committee agreed with the disclosure it has provided. The company would also provide the auditor with a copy of the disclosure and request a response as to the accuracy of the disclosure. The company would include any response as an exhibit to the company's Form 8-K filing, or if received following the due date for the Form 8-K, in a subsequent Form 8-K. As discussed above under current SEC regulations, the public company can request that the auditor respond to the company's statements in the Form 8-K regarding disagreements over accounting and financial matters.

In addition, the Committee recommends that auditing firms notify the PCAOB of any engagement partner changes on public company audits if made before the normal rotation period

ing SEC and PCAOB disclosures of auditor changes to enhance the growth of smaller auditing firms); Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 193-94), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-2-4-08.pdf> (calling for expanded Form 8-K disclosure requirements as "in the best interest of investors").

⁴⁵ See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (noting that the Committee should examine "[c]omprehensive disclosures about reasons for auditor switches").

⁴⁶ See Record of Proceedings (June 3, 2008) (Written Submission of Kenneth Nielsen Goldmann, Capital Markets and SEC Practice Director, J.H. Cohn LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Goldmann060308.pdf> (recommending additional disclosure regarding the relationship between the successor auditor and the company); Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, Comment Letter Regarding Draft Report and Draft Report Addendum 3 (June 13, 2008), *available at* http://comments.treas.gov/_files/200806_13ACAP_addendum_commentltr.pdf (supporting the Recommendation); Record of Proceedings (June 3, 2008) (Written Submission of Nell Minow, Editor and Co-Founder, The Corporate Library, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Minow060308.pdf> (stating that the Recommendation seems consistent with Sarbanes-Oxley). *But cf.* Ernst & Young LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 27 (June 27, 2008), *available at* http://comments.treas.gov/_files/EYACAPCommentLetterFINAL.pdf (worrying that the results will be "boilerplate disclosure that is of little benefit to investors while an expansion of the list of objective criteria could be more useful"); Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 4 (June 27, 2008), *available at* http://comments.treas.gov/_files/ResponsetoAdvisoryCommittee0627final.PDF (stating "a requirement for auditors to respond as to the accuracy of disclosures relating to subjective reasons is not feasible, since auditors have no basis for agreeing or disagreeing with management regarding why they dismissed the auditors").

and, other than for retirement, the reasons for those changes.⁴⁷

Recommendation 5: Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor’s standard reporting model. Further, urge that the PCAOB and the SEC clarify in the auditor’s report the auditor’s role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards.

The auditor’s report is the primary means by which the auditor communicates to the users of financial statements regarding its audit of financial statements. The standard auditor’s report, not much altered since the 1930s,⁴⁸ identifies the financial statements audited, the scope and nature of the audit, the general responsibilities of the auditor and management, and the auditor’s opinion.⁴⁹ In addition, for companies subject to Sarbanes-Oxley’s internal control requirements, the auditor’s report includes an attestation as to internal control over financial reporting.⁵⁰ The auditor’s opinion on the financial statements states whether these statements present fairly, in all material respects, a company’s financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.⁵¹

Many consider the auditor’s reporting model a pass/fail model because the auditor opines whether the statements are fairly presented (pass) or not (fail).⁵² Since the SEC does not

⁴⁷ See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga Jr., Vice Chairman, Capital Research and Management Company, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf> (calling for public disclosure on audit partner changes other than for rotation requirements); Record of Proceedings (Feb. 4, 2008) (Oral Remarks of D. Paul Regan, President and Chairman, Hemming Morse Inc., 194-195 (Feb. 4, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-2-4-08.pdf> (commenting that “if an audit partner is ... rotated [early] off of an issuer, there ought to be a disclosure, and there ought to be communication from the partner who was rotated off early as to [the reason for the early rotation] ... because in many instances ... there [i]s controversy...”). But cf. Ernst & Young LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 27 (June 27, 2008), available at http://comments.treas.gov/_files/EYACAPCommentLetterFINAL.pdf (“Unscheduled changes in an engagement partner are often due to circumstances that have no impact on the relationship between the client and the auditor”); Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 12 (June 27, 2008), available at http://comments.treas.gov/_files/ResponsetoAdvisoryCommittee0627final.PDF (stating that no benefit is gained in requiring notification to the PCAOB when there is premature changes in the engagement partner); PricewaterhouseCoopers LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 20 (June 30, 2008), available at http://comments.treas.gov/_files/PwCCommentLtrTreasCmtDraftAddendum63008.pdf (noting that there are many reasons for the engagement partner to change including personal as well as professional reasons and that the real issue is “whether the firm has the appropriate quality control processes in place”).

⁴⁸ For a historical analysis of the evolution of the auditor’s report, see George Cochrane, *The Auditor’s Report: Its Evolution in the U.S.A.*, in PERSPECTIVES IN AUDITING 16 (D.R. Carmichael and John J. Willingham 2d. ed. 1975).

⁴⁹ REPORTS ON AUDITED FINANCIAL STATEMENTS, Interim Auditing Standard AU Section 508.08 (Pub. Company Accounting Oversight Bd. 2002).

⁵⁰ AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS, Auditing Standard No. 5, para. 85 (Pub. Company Accounting Oversight Bd. 2007).

⁵¹ REPORTS ON AUDITED FINANCIAL STATEMENTS, Interim Auditing Standard AU Section 508.07-.08 (Pub. Company Accounting Oversight Bd. 2002).

⁵² Public Company Accounting Oversight Board, Standing Advisory Group Meeting Briefing Paper: Auditor’s Reporting Model 3 (Feb. 16, 2005).

accept filings with financial statements that “fail,”⁵³ the vast number of audit reports issued rarely departs from the exact standardized wording. Some believe this pass/fail model with its standardized wording does not adequately reflect the amount of auditor work and judgment.

Over thirty years ago, the audit “expectations gap” was coined⁵⁴ and has been a topic of controversy ever since. The expectations gap has been defined as “the difference between what the public and users of financial statements perceive the role of an audit to be and what the audit profession claim is expected of them during the conduct of an audit.”⁵⁵ The Committee considered testimony and commentary regarding this “expectations gap” between the public’s expectations regarding auditor responsibility for fraud detection and the auditor’s required and capable performance of fraud detection.⁵⁶

Public investors have appropriately raised questions when large frauds have gone undetected. Among the attributes that the public expects of auditors is a clear acknowledgment of their responsibility for the reliability of financial statements, particularly with respect to the detection of fraud, notwithstanding the recognition that a company’s management and board have the primary role in preventing fraud.⁵⁷ Some say the public may believe that auditors will detect more fraud than those in the profession believe can be reasonably expected. Both beliefs

53SEC Staff Accounting Bulletin, Topic 1E – Requirements for Audited or Certified Financial Statements [Interpretive response to question 2], (stating, in part, “[a]ccordingly, auditor reports filed with the SEC must include unqualified opinions”).

54C.D. Liggio, *The Expectation Gap: The Accountant’s Waterloo* Vol. 3 No. 3 JOURNAL OF CONTEMPORARY BUSINESS 27 (1974).

55Marianne Ojo, *Eliminating the Audit Expectations Gap: Myth or Reality?*, (Feb. 2006), available at http://mpr.aub.uni-muenchen.de/232/1/MPRA_paper_232.pdf.

56See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, Comment Letter Regarding Discussion Outline 4 (Jan. 30, 2008), available at http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008.doc (stating that “[i]f the discovery of material errors and fraud is not a major part of what the audit is about, it is not clear what value-added service the auditor offers the investor and capital markets”); Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 5 (Mar. 31, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> (“While auditors provide reasonable assurance that fraud material to the financial statements will be detected, they cannot be expected to provide absolute assurance that all material fraud will be found. Cost-benefit constraints and the lack of governmental subpoena and investigative powers, among other factors, make absolute assurance impossible.”); Record of Proceedings (Feb. 4, 2008) (Written Submission of Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees’ Retirement System, 5), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf> (stating that “[o]f critical importance to investors is the responsibility of auditors to detect fraud and improve the timely communication of these frauds to investors and shareowners.”); SERVING GLOBAL CAPITAL MARKETS AND THE GLOBAL ECONOMY: A VIEW FROM THE CEOs OF THE INTERNATIONAL AUDIT NETWORKS 12 (Nov. 2006) (“Nonetheless, there is a significant ‘expectations gap’ between what various stakeholders believe auditors should do in detecting fraud, and what audit networks are actually *capable* of doing, at the prices that companies or investors are willing to pay for audits.”).

57See, e.g., Sir David Tweedie, *Challenges Facing the Auditor: Professional Fouls and the Expectation Gap*, DELOITTE, HASKINS AND SELLS LECTURE, UNIVERSITY COLLEGE, CARDIFF 20 (“The public appears to require (1) a burglar alarm system (*protection against fraud*).....(2) a radar station (*early warning of future insolvency*)..... (3) a safety net (*general re-assurance of financial well-being*).....(4) an independent auditor (*safeguards for auditor independence*).....and (5) coherent communications (*understanding of audit reports*)”).

may be unreasonable in some circumstances. And, there are difficulties of detecting fraud, especially before it has resulted in a material misstatement. However, even those involved directly in the audit process on a daily basis from time to time have differing views as to what the auditor should and should not have been expected to discover.

According to existing auditing standards and SEC rules, management prepares and has the primary responsibility for the accuracy of financial statements and for prevention and identification of fraud and the auditor's role is to provide *reasonable assurance* that the financial statements are free of material misstatement.⁵⁸ These concepts are embedded in the current auditing and audit reporting standards that require that the auditor "plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud."⁵⁹ It is noteworthy that the current standard auditor's report does not actually mention "fraud" and is silent about the auditor's responsibility to *find* fraud.

Clarification of the expectations gap and confusion about auditor responsibility to detect fraud are not the only criticisms of the standard auditor's report. Over the years there have been numerous recommendations that the standard report be improved. In 1978, the Commission on Auditors' Responsibilities (Cohen Commission) made a simple observation: "For the largest corporations in the country, an audit may involve scores of auditors and tens of thousands of hours of work for which the client may pay millions of dollars. Nevertheless, the auditor's standard report compresses that considerable expenditure of skilled effort into a relatively few words and paragraphs."⁶⁰ The Cohen Commission then called for an expansion of the auditor's report to include a report not merely on the financial statements, but covering the entire audit function.⁶¹ The Cohen Commission reasoned that this new more comprehensive information would benefit users, but also clarify the role and, consequently, the legal standing of the auditor in relation to the audit.⁶²

In 1987, the National Commission on Fraudulent Financial Reporting (Treadway Commission) recommended that the standard auditor's report more clearly identify the auditor's responsibilities, the degree to which users can rely on the audit, and the limitations on the audit process.⁶³ The Treadway Commission aimed to reaffirm that management has "primary responsibility for financial statements" and to caution users of financial statements from placing more than "reasonable" assurance on the audit process.

⁵⁸ See, e.g., COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS xii (1978) (concluding that, after having been established to investigate the existence of such a gap, "[a]fter considerable study of available evidence and its own research.....such a gap does exist"). For a more recent article, see Dan L. Goldwasser, *The Past and Future of Reasonable Assurance*, The CPA Journal (Nov. 2005), available at http://www.nysscpa.org/cpajournal/2005/1105/special_issue/essentials/p28.htm.

⁵⁹ CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT, Interim Auditing Standard AU 316 (Pub. Company Accounting Oversight Bd. 2002).

⁶⁰ COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS 71 (1978).

⁶¹ COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS 75 (1978).

⁶² COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS 75-76 (1978).

⁶³ NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORT, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (Oct. 1987).

More recently, the American Assembly called for differing attestation standards for different parts of the financial statements, depending on the amount of uncertainty and judgment required in making certain determinations.⁶⁴ In addition, a February 2008 CFA Institute survey indicated that 80% of its member respondents believe that the auditor's report should provide specific information about how the auditor reached its opinion.⁶⁵ A majority of survey respondents thought it was very important to have the auditors identify key risk areas, significant changes in risk exposures, and amounts either involving a high degree of uncertainty in measurement and significant assumptions or requiring a higher level of professional judgment.⁶⁶

In 2005, the PCAOB's Standing Advisory Group (SAG), which advises the PCAOB on the establishment of auditing and related professional practice standards, considered whether the auditor's report should include more information relating to the auditor's judgments regarding financial reporting quality.⁶⁷ The SAG also considered whether required auditor communications to audit committees, such as the auditor's judgments about accounting principles⁶⁸ and critical accounting policies and practices,⁶⁹ should be incorporated into the auditor's report.⁷⁰ The PCAOB has not yet taken up a standard-setting initiative regarding the auditor's report.

Foreign jurisdictions are also currently considering changes to their auditor's reports. For instance, the European Commission under the Eighth Directive is authorized to develop its own "European Audit Report" or adopt the International Federation of Accountants' International Auditing and Assurance Standards Board's recently revised auditor's report standard.⁷¹ In December 2007, the Audit Practices Board, a part of the United Kingdom's Financial Reporting Council, issued a Discussion Paper seeking comment on potentially altering the auditor's report.⁷² Currently in Germany, public companies are generally required to issue a long-form auditor's report, discussing matters such as the company's economic position and trend of business operations and the nature and scope of the auditor's procedures. The Committee is cognizant that this debate over such disclosures is unfolding in a litigation environment different from that in the United States.

64 AMERICAN ASSEMBLY, THE FUTURE OF THE ACCOUNTING PROFESSION 12-13 (Nov. 13-15, 2003); AMERICAN ASSEMBLY, THE FUTURE OF THE ACCOUNTING PROFESSION: AUDITOR CONCENTRATION 21 (May 23, 2005).

65 CFA INSTITUTE, FEBRUARY 2008 MONTHLY QUESTION RESULTS (Feb. 2008), available at <http://www.cfainstitute.org/memresources/monthlyquestion/2008/february.html>.

66 CFA INSTITUTE, FEBRUARY 2008 MONTHLY QUESTION RESULTS (Feb. 2008), available at <http://www.cfainstitute.org/memresources/monthlyquestion/2008/february.html>.

67 Public Company Accounting Oversight Board, Standing Advisory Group Meeting: Auditor's Reporting Model (Feb. 16, 2005).

68 For this requirement, see COMMUNICATIONS WITH AUDIT COMMITTEES, Interim Auditing Standard AU Section 380.11 (Public Company Accounting Oversight Bd. 2002).

69 For this requirement, see Sarbanes-Oxley Act, 15 U.S.C. § 78j-1 (2002).

70 Public Company Accounting Oversight Board, Standing Advisory Group Meeting: Auditor's Reporting Model 4-5 (Feb. 16, 2005).

71 Directive 2006/43/EC of the European Parliament and of the Council Art. 28 (May 17, 2006); AUDITING PRACTICES BOARD, DISCUSSION PAPER—THE AUDITOR'S REPORT: A TIME FOR CHANGE? 6 (Dec. 2007).

72 AUDITING PRACTICES BOARD, DISCUSSION PAPER—THE AUDITOR'S REPORT: A TIME FOR CHANGE? (Dec. 2007).

This Committee has also heard testimony regarding expanding the auditor’s report.⁷³ One witness noted that some institutional investors believe an expanded auditor’s report would enhance investor confidence in financial reporting and recommended exploring a more “narrative” report in areas, such as “estimates, judgments, sufficiency of evidence and uncertainties.”⁷⁴

The Committee notes that the increasing complexity of global business operations are compelling a growing use of judgments and estimates, including those related to fair value measurements, and also contributing to greater complexity in financial reporting. The Committee believes this complexity supports improving the content of the auditor’s report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements. While there is not yet agreement as to precisely what additional information is sought by and would be useful to investors and other users of financial statements, the Committee concludes that an improved auditor’s report would likely lead to more relevant information for users of financial statements and would clarify the role of the auditor in the financial statement audit.

