

Responses to Questions Relating to Testimony Submitted to the

U.S. Department of the Treasury

Advisory Committee on the Auditing Profession

by

Annalisa Barrett

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March 25, 2008

Question 1: On page five of your written testimony, you conclude that the high degree of concentration among auditors is “not . . . good for the audit process . . . [or] investor confidence.” Do you believe that further limiting auditor liability is a potential solution to the problem of audit concentration? Why or why not?

Answer 1: No, we would not recommend further limiting auditor liability to address the problem of audit concentration. Limiting the liability of auditors may have unintended consequences and open the door for abuse. Rather, we suggest that other solutions be pursued to address the problem of audit concentrations, such as audit firm or partner rotation for certain companies as discussed in my written testimony.

Question 2: The January 2008 United States Government Accountability Office (“GAO”) study and report on audits of public companies considered and rejected a broad range of proposals that have been set forth by various parties to reduce the risk of further concentration in the audit market. In rejecting those proposals, including proposals to limit auditor liability, the GAO found that such proposals were ineffective and/or contained “serious drawbacks.” More specifically, in commenting on proposals relating to further limiting auditor liability, the GAO report noted that some parties have expressed concern that further limits on auditor liability could lead to lower audit quality. Do you share the concerns expressed in the GAO report that further limits on auditor liability could lead to lower quality audits. Why or why not?

Answer 2: Yes, we agree with the GAO report. There are many influences on the quality of audits, the most important of which is the expertise and integrity of the people conducting the audits. However, in our view, there is potential for complacency – or even abuse – if liability caps are put in place.

**Second Supplemental Submission to the Treasury
Department's Advisory Committee on the Auditing Profession**

**John P. Coffey
Bernstein Litowitz Berger & Grossmann LLP
(March 31, 2008)**

I respectfully submit this supplement to my prior written submissions to respond to several follow-up questions forwarded by Kristen Jaconi of the U.S. Department of the Treasury.

- Follow-Up Questions and Responses -

Question One:

Page four of your written testimony states that the Private Securities Litigation Reform Act ("PSLRA") was intended to "weed out weak or frivolous cases, and the record shows that these laws have accomplished that goal." Has the PSLRA been effective in "weed[ing] out" nonmeritorious cases brought against auditors or audit firms? If so, do you believe it is appropriate to provide further protections for auditors from meritorious securities cases brought against them?

Response to Question One:

The PSLRA has been quite effective in screening out nonmeritorious cases brought against auditors and audit firms. The dramatic decrease in the number of class actions brought against public auditors for securities fraud since the passage of the PSLRA, discussed in my January 22, 2008 submission, supports this conclusion. Moreover, an analysis of securities actions filed in 2006 and 2007 demonstrates a significant decline in the number of cases alleging GAAP violations, appearing to suggest "a movement away from the focus in recent years on the validity of financial results and accounting treatment."¹ For the reasons stated in my January 22 submission and my oral testimony provided on February 4, 2008 in Los Angeles, I do not believe it is necessary, or appropriate, to provide further protections for auditors at this time, particularly when, as this question posits, they are subject to meritorious claims.

¹ "Securities Class Action Case Filings – 2007: A Year in Review," Cornerstone Research, Jan. 2008 at 20, available at http://securities.stanford.edu/clearinghouse_research/2007_YIR/20080103-01.pdf.

Question Two:

Page eight of your written testimony states that “[a]rtificially limiting auditor liability would reduce auditor accountability, reduce audit quality, and ultimately harm the capital markets as investor confidence in the accuracy and transparency of financial statements is called into question.” Under what set of circumstances, if any, do you believe it would be in the best interests of institutional investors to support some further limitation of liability for auditors?

Response to Question Two:

Until audit firms decide to become more forthcoming about their true financial capacity to withstand a large adverse judgment, it is impossible to weigh the supposed “benefits” of reducing auditor accountability to those who rely on their work, including investors. Recent history shows that there is considerable cost associated with reducing liability exposure for auditors, and that counsels against any further dilution of incentives for auditors to perform high-quality audits. As explained in detail in my initial submission to the Committee, the litigation risk to audit firms does not warrant further weakening of private rights of recovery; the audit firms already enjoy numerous protections.

One initiative I would support is the revival of scheme liability. For the reasons explained in my January 22 submission, this would aid auditors by (a) making it riskier for third-party schemers to lie to auditors and (b) ensuring that third parties who participate in a fraud sit at the defense table with the auditors to share the blame.

Question Three:

Page nine of your written testimony persuasively argues that expanding the private right of action against third parties who engage in deceptive conduct would address auditor concerns about securities litigation. Why, in your opinion, have the major audit firms not embraced your view of this issue?

Response to Question Three:

First, in fairness, the point I raised in my testimony concerning reviving investor claims for scheme liability was spurred by the Supreme Court’s January 2008 *Stoneridge* decision. Given that the *Stoneridge* decision is a recent development in the law on which interested parties continue to weigh in, it may be premature to conclude that the major audit firms would reject the revival of scheme liability that I propose.

While I would certainly welcome others joining in the call for the renewal of scheme liability, I am not optimistic that the major audit firms would support my views in that regard. First, it is quite clear that the major audit firms are interested in limiting their own exposure from investors’ securities law claims. I therefore find it unlikely that the same firms would champion increasing investor protections overall when a logical antecedent to their position is the premise that investors are already afforded enough (or, more likely in their view, too much) protection under current law. I also believe it unlikely that the major audit firms would support undoing a Supreme Court ruling that limits liability for non-issuer defendants in private securities actions.

For these reasons, I do not foresee the major audit firms advocating the expansion of investors' rights to pursue third parties that engage in deceptive conduct – even though, as I explain in my written submission, such a change would be in the interest of investors and also benefit the audit firms in many respects.

Question Four:

In Mr. Nusbaum's written testimony he stated that "the professional judgment framework, with its safe harbor, is a recommendation that the Advisory Committee should seriously consider." In your opinion, should the Advisory Committee consider a recommendation in support of a professional judgment framework for auditors? Why or why not?

Response to Question Four:

I fully support the Advisory Committee's efforts to improve the auditing profession, not only for the sake of the profession itself, but for the benefit of issuers and investors. Implementation of a framework that provides for the immunization of auditors' judgment *via* a safe harbor, however, is fundamentally contradictory to this goal. The adoption of a professional judgment standard that includes a safe harbor would effectively eliminate necessary countervailing pressures to the economic and social pressures exerted upon public auditors by their clients.²

There is No Need for a Professional Judgment Framework as U.S. Accounting Rules Already Provide Sufficient Guidance

Our current system requires auditors to follow both principles and rules while conducting public audits. In fact, many different categories and levels of judgments (principles) currently exist under GAAP. As a result, auditors are required to routinely exercise professional judgment when conducting public audits.³ Thus, I fail to see how the adoption of a "professional judgment" framework along with a safe harbor, as Mr. Nusbaum proposes, would improve matters when there is a material error in a company's financial statements. After all, a material error is an error, regardless of the amount of professional judgment administered.⁴ Mr. Nusbaum's request for a safe harbor for the exercise of professional judgment is merely another attempt by the audit profession to immunize auditors from civil liability for their use of judgment

² See letter from Damon A. Silvers, Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO") to the U.S. Securities and Exchange Commission ("SEC") Advisory Committee on Improvement to Financial Reporting, (Feb. 10, 2008) at 3.

³ "Professional judgment is the most important resource the auditor brings to bear in an audit of financial statements and internal control. There is no audit tool more effective than the appropriate application of seasoned professional judgment – to determine the work that must be done in the circumstances and to evaluate the resulting audit evidence." Thomas Ray, Chief Auditor and Director of Professional Standards Public Company Accounting Oversight Board, speaking at the Sixth Annual Financial Reporting Conference at the Baruch College in New York City (May 3, 2007), at http://www.pcaobus.org/News_and_Events/Events/2007/Speech/05-03_Ray.aspx.

⁴ See Mr. Silvers' letter to the SEC (Feb. 10, 2008) at 4.

that departs from the rules provided under Generally Accepted Accounting Principles (“GAAP”) and Generally Accepted Auditing Standards (“GAAS”).

It is my understanding that a “professional judgment framework” for audit standards is primarily based upon the use of “principles” as opposed to hard and fast rules. In the United States, we currently have an accounting system comprised of both rules and principles, while the international community tends to follow more principles based standards (“International Financial Reporting Standards” or “IFRS”).⁵ While some public auditors and issuers may push for the ultimate convergence of GAAP and IFRS standards, accounting experts generally consider the more principles-based international standards to be of a “lower quality than GAAP and in much need of more improvement by FASB and the International Accounting Standards Board.”⁶

Recently, the Public Company Accounting Oversight Board’s (“PCAOB”) standard advisory group held a meeting on February 27, 2008 to discuss, among other things, the Securities and Exchange Commission’s advisory committee’s proposal on non-GAAP accounting judgments.⁷ Reportedly, several members said the proposal would move accounting standards further into the principles-based realm and give companies a large safe harbor from which to issue questionable accounting judgments.⁸ Committee member Lynn Turner reportedly compared the proposed framework to the Ten Commandments stating, “and we know how well people follow those.”⁹ Mr. Turner reportedly also commented that current audit standards include much of the proposed framework and that increased disclosures on how auditors and companies come to their professional judgments are what investors need.¹⁰

Shareholders are necessarily concerned with the utility of financial statements, in addition to their accuracy. I believe that an abandonment of GAAP-based specific rules in favor of IFRS-based principles accounting would severely undermine the utility of issuers’ reported financial statements and, concomitantly, investor confidence in the capital markets. This is because similar issuers may apply the same professional judgment principle differently (though reasonably) resulting in totally different financial results.¹¹ As a consequence, similar companies may arrive at completely different financial results making any side-by-side comparison

⁵ See *IFRS: No Longer If, But When*, CFO Magazine, Feb. 8, 2008, available at 2008 WLNR 2883136.

⁶ *Slow Death for GAAP: Cox*, CFO Magazine, Jan. 10, 2008, available at 2008 WLNR 885677.

⁷ See Nicholas Rummell, *SEC ‘Professional Judgment’ Plan Draws Fire From Auditors, Others*, Financial Week, Feb. 27, 2008, available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080227/REG/626395802&te>.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ “As IFRS is more principles-based and requires a greater degree of professional judgment, variations in accounting treatment may result. This is an uncomfortable proposition for practitioners accustomed to consistency.” Allison M. Henry, *Speeding Toward Convergence The Merging Of GAAP And IFRS Is Closer Than You Think – And The Profession Must Be Ready*, Accounting Today, Vol. 22, Issue 3, Section: Assurance, available at 2008 WLNR 2621461.

extremely difficult. Worse yet, it may lead to even more complexity as issuers would be forced to add multiple layers of explanations in order to justify their professional judgment as being “reasonable” under any proposed professional judgment framework.¹² Any professional judgment framework proposal that diminishes the utility of reported financial statements while adding complexity to the reporting process should be viewed by the Advisory Committee with skepticism.

A Professional Judgment Framework Would Undermine the Deterrent Value of Regulatory Enforcement and Shareholder Civil Litigation

As communicated so effectively by my partner, Salvatore J. Graziano, in his March 10, 2008 letter to the SEC’s Advisory Committee on Improvements to Financial Reporting, the adoption of a “professional judgment framework” that would replace the current “rules-based” standards under GAAP would be harmful to investors as it would make the prosecution and enforcement of meritorious claims of accounting fraud even more difficult.¹³

Over the past several years, our clients, which include state and union sponsored pension funds, have suffered billions of dollars in losses due to accounting related fraud at companies WorldCom, Nortel Networks, McKesson and Lucent, as well as the stock option backdating scandal and the current subprime mortgage crisis. In the wake of these scandals, I find it troubling that anyone advocates implementing yet another accountability-avoidance device such as the so-called safe harbor for professional judgment.

My experience representing shareholders informs my view that the problem is not the rules but rather the failure of managers and auditors to follow the rules. For example, I was lead trial counsel in the *WorldCom* litigation where the corporate officer and auditor defendants violated clear accounting rules by improperly capitalizing line costs.¹⁴ I also served as lead trial attorney for the jury trial against auditors in the *Baptist Foundation of Arizona* litigation, where the failure to investigate red flags (and nine-figure receivables from sham third-parties) led to the largest non-profit bankruptcy in our country’s history. Moreover, in the *Enron* securities fraud case (in which I have had no role), rules were broken through a scheme utilizing non-independent outside investors to fund off-balance sheet investments.¹⁵ In all three cases, Arthur Andersen served as the outside auditor and permitted the fraud to occur by relying upon the “professional judgment” of management.¹⁶ I am convinced that a professional judgment framework void of specific rules governing accounting judgments will fuel a new wave of

¹² See Salvatore J. Graziano, Esq., Partner at Bernstein Litowitz Berger & Grossmann LLP, *Submission to the Securities and Exchange Commission’s Advisory Committee on Improvements to Financial Reporting*, Mar. 10, 2008 at 7.

¹³ *Id.* at 4.

¹⁴ See *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 401 (S.D.N.Y. 2003).

¹⁵ See *In re Enron Corp. Sec. Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 614-15 (S.D. Tex. 2002).

