

Working Discussion Outline

Advisory Committee on the Auditing Profession

Over-Arching Principles

- The work and recommendations of the Advisory Committee on the Auditing Profession should be designed to further the mission of the Department of the Treasury to promote and encourage prosperity and stability by both improving the quality of the audit process and audits and ensuring the viability and resilience of the public company auditing profession.
- Enhancing the quality of the audit process and audits should contribute to the viability and resilience of the public company auditing profession.
- Confidence in the public company auditing profession is enhanced and strengthened when the profession operates in a manner transparent to investors and market participants, and adopts governance best practices.
- The quality of the audit process and audits is accomplished when the credibility of the audit meets the needs of investors and increases as the following objectives are achieved.
 - The audit process and audits should contribute to investor confidence in the financial statements by ensuring that the financial statements are reliable, complete, and timely.
 - The audit process and audits should contribute to the transparency of financial reporting for preparers and investors.
 - Audits should lower the cost of capital to companies that are audited (as a group and over time).
 - The benefits of the audit process and audits to investors, preparers, and the marketplace should outweigh the costs of the audit process and audits to preparers and their owners.

- Investors and the marketplace should understand the purposes, limitations, and results of the audit process and audits, and have confidence in the credibility of the audit provided and the quality of the services performed.
- Material financial frauds are detected and reported in a timely fashion adding to investor confidence in the reliability of the audit process and audits.
- The viability and resilience of the public company auditing profession are enhanced when a high quality audit is delivered to investors and the following objectives are achieved.
 - The public company auditing profession should attract and develop employees adequately prepared to perform high quality audits.
 - The public company auditing profession should be financially and structurally sound.
 - The public company auditing profession should operate under standards of independence necessary to maintain investor confidence and the quality of audit processes and audits.
 - The audit market benefits from a competitive and innovative population of auditing firms.

1. Consideration of Prior Recommendations.

- 1.1. Consider the recommendations of past committees studying the auditing profession, including:
 - 1.1.1. Commission on Auditors' Responsibilities ("Cohen Commission") (1978).
 - 1.1.2. National Commission on Fraudulent Financial Reporting ("Treadway Commission") (1987).
 - 1.1.3. Panel on Audit Effectiveness ("O'Malley Panel") (2000).

2. Human Capital and Its Impact on Audit Quality.

- 2.1. Consider whether the increase and enrichment of the pool of human capital in the public company auditing profession can improve audit quality.
- 2.2. Identify and consider potential areas of inquiry and courses of action:
 - 2.2.1. Recruitment and training.
 - 2.2.2. Retention, professional advancement, and alternatives.
 - 2.2.3. Education.
 - 2.2.3.1. Undergraduate.
 - 2.2.3.2. Graduate.
 - 2.2.3.3. Continuing education.
 - 2.2.3.4. Relationship between continuing education and professional development.
- 2.3. Consider the recruitment, training, retention of accounting graduates.
 - 2.3.1. Recruitment.

- 2.3.1.1. Demand for accountants predicted to grow 18-26% through 2014 (U.S. Bureau of Labor Statistics).
- 2.3.1.2. Increasing level of retirements and lack of commensurate replacement may portend a shortage of qualified accountants.
- 2.3.1.3. Enrollments in accounting programs and accounting graduates up 19% from 2000 to 2004. Increase of 9% to 40,400 Bachelor's degree recipients from 2003 to 2004.
- 2.3.1.4. Women were more than half of the 2006 accounting graduates. In 2004, minorities accounted for 23% of accounting graduates. Women account for 19% of all auditing firm partners. Minorities held 13.5% and caucasian women held 32.4% of all "officials and managers" positions in the accounting industry; 7% of auditing firms CPAs are minorities (AICPA).
- 2.3.1.5. Consider the actions that can be undertaken to seek to ensure that there is a sufficient number of graduates to meet the growing demand for auditing services.
- 2.3.1.6. Consider the actions that can be undertaken to seek to ensure the attraction of a diverse group of individuals to the auditing profession.
- 2.3.1.7. Consider and compare the competitiveness of auditing industry recruitment with other industries and disciplines who recruit similar students and the reasons for the success of some of these other industries and disciplines. Consider the compensation structure in these other industries and disciplines.