The Committee therefore recommends that the PCAOB address these issues, both long-debated and increasingly important given the use of judgments and estimates, by undertaking a standard-setting initiative to consider improvements to the auditor’s reporting model.⁷⁵ With

⁷³ See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (supporting the Committee’s considering whether to change the auditor’s report’s content given single financial reporting standards, more cohesive global auditing standards, and trends, like fair value measurement); Record of Proceedings (Dec. 3, 2007) (Oral Remarks of Ashwinpaul C. Sondhi, President, A. C. Sondhi & Associates, LLC, 255-57), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-12-3-07.pdf>; Record of Proceedings (Dec. 3, 2007) (Oral Remarks of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 253-54), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-12-3-07.pdf>.

⁷⁴ Record of Proceedings (Feb. 4, 2008) (Written Submission of Richard Fleck, Global Relationship Partner, Herbert Smith LLP, 17, 21), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fleck02042008.pdf>.

⁷⁵ See, e.g., Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 20 (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf (recommending that the Committee suggest to the PCAOB to include the International Auditing and Assurance Standards Board (IAASB) and the Auditing Standards Board (ASB), who are evaluating the auditor’s report, in undertaking this initiative); Roderick Hills, Chairman, Center for Strategic and International Studies, Hills Program on Governance, Comment Letter Regarding Discussion Outline 3 (June 5, 2008), *available at* http://comments.treas.gov/_files/commentsregardingdraftreportofadvisorycomm.pdf (agreeing that a new auditor’s reporting standard is needed to allow auditors to offer a range of attestations to reflect the range of values possible); Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees’ Retirement System, Comment Letter Regarding Draft Report and Draft Report Addendum 1-2 (June 13, 2008), *available at* http://comments.treas.gov/_files/200806_13ACAP_addendum_commentltr.pdf (supporting the Recommendation). *But cf.* Arnold Hanish, Financial Executives International, Chair, Committee on Corporate Reporting, Comment Letter Regarding Draft Report and Draft Report Addendum 4-5 (July 3, 2008), *available at* http://comments.treas.gov/_files/FEICCRTreasuryACAPCommentLetterFiled73080.pdf (suggesting that the Recommendation “can add even more stress to an already stressed system” and that changes can cause confusion); Lee Seidler, CPA, Comment Letter Regarding Draft Report and Draft Report Addendum (June 27, 2008), *available at* http://comments.treas.gov/index.cfm?FuseAction=Home.View&Topic_id=9&FellowType_id=1&CurrentPage=1 (stating that expansion always includes exculpatory language that is not useful).

regards to this initiative, the PCAOB should consult with investors, other financial statement users, auditing firms, public companies, academics, other market participants, and other state, federal, and foreign regulators. In view of the desirability of improving the quality of financial reporting and auditing on a global basis, the PCAOB should also consider the developments in foreign jurisdictions that improve the quality and content of the auditor's report and should consult with international regulatory bodies as appropriate. The PCAOB should also take cognizance of the proposal's potential legal ramifications, if any, to auditors.⁷⁶

Commentary has also suggested that auditors must more effectively communicate their responsibility regarding fraud detection with investors and the capital markets. The Committee agrees with this suggestion. Accordingly, the Committee believes that the auditor's report should articulate clearly to investors the auditor's role and limitations in detecting fraud.⁷⁷ The Committee believes that expressly communicating to investors, other financial statement users, and the public the role of auditors in finding and reporting fraud would help narrow the "expectations gap."

In addition, the Committee recommends that the PCAOB and the SEC clarify in the auditor's report the auditor's role and limitations in detecting fraud under current auditing standards. In addition, the Committee recommends, in light of this continuing "expectations gap," that the PCAOB review the auditing standards governing fraud detection and fraud reporting. Specifically, the Committee recommends that the PCAOB periodically review and update these standards.⁷⁸

⁷⁶See, e.g., Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 20 (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf ("[T]he different liability systems where these reports exist must be taken into account when assessing the standard language included in the auditor's report in the U.S. and the U.S. litigation system"); Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 22 (June 27, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (suggesting the Committee "acknowledge that the risk of catastrophic liability must inform any potential changes to the auditor's report"); PricewaterhouseCoopers LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 11, (June 30, 2008), *available at* http://comments.treas.gov/_files/PwCCommentLtrTreasCmt-DraftandAddendum63008.pdf (acknowledging that litigation issues must be taken into account).

⁷⁷See, e.g., Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft Report Addendum 6 (May 15, 2008), *available at* http://comments.treas.gov/_files/ACAPCommentLetter-May152008.pdf (urging the PCAOB to evaluate the efficacy of SAS No. 99); Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 26 (June 27, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (supporting the Recommendation); Frank Frankowski, Chief Financial Officer, Airborne Systems, Comment Letter Regarding Draft Report and Draft Report Addendum 2 (June 2, 2008), *available at* http://comments.treas.gov/_files/FrankowskiLetter.pdf; Record of Proceedings (June 3, 2008) (Written Submission of Dan Guy, Former Vice President, Professional Standards and Services, American Institute of Certified Public Accountants, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Guy060308.pdf> (recommending the addition of illegal acts to the Recommendation).

⁷⁸Donald Chapin, Comment Letter Regarding Draft Report and Draft Report Addendum 1 (June 9, 2008), *available at* http://comments.treas.gov/_files/TreasuryAdvisoryCommittee.doc (supporting the Recommendation).

Recommendation 6: Urge the PCAOB to undertake a standard-setting initiative to consider mandating the engagement partner's signature on the auditor's report.

SEC regulations require that the auditor's report be signed.⁷⁹ Under current requirements, the auditor's report signature block shows the auditing firm's name, not the engagement partner's. In 2005, the PCAOB's SAG considered whether the audit partner and a concurring partner should sign the auditor's report in their own names.⁸⁰ The Committee has received testimony and commentary regarding the benefits and complexities of engagement partner signatures.⁸¹ The Committee has also discussed and debated the merits of the senior engagement partner signing the auditor's report.⁸² Advocates believe that such signatures will foster greater accountability of the individuals signing the auditor's report, will enhance transparency, and may improve audit quality, and they also note the signature will create no additional liability concerns for the engagement partner.⁸³ These supporters analogize the signatures to the chief executive officer and chief financial officer certifications under Section 302 of Sarbanes-Oxley and directors' signatures on public company annual reports. The signature will also enhance the status of the engagement partner, putting the partner on the same level as the chief executive officer and chief financial officer. Opponents of such signatures argue that the auditing firm operates as a team and takes responsibility for the audit, but not individual partners. They also argue that no improvement in audit quality will result from such a signature.⁸⁴

⁷⁹SEC Regulation S-X, Rule 2-02a.

⁸⁰Public Company Accounting Oversight Board, Standing Advisory Group Meeting: Auditor's Reporting Model 7-8 (Feb. 16, 2005).

⁸¹*See, e.g.*, Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf> (stating that signatures could improve audit quality and enhance accountability).

⁸²*See, e.g.*, Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Donald T. Nicolaisen, Board Member, Morgan Stanley, 228-230) (stating his belief that the engagement partner should sign the auditor's report); Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Mary K. Bush, Board Member, Discover Financial Services, 231) (endorsing the engagement partner signature on the auditor's report).

⁸³*See, e.g.*, Donald Chapin, Comment Letter Regarding Draft Report and Draft Report Addendum 2 (June 9, 2008), *available at* http://comments.treas.gov/_files/TreasuryAdvisoryCommittee.doc (suggesting that if the engagement partner and concurring partner sign the auditor's report separately, some type of liability limitations should be received if the firm is not complicit in the audit failure); Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, Comment Letter Regarding Draft Report and Draft Report Addendum 2 (June 13, 2008), *available at* http://comments.treas.gov/_files/200806_13ACAP_addendum_commentltr.pdf (supporting the Recommendation); Paul Lee, Director, Hermes Equity Ownership Services Limited, Comment Letter Regarding Draft Report and Draft Report Addendum 4, (June 13, 2008), *available at* http://comments.treas.gov/_files/ACAPresponse13Jun08.pdf (noting that the signatures would increase accountability and professionalism).

⁸⁴*See, e.g.*, Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 21 (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf (arguing that regulators and others can already identify those involved in audits); Arnold Hanish, Financial Executives International, Chair, Committee on Corporate Reporting, Comment Letter Regarding Draft Report and Draft Report Addendum 5 (July 3, 2008), *available at* http://comments.treas.gov/_files/FEICCRTreasuryACAPCommentLetterFiled73080.pdf (stating that partners could become excessively conservative and seek multiple opinions from the national office before signing their name); Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 14-15

The Committee notes that engagement partner signatures are required in other jurisdictions. The European Union's (EU) Eighth Directive requires that the engagement partner sign the auditor's report.⁸⁵ Even prior to the Eighth Directive, several European countries, including France, Germany, and Luxembourg, required engagement partner signatures for a number of years.⁸⁶

The Committee notes that in Chapter VIII of this Report, the Committee is recommending disclosure of the name(s) of the senior audit partner(s) staffed on the engagement in the proxy statement to increase transparency and affirm the accountability of the auditor.

The Committee believes that the engagement partner's signature on the auditor's report would increase transparency and accountability. Therefore, the Committee recommends that the PCAOB undertake a standard-setting initiative to consider mandating the engagement partner's signature on the auditor's report. The Committee notes the signature requirement should not impose on any signing partner any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of an auditing firm.⁸⁷

Recommendation 7. Urge the PCAOB to require that, beginning in 2010, larger auditing firms produce a public annual report incorporating (a) information required by the EU's Eighth Directive, Article 40 Transparency Report deemed appropriate by the PCAOB, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VI of this Report. Further, urge the PCAOB to require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements.

The Committee considered testimony and commentary regarding the transparency of auditing firms.⁸⁸ The Committee has reviewed and considered a range of transparency reporting

(June 27, 2008), *available at* http://comments.treas.gov/_files/ResponsetoAdvisoryCommittee0627final.PDF (noting that an audit is a team effort and focusing on one partner may reduce other engagement staff's sense of responsibility); Mayer Hoffman McCann P.C., Comment Letter Regarding Draft Report and Draft Report Addendum 3 (June 17, 2008), *available at* http://comments.treas.gov/_files/MayerHoffmanMcCannCommentLetter.pdf (stating that the Recommendation "may be counterproductive since large audits require many partners in various part of the country or world"); PricewaterhouseCoopers LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 11-12 (June 30, 2008), *available at* http://comments.treas.gov/_files/PwCCommentLtrTreasCmtDraftandAddendum63008.pdf (discerning no clear benefit from the Recommendation).

85 Directive 2006/43/EC of the European Parliament and of the Council Art. 28 (May 17, 2006).

86 The Institute of Chartered Accountants in England and Wales, *SHAREHOLDER INVOLVEMENT—IDENTIFYING THE AUDIT PARTNER* (2005) (noting that Germany, France, and Luxembourg currently require audit partner signatures and European Member states must adopt such a requirement under Article 28 of the Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts).

87 This language is similar to safe harbor language the SEC promulgated in its rulemaking pursuant to Sarbanes-Oxley's Section 407 for audit committee financial experts. See SEC, Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release No. 33-8177 (Jan. 23, 2003).

88 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 10), *available at* <http://www.treas.gov/offices/domestic-finance/acap/>

options, including the PCAOB's May 2006 proposal, now finalized, requiring annual and periodic reporting pursuant to the mandate under Sarbanes-Oxley's Section 102(d).⁸⁹ This rule requires annual reporting by auditing firms on such items as a public company audit client list and the percentage of the firm's total fees attributable to public company audit clients for each of the following categories of services: audit services, other accounting services, tax services, and non-audit services. The PCAOB rule also requires firms to file a "special" report, triggered by such events as the initiation of certain criminal or civil governmental proceedings against the firm or its personnel; a new relationship with a previously disciplined person or entity; or the firm becoming subject to bankruptcy or similar proceedings.

The Committee has also considered the EU's Eighth Directive, Article 40 Transparency Report,⁹⁰ which requires that public company auditors post on their websites annual reports including the following information: legal and network structure and ownership description; governance description; most recent quality assurance review; public company audit client list; independence practices and confirmation of independence compliance review; continuing education policy; financial information, including audit fees, tax advisory fees, consulting fees; and partner remuneration policies. The Article 40 Transparency Report also requires a description of the auditing firm's quality control system and a statement by firm management on its effectiveness. Auditing firms and investors have expressed support for requiring U.S. auditing firms to publish reports similar to the Article 40 Transparency Report.⁹¹

The Committee notes that Recommendation 3 in Chapter VIII of this Report recommends that, if feasible, the PCAOB develop audit quality indicators and auditing firms publish these indicators. The Committee believes this information could improve audit quality by enhancing the transparency of auditing firms and notes that some foreign affiliates of U.S. auditing firms provide such indicators in public reports issued in other jurisdictions.⁹²

submissions/12032007/Turley120307.pdf; Record of Proceedings (Feb. 4, 2008) (Written Submission of Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf>.

89 See PCAOB, Proposed Rules on Periodic Reporting by Registered Public Accounting Firms, *available at* http://www.pcaobus.org/rules/docket_019/2006-05-23_release_no._2006-004.pdf.

90 Directive 2006/43/EC of the European Parliament and of the Council Art. 40 (May 17, 2006), *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:157:0087:0107:EN:PDF>.

91 See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf> (recommending auditing firm disclosure of quality control policies and procedures); Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (supporting an annual transparency report for U.S. auditing firms); Record of Proceedings (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 10), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf> (suggesting the PCAOB require auditing firms to publish transparency reports like the European Union's Article 40 Transparency Report).

92 See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf> (recommending auditing firm disclosure of key performance indicators, such as "percent of training dollars spent on staff compared to the fees received for the audit, average experience of staff, partner time allocated to each audit").

Furthermore, for several years auditing firms in the United Kingdom have published annual reports containing audited financial statements pursuant to limited liability partnership disclosure requirements as well as a discussion of those statements, a statement on corporate governance, performance metrics, and other useful information. In the United States, auditing firms typically do not prepare audited financial statements. Some witnesses have called for the public disclosure of audited financial statements,⁹³ whereas one auditing firm representative questioned the usefulness of disclosing financial statements of the smaller auditing firms.⁹⁴ The Committee received testimony and commentary opposed to the public release of financial statements.⁹⁵

93 See, e.g., Record of Proceedings (June 3, 2008) (Written Submission of John Biggs, Audit Committee Chair, Boeing, Inc., and former Chief Executive Officer and Chairman, TIAA-CREF), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Biggs060308.pdf> (stating that audited financial statements would be useful for audit committees); James D. Cox, Duke University, and Lawrence A. Cunningham, George Washington University, Comment Letter Regarding Draft Report and Draft Report Addendum 1-2 (July 4, 2008), *available at* http://comments.treas.gov/_files/JointCommentLetteronFACAPJuly2008.doc (supporting financial statement disclosure for assessing audit quality and independence); Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf> (calling for auditing firm disclosure of audited financial statements); Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, Comment Letter Regarding Draft Report and Draft Report Addendum 3 (June 13, 2008), *available at* http://comments.treas.gov/_files/200806_13ACAP_addendum_commentltr.pdf (recommending that all audited financial statements be publicly available on the PCAOB's website).

94 Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Neal Spencer, Managing Partner, BKD, LLP, 38-39), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> (analogizing the auditing firm to a vendor and noting that the profitability or financial strength of vendors "has little, if any, relevance other than perhaps related to concerns about their ability to financially support their continued existence" and noting that the profitability or financial condition of an auditing firm is not directly related to audit quality; and noting that the "most relevant financial information for users" of smaller auditing firms is insurance-related information and noting that larger auditing firms with limited commercial insurance coverage may need to disclose different financial information).