¹⁶ See *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), 2003 WL 21488087, at **4 (S.D.N.Y. June 25, 2003) (denying Andersen’s motion to dismiss); *In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005) (denying Andersen’s motion for summary judgment); see *In re Enron*, 235 F. Supp. 2d at 681.

financial book-cooking, after which it will be even more difficult for shareholders to obtain recoveries against those who commit securities fraud because these individuals would simply argue that their conduct was “reasonable.”

There is a tremendous amount of incentive for companies to report favorable financial results. Public auditors feel similar social and economic pressures to approve of favorable financial results. The removal of specific accounting rules designed to counter these incentives will make it even more difficult for auditors to challenge management looking to push the envelope beyond permissible boundaries in order to report misleading financial results.¹⁷ Because a professional judgment framework would make it more difficult for shareholders and auditors to challenge management’s accounting decisions, I do not believe the Committee should consider proposing such a framework.

**There is No Need to Immunize Issuers and Auditors from Liability
by Adopting a Professional Judgment Framework with a Safe Harbor**

Providing a safe harbor for the use of professional judgment would not improve the quality of issuers’ financial statements or public audits. I am unaware of any evidence to the contrary. I do not believe investors will respect a professional judgment framework that also immunizes auditors from responsibility for judgment which results in material errors. Moreover, in light of the negative impact that a safe harbor would have on shareholder litigation and regulatory enforcement, I do not see how a safe harbor could possibly benefit shareholders.

Professional judgment, properly applied, should have a positive impact on audit quality as well as the quality of financial information reported to investors. But professional judgment should be valued as *judgment* and nothing more. The push for a professional judgment framework apparently stems from a desire to replace GAAP with a single, universally accepted international standard for financial reporting.¹⁸ This desire, however, in no way supports the adoption of a safe harbor that will afford public auditors a “free pass” so long as their poor judgment is well documented and made in “good faith.”

The notion that somehow auditors conduct poor audits when they fear being second guessed defies logic. Public auditors should be deterred from straying from the requirements of GAAP and GAAS by the knowledge that if they do so, their conduct will not go unchallenged. During the February 4 hearing in Los Angeles, Cynthia Fornelli, executive director of the Center for Audit Quality, could not identify any specific examples where public auditors were

¹⁷ “Barbara Roper, director of investor protection for the Consumer Federation of America, called one professional judgment framework proposal recently considered by the PCAOB advisory committee ‘hopelessly naïve’ in its attempt to aid investors, while at the same time it would likely discourage auditors from challenging their clients’ judgments when warranted. ‘I want issuers and auditors to sweat it out if they’re getting it right or not... (and) this recommendation will make it less likely that will happen,’ she said.” See Sarah Johnson, *Putting Auditor Judgments Under A Microscope*, CFO.com, Feb. 27, 2008, available at http://www.cfo.com/printable/article.cfm/10764949/c_2984368?f=options.

¹⁸ See *IFRS: No Longer If, But When*, CFO Magazine, Feb. 8, 2008, available at 2008 WLNR 2883136.

inappropriately second-guessed.¹⁹ The fact that issuers and auditors fear being second guessed is not sufficient justification for affording them the proposed safe harbor.

In conclusion, I do not believe the Advisory Committee should consider a recommendation in support of a professional judgment framework for auditors because the current system already includes both principles and rules and such a framework would undermine the deterrent value of regulatory enforcement and shareholder litigation. Additionally, the case for a safe harbor for auditors who document poor judgment resulting in material errors made in “good faith” has not been made.

Question Five:

In Mr. Grundfest’s written testimony he argues that the current measure of damages in a securities fraud case “leads to inflated liability exposure that fails to serve the purposes of the law.” Do you agree? Please explain. Should the Advisory Committee issue a recommendation that supports Mr. Grundfest’s views on this issue? Why or why not?

Response to Question Five:

I disagree with Prof. Grundfest’s position. The existing, out-of-pocket measure of damages in private securities fraud class actions should not be disturbed, as it fairly compensates injured investors and also serves to deter fraud.

First, it should be noted that the out-of-pocket measure of damages in securities fraud cases is tried-and-true and widely accepted. The out-of-pocket damages measure has been endorsed by the courts – including the United States Supreme Court – for decades.²⁰ Congress also approves of the out-of-pocket measure. Indeed, the PSLRA explicitly contemplates an out-of-pocket measure of damage in private securities litigation (including class actions), by permitting plaintiffs to recover damages equal to the difference between the purchase price of the security at issue and “the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.”²¹ It should come as little surprise, then, that the out-of-pocket measure is not only routinely used by plaintiffs in securities fraud class actions, but it is

¹⁹ See Letter from Mr. Silvers to the SEC at 4 n.4. Feb. 10, 2008 (“Question to Cynthia Fornelli, executive director of the Center for Audit Quality, by a member of the U.S. Treasury Department’s Advisory Committee on the Auditing Profession at the Feb. 4 meeting in Los Angeles: ‘Are you aware of any specific examples, especially of the major corporate billion dollar scandals, where the auditors were inappropriately second-guessed on those cases?’ Fornelli: ‘I cannot provide it to you, but sometimes it is the fear of being second guessed. Or the fear of not having your judgment respected.’”).

²⁰ See, e.g., *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 344 (2005) (observing that “the Restatement of Torts, in setting forth the judicial consensus, says that a person who ‘misrepresents the financial condition of a corporation in order to sell its stock’ becomes liable to a relying purchaser ‘for the loss’ the purchaser sustains ‘when the facts ... become generally known’ and ‘as a result’ share value ‘depreciate[s].’”).

²¹ 15 U.S.C. § 78u-4(e)(1) (2006); see also 15 U.S.C. § 78bb(a) (permitting plaintiffs to recover “actual damages.”).

also the measure of damages relied upon by defendants in the same cases. Of course, experts working on behalf of the opposing parties sometimes calculate the amount of out-of-pocket damages differently in a given case – often as a result of their differing views of the liability facts (i.e., what portion of a stock drop may be attributable to the alleged fraud). But there is no real dispute among practitioners (or the courts) that the prevailing out-of-pocket measure appropriately and correctly accounts for damages to the injured investors. Therefore, the existing measure of damages serves the purpose of the law to compensate victims for losses they have suffered.

Prof. Grundfest does not directly confront these aspects of the out-of-pocket measure. Instead, his quarrel with the existing legal framework appears to be that permitting defrauded investors to recover the full amount of damage they have suffered from a securities fraud is undesirable in light of his perspective on other policy considerations. In its simplest terms, Prof. Grundfest's core argument is that an out-of-pocket measure achieves little good because it simply results in a transfer of wealth to shareholders at the time of the fraud from shareholders in the same company when a damages payment is made. This so-called "circularity" criticism of the existing measure of damages in securities fraud class actions is hardly new, and notwithstanding Prof. Grundfest's skilled advocacy in his written testimony, is not compelling.²²

In any event, the pursuit of private securities class actions using the out-of-pocket measure does, in fact, benefit investors and society.²³ First, as explained above, the goal – and effect – of the out-of-pocket measure is to compensate investors for their losses. It is clear, and widely accepted in every legal context of which I am aware, that damages which tortfeasors pay should not be limited to net cost to society or to the gain to the tortfeasor, but are appropriately measured by the loss suffered by the victim. Second, there is ample support for the proposition that enterprise liability not only is appropriate but also decreases the incidence of fraud by, among other things, tending to increase the level of independent oversight of corporate management.²⁴

Ultimately, Prof. Grundfest heavily relies on the contention that enterprise liability in the securities class action context is uniquely flawed. But critics of the out-of-pocket measure have not even adequately explained why their circularity argument applies only to securities class action and not to other corporate wrongdoing.²⁵ After all, the damages remedies in other types of corporate litigation often similarly affect shareholders. For example, damages paid in connection with environmental and product liability actions typically are borne by existing shareholders, despite the fact that the benefits from such wrongdoing likely redounded to a different set of

²² The instant context in which Prof. Grundfest advances his position on damages is somewhat puzzling, as audit firms, which are privately owned, represent independent sources of recovery for shareholders that do *not* implicate the "circularity" or "wealth transfer" issues raised by Prof. Grundfest in his written testimony.

²³ See, e.g., James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 Ariz. L. Rev. 497, 509-515 (1997).

²⁴ See *id.* at 511-12.

²⁵ See *id.* at 511.

shareholders.²⁶ There is nothing particularly unusual or antagonistic to economic thought about existing shareholders paying for damages for events that occurred at a time when such existing shareholders did not own company stock. So, to some extent there are always winners and losers among shareholders of a company depending upon when they bought and sold stock. Indeed, assuming that shareholders tend to be diversified as Prof. Grundfest contends and therefore often “sit on both sides of the fence” when it comes to damages, it follows that the policy favored by Prof. Grundfest would prevent one company from suing another in circumstances of significant overlapping ownership. In sum, Prof. Grundfest and others fail to provide a cogent explanation of why the “circularity” problem in securities class remedies is materially different than for remedies for other similar types of corporate wrongdoing where there are also winners and losers among past and present shareholders.

In his written submission, Prof. Grundfest devotes a great deal of energy to his contention that individuals responsible for securities fraud should be held accountable. I fully agree. As noted by Prof. Grundfest in his written testimony, that is exactly what happened in the *WorldCom* case, where I was lead trial counsel and the class collected over \$65 million from the company’s outside directors and senior management.

Prof. Grundfest’s written testimony also intimates, however, that holding corrupt enterprises accountable for fraud is somehow inconsistent with the goals of deterrence and of ensuring that individuals that committed wrongful acts also contribute to a recovery. That is not so. First, as explained above, the specter of enterprise liability adds a significant deterrent value. Second, while the existing law allows for recovery from both the offending enterprise and individual, holding individual defendants responsible for fraud alone is rarely sufficient to compensate investors for their losses or to deter fraud. While my firm’s clients routinely seek to hold individual defendants financially accountable for fraud whenever appropriate, it is also often the case that the individual defendants are only able to contribute a relatively small amount compared to the total damages suffered by the shareholders.²⁷ Given these circumstances, it would be inappropriate and unfair to expect the injured class of investors to forego recovery from the enterprise that also committed a fraud. Instead, as authorized by existing law, both the individual and corporate defendants should be held accountable for the full measure of damages suffered as a result of the fraud, to the extent possible.

In addition to the substantive points above in opposition to Prof. Grundfest’s views on damages, I respectfully submit that it would not be prudent for the Advisory Committee to endorse Prof. Grundfest’s views (or, for that matter, anyone’s particular opinions) on the appropriate measure of damages in securities litigation. The issue of appropriate damages measures in securities fraud actions at best only marginally relates to the identified, core issues before the Advisory Committee. Accordingly, it is not surprising that the matters raised by Prof. Grundfest have not, in my opinion, been explored by the Advisory Committee with sufficient

²⁶ *Id.*

²⁷ Additionally, because of the very high pleading standards that govern private securities class actions described in my January 22, 2008 written submission, it is often particularly difficult to allege securities fraud against individual defendants sufficient to survive a motion to dismiss under the existing laws, even when the evidence might show that such individuals actively participated in a fraud.

attention, rigor or depth to establish a record sufficient to adopt any particular view on damages measures in private securities litigation – and in particular one contrary to the long-established existing measure – even if the Advisory Committee were inclined to attempt to formulate a formal opinion on such matters at this time.

Question Six:

You indicated on page 2 of your presentation that "until audit firms are more forthcoming with the finances, as well as their actual insurance capacity, a proposal to treat those firms more leniently than other players in the capital markets should not advance." Did you mean to include any and all relief, such as ADR access, appeals bonds, pleading reform on appeals, etc.?

Response to Question Six:

Yes. I oppose further rolling back investor protections, particularly access to the courts and the long-standing rights and pathways attendant to that access, in response to a supposed special need for protection of audit firms, especially when audit firms have not shown that they face the financial peril they claim warrants such unprecedented measures. Moreover, I believe that investors and the U.S. capital markets benefit from increased transparency and disclosure, rather than additional secrecy (e.g., the imposition of compulsory, confidential ADR in private securities actions that some audit firms and issuers have urged).

* * * * *

I hope the Committee and other interested persons find these responses helpful.



CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

March 31, 2008

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RE: Treasury Advisory Committee on the Auditing Profession, Cynthia Fornelli Response to Follow-Up Questions from the February 4, 2008 Open Meeting

Dear Ms. Jaconi:

I am pleased to submit these responses to the follow-up questions from the Treasury Advisory Committee Members.

Follow-up questions posed by Jeff Mahoney:

Page three of your written testimony states that “a well-crafted professional judgment rule would benefit investors, auditors, and issuers.” Please explain how investors would benefit from a “professional judgment framework”? Can you identify any institutional investors that have expressed support for a “professional judgment framework”?

We believe that investors, regulators and accountants would benefit from a professional judgment framework. Such a framework should articulate the precepts used by accountants to reach good faith, well-reasoned and well-documented decisions that are within the bounds of applicable accounting standards. Having such written precepts for exercising accounting judgments not only may increase investor understanding of the accountants' decision making process but also influence accountants to make more disciplined decisions. In addition, a framework that creates respect for reasoned professional judgment may make auditing a more attractive field for the best and brightest students and facilitate retention of talent in the profession.