2.3.2. Training and supervision, and evaluation; continuing education.

- 2.3.2.1. The largest auditing firms offer training programs to employees as a supplement to undergraduate and post-graduate education.
- 2.3.2.2. Consider whether and how training can be enhanced to seek to ensure high quality audits.
- 2.3.2.3. Consider whether and how training can be enhanced to foster recruitment, retention, and professional advancement.
- 2.3.2.4. Consider whether high ethical standards are incorporated into training and employee evaluations.
- 2.3.2.5. Consider whether employees are trained and evaluated to make decisions that ensure the representational faithfulness of the financial statements.
- 2.3.2.6. Consider the impact of the size of an auditing firm and its ability to recruit, retain, and offer training to accounting graduates on audit quality.
- 2.3.2.7. Consider whether and how continuing education programs can be enhanced to seek to ensure high-quality audits.
- 2.3.2.8. Consider whether and how continuing education can be enhanced to foster recruitment, retention, and professional advancement.
- 2.3.2.9. Consider how the use of the Internet and other technological developments can be used to enhance training and continuing education.
- 2.3.2.10. Consider whether and how training and continuing education relating to International Financial Reporting Standards and international auditing standards need to be enhanced.

- 2.3.2.11. Consider whether and how training and continuing education relating to financial reporting tools and developments, such as eXtensible Business Reporting Language, can be enhanced.
- 2.3.2.12. Consider whether improved supervision at the auditing firms is needed to ensure high-quality audits. Consider ways to foster improved supervision, if needed. Consider whether and how training and continuing education can be enhanced to provide accountants with improved management and supervisory skills as they reach the supervisory levels.
- 2.3.2.13. Consider the processes by which auditing firms train and develop employees for the appropriate auditing assignments.
- 2.3.2.14. Consider whether the Public Company Accounting Oversight Board should have a role in enhancing training, supervision, and continuing education, and, if so, what that role should be. Consider interviewing the PCAOB regarding its inspection process.

2.3.3. Retention.

- 2.3.3.1. AICPA survey: 15-20% turnover rates at the largest auditing firms; lower turnover rates at smaller firms.
- 2.3.3.2. Consider the ways auditing firms can improve retention of quality partners and employees. Consider the reasons accountants are leaving the profession. Consider whether the public company auditing profession is viewed as providing a challenging and fulfilling work environment. Consider whether the public company auditing profession is respected and whether the degree of respect impacts employee retention. Consider whether and how liability risk impacts partner and

employee retention. Consider whether and how the auditor independence standards impact partner and employee retention. Consider whether the auditing firms are investing in technologies that can improve employee retention and experience. Consider the compensation structure of auditors vis-à-vis other financial services industry professionals.

2.4. Consider the state of accounting education and CPA licensing requirements.

2.4.1. Consider the accounting curriculum.

2.4.1.1. Multi-disciplinary approach vs. technical approach.

2.4.1.1.1. Debate since the late 1950s.

2.4.1.1.2. Consider whether the accounting curriculum should focus on technical accounting standards or also reflect to a greater degree a multi-disciplinary approach focusing on business, finance, law, and ethics and other areas.

2.4.1.1.3. Consider what approach is more likely to ensure high quality audits.

2.4.1.1.4. Consider what approach teaches high ethical standards.

2.4.1.1.5. Consider whether there is a role for increased clinical education at the undergraduate or graduate level. Consider whether the current accounting curriculum prepares accounting graduates for their first positions in the auditing industry.

- 2.4.1.1.6. Consider the impact on the curriculum of the potential acceptance of International Financial Reporting Standards and international auditing standards.
- 2.4.1.1.7. Consider the impact on the curriculum of the Internet and technological developments, such as eXtensible Business Reporting Language.
- 2.4.1.2. The 150-hour requirement, the 120-hour requirement, and the professional school of accountancy.
 - 2.4.1.2.1. In 1998, the American Institute of Certified Public Accountants approved the 150-hour requirement for application for AICPA membership, reasoning the extra year or 30 hours of post-graduate education should replace the 120-hour requirement, given accounting complexity.
 - 2.4.1.2.2. 48 of 54 states and jurisdictions have adopted the 150-hour requirement, thus making 150 hours mandatory to be licensed as a CPA. Yet many states test at the 120-hour level.
 - 2.4.1.2.3. Consider the costs and benefits of the 150-hour requirement.
 - 2.4.1.2.4. Consider the impact of the 150-hour requirement upon the recruitment of undergraduates as accounting majors.
 - 2.4.1.2.5. Consider whether the 150-hour requirement has improved audit quality.

2.4.1.3. Academics and practice.

2.4.1.3.1. Some observers have suggested that much academic research focuses on social science research rather than the skills and judgments needed to ensure high quality audits. Consider the possible “schism” between the academic and practice communities.

2.4.1.3.2. Consider what “common body of knowledge” accounting students should acquire.

2.4.1.3.3. Consider whether accounting academics need to be encouraged to undertake a more “practice-oriented” approach, including more practice-oriented research.