95 Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 20 (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf (opposing disclosure of financial statements due to increased litigation risk and the impact on concentration); Record of Proceedings (June 3, 2008) (Written Submission of Charles W. Gerdtts, III, General Counsel, PricewaterhouseCoopers LLP, 12), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Bedard060308.pdf> (suggesting that audited financial statements would not help audit quality, may harm competition, and could increase settlement awards); Record of Proceedings (June 3, 2008) (Written Submission of Kenneth Nielsen Goldmann, Capital Markets and SEC Practice Director, J.H. Cohn LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Goldmann060308.pdf> (stating that smaller firms would leave the public company audit market due to the fact that "they would view such disclosure as placing them in a negative competitive position with respect to larger audit firms, current and potential clients, and potential plaintiffs"); David McDonnell, Chief Executive Officer, Grant Thornton International Ltd, and Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Ltd Board of Governors, Comment Letter Regarding Draft Report and Draft Report Addendum 5 (June 27, 2008), *available at* http://comments.treas.gov/_files/GTCommentlettertoACAPJune2008_FINAL.pdf (noting the lack of evidence that audit quality would improve but states that the Recommendation would have an adverse affect on concentration and smaller firms); Record of Proceedings (June 3, 2008) (Written Submission of Michael R. Young, Partner, Willkie Farr & Gallagher LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Young060308.pdf> (noting that the Recommendation may result in larger settlement demands).

The Committee recommends that the PCAOB require that, beginning in 2010, larger auditing firms (those with 100 or more public company audit clients that the PCAOB inspects annually) produce a public annual report incorporating (a) information required by the Article 40 Transparency Report deemed appropriate by the PCAOB in consultation with investors, other financial statement users, auditing firms, public companies, academics, and other market participants, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VIII of this Report. These disclosure requirements should supplement any rules approved by the SEC as a result of the PCAOB's June 2008 rulemaking on annual and special reporting.

Further, the Committee also recommends that the PCAOB require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements prepared in accordance with generally accepted accounting principles or international financial reporting standards.

The Committee also recommends that the PCAOB determine which of the requirements included above should be imposed on smaller auditing firms (those with fewer than 100 public company audit clients), taking into account these firms' size and resources.

Litigation

Members of the Committee engaged in extensive discussion regarding the possible impact of the current U.S. liability system on audit effectiveness and the continued sustainability of the public company auditing profession. The discussion involved complex issues that have long been a source of concern and debate, and the Committee was unable to reach a consensus as to whether limits on auditor liability would be beneficial or harmful to the capital markets and to investors or, for that matter, whether such limits are necessary to sustain the auditing profession. The discussions were extensive and to assist the reader, a summary of the divergent views voiced by Committee members appears later in this section. However, since there was not a consensus, no recommendation is presented in this Report.

The Committee addressed issues regarding investor protection, market stability, and auditing firm sustainability in light of the current litigation environment. For example, throughout its deliberations, the Committee considered the vital role that independent audits play in the capital markets, the difficulty of increasing competition and reducing concentration in the audit market, and the impact of events that could lead to failure of a large auditing firm, which some, but not all, members believe includes litigation arising out of an audit of either a public or a private company. As regards a loss of a large auditing firm, some Committee members believe it could have serious repercussions for markets and investors, threatening the sustainability of the remaining larger firms (at least in their current form). Other Committee members believe that it would have serious repercussions, but would not be a lasting threat to the sustainability of the public company auditing profession.

In a broad context, the Committee considered various possible safeguards to prevent the loss of a large auditing firm which could result from a range of reasons. For example, the Committee has recommended that the PCAOB monitor on an on-going basis significant risks—

existing and emerging—that have the potential to threaten audit quality.⁹⁶ Public company auditors, post-Sarbanes-Oxley, are now regulated, and the PCAOB has the ability to request information from registered auditing firms and to evaluate the quality of their practices, their financial information, and the threat of risks arising from either performance failures. As the federal regulator of public company auditors and the body charged with responsibility for timely issuance of standards for audits of public companies, the PCAOB is uniquely qualified to monitor the firms, to cause changes designed to make audits more effective, and to undertake actions should a firm’s sustainability come into question, possibly in conjunction with actions taken by the SEC and/or the DOJ.

The Committee has also proposed a preservation and rehabilitation plan that requires Congressional action and which, if enacted, could be implemented in the event of threats to an auditing firm’s ability to function.⁹⁷ However, a number of auditing firms, Committee members, and others question whether the Committee’s recommendation for such a preservation and rehabilitation process, which would require increased monitoring and contingency planning, adequately addresses the nuances of the U.S. litigation environment and the risks it poses for auditing firms. However, in making the recommendations cited above, the Committee did not address litigation risk or barriers to entry expressly, but instead sought through a variety of measures to reduce the risk that a crisis in a major auditing firm, whatever its cause, would have a harmful systemic effect on companies, investors, and the capital markets as a whole.

Information Gathered

The Committee as a whole requested and received a wide range of information bearing on the litigation environment in the United States with respect to the auditing profession. This included testimony, commentary, and other information presented by the auditing profession, investors, public companies, insurers, academics, and others regarding the current litigation environment for auditing firms in the United States and its possible effect on audit quality, competition, governance, transparency, global networking, and sustainability. The Committee also considered prior studies evaluating the auditor litigation environment, including the work of the Cohen Commission and other major reports.

The six largest auditing firms that each audit more than 300 U.S. public companies and together audit over 99% of the total U.S. public company market capitalization were asked by the Committee to supply a wide range of information regarding historical and pending litigation. Additionally, some Committee members asked the firms to provide additional specific details regarding past and pending litigation, as well as details regarding individual firm financial resources, including financial statements.⁹⁸ In responding, these firms provided that

96 See Chapter VIII, Recommendation 2(a).

97 See Chapter VIII, Recommendation 2(b).

98 A listing of the litigation and financial resource related data requested from the auditing firms, the Center for Audit Quality (“CAQ”), and the American Institute of Certified Public Accountants is available on the U.S. Department of the Treasury website at <http://www.treas.gov/offices/domestic-finance/acap/DataMatrices.pdf>. The data provided in response to the request is available on the CAQ’s website at <http://www.theqaq.org/publicpolicy/treasurydata.htm>. Subsequent to that request, individual Committee members requested at various times throughout the proceedings additional detailed data from representatives of the auditing firms in an effort to evaluate the firms’ alleged need for further limits on liability. The firms gener-

data they believed relevant to the Committee's work and did so in an aggregated and summarized format. The firms chose to provide only aggregated data and expressed concern that providing information about claims, settlements, and financial resources on an individual-firm and detailed-claim basis could possibly increase their litigation risk. Various members of the Committee stated that the aggregated data provided were insufficient for the needs of the Committee in its deliberations and found difficulty in evaluating the large range of issues presented without more detailed information. Other members of the Committee stated that the aggregated data, rather than any single firm's liability profile, best informed the Committee's discussion at least as it pertains to catastrophic litigation risk.

The six largest auditing firms disclosed that they are currently defendants in ninety private actions related to audits of both public and private companies (either shareholder class actions or actions brought by companies or bankruptcy trustees) with damage claims against the auditors in each case in excess of \$100 million. Forty-one of these cases seek damages in excess of \$500 million, twenty-seven cases seek damages in excess of \$1 billion, and seven cases seek damages over \$10 billion. Of the forty-one claims in excess of \$500 million, nineteen were lodged by private companies or bankruptcy trustees and allege claims of over \$30 billion in the aggregate.⁹⁹ For one such claim relating to the audit of a private company, there currently is a judgment in excess of \$500 million now pending in Florida against one of the smaller of the six largest auditing firms.

Over a twelve-year period, since the enactment of the Private Securities Litigation Reform Act of 1995, the six largest auditing firms have paid out \$5.66 billion to resolve 362 cases related to public company audits, private company audits, and all other non-audit services,¹⁰⁰ with 65% of the total (\$3.68 billion) related to public company audits. Information provided by the six largest auditing firms indicates that the weighted average of "litigation and practice-protection costs" was 6.6 percent of these firms' revenues and 15.1% of these firms' audit-related revenues for the most recent fiscal year.¹⁰¹

ally chose not to provide such data. As one example, see Record of Proceedings (June 3, 2008) (Questions for the Record of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young, LLP, 8-9 (June 30, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-6-3-08.pdf>.

99 See CENTER FOR AUDIT QUALITY, SECOND SUPPLEMENT TO REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION APPENDIX B (Apr. 16, 2008), *available at* <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

100 Other data provided to the Committee, based on a sample of fifty-one securities class actions filed and resolved from 1996-2002 in which auditors were named as defendants, indicated that the median settlement payment made by the defendant auditing firm was \$1.8 million. Zoe-Vonna Palmrose, *Maintaining the Value and Viability of Independent Auditors as Gatekeepers Under SOX: An Auditing Master Proposal* 30 (Revised Oct. 5, 2006), *available at* http://www.tcf.or.jp/data/20050928_Zoe-Vonna_Palmrose.pdf. The data also indicated that in 23% of the actions examined with claims against auditors, the auditors were dismissed or otherwise made no contribution to the resolution of the case. *Id.* at 31.

101 Note that the 15.1% includes non-audit litigation costs. The CAQ has noted these costs are "relatively small." CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 27 (Jan. 23, 2008), *available at* <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>. Note that in 1999, the four largest auditing firms reported that 7.7% of audit-related revenues went for audit litigation and practice protection costs. *See id.*

While claims can be large, some Committee members noted that the payments made by auditing firms upon settlement or final judgment are on average only a small percentage of the alleged claims. For example, over the 1996-2007 time period median settlements in shareholder class actions (a subset of litigation against auditing firms) in which an auditing firm was named as a defendant were 4.8% of the total estimated damages.¹⁰² Other Committee members noted that average settlement figures are less relevant to considering the sustainability of the major auditing firms than the possibility of a large litigation loss in the context of a very large claim.

Diversity of Committee's Views

The Committee members disagree as to whether either the historical record or pending litigation supports the argument that litigation threats faced by the auditing profession are sufficient to justify substantial change to the current liability regime. Also, Committee members disagree as to whether recommendations to limit liability are in the interest of investors. Further, among those who agree that change is warranted, there are differing views as to what change would be most appropriate to limit liability risk.

Members of the Committee who believe that the catastrophic litigation risk faced by the auditors of public companies is an unacceptably severe hazard to auditing firms, to investors, and to the stability of the U.S. capital markets, requiring actions to reduce the hazard, expressed one or more of the following views:

- The information presented to the Committee amply demonstrates that the litigation environment, in which auditing firms operate, poses a significant threat to firms' sustainability. Data provided by the accounting profession and testimony from academics, legal, and insurance experts make clear that the threat of the loss of a major auditing firm due to litigation is real.¹⁰³ Such a loss would threaten the sustainability of the

102 CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS—2007 REVIEW AND ANALYSIS 8 (2008), available at http://securities.stanford.edu/Settlements/REVIEW_1995-2007/Settlements_Through_12_2007.pdf.

103 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Peter S. Christie, Principal, Friemann Christie, LLC, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Christie120307.pdf> ("The problem with professional liability claims arising from audits of the world's largest companies is that there is no ability to realistically compute either the amount of the possible future claim or the likelihood of it happening. At the same time few will believe such mega claims cannot happen, and indeed most would speculate it is only a matter of time before they do."); Record of Proceedings (Dec. 3, 2007) (Written Submission of James D. Cox, Professor of Law, Duke University, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Cox120307.pdf> ("...[I]t is not unthinkable that one or more Big Four accounting firms could suffer fatal liability blows in yet to surface financial frauds of their audit clients."); Record of Proceedings (Dec. 3, 2007) (Written Submission of Lawrence A. Cunningham, Professor of Law, George Washington Law School, 12) (Dec. 3, 2007) ("Since Arthur Andersen's dissolution, there has been valid concern that one of the four remaining similar firms could face a like fate from kindred criminal or civil culpability. Should that occur, with only three such firms left, a crisis would occur."); Record of Proceedings (Dec. 3, 2007), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-12-3-07.pdf> (Oral Remarks of Lewis Ferguson, Partner, Gibson, Dunn & Crutcher LLP, 150) ("[S]everal features of the U.S. legal system . . . increase the risk that at some point in the future one or more of the large accounting firms may face circumstances that could lead to its failure, further increasing concentration at the top end of the profession and creating a host of problems.").

public company auditing profession as a whole, with serious adverse consequences to the stability of our capital markets and the confidence and protection of investors.

- The profession faces catastrophic litigation risk different from that of other businesses. Under the U.S. litigation system, auditors are potentially liable for the entire drop in market capitalization of their public company audit clients. The average public company common stock capitalization has increased from approximately \$1.375 billion in 1997 to \$3.842 billion in 2007.¹⁰⁴ This exposure is unrelated to the scope of any audit error or misconduct, and dramatically dwarfs audit fees.
- Claims today in securities class actions can be significant multiples of the capital of even the largest auditing firms.
- The private litigation system makes it very difficult for auditing firms to bring large cases to trial. Firms are forced to settle cases even where they believe the claims lack merit and they have strong defenses, because the size of the claims means that if the firm does not prevail at trial, the resulting award could destroy the firm. Firm management cannot prudently risk the fate of a firm on the outcome of a trial.¹⁰⁵
- Auditing firms have thus far been able to settle large claims for affordable amounts. However there is no assurance or control system that assures the ability to do so in the future. That will depend on the voluntary willingness of claimants to negotiate reasonable settlements. Any single claimant seeking \$500 million or more has the capacity to make unreasonable demands or to force trial. The uncertainty of litigation means that either could prove fatal to the firm. Settlement with an immediate payout of any of the claims at a level in excess of \$500 million could result in the demise of any of the largest firms. It is not acceptable public policy to leave the health of our economy or the competitiveness of our capital markets to the unfettered discretion of any of dozens of claimants and their counsel.
- The threat of disproportionate, catastrophic liability is not necessary to preserve or enhance audit quality. Auditors have many incentives to perform audits to the best of their ability, without the added threat of catastrophic liability. Professional standards, PCAOB inspections and SEC enforcement activities, internal firm evaluations, ordinary civil liability based on actual misconduct, and reputational concerns, are all more than sufficient to ensure professional behavior.
- The threat of disproportionate liability can harm audit quality by discouraging the best

104 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 45 (Jan. 23, 2008).

105 See, e.g., Record of Proceedings (June 3, 2008) (Written Submission of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, 5-6), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Oberly060308.pdf> (noting that a catastrophic claim against an auditing firm “effectively denies audit firms access to the judicial system even when they’ve done the quality work expected of them” and that “[n]o firm has insurance coverage for the largest of claims, no firm has the capital to pay the largest of claims, and no firm could retain its partners by slashing future earnings by an amount necessary to pay the largest of claims”).

and brightest from entering and remaining in public company auditing, inhibiting the use of professional judgment, impeding the evolution of more useful audit reports, and causing overly cautious audits or “defensive” auditing.

- The combination of catastrophic litigation risk and difficulty obtaining insurance¹⁰⁶ exacerbates concentration in the profession. Smaller firms are reluctant to pursue public company clients to increase their market share given the disproportionate threat of liability.¹⁰⁷
- The U.S. capital markets are increasingly a part of a global capital market system and therefore any deliberations regarding litigation reform require forward-looking consideration of the impact of global factors. Concerns with regard to liability reform are not unique to the United States, as is evidenced by recent consideration of liability within the EU.¹⁰⁸ Because the larger auditing firms operate through global networks that include U.S. firms, it is important that the U.S. system not remain stagnant and put U.S. firms, and markets, at a disadvantage.

Among those Committee members who support change, some believe the potential changes that should be considered are: caps on the damages paid by auditing firms; caps on bonds auditing firms must post to appeal an adverse civil judgment; permitting auditing firms to appeal denials of motions to dismiss; strengthening the bankruptcy defenses available for auditing firms; revising SEC Rule 10b-5 to utilize an “actual knowledge” standard; and providing government insurance for auditing firms. These are several of the wide range of proposed changes the Committee considered from those who testified before the Committee in support of liability changes.