The Securities and Exchange Commission's Advisory Committee on Improvements to Financial Reporting (CIFiR) voted unanimously to submit to the Chairman of the Commission, and to publish for public comment, a

“developed proposal” calling for the Commission to adopt “a judgment framework for accounting judgments.” Please see CIFIIR, “Progress Report,” at pages 68-76 (February 11, 2008), which is available on the SEC web site. Investor representatives on CIFIIR include individuals from MFS Investment Management, the CFA Institute, TIAA-CREF, Moody’s Investor Services, and The Motley Fool.

Page five of your written testimony suggests that independence rules be based “on the auditor’s ability to conduct a fair and impartial audit in the eyes of a reasonable investor.” Under that approach, please explain who would determine whether the auditor’s activity was fair and impartial to “a reasonable investor”? Can you identify any institutional investors that have expressed support for such an approach to the independence rules?

The position in my testimony is based on the Commission’s auditor independence rules. Rule 2-01(b) of Regulation S-X, 17 CFR 210.2-01(b), states:

(b) The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a ***reasonable investor*** with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, ***the Commission will consider*** all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission. (Emphasis added.)

This rule establishes the “reasonable investor” test for auditor independence and clarifies that the Commission would be the ultimate arbiter of what may be considered to be fair and impartial to a reasonable investor.

This rule was adopted by the Commission in 2000 pursuant to the Administrative Procedure Act. According to the adopting release, the Commission received nearly 3,000 comment letters and held four days of public hearings before final consideration and adoption of this rule. Investor groups as well as others had the opportunity to provide comments to the Commission.

Page five of your written testimony raises concerns about the sustainability of the audit profession and states that the “CAQ supports the continued discussion of the concept of a liability cap” The January 2008 report of the United States Government Accountability Office entitled “Audits of Public Companies—Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action” considered and rejected proposals to place caps on auditors’ liability. What was the flaw in the GAO’s analysis that led them to a conclusion that is in direct conflict with that of the Center for Audit Quality (“CAQ”)?

The General Accountability Office’s report concludes that there is no compelling need to take ***any*** action to address current levels of audit firm concentration. It did not make an independent conclusion about the potential benefits or risks of liability reform; its discussion instead focused on



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opinions offered by those it interviewed. The inside front cover of the report summarizes its findings as follows:

Academics and business groups have put forth proposals to reduce audit market concentration and address challenges facing smaller accounting firms, including capping auditors' liability and creating an office to share technical expertise. Market participants raised questions about the overall effectiveness, feasibility, and benefit of these proposals, and none were widely supported. Given the lack of significant adverse effect of concentration *in the current environment* and that *no clear consensus exists* on how to reduce concentration, no compelling need for immediate action appears to exist. (Emphasis added.)

In fact, the GAO recognizes the potential risk of catastrophic litigation on page 32 of its report by observing that, while current levels of concentration do not seem to be having significant adverse effects, there is potential for further concentration that does raise concern including the risk that “civil litigation could result in their insolvency or inability to continue operations.” Moreover, on page 55 of the report, the GAO states that “litigation could result in even more market concentration if firms that were sued ultimately went out of business. Several proposals have been made to reduce the potential for litigation to cause further concentration in the market for audit services, including placing caps on auditors' liability and targeting enforcement against responsible individuals, among others.”

The CAQ agrees with the GAO conclusion that the “current environment” could change quickly if catastrophic litigation, criminal indictment, or another major adverse event arises for a major accounting firm. We fully appreciate the difficulty of working through the complex issues associated with revisions to securities laws, bankruptcy laws, criminal and civil rules of procedure, state legal liability issues, damage computations, and the many other aspects of liability reform, particularly given the Treasury Advisory Committee's relatively short duration and the breadth of its task. We believe, however, that should a major auditing firm collapse the potentials for a disruption to the securities markets and for investor confusion are too great to ignore. Accordingly, we believe that discussion of this issue should continue.

To be clear, the CAQ testimony does not specifically endorse enactment of liability caps for auditors. We believe, however, that such caps, among other reforms, merit further research and discussion.

If most institutional investors believe that limiting an auditors' liability will reduce, rather than enhance, the quality of audits [See September 2006, “Study on the Economic Impact of Auditors' Liability Regimes—Final Report To EC-DG Internal Market and Services,” by London Economics in association with Ralph Ewert, page xlii], why does the CAQ support further limits on auditor liability?

As the Advisory Committee is aware, the study referenced in this question was conducted for the purpose of considering possible liability reform in the European Union. The legal liability systems in EU countries have several differences from those in the United States. The Study found that there is a “tipping point” at which an auditing firm may not be able to pay a damage award and survive, and that a failure of a large audit network could “create very serious problems for companies whose



financial statements need to be audited.” (See pages xxxiv-xxxvii of the Executive Summary and pages 104 and 119-133 of the Report.) The Study also found, “With the exception of institutional investors, differences in liability regimes are not perceived as having a significant impact on audit quality.” (See page xlv of the Executive Summary.) Nonetheless, we recognize the concern that some may have regarding whether redefining or limiting an auditor’s potential legal liability could result in a reduction in the quality of audits.

We believe high audit quality depends on the good character and integrity of the people performing the audits, which is based on each firm having the proper tone at the top and culture, recruiting good people, compensating them fairly, providing them with timely training, establishing a strong audit process, and having effective internal controls.

When discipline is necessary, an action by the Securities and Exchange Commission, the Public Company Accounting Oversight Board, a State Board of Accountancy, or the firm itself not only may impose remedial action but also often may end a CPA’s career in auditing public companies. Disciplinary actions provide significant incentives for individuals involved in each engagement to perform a high quality audit.

In terms of compensating those who have suffered financial loss due in part to the misconduct of an auditor, the CAQ believes that auditors should be held accountable for their work and be legally liable if their misconduct constitutes a violation of the securities laws or other applicable statutes. We also believe, however, that further consideration should be given to increasing the link between the nature and extent of the auditor’s misconduct and any damages that are paid, as opposed to damages being linked primarily to changes in a company’s market capitalization. As noted in response to the prior question, this a difficult issue that deserves further studies. The CAQ would be pleased to participate in those efforts.

Follow-up questions posed by Gaylen R. Hansen:

Could you elaborate on what you might want to propose as an alternative to the 150 hour educational requirement with respect to internships?

It is important to be clear that neither the profession nor the Center for Audit Quality is suggesting that internships could be a replacement for the 150 hour education requirement. Internships should be a viable option for fulfilling a portion of the educational requirements, however.

The current certification requirements for the CPA exam, as contained in the Uniform Accountancy Act and adopted by the vast majority of states, specify that 150 hours of classroom learning must be achieved. Each state specifies how many of those 150 hours must be in specific areas of study. The requirements do not take into account the knowledge and experience obtained outside of the classroom setting, or in other areas of specialization that are critical to understanding our complex financial system.

Each year, thousands of university students intern with firms. The opportunities for internships provided by firms of all sizes in public practice (and other companies or organizations) could



contribute to any one of the opportunities to increase flexibility. For example, universities may grant credit for internship experiences. In fact, some do now. Requirements might involve adding a further "deliverable" such as a paper about the experience. This makes the internship visible on college transcripts so that state boards can easily verify the internship experience.

There is also another important area that we believe deserves further study -- how we can bring into the profession those with specialized technical skills who have chosen alternate academic studies. As our financial system becomes more and more complex, the need for CPAs with specialized skills in traditional areas like taxation and internal controls, and in newer areas such as valuation, is likely to increase. We need to realize that these skills are core competencies that all auditors should possess in the very near future. In our current labor pool, though, the professionals who may be best suited to provide such specialized skills may not have chosen accounting as an undergraduate major. However, we think that working to transition these professionals, and helping them meet their requirements to sit for the Uniform CPA Exam, may be worthy of further consideration.

On page 6 of your report - you talk about "new and better methods to reduce the threat [of fraud]. What do you see as those new and better methods? What is your opinion about sell-side advisory institutions that have developed predictive algorithms - such as Glass-Lewis and others?

My testimony states that the auditing profession "is committed to an effort to work with other responsible parties to seek new and better methods to reduce the threat [of fraudulent financial reporting]" and that "auditors should continue to develop and employ improved techniques to identify material fraud."

Authoritative auditing standards state that auditors have an obligation to plan and perform the audit to obtain reasonable assurance about whether financial statements are free of material misstatements, whether caused by error or fraud. Statement on Auditing Standards No. (SAS) 99, as incorporated into the interim standards of the Public Company Accounting Oversight Board (PCAOB), identifies "fraud risk factors" and provides guidance on consideration of fraud during a financial statement audit. SAS 54, which also has been incorporated into the PCAOB's interim standards, provides additional guidance on an auditor's consideration of the possibility of other types of illegal acts by its audit clients. PCAOB Auditing Standard No. (AS) 5 addresses the identification and evaluation of the risk of fraud while conducting an audit of internal control over financial reporting that is integrated with an audit of financial statements. AS 5 identifies management fraud as an area of higher risk and describes the types of controls that might address fraud risks, such as controls in the areas of significant or unusual transactions, journal entries and adjustments made in the period-end financial reporting process, related party transactions, significant management estimates, and incentives or pressures on management to manage inappropriately financial results.

To implement these standards, auditing firms currently use extensive procedures to identify and assess risks that financial statements may be materially misstated due to fraud. The largest firms have developed their own approach to planning, testing and analyzing material accounts, transactions and controls for indications of fraud. While auditors provide reasonable assurance that fraud material to the financial statements will be detected, they cannot be expected to provide



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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.

The inability to provide absolute assurance, however, does not mean that auditors cannot improve their performance in this area. New and better methods of fraud detection may come from sharing best practices among the firms and broad dissemination of academic and other research that highlights current fraud schemes and how to spot them. Auditors also may benefit from having information and data about certain industry practices, so that they may know when a client is far from the norm for its industry and determine the reason for that variance.

It should be understood, however, that auditors alone cannot solve the problem. The only effective way to address the risk of financial statement fraud is for business leaders, regulators, auditors and other market participants (such as legal counsel and underwriters) to work together to increase efforts and methods for fraud prevention and detection. The CAQ believes that representatives of the various market participants should meet to discuss their respective roles and decide how to collaborate on projects that would lead to more effective fraud prevention and detection programs. Public discussions of these topics also may narrow the “expectations gap” between what investors expect in this area and what each participant may accomplish.

Part of this effort may include the continued development of predictive algorithms, such as those developed by Glass-Lewis and others. Many of these tools attempt to identify discrepancies within a set of financial statements or to identify similarities or differences between a set of financial statements and a particular model in an effort to identify suspicious accounts and transactions.

The question above asks for my opinion about sell-side advisory institutions that have developed such predictive algorithms. In my view, these institutions are attempting to use information technology and public information to advance fraud detection techniques. While these efforts are laudable and such algorithms may prove to be helpful tools, because of the subjective nature of fraudulent conduct such algorithms are not a substitute for management’s diligent preventive and detective measures or an effective audit.

Also on page 6, addressing the competitive disadvantages of transparency, ... are there any specific disadvantages that you could envision?

Currently, public accounting firms are not required to make internal financial information public. They do voluntarily make certain data public – such as total net revenue, percent of revenue from audit, tax, and consulting, number of partners and number of professional staff. We believe there is a link between such data and the public’s perceptions of the firms’ ability and commitment to perform high quality audits. The firms are happy to continue to discuss with the Committee and others the disclosure of additional information that would address investors’ valid concerns about audit quality, such as the type of financial information required under the EU’s 8th Directive. However, the more sensitive financial data – such as firm capitalization, profitability, and partner compensation – currently are not disclosed. We find less correlation of that information with audit



quality and a greater potential for misuse of that data in litigation against the firms and in competition for clients and personnel.

For many accounting firms other than the largest firms, the public company audit practice comprises just a small portion of their overall revenue. As Neal Spencer mentioned in his written testimony for the February 4 hearing, requiring financial transparency could influence these firms to exit the public company audit market. It could also deter firms not currently auditing public companies from considering such a practice. This could have the unintended consequence of exacerbating the concerns with concentration and audit firm choice.

If firms that do not have to disclose certain financial information are aware of their competitor's data, they can use that to their advantage in several different situations – when competing for new business against a disclosing firm; when recruiting new and senior staff; and when vying for preferential treatment with lenders or insurers.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality



CENTER FOR AUDIT QUALITY

**Joseph A. Grundfest, W.A. Franke Professor of Law and Business,
Stanford Law School
Advisory Committee on the Auditing Profession
Questions for the Record
February 4, 2008 Meeting**

Jeff Mahoney of the Council of Institutional Investors asked the following questions for the record relating to the testimony before the Advisory Committee on the Auditing Profession on February 4, 2008:

Page three of your written testimony indicates that class action securities fraud settlements “have weak deterrent effects” because they are generally funded by insurance or by corporate payments rather than from the pockets of those who are responsible for the fraud. Do you, therefore, agree that audit firm’s should be given further liability protections because that they allegedly can not obtain sufficient commercial insurance to cover their potential securities fraud settlements?