2.4.1.3.4. Consider whether professional training programs and continuing education better provide the additional information and perspective beyond technical skill and academic education that can assist in developing the judgment and other practical skills necessary for high-quality audits.

2.4.2. Consider the status of accounting faculty.

2.4.2.1. Shortage of faculty PhDs.

2.4.2.1.1. In 1967, the Association to Advance Collegiate Schools of Business decided that the doctorate was the terminal degree needed to teach accounting in the collegiate setting. To maintain the AACSB accreditation, 50% of faculty must have doctorates in accounting.

- 2.4.2.1.2. One-half of accounting faculty is eligible to retire in the next few years: One-third of accounting faculty is 60 or older; one-half is 55 or older.
 - 2.4.2.1.3. Consider the reasons for this potential accounting faculty shortage, including doctoral program recruitment and compensation.
 - 2.4.2.1.4. Consider ways to increase the number of accounting faculty. Consider the AAC-SB accreditation requirements.
- 2.4.2.2. The impact of an increasingly complex and globalized financial reporting environment on accounting faculty.
- 2.4.2.2.1. Consider ways to ensure that accounting faculty is able to prepare students to undertake high quality audits in a complex financial reporting environment. Consider ways to encourage faculty to keep apprised of financial reporting and auditing profession developments.
 - 2.4.2.2.2. Consider the impact of a more multidisciplinary approach to the accounting curriculum.
 - 2.4.2.2.3. Consider the impact of International Financial Reporting Standards and international auditing standards on faculty resources and requirements.
 - 2.4.2.2.4. Consider the impact of the potential increased use of clinical programs on faculty resources and requirements.

2.4.2.2.5. Consider the benefits of and how to balance the class room education experience for students between theory and practical experience.

2.4.3. Consider the adequacy of CPA licensing requirements.

2.4.3.1. Consider and understand the role of the State Boards of Accountancy in licensing, education, and enforcement.

2.4.3.2. Consider the education requirements.

2.4.3.3. Consider the CPA examination.

2.4.3.4. Consider the professional experience requirements.

2.4.3.5. Consider the continuing education requirements.

3. The Auditing Firm and the Audit: Organization, Financial Resources, and Communication.

3.1. Consider the state licensing regime.

3.1.1. Consider the impact of a multi-state licensing regime on audit quality.

3.1.2. All 50 states and 5 territories through state licensing boards license certified public accountants. State boards set requirements for moral character, higher education, continuing education, experience, and examination for licensure as a CPA. State boards set ethical and continuing practice standards and possess disciplinary powers.

3.1.3. Consider the costs and benefits of a multi-state licensing regime.

3.1.4. Consider whether the Uniform Accountancy Act, promulgated by the American Institute of Certified Public Accountants and the Na-

tional Association of State Boards of Accountancy and aiming to increase licensing uniformity, addresses the inefficiencies of multi-state licensing.

- 3.1.5. Consider the relationship between the multi-state licensing regime and the Public Company Accounting Oversight Board.
- 3.2. Consider whether a professional qualification or other mechanism for public company auditing firms, in addition to registration with the Public Company Accounting Oversight Board, should be established similar to what currently exists for individuals with CPA licensing.
- 3.3. Consider whether and, if so, how the Public Company Accounting Oversight Board can enhance qualification and related mechanisms for public company auditing firms as a result of its registration, inspection, or disciplinary regime.
 - 3.3.1. Examining qualifications of individuals or firms.
 - 3.3.2. Training or remediation.
 - 3.3.3. Monitoring and supervision.
- 3.4. Consider insurability and liability risk.
 - 3.4.1. Liability.
 - 3.4.1.1. A September 2006 European Commission study reported that the total costs of judgments, settlements, legal fees, and related expense for U.S. audit practices of the largest accounting firms had risen to \$1.3 billion in 2004, or 14.2% of revenue, up from 7.7% in 1999.
 - 3.4.1.2. Consider the impact of auditor liability risk on human capital, the nature of the audit process, and the conduct of audits, including the use of judgment and possibility of “defensive auditing,” and other aspects of audit quality, including whether potential liability increases audit quality.

- 3.4.1.3. Consider major financial frauds and how auditor behavior and/or audit failure has contributed to increased liability exposure and costs.
- 3.4.1.4. Consider whether any potential changes should be considered in auditor liability regimes.
- 3.4.1.5. Consider how altering auditor liability regimes would impact audit quality.
- 3.4.1.6. Consider how altering auditor liability regimes would impact investors.
- 3.4.1.7. Consider the costs and benefits of various auditor liability regimes (and corresponding disclosure regimes) to investors and the marketplace (including issues of moral hazard).