106 See, e.g., Record of Proceedings (June 3, 2008) (Written Submission of Barry Mathews, Deputy Chairman, Aon Corporation, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Mathews060308.pdf> (noting the “inability of the commercial insurance market to supply necessary coverage at a reasonable price”).

107 See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Lewis H. Ferguson III, Gibson, Dunn & Crutcher LLP, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Ferguson120307.pdf> (noting that the risk of liability may be preventing second-tier firms from even attempting to reach the market serviced by the Big Four firms, “feeling that auditing the largest companies not only may greatly increase infrastructure costs but disproportionately increases litigation risk and defense and insurance costs”); Record of Proceedings (Feb. 4, 2008) (Written Submission of Neal Spencer, Managing Partner, BKD, LLP, 1-3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Spencer020408.pdf> (noting that “[t]here are a number of barriers to expanding the number of firms competing in the public company auditing market,” including resources, institutional bias, difficult (if not impossible) insurability, and liability risks”).

108 See Commission Recommendation of 5/VI/2008 concerning the limitation of the civil liability of statutory auditors and audit firms (June 5, 2008), *available at* <http://www.iasplus.com/europe/0806auditorliabilityrecommendation.pdf>. The Commission’s recommendations set out three recommended approaches for limiting liability: by contract with the audit client, by caps or formula limitation, and through proportionate liability. It noted that different options may be appropriate for different member states, due to the variation in legal regimes.

Conversely, other Committee members do not believe the case has been made that the risk of litigation is catastrophic and they oppose significant change to the liability regime for auditing firms. Committee members who oppose change agree with one or more of the following views:

- Sustainability of the auditing profession ultimately rests upon the conduct of the auditing firms themselves, their business model, governance, leadership, and especially their “tone at the top” – all of which are inextricably linked to audit quality. Auditing firms can best protect themselves from catastrophic liability by performing high quality and informative audits in compliance with existing professional standards.¹⁰⁹
- The data made available to the Committee, including that provided by the auditing firms and the CAQ,¹¹⁰ fails to demonstrate that the litigation environment in which the auditing firms operate poses a significant threat to the sustainability of the auditing profession or that warrants further limits on auditor liability relative to other professions.¹¹¹ Based on the information available to the Committee, the risk of demise of a large auditing firm due to catastrophic litigation loss appears overstated.¹¹²
- As noted in a January 2008 U.S. Government Accountability Office report, “investors and other users of financial statements expect auditors to bring integrity, independence, objectivity, and professional competence to the financial reporting process and to prevent the issuance of misleading financial statements. The resulting sense of confidence in companies’ audited financial statements, which is key to the efficient func-

109 See, e.g., Record of Proceedings (June 3, 2008) (Written Submission of Kayla J. Gillan, Chief Administrative Officer, RiskMetrics Group, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Gillan060308.pdf> (noting the best protection against catastrophic liability is for auditors to follow professional standards).

110 CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 24, 27 (Jan. 23, 2008), *available at* <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>; CENTER FOR AUDIT QUALITY, SECOND SUPPLEMENT TO REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 1 (Apr. 16, 2008), *available at* <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>.

111 See, e.g., James D. Cox, Duke University, and Lawrence A. Cunningham, George Washington University, Comment Letter Regarding Draft Report and Draft Report Addendum 1, 11 (July 4, 2008), *available at* http://comments.treas.gov/_files/JointCommentLetteronFACAPJuly2008.doc (noting that “proposals to reduce auditor liability risk on the grounds that financial devastation could otherwise result cannot be evaluated without reading, at a minimum, audited financial statements of the firms” [which was requested but not provided to the Committee] and “[i]t would seem difficult for the Committee to fairly recommend anything . . . without providing [Committee] Members with information that extends materially beyond that provided so far”).

112 See, e.g., Record of Proceedings (Feb. 4, 2008) (Oral Remarks of John P. Coffey, Partner, Bernstein Litowitz Berger & Grossman LLP, 106), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-2-4-08.pdf> (“[I]t’s extremely unlikely that such an institutional lead plaintiff would insist on a settlement (or enforce a judgment) that would result in the failure of another audit firm”); (Feb. 4, 2008) (Questions for the Record of Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company, 2 (Mar. 26, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> (“No doubt the failure of another large firm could cause significant disruption in the short-term, however, we believe the market would adapt in the long term much the same way it adjusted after the collapse of Arthur Andersen.”).

tioning of the markets for public companies' securities, can exist only if reasonable investors perceive auditors as independent and expert professionals who will conduct thorough audits."¹¹³ Easing auditor liability adversely impacts investor perception of audit quality and confidence in audited financial statements because most investors,¹¹⁴ consistent with the view of many market participants¹¹⁵ and the results of numerous academic studies,¹¹⁶ have concluded that auditing firms would reduce the intensity of their audits if the risk of litigation is further minimized.

- While some auditing firms assert that they are unable to commercially insure liability risks in a manner that provides meaningful protection, this situation is not unique among U.S. industries¹¹⁷ and may actually be beneficial to ensuring audit quality.¹¹⁸ Arguments about the implications of the limits of auditing firms' ability to obtain insurance are misleading. Auditing firms, like many other businesses, frequently have difficulty in obtaining coverage that fully insures the entity against catastrophic risk. Some firms currently use insurance to manage in part their routine litigation expenses, others find using third party insurers too expensive in relation to the benefit of smoothing litigation expenses. The Committee was not provided with any evidence

113 U.S. GOVERNMENT ACCOUNTABILITY OFFICE, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION 7 (Jan. 2008), *available at* <http://www.gao.gov/new.items/d08163.pdf>.

114 *See, e.g.*, Written Submission of Gregory W. Smith, General Counsel, Colorado PERA to the Treasury Department's Advisory Committee on the Auditing Profession Subcommittee on Firm Structure and Finances 2 (Feb. 12, 2008) ("The defensibility of our reliance on audited financials is directly related to our knowledge that failure of the auditor to adhere to established standards carries substantial exposure to liability"); Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company, 2 (Mar. 26, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> ("We share the concerns [of foreign regulators and a representative of investors] expressed in the GAO report that further limits on auditor liability could lead to lower quality audits. We believe the legal liability exposure each firm faces for each audit engagement is a very effective incentive for the firms to conduct high quality audits that eliminate most of the risk of litigation from private litigants").

115 *See, e.g.*, Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Annalisa Barrett, Vice President and Senior Research Associate, The Corporate Library LLC, 1 (Mar. 25, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> ("[W]e would not recommend further limiting auditor liability...Limiting the liability of auditors may have unintended consequences and open the door for abuse").

116 *See, e.g.*, Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, Comment Letter Regarding Discussion Outline 12 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/TREASURYLETTER3BAILEY61608.doc ("There are few matters on which most academic research agrees, but one of these is that reducing the cost of failure will lead to a lower level of effort in attending to the activity in question. Audits are no exception").

117 *See, e.g.*, Record of Proceedings (Dec. 3, 2007) (Written Submission of Peter S. Christie, Friemann Christie, LLC, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Christie120307.pdf> (noting similar insurability issues faced by financial companies, energy companies, and pharmaceutical companies).

118 *See, e.g.*, Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Joseph A. Grundfest, W.A. Franck Professor of Law and Business, Stanford Law School, 1 (Mar. 5, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/QFRs-2-4-08.pdf> (noting that the lack of insurance "increases the [audit firm] industry's incentive to exercise appropriate care and therefore promotes socially responsible conduct").

indicating that the alleged inability of the auditing firms to obtain insurance represents, in itself, a threat to the auditing profession.

- Auditing firms would reduce the quality of their audits if the threat of litigation were to be reduced.¹¹⁹
- Investors, particularly institutional investors with fiduciary obligations to fund beneficiaries, believe the right to seek recovery when auditors participate in fraud or have breached their professional duties is both an important motivator of audit quality and an important mechanism for holding auditing firms accountable to the investing public.¹²⁰
- While the global capital markets and environment in which auditing firms operate are relevant to consideration of the future of the auditing profession, the quality of the U.S. capital markets is based substantially on the investor protections afforded in those markets, and any significant accommodation of global considerations should not come at the expense of existing market features providing investor protections.¹²¹
- The argument in support of the need for further limits on auditor liability has been further weakened by recent U.S. Supreme Court decisions that raise the hurdles an investor must overcome in recovering losses from auditing firms.¹²² In addition, with the passage of Private Securities Litigation Reform Act, lead plaintiffs are appointed in class action cases and this has resulted in more responsible institutions playing an active role in bringing and overseeing the litigation.¹²³

119 See, e.g., William J. Estabrook, Executive Director, Ohio Police & Fire Pension Fund, Comment Letter Regarding the Draft Report and Draft Report Addendum 1 (July 9, 2008), available at http://comments.treas.gov/_files/LTRToAdvisoryCommitteeonAuditingProfession7908.pdf (“The risk of litigation encourages auditors to maintain a high level of audit quality”).

120 See, e.g., Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees’ Retirement System, 2 (Apr. 30, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> (“Limiting auditor liability would reduce auditor and audit firm accountability, provide a significant market incentive to take audit shortcuts, aggressive treatments and reduce overall quality to the detriment of investors.”).

121 See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, Comment Letter Regarding Discussion Outline 10 (Jan. 30, 2008), available at <http://treas.gov/files/TREASURYLETTER3-BAILEY61608.doc> (expressing concern that globalization could harm investors by lowering “U.S. based audit quality and independence for all U.S. registrants”); but cf. London Economics in association with Professor Ralf Ewert, Study on the Economic Impact of Auditors’ Liability Regimes *xlii* (Sept. 2006), available at http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf (Finding that “the majority of institutional investors having responded to the survey, as well as representatives of organizations representing institutional investors, are concerned that a limitation of auditors’ liability will affect audit quality negatively”).

122 See, e.g., Record of Proceedings (June 3, 2008) (Questions for the Record of Michael R. Young, Wilkie Farr & Gallagher LLP, 6 (July 3, 2008)) available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-6-3-08.pdf> (noting that “[b]oth *Dura Pharmaceuticals* and *Tellabs* should help the firms reduce their legal liability”).

123 See, e.g., Brief of Council of Institutional Investors as Amicus Curiae Supporting Respondents 7-12, *Tellabs, Inc. v. Makor Issues & Rights, LTD* 127 S. Ct. 2499 (Mar. 9, 2007) (No. 06-84), available at <http://www.cii.org/UserFiles/file/resource%20center/key%20governance%20issues/legal%20issues/03-09-07%20CII%20>

- Requiring all audit-related litigation involving public companies to be brought in federal court would generally not benefit investors or the capital markets, particularly if the applicable standards of care would be lower than under existing laws and regulations.¹²⁴ Those expressing this view express this view only with respect to litigation and do not wish to convey an impression that they object to the federalization of auditing regulation under Sarbanes–Oxley.

This Committee’s charge is primarily to identify matters impacting—positively and negatively—audit quality and the sustainability and competitiveness of the auditing profession. While the Committee’s charge does not include venturing into the general area of litigation policy, some Committee members feel that if, and when, such change is considered, it should go forward in a context broader than just consideration of the impact on the auditing firms. Litigation is clearly of significant concern to the auditing firms but is also of concern to investors and other market participants. And, changes in the litigation environment impacting auditors may potentially affect other market participants. The Committee believes it is important that the litigation system be fair and rational in serving the needs of both auditing firms and the public interest. However, as noted above, Committee members could not agree whether or not the existing litigation system satisfies those objectives.

amicus%20Tellabs%20v_%20Makor.pdf (describing the benefits to investors, defendants, and the capital markets of the lead plaintiff provisions of the PSLRA).

124 See Julie Becker, General Counsel and Carol Nolan Drake, Director, External Relations, Ohio Public Employees Retirement System, Comment Letter Regarding Draft Report and Draft Report Addendum 3-4 (July 9, 2009), available at http://comments.treas.gov/_files/AdvisoryCommitteeAuditProfessionalDraftAddendum.pdf (“Any weakening of the standard of care imposed on accountants who conduct audits of public companies, including for example the removal of fraud on the market presumption to establish reliance; the creation of a special “professional judgment” rule; the implementation of special safe harbor provisions for auditors; the discontinuance of a negligence standard for claims by companies against their auditors, and/or the legislation of a standardized scienter requirement to be applied to auditors, would be adverse to protecting the interests of investors and, therefore, the capital markets”). See also Samuel K. Cotterell, Chair, National Association of State Boards of Accountancy, and David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, Comment Letter Regarding Draft Report and Draft Report Addendum 3 (June 29, 2008), available at http://comments.treas.gov/_files/June2908LetterheadTreasuryAdvisoryCommitteeontheAuditingProfession.pdf (stating “NASBA notes that giving the federal courts exclusive jurisdiction over private causes of action arising out of some state law claims is without precedent and might be unconstitutional... NASBA maintains that state courts are in the best position to interpret state law claims”).

VIII. CONCENTRATION AND COMPETITION

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

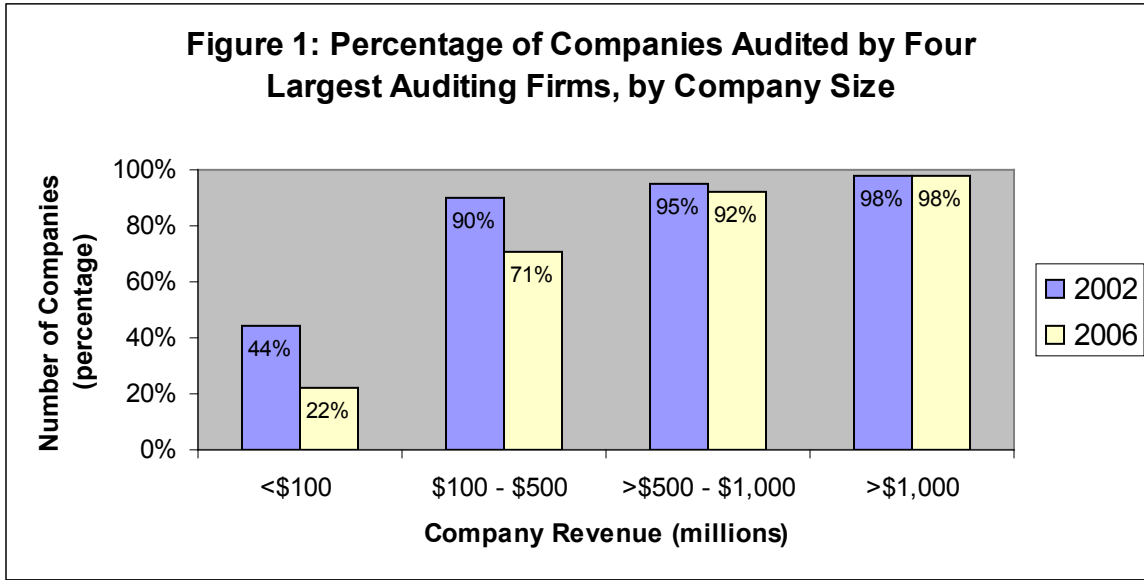
During the course of its deliberations, the Committee received testimony and commentary from the Government Accountability Office (GAO), the Public Company Accounting Oversight Board (PCAOB), academics, auditing firms, investors, and others regarding audit market concentration and competition.