The conclusion suggested does not follow from the premise. It could be argued that the lack of insurance prevents externalization in a form that increases the industry’s incentive to exercise appropriate care and therefore promotes socially responsible conduct.

Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company
Advisory Committee on the Auditing Profession
Questions for the Record
February 4, 2008 Meeting

Jeff Mahoney of the Council of Institutional Investors asked the following questions for the record relating to the testimony before the Advisory Committee on the Auditing Profession on February 4, 2008:

- Do you believe that providing a “business judgment framework” for auditors as described in Ms. Fornelli’s written testimony would benefit investors and the capital markets? Why or why not?

While we agree that “business judgment” plays a critical role in an audit and there is a need to defer to professional judgment by experts, we are concerned that any attempt to define further the framework in which business judgments are made could have the same effect as a liability limitation or safe harbor. We don’t believe that limiting liability or providing a safe harbor to audit firms would benefit investors and the capital markets.

- Page three of your testimony indicates that you believe that FASB standards have “resulted in broadly applicable accounting standards that do not adequately consider industry specific concerns.” Do you believe that investors and other users of financial reports benefit from industry specific accounting standards and related guidance? Do you believe that industry specific accounting standards and related guidance increase or reduce complexity in financial reporting?

As a general principle, industry specific accounting standards and guidance increases complexity and is not merited unless the unique nature of the industry requires specific standards to improve overall relevancy and transparency of financial information to investors. Historically, the industry specific guidance for investment companies endeavored to bridge the divide between what was relevant for mutual fund investors versus corporate investors and adopted guidance that provided more transparency to the intended audience (mutual fund investors).

- Do you accept the argument made by the large audit firms that there should be further limits on auditor liability to protect the market from the potential failure of another large auditing firm? Why or why not?

No. We do not accept the argument made by the large audit firms that there should be further limits on auditor liability to protect the market from the potential failure of another large auditing firm. We do not believe that liability caps are necessary. We believe any limit on auditor liability would not be in the interest of investors. We believe audit quality would be adversely impacted if auditors were not subject to legal redress by investors for failed audits. We note that there has been a significant reduction in litigation due to market reform, and we would support further reform of the litigation system including revising the standard for bringing litigation, requiring the losing party to pay legal fees of the prevailing party, and changing the bonding requirements to make appeals possible when the penalties levied in initial decisions are so excessive it essentially prevents an entity from posting a bond to file an appeal.

While we hope that another large audit firm failure does not occur, we stated in our testimony and firmly believe that “a too big to fail” approach to the firms is not in the interest of investors. 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.

· The January 2008 United States Government Accountability Office (“GAO”) study and report on audits of public companies considered and rejected a broad range of proposals that have been set forth by various parties to reduce the risk of further concentration in the audit market.

In rejecting those proposals, including proposals to limit auditor liability, the GAO found that such proposals were ineffective and/or contained “serious drawbacks.” More specifically, in commenting on proposals relating to further limiting auditor liability, the GAO report noted that some parties have expressed concern that further limits on auditor liability could lead to lower audit quality. Do you share the concerns expressed in the GAO report that further limits on auditor liability could lead to lower quality audits. Why or why not?

Yes. We share the concerns 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. The value of audits would likely be diminished if the auditors had safe harbors, liability caps or immunity.

- In Section II, you comment, "Auditor independence rules need to be centralized in a national standard setter...". Who would you envision setting these rules, taking into consideration that auditor independence also impacts non-public companies as well as non-audit services that CPAs perform for both public and private companies, such as tax preparation? Who would staff and pay for the national standard setter? Who would enforce its rules?

While we don't expect that the States would accept a National standard setter, and it would be detrimental to investors to re-open or amend Sarbanes-Oxley, we believe that the PCAOB would be the ideal organization to set National Standards informed by investor groups such as the ICI and CII. Federal legislation that would allow audit firms to opt-in to a National program would streamline the independence rules for the large audit firms.

- In Sections III and V, you mention the AICPA a number of times and call for it to get back into standard setting, periodic testing of technical education, and performing background checks. What do you see as the appropriate role for membership organizations such as the AICPA and state societies in the audit profession in light of the decision of the Congress to move from a self-regulatory system to the Sarbanes-Oxley model? Are there any advantages at this point in backtracking and widening the influence of industry groups? If so, how do you insure balance with independence and principles of public protection?

We are supportive of Sarbanes-Oxley legislation and would oppose re-opening or amending it. On further reflection, we believe that the PCAOB would be better suited than the AICPA to provide educational standards, background checks and independence rules for auditing firms. For all practical purposes, the major accounting firms would need to comply with the PCAOB's standards so that their accountants could be vetted to perform public company audits. We would encourage the PCAOB to take a broader role in ensuring the public accounting profession meets the highest quality standards for performing public company audits. Federal legislation that would empower the PCAOB with the ability to issue a National CPA license would augment the existing State-run process.

Dennis Johnson, Senior Portfolio Manager, Corporate Governance
California Public Employees' Retirement System
Treasury – Advisory Committee on the Auditing Profession
Responses to Questions for the Record
April 30, 2008

Here is the link to CalPERS Global Principles of Accountable Corporate Governance that is referenced in our responses below.

<http://www.calpers-governance.org/principles/docs/2008-04-22-global-principles-final.pdf>

Reference & Question: On page 5 of 8 - you discuss the PCAOB inspection reports and call for public access for the QC portion of the reports that are not made public (Part II of the report).

I am unclear specifically what you are asking for here. Are you asking for access inside the 1 year remediation period or after the one year remediation period in the event the firm does not remediate? The PCAOB is currently posting reports on its website where the firms have not remediated, is that sufficient, or are you asking for more?

- CalPERS through its Global Principles of Accountable Corporate Governance supports the PCAOB providing information to Audit Committees - public access to all firm-specific inspection reports, even if an issue is remediated. Providing this information, although remediated, would provide insight on possible trends by the audit firm on audit firm quality and in determining whether a company continues to use the current auditor or in hiring a replacement. We understand and support the PCAOB's desire to provide adequate time for a firm to remediate issues identified.

Reference & Question: On page 7 of 8 - you discuss CalPERS decision to choose auditors from "other tiers." Is there anyway that you might be able to share with ASCAP how you screen and determine the acceptability of non-Big X auditors? Are there any particular criteria? Is there a mandatory rotation of firms within your system?

- By California law, CalPERS must rotate its auditors every five years. Specifically, the California Public Employees' Retirement Law (PERL) Government Code 20228 - Audit of Financial Statements states "The board shall annually employ a certified public accountant, who is not in public employment, to audit the financial statements of this system. The term for which the board may contract to employ a certified public accountant shall not exceed five years. The board shall not contract to employ the same certified public accountant for two consecutive five-year terms..."
 - o CalPERS' Finance Committee (Charter [attached](#)) has the authority and responsibility to assist the Board in fulfilling its fiduciary responsibilities which include oversight and selection of CalPERS external independent auditor. The Finance Committee with the assistance of the Office of Audit Services (OFAS Charter <http://www.calpers.ca.gov/index.jsp?bc=/about/organization/divisions-offices/audit-services/oas-charter.xml>) lead in the process for selecting the

external financial statement auditor. (#21 of charter)

- o The minimum qualifications (see attached) for prospective external financial statement audit firms include experience auditing (a) other defined benefit public pension funds of a minimum size, (a) experience in auditing a variety of investments, (c) experience in actuarial work (or a qualified subcontractor), and (d) qualified CPA staff at the partner, manager and on-site supervisor level. The Minimum Qualifications from our last RFP are attached.
- o CalPERS also assesses the independence of the candidate firms by obtaining all contracts that the candidate firms have with CalPERS; by searching the internet; by obtaining copies of any reviews of the audit firm by the PCAOB and other entities - i.e. peer reviews; and by completing references and due diligence.

Question: Do you believe that institutional investors or the capital markets would benefit from further limits on auditor liability? Why or why not?

- CalPERS through its Global Principles of Accountable Corporate Governance does not believe that institutional investors or the capital markets would benefit from further limits on auditor liability and are against supporting any monetary liability cap by auditors. CalPERS does not believe that limiting auditor liability in this way is an effective or appropriate way to increase high-quality audit firm choice not is it a way to improve audit quality. Limiting auditor liability would reduce auditor and audit firm accountability, provide a significant market incentive to take audit shortcuts, aggressive treatments and reduce overall audit quality to the detriment of investors.

Question: Do you support the approach described on page six of the written testimony of Ms. Fornelli that would provide defendants (including auditing firms) in a private lawsuit in federal district court the right to appeal a denial of a motion to dismiss?

- CalPERS' staff does not support the incremental approach to give defendants in a private lawsuit in federal district court the right to appeal a denial of a motion to dismiss. Both parties spend considerable effort and time in preparing for a lawsuit. Plaintiff's right to discovery is triggered when the complaint survives a motion to dismiss. To arrive at this point in the litigation can take months if not years. The process time is very lengthy and to allow defendants the right to appeal a denial of motion would delay the gathering of admissible evidence. Staff believes that surviving a motion to dismiss is a hurdle. That hurdle should not be made even larger by allowing defendants to make appeals that could delay a case by years.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

AUDIT OF BASIC FINANCIAL STATEMENTS

MINIMUM QUALIFICATIONS CERTIFICATION

As prescribed in the Minimum Qualifications, Section IV of the Request for Proposal, all respondents are required to sign and return this attachment, along with written evidence of how each qualification is met. The undersigned hereby certifies that the firm submitting this response fulfills the minimum qualifications outlined below, as well as the requirements contained in the Request for Proposal.

Minimum Qualifications include:

- A. The firm must be a professional public accounting firm that provides audit and other attest services. Actuarial services may be performed either by the firm, by a joint venture(s) with an actuarial firm(s), and/or by subcontract(s) with an actuarial firm(s). If a joint venture is formed with or a subcontract(s) is(are) used to obtain the services of an actuarial firm(s), the firm(s) offering actuarial services shall meet specific minimum qualifications described later in this section. CalPERS reserves the right to approve the subcontractor and joint venture actuarial firm(s) per Sections V.A. 7 and 8. Moreover, the actuarial firm under contract with CalPERS may not be used by the audit firm to avoid a potential conflict of interest.

- B. The firm must have conducted, within the last five (5) years, at least two (2) audits of defined benefit pension plans with assets that exceeded six billion dollars (\$6,000,000,000) at the time of the audit. This requirement may be met with two (2) years of auditing the same defined benefit pension plan of a minimum size of \$6 billion. Alternatively, the firm may meet this requirement by simultaneously auditing in each of two (2) years more than one (1) defined benefit pension plan with combined total assets exceeding \$6 billion, provided that one (1) of the individual plans has at least \$3 billion in assets.

- C. The firm must have experience in auditing the following classes of investments, which are at least the size shown for each class:

Equity securities, \$2.5 billion;
Fixed income securities, \$1.5 billion;
Real estate, \$1 billion;
Alternative investments, \$1 billion, and
Securities lending, \$0.5 billion.

Experience auditing these investments may be gained at a variety of different entities, such as mutual funds, insurance companies, banks, REIT's, and investment portfolios of a company.

- D. The firm must have its own actuarial staff within its organization, or form a joint venture(s) with and/or subcontract(s) with an actuarial firm(s). The actuaries [staff, joint venture or subcontractor(s)] must have experience in performing actuarial work on (1) two defined benefit pension plans with assets totaling at least \$10 billion within the last five (5) years, (2) actuarial work in the healthcare industry within the last five (5) years and (3) actuarial work with a long-term care program within the last five (5) years.
- E. The principle actuary assigned to this audit must have at least five (5) years of experience in the defined benefit pension actuarial area and must be a fellow or associate of the Society of Actuaries.
- F. The firm must have an established office located within the United States.
- G. The firm must be licensed by the State of California under the Accountancy Act, Article 4, Section 5072, and a copy of the license shall be submitted to CalPERS per the Proposal Questionnaire, Attachment D, Item J.
- H. The Principle/Partner (Engagement Partner) responsible for the CalPERS account, and the partner who signs the audit opinion with the firm name and the partner's own name, must be located in the United States and have at least eight (8) years of experience in public accounting. Such experience must include audits of defined benefit pension plans. This person shall be a Certified Public Accountant licensed by the State of California, and a copy of the license shall be submitted to CalPERS per the Proposal Questionnaire, Attachment D, Item I.
- I. The Audit Manager responsible for the CalPERS account must be located in the United States and have at least four (4) years of experience in public accounting. Such experience must include audits of defined benefit pension plans. This person shall be a Certified Public Accountant licensed by a state in the United States, and a copy of the license shall be submitted to CalPERS per the Proposal Questionnaire, Attachment D, Item I.
- J. The On-Site Audit Supervisor directly overseeing the CalPERS account must be located in the United States and have at least two (2) years of professional auditing

experience. Such experience must include audits of defined benefit pension plans. This person shall be a Certified Public Accountant licensed by a state in the United States, and a copy of the license shall be submitted to CalPERS per the Proposal Questionnaire, Attachment D, Item I.