3.4.2. Status of insurability.

- 3.4.2.1. Smaller auditing firms are generally able to purchase commercial insurance to cover professional liability claims. Smaller firms can purchase insurance through American Institute of Certified Public Accountants, which established the AICPA Professional Liability Insurance Program in 1967, currently serving over 24,000 auditing firms.
- 3.4.2.2. The largest auditing firms are unable to purchase commercial insurance directly in the marketplace and must use captive insurance funds.
- 3.4.2.3. Understand the insurance and risk management practices of the larger auditing firms in the United States.
- 3.4.2.4. Consider how major audit failures have impacted the insurability of the auditing firms.

- 3.4.2.5. Consider the impact of potential litigation exposure on audit quality.
- 3.4.2.6. Consider whether auditing firms in the United States should be required to maintain a certain level of insurance.
- 3.4.2.7. Consider the reasons why the largest auditing firms are prevented from being offered commercial insurance.
- 3.4.2.8. Consider how altering insurance structures or regimes would impact audit quality.
- 3.4.2.9. Consider the costs and benefits of various insurance structures and regimes to investors and the marketplace (including issues of moral hazard).

3.5. Consider organizational structure.

- 3.5.1. Most auditing firms in the United States are organized as limited liability entities, the largest being limited liability partnerships. The largest auditing firms have global networks of affiliates.
- 3.5.2. Consider the impact these limited liability entities have on the quality of corporate governance, including management succession, oversight, compensation, and audit quality.
- 3.5.3. State law and independence standards may prohibit investment of outside capital, typically limiting capital investment and partnership interests to the auditing partners themselves.
- 3.5.4. Consider whether alternative structures exist for auditing firms beyond the limited liability entity model and whether and how any such structure could enhance audit quality.
- 3.5.5. Consider how the global network of affiliate structure impacts audit quality.

- 3.5.6. Consider whether and how consistency is ensured across auditing firms. Consider whether there is consistency between auditing firms' global affiliate structure and their integrated global marketing activities and practice activities. Consider whether and how any such inconsistencies within a network impact audit quality.
 - 3.5.7. Consider whether there is an approach to a global structure and organization that could lead to enhanced audit quality. Consider the feasibility of such a structure and any regulatory or financial consequences. Consider how liability and insurance issues relate to global structuring issues.
 - 3.5.8. Consider how the varying degree of quality in financial reporting and auditing and regulatory and enforcement regimes impact organizational structure and capital resources.
 - 3.5.9. Consider how the potential acceptance of International Financial Reporting Standards in the United States and the greater use of fair value and mark-to-model accounting will impact the largest auditing firms' network of affiliates.
- 3.6. Consider transparency and governance.
 - 3.6.1. Auditing firms provide the Public Company Accounting Oversight Board with proprietary information. The European Union recently adopted reporting requirements (to be effective in June 2008) for public company auditors relating to issues such as a firm's legal structure and ownership, governance, and internal quality control system.
 - 3.6.2. Consider what, if any, governance failures at the auditing firms occurred and contributed to failures in the provision of audit services and non-attest services.
 - 3.6.3. Consider to what extent, if any, auditing firms should disclose to the public their internal organization, governance, and financial resources and whether and how such a practice could enhance audit quality.

- 3.6.4. Consider whether and, if so, there should be public participation in firm governance, for example through an advisory board or ombudsman or other mechanism, and whether and how such a mechanism could enhance audit quality.
 - 3.6.5. Consider whether the auditing firms, themselves, should prepare audited GAAP financial statements for filing with the Public Company Accounting Oversight Board or the public.
 - 3.6.6. Consider how increased transparency and strengthened governance affects audit quality.
 - 3.6.7. Consider how state laws and auditor independence standards impact auditing firm governance.
 - 3.6.8. Consider whether and how governance matters impact issues and conclusions regarding liability and insurance.
- 3.7. Auditor responsibility for fraud detection and improving communication with investors.
- 3.7.1. Examine the auditor's responsibility for fraud detection and whether it is resulting in enhanced investor confidence in the reliability of the financial statements.
 - 3.7.2. The standard auditor report consists of a standardized four paragraphs stating management and auditor responsibilities, the nature of the audit, the auditor's opinion on the financial statements, and, if the audited company is subject to the Sarbanes-Oxley Act, the effectiveness of internal controls.
 - 3.7.3. Consider whether the auditor report should be more descriptive so as to improve communication with the public and investor community.
 - 3.7.4. Consider whether and, if so, how the auditor report could more clearly define the role of the auditor vis-à-vis financial statements.