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

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

2 GAO, *PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION*, GAO-03-864 (July 2003) (finding that “although audits for large public companies were highly concentrated among the largest accounting firms, the market for audit services appeared competitive according to various indicators”). The GAO has routinely examined the auditing profession. See, e.g., GAO, *THE ACCOUNTING PROFESSION, MAJOR ISSUES: PROGRESS AND CONCERNS*, GAO-96-98 (Sept. 1996); GAO, *THE ACCOUNTING PROFESSION: APPENDICES TO MAJOR ISSUES: PROGRESS AND CONCERNS*, GAO-96-98A (Sept. 1996); GAO, *THE ACCOUNTING PROFESSION: STATUS OF PANEL ON AUDIT EFFECTIVENESS RECOMMENDATIONS TO ENHANCE THE SELF-REGULATORY SYSTEM*, GAO-02-411 (May 2002); GAO, *CPA AUDIT QUALITY: STATUS OF ACTIONS TAKEN TO IMPROVE AUDITING AND FINANCIAL REPORTING OF PUBLIC COMPANIES*, GAO-89-38 (Mar. 1989).

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



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

The Committee considered the testimony of several witnesses regarding the reasons for the continued concentration in the large public company audit market. Auditing firms, public companies, market participants, academics, investors and others reasoned that large public companies with operations in multiple countries need auditing firms with global resources and technical and industry expertise to deal with an increasingly complex business and financial reporting environment.⁴ These needs limit auditor choice to only the largest auditing firms for many large public companies. The Committee heard from witnesses who also described barriers to the growth of smaller auditing firms, including the behavior of underwriters and other capital market participants.⁵

In analyzing these data on concentration and limited auditor choice in the large public company audit market, the Committee focused on the potential negative impact of concentration on audit quality. Some have suggested the lack of competition may not provide sufficient incentive for the dominant auditing firms to deliver high quality and innovative audit servic-

4 See, e.g., 2008 GAO REPORT 21 (reporting that surveyed companies in auditor selection decisions most frequently cited size and complexity of their operations (92%), the auditor’s technical capability with accounting principles and auditing standards (80%), and the need for industry specialization or expertise (67%)); Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>; Record of Proceedings (Feb. 4, 2008) (Written Submission of Neal D. Spencer, Managing Partner, BKD, LLP, 1-4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Spencer020408.pdf>.

5 Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Brad Koenig, Former Managing Director and Head of Global Technology Investment Banking, Goldman Sachs, 219-220), *available at* <http://www.treas.gov/offices/domestic-finance/acap/Koenig020408.pdf> (describing underwriters’ views of auditing firms other than the largest four auditing firms).

es.⁶ Notwithstanding the increasing number of public company financial restatements,⁷ the Committee heard from several witnesses that audit quality had improved.⁸ For example, the GAO observed that market participants and public company officials had noted improvement in recent years in audit quality, including auditing firm staff's technical expertise, responsiveness to client needs, and ability to identify material financial reporting matters.⁹ Much of the improvement was credited to the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), which enhanced auditor independence, replaced the self-regulation of the auditing profession with the PCAOB, mandated evaluation and disclosure of the effectiveness of internal controls over financial reporting,¹⁰ and strengthened audit committee membership, independence, and responsibilities.

Although industry concentration can lead to increased prices, the Committee notes that the GAO concluded that higher audit market concentration has not been associated with higher fees. Public companies, auditing firms, and other market participants believe the considerable increase in audit fees in recent years is due not to market power of a concentrated industry, but to the increased requirements under Sarbanes-Oxley, the complexity of accounting and financial reporting standards, the need to hire and retain qualified audit staff, and the independence requirements (which have led to the possible re-pricing of audits to their unbundled market price).¹¹ The Committee also considered the impact of the possible loss of one of the four largest accounting firms in light of the high degree of concentration of public company auditing, and especially large public company auditing, in those firms. The GAO noted the possibility of this loss due to issues arising out of firm conduct, such as civil litigation, federal or state regulatory action or criminal prosecution, or economic events, such as a merger.¹² The GAO posited potential negative effects of such a loss, including the following: further limitations on large public company auditor choice, costs associated with changing auditors, and companies' inability to obtain timely financial statement audits.¹³ However, the GAO did not recommend insulating auditing firms directly from either the legal or market consequences of their actions.

6 2008 GAO REPORT 31-32.

7 See, e.g., SUSAN SCHOLZ, *THE CHANGING NATURE AND CONSEQUENCES OF PUBLIC COMPANY FINANCIAL RESTATEMENTS 1997-2006* (Apr. 2008).

8 2008 GAO REPORT 5; PUB. COMPANY ACCOUNTING OVERSIGHT Bd., *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms*, PCAOB Rel. No. 2007-010 (Oct. 22, 2007).

9 Record of Proceedings (Dec. 3, 2007) (Questions for the Record of Jeanette M. Franzel, Director, Financial Management and Assurance Team, U.S. Government Accountability Office, 2 (Jan. 30, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-2007.pdf> (observing that the market believes the "bar had been raised" on audit quality). See also CENTER FOR AUDIT QUALITY, *REPORT ON THE SURVEY OF AUDIT COMMITTEE MEMBERS* (Mar. 2008) (concluding that 17% of surveyed audit committee members view audit quality as good, 53% as very good, 25% as excellent, while 82% say overall quality has improved somewhat/significantly over the past several years).

10 2008 GAO REPORT 32.

11 2008 GAO REPORT 27-29. On the re-pricing of audits, see also James D. Cox, *The Oligopolistic Gatekeeper: The U.S. Accounting Profession*, in AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNIZING SECURITIES REGULATION IN EUROPE AND THE U.S. (John Armour and Joseph A. McCahery eds., 2006).

12 2008 GAO REPORT 34-35.

13 2008 GAO REPORT 35-36.

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

Recommendation 1. Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. Because smaller auditing firms are likely to become significant competitors in the market for larger company audits only in the long term, the Committee recognizes that Recommendation 2 will be a higher priority in the near term.

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

To address these issues, the Committee recommends that policy makers press for the reduction of barriers, to the extent consistent with audit quality and other public interest factors, to the growth of smaller auditing firms. For smaller firms, this includes encouraging and promoting development of technical resources in such areas as international financial reporting standards (IFRS) and fair value accounting, and development of specialized or "niche" practices or industry "verticals" where they are in the best interests of investors and can lead to more effective competition. Pressure also should be applied against non-justifiable resistance to using smaller firms on the part of a variety of market actors.

When companies change auditors, the departing auditing firm continues to perform a service for its former client by consenting to have its opinion used for two years after the change is made. The charge for this service should typically be small relative to the total audit fee. However, some commentators have noted the costs associated with public companies' changing auditors and how these costs can pose a barrier to smaller firms entering the larger public

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

¹⁵ 2008 GAO REPORT 38.

company audit market.¹⁶ In response to these concerns, the Committee recommends that auditors and companies consider potential issues related to the termination of the audit relationship at the time when first entering the engagement contract so that the fees for reissuing past reports will be known in advance. In addition, if there is a change of auditors, companies should consider that accounting estimates and judgments reviewed with the departing auditing firm will also be reviewed with this new auditing firm.

In addition, PCAOB interim auditing standard *AU 315: Communications Between Predecessor and Successor Auditors*¹⁷ requires communications between predecessor and successor auditors, including when possible misstatements have been discovered by the successor auditor. Because the discussions may involve confidential information concerning the company that is in the possession of the predecessor auditor, the company must authorize many of those communications. Prompt and coordinated actions and communications among the company and predecessor and successor auditors can reduce perceived obstacles and costs related to auditor changes, which were discussed in testimony presented to the Committee. Changing auditors is a heavily regulated process in which both the predecessor and successor auditors have professional obligations to their clients. Auditors and preparers need to be cognizant of these obligations in the course of a change of auditors. When it interviews the audit committee chair in connection with an inspection of an audit engagement at a company that has undergone a change of auditors, the PCAOB should inquire about whether the transition process was cooperative and transparent. The issue of auditor changes and the importance of transparency in this area are addressed within Chapter VII of this Report.

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

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

The Committee considered testimony and commentary that certain market participants, such as underwriters, banks, and lenders, may influence and effectively limit public company auditor selection decisions.¹⁸ For instance, certain contractual arrangements limit public companies' auditor choice.¹⁹ Consistent with the large public company audit market, this practice

¹⁶See, e.g., Record of Proceedings (June 3, 2008) (Questions for the Record of Kurt N. Schacht, Managing Director, Centre for Financial Markets Integrity, CFA Institute (June 30, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-6-3-08.pdf>.

¹⁷*Communications Between Predecessor and Successor Auditors*, Interim Auditing Standard AU 315 (Pub. Company Accounting Oversight Bd. 2002).

¹⁸See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 3), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (noting that transparency regarding "restrictive contracts with underwriters" could improve auditor choice). See also 2008 GAO REPORT 47.

¹⁹See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Lewis H. Ferguson, III, Partner, Gibson, Dunn & Crutcher LLP, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Ferguson120307.pdf> ("Sometimes lenders, investors, investment bankers or credit rating agencies will insist that a company seeking to access the capital markets have its financial statements

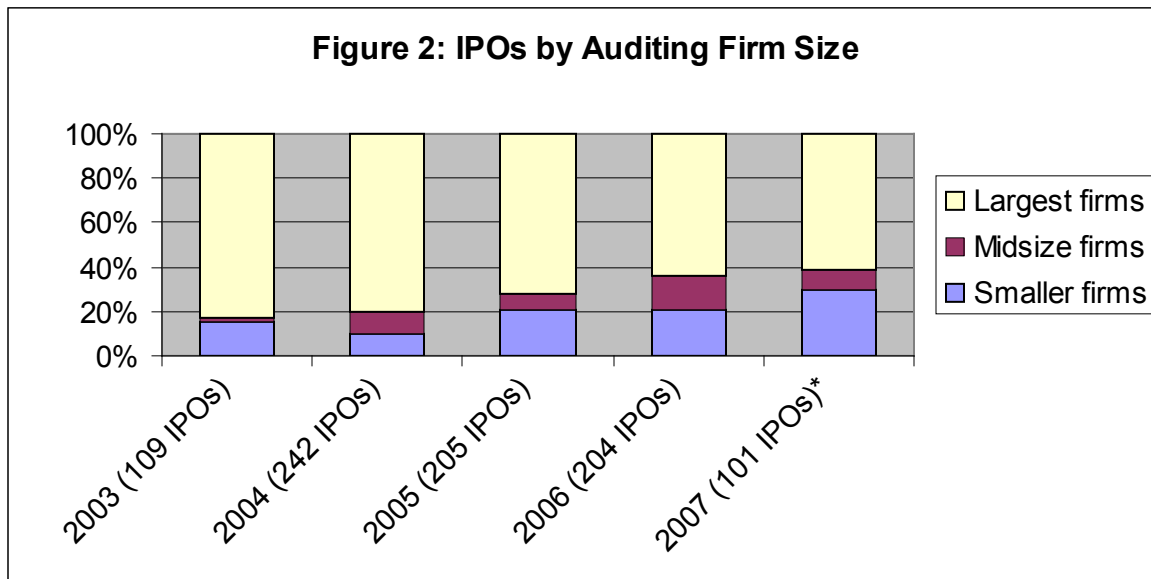
is particularly prevalent in the initial public offering (IPO) arena, where an underwriter may include in the underwriting agreement a provision limiting the company's auditor choice to a specified group of auditing firms.²⁰ Evidence suggests that auditor choice may be more limited among the largest IPOs: While midsize and smaller firms' combined share of the IPO market (by number of IPOs) has increased progressively (rising from 18% in 2003 to 40% in 2007),²¹ the largest firms continue to audit the majority of the largest IPOs.²² See Figure 2.

audited by one of the largest accounting firms, adding a bias that has the practical effect of being a barrier to entry.”).

20 See, e.g., Record of Proceedings (May 5, 2008) (Oral Remarks of Committee Member Ken Goldman, Chief Financial Officer, Fortinet Inc. 143), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-05-05-08.pdf>. See also Edwin J. Kliegman, CPA, Comment Letter Regarding Discussion Outline 2 (Nov. 26, 2007), *available at* http://comments.treas.gov/index.cfm?FuseAction=Home.View&Topic_id=3&FellowType_id=1; Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Brad Koenig, Former Managing Director and Head of Global Technology Investment Banking, Goldman Sachs, 219-220), *available at* <http://www.treas.gov/offices/domestic-finance/acap/Koenig020408.pdf> (noting underwriter practices in auditor selection).

21 2008 GAO REPORT 44.

22 Record of Proceedings (Feb. 4, 2008) (Written Submission of Brad Koenig, Former Managing Director and Head of Global Technology Investment Banking, Goldman Sachs, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/Koenig020408.pdf> (noting that from 2002-2007 the largest four auditing firms had an 87% market share of the 817 initial public offerings that exceeded \$20 million). See also 2008 GAO REPORT 44 (“Staff from some investment firms that underwrite stock issuances for public companies told [GAO] that in the past they generally had expected the companies for which they raised capital to use one of the largest firms for IPOs but that now these organizations were more willing to accept smaller audit firms.... However,...most of the companies that went public with a mid-size or smaller auditor were smaller. In addition, these firms' share of IPOs of larger companies (those with revenues greater than \$150 million) rose from none in 2003 to about 13 percent in 2007.”).



*IPOs for 2007 are January through June.

Note: The largest firms – Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP – each audited more than 1,200 public companies for 2006 according to Public Accounting Report. The midsize firms – BDO Seidman LLP, Crowe Chizek & Company LLC, Grant Thornton LLP, and McGladrey and Pullen LLP – each audited more than 100 but fewer than 425 public companies for 2006 and had around \$1 billion in revenue or less according to Public Accounting Report. Smaller firms include all other auditing firms.

Source: U.S. GOVERNMENT ACCOUNTABILITY OFFICE, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION, GAO-08-163, 46 (Jan. 2008).

The Committee believes these provisions impair competition by limiting public company auditor choice and the ability of smaller auditors to serve a greater share of the public company audit market. Accordingly, the Committee recommends that the Securities and Exchange Commission (SEC) require public companies to disclose in their registration statements, annual reports, and proxy statements any provisions in agreements limiting auditor choice.²³

²³See, e.g., Record of Proceedings (June 3, 2008) (Written Submission of Jean C. Bedard, Timothy B. Harbert Professor of Accounting, Department of Accountancy, Bentley College, 8), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Bedard060308.pdf> (supporting this Recommendation and noting that enhanced name recognition “would provide further incentives for these [smaller] firms to build the personnel quality of their organizations”); Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 5, (June 27, 2008), available at http://comments.treas.gov/_files/ResponsetoAdvisoryCommittee0627final.PDF (recommending that “the SEC adopt a rule prohibiting agreements with third parties that limit auditor selection to specific firms, other than to specify that the firm selected must be suitably qualified to perform the audit”); David McDonnell, Chief Executive Officer, Grant Thornton International Ltd, and Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Ltd Board of Governors, Comment Letter Regarding Draft Report and Draft Report Addendum 6 (June 27, 2008), available at http://comments.treas.gov/_files/GTCCommentlettertoACAPJune2008_FINAL.pdf (“Such public disclosure will create incentives for audit committees to optimize their auditor choice and help clarify that size alone is not the best criterion when selecting an auditor.”). But cf. Record of Proceedings (June 3, 2008) (Written Submission of Brian O’Malley, Senior Vice President and Chief Auditor, NASDAQ OMX, 2), available at

The disclosure should identify the agreement and include the names of the parties to the agreement and the actual provisions limiting auditor choice.²⁴

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

The Committee considered testimony that the lack of smaller firms' name recognition and reputation have hindered smaller auditing firms' ability to compete in the large public company audit market. The GAO noted that name recognition, reputation, and credibility were significant barriers to smaller auditing firm expansion.²⁵ The PCAOB has registered and oversees 982 U.S. auditing firms and 857 foreign auditing firms.²⁶ While it is not possible to include all smaller firms, the Committee received testimony and comment letters suggesting that there should be greater inclusion and participation of smaller firms in public and private sector committees, roundtables, and fellowships.²⁷ One auditing firm representative suggested the creation of a PCAOB professional practice fellowship program, reaching out to professionals from auditing firms of various sizes.²⁸

The Committee believes increasing name recognition and reputation could promote audit market competition and auditor choice.²⁹ Accordingly, the Committee recommends that reg-

<http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/OMalley060308.pdf> (noting that disclosure may add transparency but the "root causes" of decisions to limit auditor choice remain).