- K. Audit Manager and On-Site Supervisor shall be available for communication and in-person meetings throughout the year.
- L. The firm must not be under pending litigation by the State of California for causes stated in Attachment D, Item F., of this RFP.
- M. The firm must provide a statement that there are no conflicts of interest that would prevent the firm or its staff from conducting the audit work and other work in accordance with American Institute of Certified Public Accountants Professional Standards and the CalPERS Finance Committee Charter (Exhibit 12).

The undersigned hereby certifies that he/she is an individual authorized to bind the firm contractually and said signature authorizes verification of this information.

Authorized Signature

Date

Name of Firm

Name and Title (Please Print)

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (CalPERS)

FINANCE COMMITTEE CHARTER

I. STATEMENT OF POLICY

On November 3, 1992, the people of the State of California passed Proposition 162, which amended Article XVI, section 17 of the California Constitution, granting the California Public Employees' Retirement System (CalPERS) Board of Administration (Board) plenary authority over the administration of CalPERS. On December 18, 1992, the Board implemented its plenary authority by adopting Delegation Resolution No: 92-04A to take exclusive control over the administration of the system, including but not limited to adoption of budgets. Furthermore, the Board continues to have full responsibility for the financial oversight of CalPERS.

To fulfill its responsibilities of budgetary control and financial oversight, the Board must ensure that CalPERS maintains: (1) an effective budget formulation, review and approval process; (2) an adequate system of internal controls; (3) adequate safeguards over assets; and (4) effective financial reporting and administration that is in compliance with all applicable laws and regulations.

In addition to its budgetary control and financial oversight, the Board has established a long-range Strategic Plan designed to focus the organization on a set of enterprise goals aimed at meeting the needs and demands of members, employers, and retirees by achieving the System's mission. The Board is responsible for all matters related to the ongoing maintenance of the Strategic Plan and in the approval of the Three-Year Business Plan and Annual Plan that generate specific objectives, outcomes, and projects in support of the enterprise goals. It is the Annual Plan that establishes enterprise budget priorities.

The Finance Committee was established at the February 18, 1993 Board meeting, to assist the Board in meeting these responsibilities and assumed the responsibilities of the former Audit Committee. Effective April 18, 2001 it will also assume the responsibilities of the former Strategic Planning Committee.

II. GENERAL AUTHORITY AND RESPONSIBILITY

The Finance Committee shall have the authority and responsibility to adopt its own operating rules and procedures including the authority to call for assistance from CalPERS' operating staff or to request outside assistance when needed.

III. PURPOSE

The primary function of the Finance Committee is to assist the Board in fulfilling its oversight responsibilities by: overseeing the annual budget process; reviewing financial reports and other financial information provided by CalPERS staff; monitoring CalPERS' internal control system; assuring compliance with pertinent

laws, regulations and Board policies; overseeing CalPERS' financial reporting, auditing, accounting and budget processes and reviewing all matters related to the maintenance and achievement of the Strategic Plan. The Finance Committee's general duties and responsibilities include:

- Serving as an objective and independent party to monitor CalPERS' financial processes and internal control system.
- Reviewing and appraising the audit, assurance and other attest efforts of the Board's independent financial statement auditor and the Board's external real estate compliance auditor.
- Reviewing and appraising the audit and assurance efforts of the internal auditors, and receiving quarterly notices of the consulting activities of the internal auditors.
- Providing an open avenue of communication among the independent financial statement accountant, the independent real estate compliance auditor, financial and senior management, the internal audit activity, and the Board.
- Reviewing the Three-Year Business Plan and Annual Plan to assess progress toward specific goals and objectives.
- Ensuring equal opportunities to all entities who wish to participate in the CalPERS Investment programs and enterprise-wide procurement processes.
- Ensuring diversity among our business partners.
- Ensuring that an adequate system of risk evaluation exists in the organization.
- Ensuring Information Technology projects are a prudent investment of resources while meeting the business needs of the organization.

The Finance Committee will primarily fulfill these responsibilities by carrying out the activities enumerated below.

IV. AUDIT AUTHORITY AND RESPONSIBILITY

The Finance Committee shall have the following audit authority and responsibility:

A. General Audit Authority

1. To oversee audit assessments of internal administrative and accounting controls by both the external independent auditor employed by the Board, the real estate compliance auditor employed by the Board and by the

CalPERS internal auditors.

2. To serve as the primary liaison and provide the appropriate forum for handling all matters related to audits, examinations, investigations or inquiries of the State Auditor and other appropriate State or Federal agencies.

B. Independent External Financial Statement Auditor

1. To review the responses received to solicitations sent to auditing firms and to recommend the selection of the independent auditors to be engaged by the Board. This process occurs every five years under Government Code, Section 20228, which states that an auditor may not serve two consecutive terms.
2. To provide a forum which promotes independence of the external audit process. To review and to set standards for independence for the external auditor hired by CalPERS. These standards will meet or exceed those required by:
 - a. Federal and State laws and regulations,
 - b. Communications from the Public Accounting Oversight Board, and
 - c. Proposals by professional accounting and auditing organizations.

The CalPERS standards for independence are presented in Attachment A of this document.

3. To oversee CalPERS' annual financial statement audits and other audit-related services performed by the Board's external auditor and monitor the development of any recommended actions resulting from these audits.
4. To review the annual audited financial statements of CalPERS, required auditor communications, the external auditor's management letter, and any additional audit reports and other attest reports prepared by the Board's external auditor. To recommend appropriate action to the Board and CalPERS management.

C. Independent Real Estate Compliance Auditor

The independent real estate compliance auditor performs limited scope reviews and agreed-upon procedures to ensure contract compliance by CalPERS real estate general partners, advisors and property managers.

1. To review the responses received to solicitations sent to auditing firms and to recommend the selection of the real estate compliance auditor to be engaged by the Board.

2. To provide a forum which promotes independence of the real estate compliance audit process from investment management and investment general partners, advisors and property managers.
3. To oversee the periodic audits performed by the Board's real estate compliance auditor and monitor the development of any recommended actions resulting from these audits. To recommend appropriate action to the Board and CalPERS management.

D. Internal Audit Functions

1. To assure and maintain, through the organizational structure of CalPERS and by other means, the independence of the internal audit process.
2. To provide advice and recommendations to the Chief Executive Officer of CalPERS, including the assessment criteria to be utilized, in the engagement of the chief of the Audits Division or in any disengagement relation to this position.
3. To review and recommend adoption of the annual update of the biennial audit plan to the Board.
4. To oversee all contracted reviews, assessments, assurance reviews, and examinations required by the Board or requested by the Finance Committee. Assurance reviews include, but are not limited to auditing compliance with laws, rules, regulations, Board policies, internal controls, management operating procedures, and industry best practices.
5. Review internal audit reports and other periodic reports and presentations from CalPERS staff or as specified by management letters, and recommend appropriate action to the Board and CalPERS management.
6. To receive quarterly notices of the consulting activities performed by CalPERS' internal auditors.
7. To delegate management of the external financial statement auditor contract and the real estate compliance auditor contract to the Office of Audit Services. To designate the Office of Audit Services as the liaison for audits and examinations by the Bureau of State Audits and any other State or Federal auditors.

V. BUDGET AUTHORITY AND RESPONSIBILITY

The Finance Committee shall have the following budget authority and responsibility:

1. To participate in the strategic planning process.

2. To review annual policy plans to assure that resource requests are developed within constraints which include the resources available, what is important; the magnitude of change proposed; current economic conditions; and performance.
3. To evaluate funding alternatives and prioritization of programs and projects developed by the Board of Administration and other standing committees.
4. To review performance of activities to evaluate the need, effectiveness and efficiency.
5. To evaluate the plan for the fiscal year relative to goals for the year and modify and recommend approval of the annual budget to the Board.
6. To recommend performance indicators to measure or assess the relevant outputs, service levels, and outcomes of each activity.
7. To review the success in achieving the goals of the fiscal year.
8. To evaluate and act upon revisions to the current year budget, including budget change proposals (BCPs) recommended by the Chief Executive Officer.
9. To review periodic reports of CalPERS' operating expenditures and comparisons of performance with goals and objectives and recommend appropriate action to the Board and CalPERS management.
10. To assure and maintain, through the organizational structure of CalPERS and by other means, the independence of the budget review and evaluation process and to provide a forum which promotes communication to the public.
11. To maintain a system to share budget information with the appropriate state fiscal agencies and the Legislature, the Committee adopts a "two reading" process for requests to augment the budget. This process will insure that the Legislature, Control Agencies, members and other interested parties have an opportunity to provide input into the budget being recommended by this Committee. This process will allow all interested parties an opportunity to comment on the CalPERS budget.

VI. STRATEGIC PLANNING AUTHORITY AND RESPONSIBILITY

The Finance Committee shall have the following strategic planning authority and responsibility:

1. To determine the approach, direction, and roles for the ongoing strategic planning process.

2. To review the System's Three-Year Business Plan and Annual Plan to ensure that sufficient resources have been committed and sufficient progress is being made toward the accomplishment of strategic goals.
3. To review periodic assessments of political, economic, social, technological, and competitive changes to determine if revisions to the Strategic Plan are warranted.
4. To recommend to the Board revisions to the mission and strategic goals as identified through periodic assessments of the overall Strategic Plan.

VII. DIVERSITY AUTHORITY AND RESPONSIBILITY

The Finance Committee shall have the following authority and responsibility as it relates to diversity efforts:

1. To oversee and evaluate enterprise-wide internal and external Diversity Outreach initiatives.
2. To oversee and evaluate the annual Diversity Program Outreach communication plan to ensure effectiveness.
3. To review Diversity Outreach Program's Disabled Veteran's Business Enterprise reports periodically and the Small Business annual report to the Department of General Services and the Governor's office.

VIII. ENTERPRISE COMPLIANCE AUTHORITY AND RESPONSIBILITY

The Finance Committee shall have the following Enterprise Compliance authority and responsibility:

1. To ensure enterprise compliance functions are performed with independence and in accordance with professional standards.
2. To approve the annual enterprise compliance plan.
3. To review the status of the annual enterprise compliance plan and approve changes as needed.
4. To provide a forum promoting independence of the enterprise compliance process.

IX. INFORMATION TECHNOLOGY AUTHORITY AND RESPONSIBILITY

The Finance Committee shall have the following authority and responsibility for the projects they choose to monitor:

1. To review and monitor project scope, schedule, budget, and vendor selection of selected projects.

2. To ensure selected projects accomplish the objective defined in their proposals.

X. OTHER ADMINISTRATIVE SERVICES AUTHORITY AND RESPONSIBILITY

The Finance Committee shall have the following authority and responsibility related to administrative services:

1. To review the annual consulting and services contracts report.
2. To oversee operational issues and other administrative issues.

XI. COMMITTEE MEMBERSHIP

The Committee shall consist of seven (7) members appointed by the President of the Board. The Committee Chairperson and Vice-chairperson shall be elected annually by the members of the Committee. The Secretary to the Committee shall be designated by CalPERS Executive Staff.

XII. COMMITTEE ACTION

A quorum shall be the presence of a majority of the authorized members of the Committee. Action shall be by a vote of majority of the Committee, providing a quorum is present. All Committee actions shall be ratified by the Board to be effective.

XIII. COMMITTEE MEETING DATES

The Committee shall meet at least quarterly or as deemed necessary by the Committee Chair.

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (CalPERS)
FINANCE COMMITTEE CHARTER
ATTACHMENT A**

I. INDEPENDENCE

The purpose of this document is to define the standards of independence for the external auditor to be engaged by the CalPERS Board of Administration. These standards will meet or exceed those required by Federal and State laws and regulations, communications from the Public Accounting Oversight Board. These standards will also meet or exceed standards proposed by professional accounting and auditing organizations.

The external audit firm engaged to perform a financial audit and/or other audit services shall be independent in fact and appearance. The external audit firm engaged to perform the financial audit and/or other audit services shall not contemporaneously perform services that conflict with auditor independence. This policy statement is based on the principal that independence of the auditor is paramount to ensure objectivity and to express an unbiased opinion.

Therefore, this Attachment A describes the following:

1. Services that the external auditor is allowed to perform,
2. Services that the external auditor is not allowed to perform,
3. Finance Committee approval of services performed by external auditor,
4. Transition for existing consulting contracts held by the external auditor,
5. Avoidance of undue influence on the external auditor,
6. Rotation of audit firms, and
7. Disclosure reporting of external auditor services.

II. SERVICES THAT THE EXTERNAL AUDITOR IS ALLOWED TO PERFORM

The following items are within the scope of services that may be provided by the Board's independent financial statement auditor. In general, these services to be provided are those that are provided in the Statements of Auditing Standards and the Statements of Standards for Attestation Engagements promulgated by the Auditing Standards Board of the American Institute of Certified Public Accountants. The Finance Committee and the Board may make exceptions to these standards.

1. Annual financial statements audit,
2. Training,
3. Preparation of draft financial statements that are based on management's chart of accounts and trial balance and including any adjusting, correcting, and closing entries that have been approved by management,
4. Required communications,
5. Presentation of financial statement to the Finance Committee,
6. Attest services,

7. To make recommendations to management on internal control structure, risk management and/or accounting policies as a result of performing the other allowed services,
8. Provide basic accounting assistance, which is limited to services such as:
 - preparing draft notes to the financial statements based on information determined and approved by management,
 - preparing a trial balance based on management's chart of accounts, and
 - proposing adjusting and correcting entries that are identified during the audit so long as management makes the decision on accepting these entries.
9. Any other audit services approved by the Finance Committee and the Board that do not impair auditor independence.