- 3.7.5. Consider the role of the auditor in the audit.
- 3.7.6. Consider the expectations of investors and the marketplace relating to the auditor report and the audit. Consider whether and, if so, what sort of fraud investors and the marketplace expect auditors to detect.
- 3.7.7. Consider the impact, if any, of changes in auditor reports on audit quality.

4. Auditing Profession Structure: Competition, Concentration, Independence, and Other Professional Standards.

- 4.1.1. According to a 2004 GAO Report, the largest auditing firms audit over 78% of U.S. public companies and 99% of public company revenues. According to a 2004 J.D. Power & Associates survey, about one of every eight public companies retained three or more of the largest auditing firms for attest and non-attest work.
- 4.1.2. Examine whether there should be fundamental changes made in who pays the audit fee to the auditor.
- 4.1.3. Consider the impact on the structure of the public company auditing profession of the following:
 - 4.1.3.1. Auditor independence standards.
 - 4.1.3.1.1. Consider how the auditor independence standards impact audit quality, audit market competition, and the pool of human capital.
 - 4.1.3.1.2. Consider whether there is an “appropriate balance” between the auditing services and the non-attest services that auditing firms are providing today.
 - 4.1.3.1.3. Consider how auditing firms’ employee

assignment process relating to auditing services and non-attest services impacts the pool of human capital.

4.1.3.2. Mandatory partner and firm rotation.

4.1.3.2.1. Consider whether and, if so, how mandatory partner rotation impacts auditing firms and their ability to ensure audit quality.

4.1.3.2.2. Consider whether mandatory partner rotation impacts both the larger and smaller auditing firms in the same way.

4.1.3.2.3. Examine the benefits and costs of periodic firm rotation.

4.1.3.3. Other professional standards.

4.1.3.3.1. Consider whether, and, if so, how other professional standards or requirements impact the structure of the public company auditing profession.

4.1.3.4. Complexity.

4.1.3.4.1. Consider whether, and, if so, how the complexity of business and financial products affects audit quality, including the auditing firms' educational and supervisory roles. Consider whether the complexity of business and public companies, along with the accompanying financial reporting, accounting, and auditing standards prevents auditing firms with fewer resources from entering into the larger public company audit space.

4.1.3.4.2. Consider whether the global convergence of accounting standards and the global convergence of auditing standards encourage more audit market competition.

4.1.3.5. Globalization.

4.1.3.5.1. Consider the relative financial, human resources, and geographical capabilities of the largest auditing firms, the mid-size auditing firms and the smaller auditing firms.

4.1.3.5.2. Consider and compare the capabilities of the different sizes of auditing firms with the requirements of the large, mid, and small capitalization public companies.

4.1.3.5.3. Consider how the increasing globalization of the capital markets affects audit market concentration among the largest auditing firms who have global networks of affiliates.

4.1.3.5.4. Consider whether larger auditing firm resources are necessary for a high quality audit for larger, international companies.

4.1.3.5.5. Consider the ability of certain firms to carve out niches among certain multinational sectors.

4.1.3.5.6. Consider how the potential acceptance of International Financial Reporting Standards and international auditing standards will impact audit market competition.

- 4.1.4. Consider how audit market concentration impacts audit quality.
 - 4.1.4.1. Consider the reasons for public companies' seeking new auditors.
 - 4.1.4.2. Consider whether auditing firms are competing for services based on audit quality.
 - 4.1.4.3. Consider the bases on which auditing firms compete today in the United States and internationally, including an assessment of audit fee changes when auditors compete for new audits.
- 4.1.5. Consider the potential consequences of a larger auditing firm failure.
 - 4.1.5.1. Consider the sort of risks a larger auditing firm failure poses to the marketplace and investors.
 - 4.1.5.2. Consider the causes of major audit failures and steps that could be taken to prevent their reoccurrence.
 - 4.1.5.3. Consider whether and, if so, how, securities and auditing firm regulators should attempt to mitigate the risk or the impact of a larger auditing firm failure.
- 4.1.6. Consider ways to increase audit market competition.
 - 4.1.6.1. Consider the impact of auditing firm mergers on industry competition and whether a public policy change with respect to a lack of competition is warranted.
 - 4.1.6.2. Consider whether regulators are now faced with a "Too Big to Fail" public policy, and if so, consider whether public policy changes are warranted and the nature of those changes.

- 4.1.6.3. Consider how greater auditor choice can be fostered in the marketplace by the public and private sectors.
- 4.1.6.4. Consider whether there are public company sectors where audit market choice is growing.
- 4.1.6.5. Consider the ability of certain auditing firms to create niche-markets.
- 4.1.6.6. Consider how private sector participants, such as underwriters and lawyers, impact audit market choice.