24 The Committee notes that a group of market participants put together by the United Kingdom's Financial Reporting Council to study audit market competition has suggested similar disclosure of contractual obligations limiting auditor choice. See FINANCIAL REPORTING COUNCIL, FRC UPDATE: CHOICE IN THE UK AUDIT MARKET 4 (Apr. 2007) [hereinafter FRC UPDATE] (recommending that "when explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms").

25 2008 GAO REPORT 44 ("Fifty percent of accounting firms responding to [GAO's] survey that want to audit large companies said that name recognition or reputation with potential clients was a great or very great impediment to expansion. Similarly, 54 percent of these firms cited name recognition or credibility with financial markets and investment bankers as a great or very great impediment to expansion."). See also Edward J. Kliegman, CPA, Comment Letter Regarding Discussion Outline (Nov. 16, 2007), available at http://comments.treas.gov/index.cfm?FuseAction=Home.View&Topic_id=3&FellowType_id=1.

26 Data are as of Feb. 21, 2008.

27 See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, Comment Letter Regarding Discussion Outline 16 (Jan. 30, 2008), available at http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008.doc; Record of Proceedings (Dec. 3, 2007) (Questions for the Record of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 4 (Feb. 1, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-2007.pdf>.

28 Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, 4), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>. See Chapter VI (recommending the creation of a PCAOB fellowship program). While maintenance and extension of professional fellowship programs are also considered in the Committee's recommendations relating to human capital matters, extending these opportunities increasingly to firms of various sizes could assist smaller firms in their ability to compete in the public company audit market.

29 See, e.g., Record of Proceedings (June 3, 2008) (Written Submission of Jean C. Bedard, Timothy B. Harbert Professor of Accounting, Department of Accountancy, Bentley College, 8), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Bedard060308.pdf> (agreeing with the Recommendation); Record of Proceedings (June 3, 2008) (Written Submission of Kenneth Nielsen Goldman, Capital

ulators and policy makers, such as the SEC, the PCAOB, and the Financial Accounting Standards Board (FASB), include representatives of smaller auditing firms in committees, public forums, fellowships, and other engagements.³⁰ The Committee recognizes the existence of different programs within regulatory agencies available to serve as a resource and contact point for smaller auditing firms and smaller public companies, such as, the SEC's Office of Small Business Policy, the PCAOB's Forum on Auditing in the Small Business Environment, and the FASB's Small Business Advisory Committee.

Recommendation 2. Monitor potential sources of catastrophic risk faced by public company auditing firms and create a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms.

The Committee considered testimony regarding the variety of potentially catastrophic risks that public company auditing firms face. These include the intrinsic risks associated with the auditing of public companies and risks relating to failure in the provision of audit and non-audit services. They encompass civil damage claims, regulatory actions, and the loss of customers, employees, and units of multinational affiliates due to financial instability or loss of reputation.³¹

The Committee believes these risks are real and notes that over the past two decades two large auditing firms have gone out of existence. In 1990, Laventhol & Horwath, at the time the seventh largest auditing firm in the United States, filed for bankruptcy protection due in part to a failure in the provision of non-audit services, and subsequent class action litigation, loss of reputation, and inability to attract and retain clients.³² In 2002, Arthur Andersen, at the time one of the five largest auditing firms in the United States, dissolved. The Department of Justice (DOJ) had criminally indicted the auditing firm on obstruction of justice charges relating to the audit of Enron. The resulting inability to retain clients and partners and keep

Markets and SEC Practice Director, J.H. Cohn LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Goldmann060308.pdf> ("More opportunities such as this testimony for leaders of smaller firms to participate in important public policy discussions about the public company audit profession would over time enhance public understanding and acceptance that high quality in auditing is achievable in different forms and packages."); Record of Proceedings (June 3, 2008) (Written Submission of Kurt N. Schacht, Managing Director, Centre for Financial Market Integrity, CFA Institute, 2-3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Schacht060308.pdf>.

³⁰For a similar recommendation, see SEC ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES, FINAL REPORT 114 (Apr. 23, 2006).

³¹*See, e.g.*, 2008 GAO REPORT 32-36; Zoe-Vonna Palmrose, *Maintaining the Value and Viability of Independent Auditors as Gatekeepers under SOX: An Auditing Master Proposal*, in BROOKINGS-NOMURA SEMINAR: AFTER THE HORSES HAVE LEFT THE BARN: THE FUTURE ROLE OF FINANCIAL GATEKEEPERS 12-13 (Sept. 28, 2005). Civil litigation was the risk most often cited by witnesses before the Committee. *See, e.g.*, Record of Proceedings (Dec. 3, 2007) (Written Submission of James D. Cox, Brainerd Currie Professor of Law, Duke University School of Law), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Cox120307.pdf>. *See also* Eric R. Talley, *Cataclysmic Liability Risk among Big Four Auditors*, 106 COLUM. L. REV. 1641 (Nov. 2006) ("On one hand, the pattern of liability exposure during the last decade does not appear to be the type that would, at least on first blush, imperil the entire profession. On the other hand, if one predicts historical liability exposure patterns into the future, the risk of another firm exiting due to liability concerns appears to be more than trivial").

³²*See, e.g.*, 2008 GAO REPORT 33.

together its global affiliate network led to the collapse of Arthur Andersen.³³

In addition, KPMG recently faced the possibility of criminal indictment relating to its provision of tax-related services. In the end, KPMG entered into a deferred prosecution agreement with the DOJ.³⁴ Many have suggested that a criminal indictment would have led to the dissolution of the firm.

Currently, BDO Seidman is appealing a \$521 million state judgment involving a private company audit client.

As discussed above, the Committee believes that the loss of one of the larger auditing firms would likely have a significant negative impact on the capital markets. Of greatest concern is the potential disruption to capital markets that the failure of a large auditing firm would cause, due to the lack of sufficient capacity to audit the largest public companies and the possible inability of public companies to obtain timely audits.³⁵ The Committee believes these concerns must be balanced against the importance of auditing firms and their partners, as private, for-profit businesses, being exposed to the consequences of failure, including both the legal consequences and economic consequences.

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

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

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

Sarbanes-Oxley provides the PCAOB with registration, reporting, inspection, standard-

³³See, e.g., U.S. GOVERNMENT ACCOUNTABILITY OFFICE, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION 12 (July 2003) ("The criminal indictment of fourth-ranked Andersen for obstruction of justice stemming from its role as auditor of Enron Corporation led to a mass exodus of Andersen partners and staff as well as clients.").

³⁴2008 GAO REPORT 56-57, n. 60. Note that the Department of Justice did indict several individuals.

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

setting, and enforcement authority over public company auditing firms.³⁶ Under its inspection authority, the PCAOB inspects audit engagements, evaluates quality control systems, and tests as necessary audit, supervisory, and quality control procedures. For example, in its inspection of an auditing firm's quality control systems, the PCAOB reviews the firm's policies and procedures related to partner evaluation, partner compensation, new partner nominations and admissions, assignment of responsibilities, disciplinary actions, and partner terminations; compliance with independence requirements; client acceptance and retention policies and procedures; compliance with professional requirements regarding consultations on accounting, auditing, and SEC matters; internal inspection program; processes for establishing and communicating audit policies, procedures, and methodologies; processes related to review of a firm's foreign affiliate's audit performance; and tone at the top.³⁷

The PCAOB also has authority to require registered auditing firms to provide annual and periodic reports. In June 2008, the PCAOB issued *Rules on Periodic Reporting by Registered Public Accounting Firms* requiring annual and periodic reporting.³⁸ The rules remain subject to SEC approval.

The Committee therefore recommends that the PCAOB, in furtherance of its objective to enhance audit quality and effectiveness, exercise its authority to monitor meaningful sources of catastrophic risk that potentially impact audit quality through its programs, including inspections, registration and reporting, or other programs, as appropriate.³⁹ The objective of PCAOB monitoring would be to alert the PCAOB to situations in which auditing firm conduct is resulting in increased catastrophic risk which is impairing or threatens to impair audit quality.⁴⁰

³⁶ Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7211-7219.

³⁷ See, e.g., PCAOB, Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms within 12 Months after an Inspection Report, PCAOB Release No. 104-2006-078 (Mar. 21, 2006). See also the PCAOB's completed inspection reports at http://www.pcaobus.org/Inspections/Public_Reports/index.aspx#k.

³⁸ PCAOB Release No. 2008-004 (June 10, 2008).

³⁹ See, e.g., Record of Proceedings (June 3, 2008) (Oral Remarks of James Kaplan, Chairman and Founder, Audit Integrity, 280-283), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-06-03-08.pdf> (noting that "it really only requires one or two catastrophic events in order to upset or disturb the market place. And clearly, more information needs to be gathered and collected to ensure, or at least assure, that the number of tragic incidents like that are minimized and mitigated"); Record of Proceedings (June 3, 2008) (Written Submission of Brian O'Malley, Senior Vice President and Chief Auditor, NASDAQ OMX, 2-3), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/OMalley060308.pdf> (supporting this Recommendation); Record of Proceedings (June 3, 2008) (Written Submission of Kurt N. Schacht, Managing Director, Centre for Financial Market Integrity, CFA Institute, 3), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Schacht060308.pdf> (supporting this Recommendation).

⁴⁰ See, e.g., Record of Proceedings (June 3, 2008) (Written Submission of Jean C. Bedard, Timothy B. Harbert Professor of Accounting, Department of Accountancy, Bentley College, 9), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Bedard060308.pdf> (supporting this Recommendation); Record of Proceedings (June 3, 2008) (Written Submission of Charles W. Gerdtz, III, General Counsel, PricewaterhouseCoopers LLP, 8), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Bedard060308.pdf> (stating that the "concept" behind this Recommendation deserves serious consideration).

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

The Committee considered testimony regarding the importance of the viability of the larger auditing firms and the negative consequences of the loss of one of these firms on the capital markets. The Committee also considered commentary regarding issues auditing firms faced in addressing circumstances that threatened their viability, including, in particular, problems arising from the need to work with regulators and law enforcement agencies.⁴¹ Several witnesses suggested the development of a mechanism to allow auditing firms facing threatening circumstances to emerge from those situations.⁴² Committee member and former Federal Reserve Chairman Paul Volcker opined that, “[I]f we had [such an] arrangement at the time Andersen went down, we would have saved it.”⁴³ The Committee notes that it is critical to have a process in place to quickly respond to crisis events and recommends the following two-step mechanism described below.

First Step – Internal Governance Mechanism

The Committee notes that auditing firms operate as partnerships, generally led by a centralized management team, with a supervisory board of partners overseeing management’s strategy and performance.⁴⁴ In the event of threatening circumstances at a larger auditing firm, the Committee believes that a lack of effective centralized governance mechanisms may delay crucial decision making, impede difficult decisions that could sustain the firm and its human

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

42 Record of Proceedings (Dec. 3, 2007) (Written Submission of James R. Doty, Partner, Baker Botts L.L.P., 11-13), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Doty120307.pdf> (suggesting that the Bankruptcy Code be amended to prevent creditors whose claims relate to violations of professional standards from opposing reorganization under a court-approved plan; an automatic stay against partners facilitating partner retention; expanding the SEC’s emergency powers to enable the SEC to act by summary order to address the registered firm’s ability to continue to provide audit services; and encouraging the SEC or PCAOB to discourage “client poaching” by requiring public companies to show that switching auditors was not related to mega-judgments against audit affiliates in other jurisdictions). See also Record of Proceedings (Dec. 3, 2007) (Written Submission of Peter S. Christie, Principal, Friemann Christie, LLC, 6), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Christie120307.pdf> (“If it remains possible that a firm can fail for reasons other than liability claims it may be attention needs to be given to devices that will permit a firm to re-emerge.”).

43 Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Paul A. Volcker, Former Chairman, Board of Governors, Federal Reserve System, 317), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03-13-08.pdf>.

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

assets, and lessen the firm's ability to communicate with maximum responsiveness and effectiveness with private, regulatory and judicial bodies.

The Committee therefore recommends that larger auditing firms (those with more than 100 public company audit clients that the PCAOB inspects annually) establish in their partnership agreements a contingent internal governance mechanism, involving the creation of an Executive Committee (made up of partners or outsiders) with centralized firm management powers to address threatening circumstances. The centralized governance mechanism would have full authority to negotiate with regulators, creditors, and others, and it would seek to hold the firm's organization intact, including preserving the firm's reputation, until the mitigation of the threat, or, failing that, the implementation of the second step outlined below. The auditing firm voluntarily would trigger the operation of this mechanism upon the occurrence of potentially catastrophic events specified in the partnership agreement, such as civil litigation or actual or significantly threatened government or regulatory action. If necessary, the SEC and the PCAOB could encourage the firm to trigger the mechanism through private communications, public statements, or other means. Regulators could also assist in maintaining the firm's organization intact by, for example, increasing the time period for registrants that are audit clients to have audits or reviews completed and providing accelerated consultative guidance to registrants that are audit clients.⁴⁵ The Committee recognizes the precise details of such a mechanism would vary from auditing firm to auditing firm, depending on firm structures, history, and culture.⁴⁶

Second Step – External Preservation Mechanism

The Committee also recommends that the larger auditing firms establish in their partnership agreements a rehabilitation mechanism under SEC oversight. The failure of the internal governance mechanism to preserve the auditing firm outlined in the first step above would trigger this second step, which would require legislation. Upon triggering of the second step, either voluntarily by the firm or by the SEC, the SEC would appoint a trustee, subject to court approval, whose mandate would be to seek to address the circumstances that threaten survival, and failing that, to pursue a reorganization that preserves and rehabilitates the firm to the

⁴⁵ See, e.g., Securities and Exchange Commission, Temporary Final Rule and Final Rule: Requirements for Arthur Andersen LLP Auditing Clients, SEC Release No. 33-8070 (Mar. 18, 2002); Securities and Exchange Commission, Press Rel. No. 2002-39 and Order Rel. No. 33-8070 (Mar. 18, 2002) (indictment of Arthur Andersen); SEC Staff Accounting Bulletin No. 90 (Feb. 7, 1991) (bankruptcy of Laventhol & Horwath).

⁴⁶ Note that some commenters sought more prescription surrounding the implementation of this mechanism. See, e.g., Record of Proceedings (June 3, 2008) (Written Submission of Jean C. Bedard, Timothy B. Harbert Professor of Accounting, Department of Accountancy, Bentley College, 9), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Bedard060308.pdf> (recommending that the SEC and/or the PCAOB be granted the power to “require a firm to invoke its internal governance mechanism or to directly invoke the external preservation mechanism when particularly severe threats arise”); Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 27-29 (June 27, 2008), available at http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf (stating that “the only effective way to stave off disaster is to ensure that the threat itself is mitigated at its source”); Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 34-35 (June 27, 2008), available at http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf; Record of Proceedings (June 3, 2008) (Written Submission of Barry Mathews, Deputy Chairman, Aon Corporation, 1), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Mathews060308.pdf>.

extent practicable, and finally, if reorganization fails, to pursue an orderly transition.⁴⁷ If this second mechanism is to include an element that addresses claims of creditors (which could include investors with claims, audit and other clients, partners, other employees, and others), legislation to integrate this mechanism with the judicial bankruptcy process may be necessary.