III. SERVICES THAT THE EXTERNAL AUDITOR IS NOT ALLOWED TO PERFORM

The Board's independent financial statement auditor, its subsidiaries and affiliates, shall not perform the following services for CalPERS that the Board believes will impair auditor's independence while engaged to perform CalPERS' financial statement audit. These services include the following items:

1. Consulting,
2. Bookkeeping or other services related to the accounting records or financial statements of CalPERS,
3. Financial information systems design and implementation,
4. Appraisal or valuation services, fairness opinions, or contribution-in-kind reports,
5. Actuarial services,
6. Internal audit outsourcing services,
7. Management functions or human resources,
8. Broker or dealer, investment adviser, or investment banking services,
9. Legal services and expert services unrelated to the audit, and
10. Any other service that the CalPERS Finance Committee and Board determines, by policy, is impermissible.

IV. FINANCE COMMITTEE APPROVAL OF SERVICES BY THE EXTERNAL AUDITOR

The Finance Committee must approve all financial audit and other allowed services in advance of services being performed. The Finance Committee Chairman is responsible for pre-approval and shall inform the other committee members of pre-approval within 10 days, and this information shall be included in the next Finance Committee agenda. The Finance Committee may consult with chief of audit services when questions of independence arise.

Deminimus. No Finance Committee approval is required for additionally allowed services that last less than one month and cost less than \$10,000 per engagement. If aggregate total for services allowed exceeds 5% of the total amount of the financial statement audit contract, the Finance Committee or its delegate shall pre-approve the services.

V. TRANSITION

All services currently being provided by the external auditor that are not allowed shall conclude on or before June 30, 2003.

VI. UNDUE INFLUENCE

No member of the Finance Committee or CalPERS staff shall improperly influence the auditors or the firm engaged to perform audit services. Therefore, no person associated with CalPERS shall take any action to fraudulently influence, coerce, manipulate, or mislead the Board's independent financial statement auditor. To the contrary, persons associated with CalPERS shall promptly provide all information required for the auditor to form an opinion on CalPERS financial statements.

VII. ROTATION OF AUDIT FIRMS

Government Code, Section 20228 requires rotation of audit firms every five years. *Section 20228* reads as follows:

"The board shall annually employ a certified public accountant, who is not in public employment, to audit the financial statements of this system. The term for which the board may contract to employ a certified public accountant shall not exceed five years. The board shall not contract to employ the same certified public accountant for two consecutive five-year terms. The costs of the audit shall be paid from the income of the retirement fund. The audit shall be made annually. The board shall file a copy of the audit report with the Governor, the Secretary of the Senate, and the Chief Clerk of the Assembly. The board, for purposes of Section 7504, may file internally prepared financial statements with the Controller within six months of the end of the fiscal year, and shall file independently audited financial statements as soon as they are available. The audits shall not be duplicated by the Department of Finance or the State Auditor. This system shall be exempt from a pro rata general administrative charge for auditing."

VIII. DISCLOSURE REPORTING OF EXTERNAL AUDITOR SERVICES

A report of audit, attest and all other services allowed by this policy and provided by audit firms, including the fees paid to the auditor, shall be provided to the Finance Committee annually.

TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION

EDWARD NUSBAUM

**RESPONSE TO ALL FOLLOW-UP QUESTIONS FROM FEBRUARY 4, 2008
OPEN MEETING**

Question: “Page six of your written testimony states that “[t]o uphold the honor and credibility of public company accounting, all participants must have a single focus – doing what is right for investors and other financial statement users.” If the focus is on doing what is right for investors, why does your testimony and the testimony of others representing the major audit firms support further limits on auditor liability when most institutional investors do not support that position [See September 2006, “Study on the Economic Impact of Auditors’ Liability Regimes—Final Report To EC-DG Internal Market and Services,” by London Economics in association with Ralph Ewert, page xliij]?”

A robust auditing profession is crucial to investor protection and vibrant capital markets. Therefore, a sustainable audit profession is in the mutual best interest of all. Currently, this sustainability is at risk. We believe there is a need for liability reform that appropriately holds accountable all capital markets participants.

One potential trigger for the collapse of a global network, such as Grant Thornton International, or a major audit firm is a large verdict or judgment in a private lawsuit. There may be disagreement about the chances that such a catastrophic judgment will occur, but the reality of the threat cannot be disputed in view of the size and concentration of the claims that audit firms face. While we, as a firm, are not convinced that liability caps are the appropriate means to address catastrophic risk, however, we believe this threat must be taken very seriously by all capital markets participants. The Advisory Committee has a unique and timely opportunity to address this risk in a mutually beneficial manner.

Grant Thornton supports changes in the professional liability system that would contribute to a robust profession while meeting the three public interest tests outlined in my written testimony. We strongly believe that auditors must continue to enhance their performance and be appropriately accountable for wrongdoing. We would expect nothing less of other capital market participants as well. We also believe that a liability environment that supports audit firm sustainability will yield benefits for investors and other financial statement users in a number of ways.

- It will support quality auditing. Catastrophic liability is not a driver of audit quality when it is an irrational potential that is not related to any action that an accountant can control, as is often the current situation. Reducing the threat of this irrational potential is in the investors’ interest because it redirects the auditing profession’s focus and vital resources back to audit quality drivers – such as the

convergence of quality and standards, regulatory transparency and fairness, recruitment, training and retention of highly qualified individuals, and R&D investment in audit methodology. It will help the vocation attract talented and knowledgeable professionals capable of standing toe-to-toe with C-suite executives.

- It will be beneficial to the level of choice in the audit market. A catastrophic lawsuit could significantly alter the competitive landscape for audit work among large corporations. Such dislocation works against the public interest, because it erodes investor confidence and could result in further concentration of the profession.

We ask the Committee to consider a number of incremental measures that would serve the public interest by reducing sustainability risk, recognizing that no single approach would eliminate all catastrophic risk. These measures fall into three categories – specific amendments to SEC Rule 10b-5, measures that would allow for reasonable apportionment of liability based on market realities, and targeted litigation process improvements that would make it possible for defendants to thoroughly litigate legitimate defenses. These approaches are discussed in more detail in my written testimony.

The audit profession must remain strong to serve all who depend on our work. We are hopeful that institutional investors and the other capital market participants represented on the Advisory Committee will evaluate the facts gathered in connection with the Committee's work, and consider recommendations that will affirm the profession's sustainability – including specific liability reform measures that can serve investors' interests.

Question: *“On page 8 you note that global networks intend to release annual reports after next year end – what do you expect the report to include?”*

The audits of public companies are vital to the strength and stability of the global capital markets. As such, stakeholders have the right to feel confident that our networks are structured to deliver consistent, reliable, timely and high-quality audits.

Toward that end, after its next fiscal year-end, each of the global networks, including Grant Thornton International member firms, will provide important information related to audit quality on their websites. As a starting point, this network-level information will be similar to the information provided by audit firms registered in EU Member States by the EU Statutory Audit Directive, which requires the following information:

- a description of the legal structure, arrangements and ownership of the network and its member firms
- a description of the governance structure of the network
- the internal quality control system of the network and a statement by the network leadership body on the effectiveness of its functioning

- a discussion of quality assurance review processes
- an explanation of the network's independence policies and practices
- a discussion of the continuous education of auditors within the network
- financial information showing the relative size and scope of the audit network and fees charged for other services
- a description of the basis for partner remuneration

Question: *“On page 7 you talk about an interstate commission for the whole of the audit profession in the area of licensing and regulation. What would be the regulatory basis for such an arrangement and who would fund?”*

In my testimony, I stated 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.

A healthy discussion about the regulatory basis for an interstate commission as well as options for its funding would be part of this suggested evaluation. The evaluation process should bring together experts from relevant spheres to enlighten and inform the public exchange on these and other related matters.

The important point is that it is in the public interest to be open to such an evaluation. We believe that the public could be served by a new interstate entity that works to rationalize existing disparities in state licensing qualifications, continuing education requirements and peer review, while also enabling enforcement of common regulations and license discipline across state and federal jurisdictions. An evaluation of how this could be achieved would serve the markets, investors and the accounting profession well.

The Stonebridge Decision - Its Potential Impact on Auditors

A Brief Discussion by D. Paul Regan

March 22, 2008

Since I am a CPA and not an attorney, these comments are presented from my perspective as someone that has worked on, and testified in, many large securities cases that have involved CPAs as defendants. These have included: Enron, Sunbeam, Xerox, and Parmalat, to name a few.

I have several concerns about the Stonebridge case, these include:

- By excluding many 3rd party schemers from liability who have aided and abetted corporations in schemes that were designed to materially misstate the company's financial statements, such 3rd party schemers will be:
 - Emboldened,
 - Used more extensively and perhaps more ingeniously, to establish and finance more extensive schemes which will include barriers to auditors, making management fraud more difficult to detect.
- Excluding these 3rd party schemers from liability will expose auditors to a greater share of the damage that are recoverable in resulting litigation. This arises since 3rd party schemers will no longer share in settlements or judgments that have reduced the proportion which the auditor has been responsible in the past.
- From a different perspective, I am also concerned that this case might cascade into decisions similar to the California case titled *Bily v. Arthur Young*. The Bily case makes it extremely difficult for shareholders to recover damages from CPA firms unless certain very stringent and limited conditions are present. It has been argued that this case has emboldened certain California entities, and reduced audit quality, because it has so substantially reduced audit risk.



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March 31, 2008

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

Dear Committee Members:

I am pleased to provide to you the answers to the supplemental questions that I received in follow up to my February 4, 2008 testimony before the U.S. Treasury Advisory Committee on the Auditing Profession. They are attached as Appendix A to this letter.

In addition, I would like to take the opportunity to clarify an issue, which has arisen in these questions and elsewhere. We are concerned about the way that some have interpreted statements about the liability risk facing the profession in the recent report by the Government Accountability Office, Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action (January 2008) (the Report). In the Report, the GAO concluded that there is no compelling need to take *any* action to address current levels of audit firm concentration.¹ Nevertheless, on several occasions, we have heard it suggested that the GAO undertook an independent analysis of the need for liability reform, and determined there was no need.

In fact, far from concluding that litigation risk is not a cause for concern, the Report expresses concern about the potential catastrophic impact of litigation risk faced by the profession, noting that “[a]lthough the current level of concentration does not appear to be having significant adverse effect, the potential for further concentration in the audit market did raise concerns....For example, audit firms face the risk that civil litigation could result in their insolvency or inability to continue operations.”² The Report also cites litigation risk and lack of insurance coverage as potential barriers to entry for smaller firms.³ It continues by summarizing various third parties’

¹ GAO report at 6.

² GAO report at page 32-33 (footnotes omitted).

³ GAO report at page 55 (footnotes omitted).

views on potential ways to address these risks.⁴ The Report does not, however, take a position on the relative merits of this third party commentary, and there is no evidence that the GAO undertook any independent analysis of these points. For your convenience, I have included in Appendix B to this letter excerpts from the Report that I have cited herein.

I appreciate the opportunity to provide the Committee with information and views on the important topics it is considering, and I would welcome the opportunity to discuss these or any other questions the Committee may have in more details.

Sincerely,

A handwritten signature in cursive script, appearing to read "Barry", written in black ink.

Barry Salzberg

Attachments

⁴ Id.

**Advisory Committee on the Auditing Profession
Questions for the Record for Barry Salzberg**

- 1. Page one of your written testimony states that “the Committee can benefit from the recent work [of] . . . the U.S. Government Accountability Office’s (GAO) updated study on concentration and competition in the auditing profession.” The GAO report you reference in your testimony considered and rejected a broad range of proposals that have been set forth by various parties to reduce the risk of further concentration in the audit market. In rejecting those proposals, including proposals to limit auditor liability, the GAO found that such proposals were ineffective and/or contained “serious drawbacks.” More specifically, in commenting on proposals relating to further limiting auditor liability, the GAO report noted that some parties have expressed concern that further limits on auditor liability could lead to lower audit quality. What evidence do you have that the GAO’s analysis was faulty and that further limits on auditor liability will not lead to lower audit quality?**

Answer: We understand the crux of your question to be whether we believe a cap or other limit on catastrophic damage awards would result in reduced audit quality. We believe it would not. There are much more compelling incentives for audit quality than private litigation.

First and foremost, the vast majority of audit professionals care deeply about the quality of the work that they do, and all have a professional and ethical responsibility to provide quality audits. Not only are auditors professionally and ethically motivated to perform quality audits, but they also are motivated by the fact that their business success and compensation depends on the quality of their work. Partners work hard to protect their individual and firm reputations. Loss of reputation is tantamount to loss of livelihood. Audit firms consequently dedicate significant resources to ensuring the performance of quality audits.