It is important that this mechanism not be used as insurance for partner capital; that is, this mechanism should not be developed to “bail out” a larger auditing firm, but rather to preserve and rehabilitate the firm in the hope of ensuring the stable functioning of the capital markets and the timely delivery of audited financial statements to investors and other financial statement users. Accordingly, there must be powers that can be exercised in furtherance of the objective of holding the firm together.⁴⁸

In addition, the Committee recommends that, in order for the SEC to make effective and timely use of its powers under this Recommendation and for the DOJ to have the opportunity to be informed as to the consequences that would result from a potential charging decision against a public auditing *firm* (as distinct from individuals within a firm), the DOJ should inform the SEC prior to bringing criminal charges against such a firm.

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

Recommendation 3. Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators.

A key issue in the public company audit market is what drives competition for audit clients and whether audit quality is the most significant driver. Currently, there is minimal publicly

⁴⁷ Some witnesses questioned whether the SEC would be willing to assume such a role. *See, e.g.*, Record of Proceedings (June 3, 2008) (Written Submission of Charles W. Gerdtts, III, General Counsel, PricewaterhouseCoopers LLP, 9), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Gerdtts060308.pdf> (noting that the SEC may not have the resources, expertise, or will to assume such a role).

⁴⁸ Record of Proceedings (Dec. 3, 2007) (Written Submission of James R. Doty, Partner, Baker Botts L.L.P., 11), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Doty120307.pdf> (Dec. 3, 2007) (“It is an anecdotal but firmly held perception of the profession that no accounting firm has entered bankruptcy and emerged to continue its practice. The hard assets of the firm are not significant: the professionals and the clients are the lifeblood of the registered firm. With any anticipation of bankruptcy, these mobile assets are gone.”).

available information regarding indicators of audit quality at individual auditing firms. Consequently, it is difficult to determine whether audit committees, who ultimately select the auditor, and management are focused and have the tools that are useful in assessing audit quality that would contribute to making the initial auditor selection and subsequent auditor retention evaluation processes more informed and meaningful.⁴⁹ In addition, with the majority of public companies currently putting shareholder ratification of auditor selection to an annual vote, shareholders may also lack audit quality information important in making such a ratification decision.⁵⁰

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

The Committee recognizes the challenges of developing and monitoring indicators of audit quality, especially in light of the complex factors driving the potential impact on the incentives of market actors, and the resulting effect on competitive dynamics among auditors.⁵¹

The Committee has considered testimony and comment letters as well as other studies and reports in developing this recommendation. A possible framework for PCAOB consideration is reviewing annual auditing firm reports in other jurisdictions. For example, one auditing firm's United Kingdom affiliate lists in its annual report nine "key performance indicators, including average headcount, staff turnover, diversity, client satisfaction, audit and non-audit work, proposal win rate, revenue, profit, and profit per partner."⁵² The Financial Reporting Council recently published a paper setting out drivers of audit quality.⁵³ In addition, the PCAOB also could consider some of the factors that auditing firms present to audit committees, such as engagement team composition, the nature and extent of firm training programs, and the nature and reason for client restatements.⁵⁴

The Committee therefore recommends that the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and requiring auditing

⁴⁹ See, for example, New York Stock Exchange, Listed Company Manual § 303A, which the SEC approved on November 4, 2003, for the responsibilities of exchange-listed companies' audit committees.

⁵⁰ INSTITUTIONAL SHAREHOLDER SERVICES, U.S. CORPORATE GOVERNANCE POLICY – 2007 UPDATES 3 (2006).

⁵¹ If the idea proves to be workable, implementation could be a major undertaking for the PCAOB. Developing meaningful quality indicators, defining how they should be measured, and rolling out the measurement process could take significant PCAOB time and effort. Auditing firms, public companies, investors, and academics would all likely have valuable ideas as to approaches the PCAOB could take. However the indicators were devised, firms would have to build their internal processes for measuring the audit quality indicators and the PCAOB would have to develop procedures and training to monitor those processes.

⁵² See KPMG LLP, UK ANNUAL REPORT 2007 46.

⁵³ FRC UPDATE 4.

⁵⁴ Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>.

firms to publicly disclose these indicators.⁵⁵ Testimonies and comment letters have suggested specific output-based audit quality indicators—indicators determined by what the auditing firm has produced in terms of its audit work, such as number of frauds discovered and nature and reason for financial restatements related to time periods when the underlying reason for restatement occurred during the auditing firm’s tenure as auditor for the client—and input-based audit quality indicators—indicators of what the auditing firm puts into its audit work to achieve a certain result, such as the auditing firm’s processes and procedures used for detecting fraud, the average experience level of auditing firm staff on individual engagements, the average ratio of auditing firm professional staff to auditing firm partners on individual engagements, and annual staff retention.⁵⁶ The Committee believes that the PCAOB should consider both output-based and input-based indicators.⁵⁷ The Committee also recommends

⁵⁵ See, e.g., Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 29, (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf; Ernst & Young LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 33-34, (June 27, 2008), *available at* http://comments.treas.gov/_files/EYACAPCommentLetterFINAL.pdf; Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 36-38, (June 27, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (noting that the feasibility study should state the overarching objectives of quality indicators, consider the differences in firm size, partnership model, audit practice scope and audit specialty, and recognize the costs, difficulty and complexity involved); Record of Proceedings (June 3, 2008) (Written Submission of Kenneth Nielsen Goldman, Capital Markets and SEC Practice Director, J.H. Cohn LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Goldmann060308.pdf>.

⁵⁶ See, e.g., Anonymous Retired Big 4 partner, Comment Letter Regarding Discussion Outline (Nov. 2007) (recommending public disclosure of the following audit quality drivers: 1) average years of experience of audit professionals, 2) ratio of professional staff to audit partners, 3) chargeable hours per audit professional, 4) professional chargeable hours managed per audit partner, 5) annual professional staff retention, and 6) average annual training hours per audit professional); Matthew J. Barrett, Professor of Law, Notre Dame Law School, Comment Letter Regarding Draft Report and Draft Report Addendum (June 13, 2008), *available at* http://comments.treas.gov/index.cfm?FuseAction=Home.View&Topic_id=9&FellowType_id=1&CurrentPage=1; Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees’ Retirement System, Comment Letter Regarding Draft Report and Draft Report Addendum 3, (June 13, 2008), *available at* http://comments.treas.gov/_files/200806_13ACAP_addendum_commentltr.pdf (suggesting to include, among other things, “average headcount, staff turnover, diversity, client satisfaction, audit and non-audit work, proposal win rate, revenue, profit, profit per partner, engagement team composition, the nature and extent of training programs and the nature and reason for client restatements”); Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf> (recommending the issuance of regulatory guidance on qualitative factors to be used by audit committees and other market participants to evaluate auditing firms); Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (suggesting that disclosure of “key elements that drive audit quality would be a useful benefit to the capital markets” and could include “firm disclosure and discussion of the levels of partner and staff turnover, average hours of professional training, risk management and compliance measurements, and metrics related to the quality of management and firm governance processes”); Anonymous Private Investor, Former Auditor, and Former CFO, Comment Letter Regarding Draft Report and Draft Report Addendum (May 11, 2008), *available at* http://comments.treas.gov/index.cfm?FuseAction=Home.View&Topic_id=9&FellowType_id=1&CurrentPage=2 (recommending that the auditor’s report disclose, in addition to the location of the office conducting the audit, the percentage of office revenue attributed to the client, the length of the audit firm’s tenure with the client, and the length of time until the lead and concurring partner must rotate).

⁵⁷ See, e.g., Matthew J. Barrett, Professor of Law, Notre Dame Law School, Comment Letter Regarding Draft Report and Draft Report Addendum (June 13, 2008), *available at* <http://comments.treas.gov/index>.

that, if the proposal is feasible, the PCAOB, through its inspection process, should monitor these indicators.

Recommendation 4. Promote the understanding of and compliance with auditor independence requirements among auditors, investors, public companies, audit committees, and boards of directors, in order to enhance investor confidence in the quality of audit processes and audits.

The Committee considered testimony and comment letters regarding the significance of the independence of the public company auditor—both in fact and appearance—to the credibility of financial reporting, investor protection, and the capital formation process.⁵⁸ The auditor is expected to offer critical and objective judgment on the financial matters under consideration, and actual and perceived absence of conflicts is critical to that expectation.

cfm?FuseAction=Home.View&Topic_id=9&FellowType_id=1&CurrentPage=1 (suggesting that the SEC require registrants to publicly disclose any financial fraud uncovered by the auditor, including numbers and amount of all audit adjustments, and the number of restatements of financial statements with unqualified opinions); Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft Report Addendum 10 (May 15, 2008), *available at* http://comments.treas.gov/_files/ACAPCommentLetterMay152008.pdf (suggesting that the Committee consider “output-based measures of audit quality” such as fewer client frauds, fewer client restatements, less earnings management, and more accurate auditor reporting before a bankruptcy filing); Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>; Gilbert F. Viets, Comment Letter Regarding Draft Report and Draft Report Addendum 2-3, (May 19, 2008), *available at* http://comments.treas.gov/_files/TREASURYLETTER3.doc (suggesting disclosure of instances where the auditor found and corrected, prior to their disclosure, material financial statement errors and the firms’ “acceptable audit risk” in discovering material errors). The Committee recognizes the concerns noted by certain testimony and commentary regarding the use of audit quality indicators. *See, e.g.*, Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 37 (June 27, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (“Any feasibility study should also consider—as the [UK’s Financial Reporting Council] has recognized—how the key indicators being considered may vary due to factors unrelated to audit quality.”); Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 11 (June 27, 2008), *available at* http://comments.treas.gov/_files/ResponsetoAdvisoryCommittee0627final.PDF (“Disclosure of indicators would only be meaningful if they have a clear and demonstrable relationship to audit quality and, even if they do, only if they can be understood in the context of a particular audit.”); Record of Proceedings (June 3, 2008) (Written Submission of Brian O’Malley, Senior Vice President and Chief Auditor, NASDAQ OMX, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/OMalley060308.pdf> (cautioning against an auditing industry managing itself towards some set of preconceived metrics that might sway them from investor protection).

⁵⁸*See, e.g.*, Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (“Independence forms the bedrock of credibility in the auditing profession, and is essential to the firms’ primary function in the capital markets.”); Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf>.

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

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

In the United States, various oversight bodies have authority to promulgate independence requirements, including the SEC and PCAOB for public company auditors, and the AICPA and state boards of accountancy for public and private company auditors.⁵⁹ The Committee recommends that the SEC and PCAOB compile and publish their independence requirements in a single document and make this document easily accessible on their websites.⁶⁰ The Com-

⁵⁹ See, e.g., SEC Regulation S-X, Article 2, Rule 2-01 -- Qualifications of Accountants, 17 CFR § 210.2-01; SEC Financial Reporting Policies, Sec. 602.01 – Interpretations Relating to Independence; SEC Final Rule, Amendments to SEC Auditor Independence Requirements “Strengthening the Commission’s Requirements Regarding Auditor Independence”, SEC Rel. No 33-8183 (2003); SEC Final Rule, Revision of the Commission’s Auditor Independence Requirements, SEC Rel. No. 33-7919 (2001); PCAOB, Interim Independence Standards, ET Sections 101 and 191; Independence Standards Board, Independence Standards Nos. 1, 2, and 3, and ISB Interpretations 99-01, 00-1, and 00-2; PCAOB Bylaws and Rules, Section 3, Professional Standards; AICPA Code of Professional Conduct, ET Sections 100-102.

⁶⁰ See, e.g., Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 38-39, (June 26, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (agreeing that “such a document would make it easier for auditors to understand the independence requirements that apply to them”); Record of Proceedings (June 3, 2008) (Written Submission of Brian O’Malley, Senior Vice President and Chief Auditor, NASDAQ OMX, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/OMalley060308.pdf> (stating that the Recommendation would be a “great asset”); PricewaterhouseCoopers LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 19, (June 30, 2008), *available at* http://comments.treas.gov/_files/PwCCommentLtrTreasCmtDraftandAddendum63008.pdf (supporting this Recommendation). Note that the Committee received testimony and comment letters suggesting that the Department of Labor independence rules be included in this compilation. See, e.g., Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 30, (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf; Record of Proceedings (June 3, 2008) (Written Submission of Kenneth Nielsen Goldmann, Capital Markets and SEC Practice Director, J.H. Cohn LLP, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Goldmann060308.pdf> (recommending the inclusion of the Department of Labor and others in the Recommendation); Mayer Hoffman McCann P.C., Comment Letter Regarding Draft Report and Draft Report Addendum 5, (June 17, 2008), *available at* http://comments.treas.gov/_files/MayerHoffmanMcCannCommentLetter.pdf (suggesting the Recommendation include the SEC, PCAOB, AICPA, DOL, and GAO).

mittee recommends that the AICPA and state boards of accountancy clarify and prominently state that differences exist between their standards and those of the SEC and the PCAOB and indicate, at each place in their standards where differences exist, that additional SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements.⁶¹

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

The Committee considered testimony and commentary that, to comply with the detailed and complex⁶² requirements, some auditors may be taking a “check the box” approach to compliance with independence requirements, and losing focus on the critical need to exercise independent judgment or professional skepticism about whether the substance of a potential conflict of interest may compromise integrity or objectivity, or create an appearance of doing so.⁶³

The Committee recommends that auditing firms develop appropriate independence training materials for auditing firms, especially partners and mid-career professionals, that help to foster a healthy professional skepticism with respect to issues of independence that is objectively focused and extends beyond a “check the box” mentality.⁶⁴ The training materials should

61 The Committee took note of concerns expressed regarding independence issues from a variety of perspectives. *See, e.g.*, Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, Comment Letter Regarding Discussion Outline 9 (Jan. 30, 2008), *available at* http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008.doc (suggesting simplifying the current SEC independence standards); Dana R. Hermanson, Kennesaw State University, Comment Letter Regarding Discussion Outline 1 (Oct. 4, 2007), *available at* http://comments.treas.gov/_files/HermansonStatement10407.pdf (stating that consulting and auditing were incompatible and posed a significant threat to the long-term sustainability of the profession); Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (“The independence rules should be re-evaluated periodically to examine whether the rules continue to strike the right balance between cost burden and benefit.”); Record of Proceedings (Dec. 3, 2007) (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf> (recommending consideration of potential changes to aspects of independence rules). Note that one witness called for adoption of a single set of independence rules for public and private companies. *See, e.g.*, Record of Proceedings (June 3, 2008) (Written Submission of Kurt N. Schacht, Managing Director, Centre for Financial Market Integrity, CFA Institute, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Schacht060308.pdf>.

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

63 *See, e.g.*, CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT, Interim Auditing Standard AU 316, Paragraph .13 (Pub. Company Accounting Oversight Bd. 2002) (“Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.”).

64 *See, e.g.*, Record of Proceedings (June 3, 2008) (Written Submission of Dan Guy, Former Vice President, Professional Standards and Services, American Institute of Certified Public Accountants, 3), *available at* <http://>

focus on lessons learned and best practices observed by the PCAOB in its inspection process and the experience of other relevant regulators as appropriate. To ensure the implementation of this training on an overall basis, the PCAOB should review this training as part of its inspection program.

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

Although not statutorily required, the majority of public companies in the United States—nearly 95% of S&P 500 and 70%-80% of smaller companies—put auditor ratification to an annual shareholder vote.⁶⁵ Even though ratification of a company’s auditor is non-binding, the Committee learned that corporate governance experts consider this a best practice serving as a “check” on the audit committee.⁶⁶ Pursuant to Sarbanes-Oxley, audit committees of exchange-listed companies must appoint, compensate, and oversee the auditor.⁶⁷ SEC rules implementing Sarbanes-Oxley specifically permit shareholder ratification of auditor selection.⁶⁸ Ratification allows shareholders to voice a view on the audit committee’s work, including the reasonableness of audit fees and apparent conflicts of interest.

The Committee believes shareholder ratification of auditor selection through the annual meeting and proxy process can enhance the audit committee’s oversight to ensure that the auditor is suitable for the company’s size and financial reporting needs.⁶⁹ This may enhance competition in the audit industry. Accordingly, the Committee encourages such an approach as a best practice for all public companies. The Committee also urges exchange self-regulatory organizations to adopt such a requirement as a listing standard. In addition, to further enhance audit committee oversight and auditor accountability, the Committee recommends that disclosure in the company proxy statement regarding shareholder ratification include the name(s) of the senior auditing partner(s) staffed on the engagement.⁷⁰ The Committee notes

www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Guy060308.pdf (stating that auditors fail to detect material financial statement fraud due to, among other things, the lack of professional skepticism); Record of Proceedings (June 3, 2008) (Written Submission of Brian O’Malley, Senior Vice President and Chief Auditor, NASDAQ OMX, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/OMalley060308.pdf> (noting that “auditor skepticism throughout an auditor’s career is the keystone, all incentives and disincentives should be focused on its achievement”); PricewaterhouseCoopers LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 19, (June 30, 2008), *available at* http://comments.treas.gov/_files/PwCCommentLtrTreasCmtDraftandAddendum63008.pdf (stating that “independence forms the bedrock of credibility in the auditing profession, and is essential to the firm’s primary function in the capital markets”).

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

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

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

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

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

70 *See, e.g.*, Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, Comment Letter

that there might be other audit-engagement specific data, such as the auditor's tenure with a specific public company client, useful to shareholders and audit committees.

Recommendation 6. Enhance regulatory collaboration and coordination between the PCAOB and its foreign counterparts, consistent with the PCAOB mission of promoting quality audits of public companies in the United States.

The globalization of the capital markets has compelled regulatory coordination and collaboration across jurisdictions. Regulators of public company auditors are no exception, as companies increasingly seek investor capital outside their home jurisdictions and the larger auditing firms create, expand, and, in some audits, increasingly rely on global networks of affiliates in order to provide auditing and other services to companies operating in multiple jurisdictions.⁷¹ The Committee considered commentary regarding the PCAOB's regulatory role on a

Regarding Draft Report and Draft Report Addendum 4, (June 16, 2008), *available at* http://comments.treas.gov/_files/TREASURYLETTER3BAILEY61608.doc ("Knowing that any failure will be clearly and unambiguously associated with the named individuals and that the veil of the firm will not be there to obscure their responsibility may be of value."); Record of Proceedings (June 3, 2008) (Written Submission of Jean C. Bedard, Timothy B. Harbert Professor of Accounting, Department of Accountancy, Bentley College, 11), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Bedard060308.pdf> (supporting the Recommendation and suggesting further that the Committee recommend an advisory shareholder vote on each member of the audit committee for companies that have not adopted a majority vote provision for all board members, and that the engagement partner sign both his or her name as well as the firm's name to the audit report, making it a more direct public statement of responsibility than proxy disclosure); Paul Lee, Director, Hermes Equity Ownership Services Limited, Comment Letter Regarding Draft Report and Draft Report Addendum 4, (June 13, 2008), *available at* http://comments.treas.gov/_files/ACAPresponese13Jun08.pdf (stating that an auditor should not continue in office unless it receives a majority of the votes of shareholders in favor of ratification, and noting that accountability and professional judgment would be increased if auditors' reports were signed by individuals as well as in the names of the relevant auditing firm); Record of Proceedings (June 3, 2008) (Written Submission of Kurt N. Schacht, Managing Director, Centre for Financial Market Integrity, CFA Institute, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Schacht060308.pdf> (supporting the Recommendation and further recommending disclosure of other key engagement individuals in addition to the lead audit partner, and transparent disclosure of audit quality, firm financial strength, and professional skill level at least to the audit committee, if not publicly). *But cf.* Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 21-22, (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf (noting that the Recommendation goes against the team nature of audits, raises personal security and privacy concerns, and is unrelated to audit quality); Ernst & Young LLP Comment Letter Regarding Draft Report and Draft Report Addendum 28, (June 27, 2008), *available at* http://comments.treas.gov/_files/EYACAPCommentLetterFINAL.pdf; Mayer Hoffman McCann P.C., Comment Letter Regarding Draft Report and Draft Report Addendum 3, (June 17, 2008), *available at* http://comments.treas.gov/_files/MayerHoffmanMcCannCommentLetter.pdf (suggesting that "[o]ther individuals involved in the audit might actually feel less responsibility if only the engagement and concurring partners sign the report or only top partners are named, precisely the opposite of what should be encouraged"); David McDonnell, Chief Executive Officer, Grant Thornton International Ltd, and Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Ltd Board of Governors, Comment Letter Regarding Draft Report and Draft Report Addendum 4, (June 27, 2008), *available at* http://comments.treas.gov/_files/GTCommentlettertoACAPJune2008_FINAL.pdf (noting the team effort aspect of audits and stating that partners may be unwilling to accept the added risk, personal security issues, and privacy issues). As discussed above, the Committee also believes that this ratification process would be made more meaningful if accompanied by the development and disclosure of key indicators of audit quality.

⁷¹ See Record of Proceedings (Feb. 4, 2008) (Written Submission of Cynthia M. Fornelli, Executive Direc-

global basis.⁷²

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

In May 2008, the PCAOB hosted its second International Auditor Regulatory Institute where representatives from more than 45 jurisdictions gathered to learn more about PCAOB operations. In 2006, the PCAOB formally joined the International Forum of Independent Audit Regulators, created to encourage regulatory collaboration and sharing of regulatory knowledge and experience.

The Committee believes that these types of global regulatory coordination and cooperation are important elements in making sure public company auditing firms of all sizes are contributing effectively to audit quality. The Committee strongly supports the efforts of the PCAOB to enhance the efficiency and effectiveness of its programs by communicating with foreign regulators and participating in global regulatory bodies. The Committee urges the PCAOB and its foreign counterparts to continue to improve regulatory cooperation and coordination on a global basis.⁷³

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

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

73 *See, e.g.*, Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor, and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft Report Addendum 11, (May 15, 2008), *available at* http://comments.treas.gov/_files/ACAPCommentLetter-May152008.pdf (agreeing with the Recommendation); Record of Proceedings (June 3, 2008) (Written Submission of Brian O’Malley, Senior Vice President and Chief Auditor, NASDAQ OMX, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/OMalley060308.pdf> (agreeing with the Recommendation); Record of Proceedings (June 3, 2008) (Written Submission of Kurt N. Schacht, Managing Director, Centre for Financial Market Integrity, CFA Institute, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Schacht060308.pdf> (agreeing with this “most important” Recommendation).

In addition, the Committee recognizes the challenges that the globalized regulatory environment creates for smaller firms, particularly with respect to the increasing acceptance of IFRS.⁷⁴ The Committee believes that regulators and policy makers must recognize the importance of including smaller firms in international roundtables, discussions, and policy making decisions.⁷⁵

⁷⁴Record of Proceedings (June 3, 2008) (Questions for the Record of Kenneth Nielsen Goldmann, Capital Markets and SEC Practice Director, J.H. Cohn LLP, 21-22 (June 30, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-6-3-08.pdf> (noting the difficulty and costs associated with implementing IFRS for smaller firms); Record of Proceedings (June 3, 2008) (Questions for the Record of Kurt N. Schacht, Managing Director, Centre for Financial Market Integrity, CFA Institute, 73-74 (June 30, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-6-3-08.pdf> (stating the difficulty in maintaining competence in IFRS, GAAP, and local/national standards).

⁷⁵*See, e.g.*, Record of Proceedings (June 3, 2008) (Written Submission of Kurt N. Schacht, Managing Director, Centre for Financial Market Integrity, CFA Institute, 3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Schacht060308.pdf> (stating that demonstrating technical competence in international matters is of increased importance especially for smaller firms).

IX. SEPARATE STATEMENTS

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

X: APPENDICES

Appendix A

DEPARTMENT OF TRANSPORTATION

Surface Transportation Board

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Decided: June 8, 2007.

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

Vernon A. Williams,
Secretary.

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

DEPARTMENT OF THE TREASURY

Advisory Committee on the Auditing Profession

AGENCY: Department of the Treasury, Departmental Offices.

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

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

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

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

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

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

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

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

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

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

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

Dated: June 8, 2007

Taiya Smith,

Executive Secretary.

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

BILLING CODE 4811-42-P

Appendix B

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

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

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

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

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

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

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

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

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

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


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

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

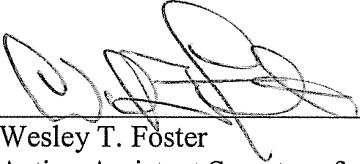
H. Number and Frequency of Meetings. The Committee shall meet at such intervals as are necessary to carry out its duties. It is estimated that the Committee will meet not more than eight times.

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

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

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

May 17, 2007
Date

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

6-5-07
Date

Appendix C

November 20, 2006
hp-174

Remarks by

Treasury Secretary Henry M. Paulson, Jr.

on the Competitiveness of U.S. Capital Markets Economic Club of New York.
New York, NY

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

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

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

Recent Past

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

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

In the United States, whenever there is a major problem in our capital markets, we shine a light on it and move quickly to clean it up. The vast majority of corporate leaders are honest people, but those executives who put their personal interest above the interests of their shareholders undermined confidence in our markets. That's not competing, that's cheating. And

perpetrators are being punished.

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

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

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

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

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

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

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

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

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

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

Each of these warrants deeper discussion.

Foreign Market Development

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

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

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

One important feature of the IFRS accounting system is that it is principles-based, rather than rules-based. By “principles-based,” I mean that the system is organized around a relatively small number of ideas or concepts that provide a framework for thinking about specific issues. The ad-

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

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

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

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

Legal Burden

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

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

Regulatory Structure

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

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

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

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

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

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

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

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

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

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

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

Sarbanes-Oxley and Governance

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

These changes were necessary to rein in abuses. But significant changes always cause stress, and early implementation of new rules may produce uneven results. We must recognize the benefits of the new rules, and remain open-minded about how they affect the system, both positively and negatively. At this time, I do not believe we need new legislation to amend Sarbanes-Oxley. Instead, we need to implement the law in ways that better balance the benefits of the legislation with the very significant costs that it imposes, especially on small businesses.

By far the single biggest challenge with Sarbanes-Oxley is section 404, which requires management to assess the effectiveness of a company's internal controls and requires an auditor's attestation of that assessment. Companies should invest in strong internal controls and

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

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

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

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

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

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

Accounting

The corporate scandals were, for the most part, accounting scandals, so it is not surprising that so much of the recent reform has focused on the accounting industry. Our accounting system is the lifeblood of our capital markets. And it has historically represented a very high standard. But it was abused in the corporate scandals by manipulation and smoothing of earnings.

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

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

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

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

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

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

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

The PWG, Derivatives, and Hedge Funds

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

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

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

Conclusion

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

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

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

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

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

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

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

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

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

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

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

Thank you very much.

Appendix D

March 13, 2007
HP-306

Opening Remarks by

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

Washington, DC

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendix E

May 17, 2007
HP-408

Paulson Announces First Stage of Capital Markets Action Plan

Washington, DC

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

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

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

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

Provide Investors with A Transparent and Sustainable Auditing System

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

Gain Better Understanding of Reasons for Increasing Financial Restatements

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

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

Enhance Financial Reporting

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

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

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

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

Appendix F

May 17, 2007
HP-407

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

Washington, DC

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

The Key Test of Accurate Financial Reporting is Trust

By Henry Paulson

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

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

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

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

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

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

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

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

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

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

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

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

The writer is US Treasury secretary.

Appendix G

October 2, 2007
hp-585

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

Washington, DC

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

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

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

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

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

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

Committee members include:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Committee observers include:

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

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

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

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

Sir David Tweedie, Chairman of the International Accounting Standards Board

Appendix H

October 15, 2007
hp-610

Under Secretary for Domestic Finance

Robert K. Steel

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

Washington D.C.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendix I

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

By-Laws and Operating Procedures

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

Section I: Purpose, Organization, and Operation.

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

Section II: Members and Observers.

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

Section III: Meetings.

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

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

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

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

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

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

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

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

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

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

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

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

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

Section IV: Officials.

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

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

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

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

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

Section V: Subcommittees.

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

Section VI: Steering Committee.

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

Section VII: Records.

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

Section VIII: Expenses.

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

Section IX: Amendments.

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

Appendix J

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

December 3, 2007 Meeting

Panel I: Human Capital

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

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

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

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

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

Panel II: Firm Structure and Finances

Peter S. Christie, Principal, Friemann Christie, LLC

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

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

James R. Doty, Partner, Baker Botts LLP

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

Panel III: Concentration and Competition

Paul Boyle, Chief Executive, Financial Reporting Council

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

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

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

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

Panel IV: General Sustainability

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

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

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

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

February 4, 2008 Meeting

Panel I: Human Capital

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

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

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

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

Barry Salzberg, Chief Executive Officer, Deloitte LLP

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

Panel II: Firm Structure and Finances

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

Richard Fleck, Global Relationship Partner, Herbert Smith LLP

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

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

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

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

Panel III: Concentration and Competition

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

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

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

Neal D. Spencer, Managing Partner, BKD, LLP

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

June 3, 2008 Meeting

Panel I: Human Capital

Jean C. Bedard, Timothy B. Harbert Professor of Accounting, Department of Accountancy, Bentley College

John Biggs, Audit Committee Chair, Boeing, Inc., and former Chief Executive Officer and Chairman, TIAA-CREF

Kayla J. Gillan, Chief Administrative Officer, RiskMetrics Group

William Kinney, Charles & Elizabeth Prothro Regents Chair in Business and Price Waterhouse Fellow in Auditing, University of Texas at Austin

Anne M. Lang, Chief Human Resources Officer, Grant Thornton LLP

Frank K. Ross, Director, Center for Accounting Education, Howard University School of Business

Panel II: Firm Structure and Finances

Harvey Goldschmid, Dwight Professor of Law, Columbia Law School

Dan Guy, Former Vice President, Professional Standards and Services, American Institute of Certified Public Accountants

Barry Mathews, Deputy Chairman, Aon Corporation

Nell Minow, Editor and Co-Founder, The Corporate Library LLC

Jules W. Muis, Former Vice President & Controller, World Bank

Kathryn A. Oberly, Vice Chair and General Counsel, Ernst & Young LLP

Rex Staples, General Counsel, North American Securities Administrators Association

Michael R. Young, Partner, Willkie Farr & Gallagher LLP

Robin G. Munden, General Counsel, Crowe Chizek and Company LLC (Written Submission Only, No Oral Testimony)

Panel III: Concentration and Competition

Mark Anson, President and Executive Director, Investment Services, Nuveen Investments

Charles W. Gerdts, III, General Counsel, PricewaterhouseCoopers LLP

Kenneth Nielsen Goldman, Capital Markets and SEC Practice Director, J.H. Cohn LLP

James Kaplan, Chairman and Founder, Audit Integrity

Brian O'Malley, Senior Vice President and Chief Auditor, NASDAQ OMX

Kurt N. Schacht, Managing Director, Centre for Financial Market Integrity, CFA Institute

Appendix K

Working Discussion Outline

Advisory Committee on the Auditing Profession

Over-Arching Principles

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

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

1. Consideration of Prior Recommendations.

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

2. Human Capital and Its Impact on Audit Quality.

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

2.3.1. Recruitment.

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

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

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

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

develop employees for the appropriate auditing assignments.

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

2.3.3. Retention.

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

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

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

2.4.1. Consider the accounting curriculum.

2.4.1.1. Multi-disciplinary approach vs. technical approach.

2.4.1.1.1. Debate since the late 1950s.

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

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

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

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

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

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

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

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

3.1. Consider the state licensing regime.

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendix L

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