Second, auditors’ work and quality control systems are subject to a robust oversight system. Regulators have the power to impose a variety of sanctions, including the ultimate sanctions of barring individual CPAs from auditing public companies and taking actions that could put a firm out of business. These are much more powerful and reliable incentives than private litigation. In fact, since the implementation of the Sarbanes Oxley Act, the oversight of the profession has been greatly enhanced, and now includes:

- The PCAOB, which has standard setting authority, a broad inspection program, and the ability to impose a wide variety of sanctions against individual auditors and auditing firms;
- Enhanced SEC powers and resources; and
- Enhancements to public company audit committee independence, qualifications, and duties related to the selection and oversight of outside auditors.

Moreover, the liability caps that we urged the Committee to consider would only mitigate catastrophic judgments; existing ongoing private litigation costs would in no way be eliminated. As noted in the report that the profession submitted to the Committee on January 23, litigation-related costs for the six largest firms are the second largest expense item after personnel related costs, constituting 6.6% of all revenues and 15.1% percent of audit-related revenues. This is

dramatically greater as a percentage of revenue than in any other type of profession or business in the United States that we can identify, and therefore serves and would continue to serve as a significant ongoing motivator for audit quality. Realistic caps on liability would still be far in excess of the fees earned from a client, and therefore would not change any motivation to maintain audit quality. In fact, we are concerned that the profession's ability to attract and retain the best talent over the long term could be negatively impacted by the level of risk the profession currently faces—including the risk of a catastrophic civil judgment.

As I also note in my cover letter, the GAO report did not include independent analysis of the existence of any link between the threat of catastrophic litigation and audit quality, but rather restated opinions offered by those whom it interviewed. The report did not state a conclusion that there is a basis for these opinions, nor did it reach any overall conclusion on this point, outside the context of its conclusion about whether there was a need to take *any* action given the level of competition in the profession currently. In fact, the GAO report noted on page 32 that while current levels of concentration are not having significant adverse effects, further concentration could result from “civil litigation [that] could result in [firms’] insolvency or inability to continue operations.”

2. Page seven of your written testimony indicates that you believe that a professional judgment rule or framework “should provide protection in appropriate circumstances from civil liability and SEC or PCAOB action.” Have you discussed this view with Deloitte LLP’s legal counsel or any other legal experts? If so, do they agree that the professional judgment rule or framework would reduce the civil liability of auditor’s?

Answer: There will always be debates as to whether a particular judgment was or was not reasonable, even if there were a rule in place, so a rule would not entirely remove the risk of litigation. However, for any profession to function effectively, it is necessary to recognize and respect the fact that reasonable people may reach different conclusions based on equally appropriate evaluations. We and our legal advisors are confident that the SEC has the statutory authority to adopt a professional judgment rule that would provide significant protection against inappropriate second-guessing of preparers and auditors in private litigation. Analogous protections currently exist in other areas of the federal securities laws, such as in the context of issuer repurchases of securities, forward looking information, and tender offer best price rules.

Of course, any professional judgment rule must first and foremost be geared toward enabling preparers and auditors to make reasonable judgments about the accounting methods that best communicate financial information to investors. The rule should not provide protection from mistakes or inappropriate decisions. To ensure these goals are met, we believe such a rule could be modeled after the Business Judgment Rule, which has existed for many years and its application has been tested and proven to be effective.

The essence of the question is the extent of protection such a rule would provide. We are more interested in the implementation of a professional judgment regime than its specific protective provisions. It is likely that IFRS will become the U.S. standard, and such a principles-based regime makes the existence of a rule, protocol, or policy statement essential. We have views as to our preference, but we fully understand and respect that the SEC will determine the form and content of any such Commission or staff action.

- 3. Page seven of your written testimony indicates that you support the “movement towards international convergence with the independence standards of the International Federation of Accountants (IFAC).” Is the IFAC’s independence standard setting body composed of full-time standard setters? How many investors sit on the IFAC independence standard setting body? How is the IFAC’s independence standard setting body funded? Do you have any concerns about the current structure or process of IFAC’s independence standard setting body?**

Answer: Since 2005, the Public Interest Oversight Board (PIOB) has overseen the auditing, independence and education standard setting activities of the International Federation of Accountants (IFAC). The PIOB is an independent board comprised of non-profession members appointed by the International Organization of Securities Commissions, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, and The World Bank. A list of PIOB members can be found at www.ipiob.org. IFAC is comprised of professional accountancy organizations from around the world, and is primarily funded through membership dues, annual financial contribution from the Forum of Firms, funding grants, and revenue from publications.

The IFAC standard setting board responsible for setting independence standards is the International Ethics Standards Board for Accountants (IESBA). The IESBA has 18 volunteer members, no more than 50% of whom are practitioners, who are appointed by IFAC with approval by the PIOB. IFAC’s standard-setting boards, including the IESBA, seek advice and input from a Consultative Advisory Group (CAG) composed of organizations with technical and public interest perspectives, including the PCAOB. Lists of IESBA and CAG members can be found at <http://www.ifac.org/ethics>.

We do not have any concerns about the current structure or process of IFAC or its standard setting boards. We recommend that the PCAOB and SEC adopt the same principles-based approach to auditor independence that the IFAC has embraced and work towards convergence with IFAC’s high quality, global independence standards. We believe this approach is preferable to the current rules-based approach, as it allows for identification and application of appropriate safeguards to eliminate or reduce independence threats to an acceptable level. Moreover, we believe that consistent high quality global standards related to financial reporting, auditing and independence would contribute to enhanced quality and consistency of practice throughout the world, thereby strengthening public confidence in financial reporting and the capital markets.

Please note that, as discussed in Question 5 below, even if IFAC’s principles-based approach is not adopted in the U.S., we reaffirm the view set forth in my written testimony that certain amendments should be made to the existing SEC and PCAOB rules to improve the ability of firms to comply, without impacting the independence of auditors.

4. **On page ten of your written testimony regarding national licensing, you raise concerns about an example in which an audit firm or individual who is sanctioned for work on an audit that occurred entirely in one state may also be subject to an investigation and possible discipline by another state in which he holds a CPA license. To extend your example, if I held a CPA license in the states of North Carolina and Michigan and was sanctioned in North Carolina for robbing a North Carolina bank, why should Michigan be barred from investigating and disciplining me for the same offense?**

Answer: Your example involves criminal conduct, unrelated to an audit, and is very different from the type of duplicative process on which we focused in my written testimony. We do not object to a CPA being barred from practicing in every state under your example. In fact, that is the effective result today for public company audits when CPAs are denied the privilege of practicing before the SEC. And this also would be the result if there were a national license.

Our concern is focused on the increasing instances of multiple and duplicative investigations into the same audit-related conduct conducted by states with no nexus to the conduct. These duplicative investigations may involve examination of an entire firm and its policies and procedures, long after the SEC, PCAOB or state with nexus to the conduct has completed its investigation, imposed sanctions and the firm has made any necessary changes to the policies and procedures in place at the time of the alleged misconduct. We see no public benefit to such duplicative investigations. In fact, we believe that centralized and rationalized reviews of potential audit failures would serve the public interest better and more efficiently, and would eliminate the risk of conflicting findings and redundant penalties.

5. **On page 7, you mention that IFAC has a “threats and safeguards approach” to independence standards. Is that something that you support and why?**

Answer: We believe that consistent high quality global standards related to financial reporting, auditing and independence would contribute to enhanced quality and consistency of practice throughout the world. We therefore support the movement towards international convergence with the independence standards that are issued by IFAC. We believe that IFAC’s conceptual framework is consistent with the U.S. system, but allows for more principles-based analysis. Under the IFAC approach, possible independence concerns are assessed first by:

- Identifying threats to independence;
- Evaluating whether these threats are clearly insignificant; and
- In cases where they are not clearly insignificant, identifying and applying appropriate safeguards to eliminate or reduce the threats to an acceptable level.

A move towards convergence with IFAC’s approach would likely lend support for some modifications to U.S. independence rules that we support for the reasons enumerated in my written testimony. These are:

- *De minimis* exceptions for scope of services violations;
- “Up & over” rule changes to ease restrictions for affiliates in portfolio companies; and
- Lengthening of the period for audit lead partner and concurring partner rotation.

However, as I noted in my written testimony, we believe that the above changes can be made under the existing U.S. system, whether or not there is convergence with the IFAC approach.

6. In your testimony (p. 5) you ask the Advisory Committee to consider recommending that the SEC support the use of ADR to resolve claims relating to accounting and auditing issues, including a recommendation that would enable companies to include provisions in their articles of incorporation that require the use of ADR for investor claims against the company and its advisors (such as auditors). Neither DT nor CAQ provide any evidence, such as data on the current use of and outcomes from ADR by audit firms, to support this recommendation. Please provide such evidence.

Answer: As I noted in my written testimony, arbitration is a dispute resolution process that is an alternative to the potentially time-consuming, adversarial and costly nature of traditional trial litigation.⁵ In arbitration, the parties to a dispute submit the matter to a panel of one or more third-party neutrals who render a decision on the matter after a hearing. The arbitration process gives the parties the ability to share their ideas and concerns in a less formal and more cooperative setting, which can increase the likelihood that the outcome reached is one that the parties consider to be fair and equitable.

Based on publicly available information, we believe that a number of accounting firms now regularly use ADR in their audit engagement letters with public companies. Deloitte & Touche LLP began using ADR in its audit engagement letters early last year and has met with overwhelming success in reaching agreement with its clients on the use of ADR. We believe this level of success is generally because our clients also see a significant benefit, from both a legal and business perspective, to resolving auditor/client disputes through ADR. (It is important to note that these engagement letters do not obligate shareholders or creditors to resolve their own claims in arbitration.) Indeed, it is our understanding that many of our clients regularly include ADR provisions in their contracts with their customers and suppliers.

Because most accounting firms, like Deloitte & Touche LLP, began to include ADR provisions in their audit engagement letters only recently and because of the inherently confidential nature of the arbitration process, specific information and data on particular matters and outcomes are not readily available. The following studies and surveys, however, address the use and perceptions of arbitration more generally:

- In a 2003 study conducted by the American Arbitration Association, published in 2006 under the title “Dispute-WiseSM Business Management: Improving Economic and Non-Economic Outcomes in Managing Business Conflicts”, approximately 72% of the companies surveyed reported that they had used arbitration during the previous three years. Cost savings, time savings, and the view that arbitration “provides a more satisfactory process” than litigation were identified as some of the primary reasons for using arbitration, with approximately 71% believing that arbitration saves money, approximately 73% indicating that arbitration saves time, and approximately 66% concluding that arbitration “provides a more satisfactory process” than litigation.⁶ A subset of the study participants consisting of *Fortune* 1000

⁵ In many cases, alternative dispute resolution (or ADR) also includes mediation. Mediation is a voluntary and confidential process in which parties, typically with the assistance of a neutral third-party mediator, are given an opportunity to share perspectives and generate potential solutions in an effort to reach a mutually agreeable resolution to a dispute.

⁶ Survey participants (*Fortune* 1000 and other companies combined) who used arbitration were also asked questions concerning the effect arbitration has on costs of the dispute resolution process (exclusive of judgment or award

companies reported similar views about why they used arbitration, with approximately 68% indicating that they used arbitration because they believe it saves time, approximately 65% claiming that arbitration saves money and approximately 60% concluding that arbitration “provides a more satisfactory process” than litigation. Indeed, the overwhelming majority of all companies participating in the survey (approximately 76%) reported that they were either “satisfied”, “very satisfied”, or “extremely satisfied” with their recent arbitration experiences.

- In an April 2005 Harris Interactive® survey entitled “Arbitration: Simpler, Cheaper, and Faster Than Litigation”, of 609 U.S. adults who had participated in a non-court ordered binding arbitration process that reached a decision, arbitration was perceived to be faster, simpler and cheaper than going to court by approximately 74%, 63% and 51%, respectively. Approximately 75% of the participants indicated that they were either “very satisfied” or “moderately satisfied” with the fairness of the process and approximately 72% indicated they were either “very satisfied” or “moderately satisfied” with the fairness of the outcome.

The use of arbitration as a method to resolve disputes has several advantages. It helps the parties focus on central issues more quickly and, as the studies described above indicate, it is potentially less costly than traditional trial litigation. There is no jury and, therefore, no need to hire expensive jury consultants. Discovery, which can often be a prolonged and costly process, is usually reduced to a limited exchange of documents, witness lists and depositions as necessary for a fair proceeding. Also, because arbitrations are not subject to court docket backlogs, the proceedings can be scheduled as soon as the parties are available and can continue uninterrupted, thereby potentially resulting in a much faster resolution than may be obtained in traditional trial litigation.

In arbitration, moreover, the parties can restrict arbitrators to those individuals who have particular expertise and can also arrange for arbitration panels where one or more of the arbitrators are selected by the parties themselves. This helps ensure that disputes are resolved by individuals with the requisite background and training relevant to the issues in dispute. Resolution of disputes involving very complex issues by such individuals should result in fairer outcomes.

Although there are some potential disadvantages (such as limited appeal rights and the potential for compromise decisions), we believe using arbitration as a means of resolving disputes has, for all parties, a number of significant potential benefits over traditional trial litigation. Therefore, we continue to encourage the Advisory Committee to recommend that the SEC support the use of ADR to resolve claims relating to accounting and auditing issues.

costs) and time required to resolve disputes, in each case as compared to litigation. Of those participants that responded to these questions, 58% believed that arbitration “decreased costs” and 67% believed that arbitration “decreased time”. In contrast, only 8% of those responding believed that arbitration “increased costs” and only 7% believed that arbitration “increased time” as compared to litigation; 34% believed there was “no effect” on such costs and 26% believed there was “no effect” on time.

Appendix B

The Report does not take a position on the relative merits of third party commentary on relative merits of liability reform mechanisms. *See, e.g.*, Report “Results in Brief” at page 6:

Some have also put forth proposals to reduce the risk of further concentration that could arise if one of the largest firms leaves the market as the result of a large litigation judgment or a regulatory action. Proposals to reduce this risk include placing caps on auditors’ liability and having regulators or others take enforcement actions only against responsible partners or employees rather than the firm as whole. However, some of the academics and others we spoke with saw such liability caps and enforcement limitations as potentially reducing the incentives for auditors to conduct quality work. Other proposals have been offered to help midsize and smaller firms expand their market share, thus potentially easing concentration. These proposals include allowing outside ownership of these firms in order to provide capital to expand their operations, creating a group of accounting and auditing experts to provide needed expertise to smaller auditing firms, and establishing a profession wide accreditation program to help these firms overcome some of the name recognition and reputation challenges they face. However, while each action could offer benefits, market participants generally saw these proposals as having limited effectiveness, feasibility, and benefit.

In light of limited evidence that the currently concentrated market for large public company audits has created significant adverse impact and the general lack of any proposals that were clearly seen as effective in addressing the risks of concentration or challenges facing smaller firms without serious drawbacks, we found no compelling need to take action. As a result, this report does not include any recommendations.

The Report expresses concern about the potential catastrophic impact of litigation risk faced by the profession. *See* Report at pages 32-33:

Although the current level of concentration does not appear to be having significant adverse effect, the potential for further concentration in the audit market did raise concerns. Further concentration could arise as a result of several events. For example, audit firms face the risk that civil litigation could result in their insolvency or inability to continue operations. Since 1998, audit firms may have paid at least ten settlements or awards of \$100 million or more that have resulted from private litigation. In addition, a jury recently found BDO Seidman, the sixth largest accounting firm, liable for \$521.7 million in damages, although BDO Seidman plans to appeal the verdict. Several officials we spoke with commented that litigation increases during periods of high market volatility. As a result, litigation-related costs to auditors could increase in the case of an economic downturn. Officials from the largest firms told us that litigation costs have significantly increased since 2003. Some officials we interviewed from the largest firms and the insurance industry told us that the largest firms do not have insurance coverage to protect against the largest claims, both because insurance at that level is not available and because of fear that having more insurance could induce plaintiffs to seek higher awards. However, full information on litigation risk and costs and accounting firms’ insurance coverage is not publicly available, so we could not identify the magnitude of the risk that litigation poses to these firms. Some officials we spoke with also suggested that litigation could damage a firm’s reputation, causing the firm to fail if its clients began seeking other firms for their audits. For example, according to some academics, Laventhol & Horwath,

the seventh-largest accounting firm in 1990, declared bankruptcy that year in part due to a series of class action lawsuits that resulted in a loss of reputation and the firm's inability to attract new work." (footnotes omitted)

The Report cites litigation risk and lack of insurance coverage as potential barriers to entry for smaller firms. *See Report at page 55.*

The risk of being sued appears to reduce some audit firms' willingness to seek out additional public company clients. We reported in 2003 that litigation risk was a barrier for smaller firms seeking to audit larger public companies because of the difficulty of managing this risk and of obtaining affordable liability insurance. In the survey we conducted for this report, over half (61 percent) of midsize and smaller audit firms reported that liability/tort reform would be at least somewhat effective in helping them increase their market share. Further, litigation could result in even more market concentration if firms that were sued ultimately went out of business.... (footnotes omitted)

The Report summarizes various third parties' views on potential ways to address these risks, but does not state its own views on these points. *See Report at page 55.*

A number of market participants and academics, and a recent report commissioned by Senator Charles Schumer and New York City Mayor Michael Bloomberg have recently advocated placing caps on auditors' potential liability as a means of reducing the risk of litigation that could lead to the loss of another large audit firm.... Some have argued that caps would not only decrease litigation risk but would also increase the availability of insurance. Both of these developments could reduce the risk of a firm failing because of litigation. In addition, some believe liability caps could also lead to increased efficiencies if audit firms could reduce the amount of time they spent protecting themselves against lawsuits.

While some market participants thought that capping auditors' liability would be beneficial, others pointed out that such caps could have negative effects and would not protect firms against all risks that could lead to failure. Some of the former regulators and a representative of investors we spoke with were concerned that having less potential liability would limit the extent to which audit firms were held responsible for their work and could lead to lower audit quality. Others were concerned that caps would limit investors' ability to recoup losses they incurred if an auditor was found to have committed fraud. In addition, caps would not reduce the risk that firms face from enforcement actions, which could also lead to failure. Finally, a few questioned the fairness of capping liability for auditors but not for others who faced similar risk, such as public companies and investment banks.

Advisory Committee on the Auditing Profession
Neal Spencer Responses to Jeff Mahoney Questions in Follow-up to
Testimony Provided February 4, 2008

Question #1:

You indicated in your written testimony that audit concentration issues can be addressed by limiting “the dollar amount of professional liability claims.” Your recommendation appears to be in direct conflict with the conclusions contained in the January 2008 report of the United States Government Accountability Office entitled “Audits of Public Companies—Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action” (GAO report), which considered and rejected proposals to limit auditor liability as a means for reducing audit market concentration. How do you reconcile your views with those contained in the GAO report?

Response:

In its original report in 2003, and in its follow-up report in January 2008, the GAO recognized that “litigation risk was a barrier for smaller firms seeking to audit larger public companies because of the difficulty of managing this risk and of obtaining affordable liability insurance . . . Further, litigation could result in even more market concentration, if firms that were sued ultimately went out of business.” The GAO also expressed in its report input from other market participants of the potential negative consequences of such a liability cap.

Ultimately, the GAO concluded on this topic that “Given the lack of significant adverse effect of concentration in the current environment and that no clear consensus exists on how to reduce concentration, no compelling need for immediate action appears to exist.”

Our testimony was focused on what efforts could/should be taken to increase competition in audits of public companies. The single biggest deterrent to smaller firms entering or expanding their public company audit practice is liability exposure. If the goal of the Committee is to reduce concentration in this market, liability reform is necessary.

We do not believe our recommendation for a liability cap is inconsistent with the GAO report. In its report, the GAO acknowledged that “over half of mid-size and smaller audit firms reported that liability/tort reform would be at least somewhat effective in helping them increase their market share.” GAO did not reject the concept or the benefits of a liability cap; rather, they took a wait-and-see approach by declining to make any recommendations on the premise that there is currently no significant adverse effect of concentration. If the Committee believes that significant concentration does exist, and that potential negative impacts to the market of the potential future departure of another large accounting firm from the market are real and significant, then we strongly encourage the Committee to be proactive in its consideration of our recommendation.

Question #2:

Your written testimony states that “[f]or smaller firms, the level of professional liability insurance may be far more relevant than other financial information for which transparency is being considered?” In your opinion, what financial or other information should the larger audit firms be required to disclose to the public, and what financial or other information should the smaller audit firms be required to disclose to the public?

Response:

In order to appropriately respond to your question, we first have to make some assumptions about the purpose for which disclosure is requested. In many respects, the auditor-client relationship is a purchaser-vendor relationship. Albeit the auditor is an important vendor, assisting companies and their investors in achieving reliable financial information, but a vendor nonetheless.

Accordingly, the relevant question may be: what information about vendors do businesses (purchasers) typically need? For example, you would certainly want to know about the quality of a plumbing company’s service, the value for the costs incurred of an auto repair shop or whether your software vendor will be there a year from now.

However, in most cases, 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. In most cases, businesses don’t pursue this kind of information, because even if vendors go out of business, they can be replaced without significant impact.

So what’s different about audit firms? How would the public be benefited from financial disclosure on the part of audit firms? Here are some alternatives we have considered:

- 1) **Is the profitability or financial condition of an audit firm a gauge of the quality of work performed?** Certainly not directly, if at all. In every industry, some companies are more profitable or more financially strong than others, but how well the business is run financially may have no bearing on the quality of its products or services.

Differences in profitability between firms quoting similar fees are generally driven by conditions such as effective utilization of personnel, leverage, economies of scale, nature of services provided, nature of clients served and geographic location.

- 2) **Does the financial condition of an audit firm provide a company some level of assurance that the audit firm will not financially fail in the middle of an audit?** Historically, this has never been a problem or concern. Companies have far less concern about the ability of their auditor to complete the engagement than they might, for example, about a construction contractor's ability to complete a large long-term contract. An audit is performed within a finite window of time and then it is done. Auditors can be, and are, replaced from one year to another.
- 3) **Does the financial condition of an audit firm demonstrate an ability to attract qualified personnel and invest in appropriate technical resources?** Perhaps indirectly, but auditors have historically found other ways to convince companies of the adequacy of their resources and technical capabilities. If a firm has the requisite expertise to audit a particular client, their ability to develop additional resources is secondary.
- 4) **Does the financial condition of an audit firm demonstrate the ability for the auditor to make restitution for deficient work?** Among all of the alternatives discussed, this one seems the most plausible, but it views audit firms as a type of insurer, rather than as a vendor. This is an unfortunate mischaracterization of the auditor's role, but one that the current market environment fosters.

A firm's ability to make restitution is directly related to its insurance coverage and, perhaps only in catastrophic circumstances, its capital. Many firms the size of BKD and smaller manage their liability risk through use of traditional professional liability insurance, where a certain (hopefully substantial) amount of the risk is transferred to the insurer. We believe the amount of capital maintained within accounting firms (at least the smaller ones) is determined primarily by working capital and other operating needs, rather than as a method of funding potential professional liability claims. However, we realize that capital is at risk. For this and other reasons (such as taxation), most firms structured as partnerships have significant incentives to distribute earnings to their partners and retain only enough capital to fund their operating needs. We believe a smaller firm's ability to withstand liability claims is demonstrated primarily by the strength of its insurance program.

With respect to smaller firms, we believe the most relevant financial information for users is insurance-related information. However, that kind of information is more appropriately dealt with in one-on-one discussions between the audit committee and auditor in the auditor selection process; therefore, we do not believe any public disclosure is necessary.

We understand that in some larger firms, insurance programs may have less real transfer of risk to an independent third-party insurer and at least some firms have formed captive insurance companies. Our knowledge of those firms' insurance programs and capitalization policies is insufficient for us to form an opinion on what financial information about those firms may be relevant to public users.

Also, we believe that few firms prepare internal financial statements in accordance with Generally Accepted Accounting Principles (GAAP); therefore, the way each firm calculates capital can vary widely. Many firms maintain their capital on an income tax basis, which may be significantly different from what GAAP capital would look like for such a firm. Guidance would be needed to achieve consistency in reporting before capital would be a meaningful disclosure.

May 21, 2008

Mr. Arthur Levitt, Jr. and Mr. Don Nicolaisen, Co-Chairmen
Advisory Committee on the Auditing Profession
Office of Financial Institutions Policy
Room 1418
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Chairman Levitt and Chairman Nicolaisen:

Thank you for your inquiries following my testimony before the Advisory Committee on the Auditing Profession on February 4, 2008. Please find below my response.

Question 1 - on increasing disclosure about reasons for auditor switches

Mr. Nusbaum's written testimony stated that "Comprehensive disclosures about reasons for auditor switches" is one change that would make for a "more competitive audit market" Do you agree with Mr. Nusbaum on this issue? Why or why not?

Question 2 - on limiting auditor liability

The January 2008 United States Government Accountability Office ("GAO") study and report on audits of public companies considered and rejected a broad range of proposals that have been set forth by various parties to reduce the risk of further concentration in the audit market. In rejecting those proposals, including proposals to limit auditor liability, the GAO found that such proposals were ineffective and/or contained "serious drawbacks." More specifically, in commenting on proposals relating to further limiting auditor liability, the GAO report noted that some parties have expressed concern that further limits on auditor liability could lead to lower audit quality. Do you share the concerns expressed in the GAO report that further limits on auditor liability could lead to lower quality audits. Why or why not?

Response: With respect to both of these questions, the many constituencies of NYSE Euronext, including our employees, customers, and listed companies have strongly held, and differing, views on both the desirability and impact of changes to the current disclosure requirements relating to auditor changes and the question of providing limits on auditor liability. NYSE Euronext as an institution, however, does not have a position on either of these issues.



With respect to the broader question of liability reform, however, we would note that the extraordinary cost imposed on business by class-action lawsuit abuse is commonly cited as a factor leading companies worldwide to list on alternate markets, jeopardizing the competitive position of the U.S. markets. NYSE Euronext believes that current and potential issuers (whether located in the U.S. or abroad) must not be dissuaded or inhibited from accessing U.S. capital markets by unreasonable and unpredictable extensions of securities fraud liability, and therefore support action to reduce abusive class-action lawsuits.