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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:

Deloitte LLP is pleased to respond to the request for comments from the U.S. Treasury Advisory Committee on the Auditing Profession (the "Committee") on the recommendations in its *Draft Report—May 5, 2008* (the "May 5th Report") and *Addendum to VI. Firm Structure and Finances* (the "June 3rd Addendum"). We recognize that the Committee has dedicated significant time and effort to this process, and we believe that a number of the Committee's recommendations will be useful to protect and enhance the sustainability of a strong audit profession. As discussed in more detail below, we have some comments on the Committee's specific recommendations. More importantly, however, we are concerned that the May 5th Report and June 3rd Addendum do not adequately address an issue that is most critical to the profession and its long-term sustainability—the catastrophic litigation risk confronting the profession.

CATASTROPHIC LITIGATION RISK

The Department of Treasury formed the Committee to "provide informed advice. . . on the sustainability of a strong and vibrant auditing profession"[1] because of the importance of independent auditors to our U.S. and global capital markets.[2] The risk of catastrophic liability that could result in the loss of another major auditing firm is perhaps the greatest threat facing the auditing profession. The extent of the risk facing the audit firms is unique and systematic. Public company audit firms face potential damages up to the market cap of *each* of their numerous public company clients, and the size of these claims precludes the firms from being able to take advantage of our court system to resolve them. Yet, despite the very real and systematic nature of this risk, the Committee makes only passing reference to it in the Litigation section of the June 3rd Addendum and in the context of Recommendation 2 of the Concentration and Competition section in the May 5th Report; both are

[1] *Charter of the Advisory Committee on the Auditing Profession* (July 3, 2007). *See also* Remarks of Robert K. Steel, Under Secretary for Domestic Finance, Advisory Comm. Meeting Webcast at 0h:6m (Oct. 15, 2008).

[2] *See, e.g.*, Comment of Brian O'Malley, Senior Vice President and General Auditor, NASDAQ Stock Market, Advisory Comm. Meeting Webcast at 5h:20m (June 3, 2008) ("Could the market sustain another loss? I would say no.").

insufficient statements of the potential risk and its impact. Moreover, the recommendations themselves do not provide any meaningful reduction of that risk.

The Committee's very modest litigation reform recommendations set out in the June 3rd Addendum will not change the litigation landscape for the firms in any significant way. And the new bankruptcy-like system for troubled audit firms proposed in the May 5th Report is highly unlikely to be effective in preserving a firm that will be capable of conducting audits of global companies. This is because neither recommendation does anything to address the source of the risk. Therefore, even if the Committee's recommendations in this area were adopted, the profession would continue to be threatened by catastrophic civil judgments that could destroy a firm.

Investors in the U.S., and indeed the global, capital markets cannot afford the loss of another major audit firm. It is therefore imperative that the Committee's final report clearly acknowledge the risk facing the profession and either present comprehensive solutions to address the source of the risk, or, at a minimum, outline the problem sufficiently to allow others who seek to do so to evaluate effectively the risks and relative merits of potential solutions. We are concerned that if the final report fails to do this, even in the face of overwhelming evidence of the risk, the Committee will not only be submitting to the Treasury a report that falls short of its mission, but also may mislead the public into believing that the risk is minimal, or that the Committee's modest recommendations are adequate to address the risk.

There are those who downplay the extent of the profession's risk exposure. Specifically, some point out that most securities class actions are settled at amounts substantially less than the potential exposure. For instance, the Committee heard testimony from a plaintiffs' lawyer that "it is extremely unlikely that such an institutional lead plaintiff would insist on a settlement (or enforce a judgment) that would result in the failure of another audit firm."[3] In fact, it is clear from the litigation data provided by the firms that plaintiffs are indeed willing to, and do, seek damage claims for well above an amount a firm can pay. Although most may intend to request much less during settlement negotiations, it would only take one plaintiff's attorney who misjudges the maximum amount a firm can pay, or who refuses to settle a case for a reasonable amount, for an entire firm to be jeopardized.[4] This risk is exacerbated by the increasing number of global plaintiffs who may neither understand the U.S. litigation system nor be vested in the fate of the U.S. firms. Similarly, two plaintiffs' attorneys (either in the same or different matters) may each seek to extract the maximum from the audit firm for that attorney's own clients, regardless of the effect it will have on the firm.

Some also maintain that the risk is not great because the firms have enough revenue and capital to pay claims. Revenue and capital, of course, should not be confused with free cash to pay claims. Both revenue and capital are needed to run the business and maintain audit quality.[5] Moreover, contributed capital by the six largest firms today represents a small percentage of the value of damages sought by

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[3] John Coffey, Advisory Comm. Meeting Minutes at 106 (Feb. 4, 2008).

[4] *See* Written Submission of Michael R. Young, Willkie Farr & Gallagher LLP (June 3, 2008) at 3 ("[A]side from whether the plaintiffs' lawyers are genuinely interested in the survival of the audit firm so they can sue it again, they have very little concept of how much cash can be extracted while leaving the firm viable.").

[5] In fact, as the firms' data submissions show, on average 46.5% of the firms' revenue is spent on personnel-related expenses (not including partner compensation). Center for Audit Quality, *Report of the Major Public Company Audit Firms to the Department of Treasury Advisory Committee on the Auditing Profession* (Jan. 23, 2008) at 27.

the aggregate outstanding claims. Given these numbers, and the unpredictability of courtroom outcomes,[6] it is understandable why audit firms are forced to try to settle potential mega-cases, no matter what their level of culpability—if any—rather than risk an award that could severely deplete partners' capital, or even put the firms out of business.[7] This effectively denies the firms access to the judicial system.

i. <u>The Record before the Committee</u>

The profession has demonstrated that the catastrophic risk it faces is real. Data submitted to the Committee by the Center for Audit Quality on January 23rd and April 16th [8] reflect that the six largest public accounting firms are facing 90 active lawsuits in which the potential liability exposure for each case is at least $100 million. Forty-one of these lawsuits have the potential to result in damages of over $500 million; twenty-seven of those involve damage claims over $1 billion; and seven of these seek at least $10 billion in damages. Given that the potential exposure is many multiples of the aggregate capital of the six largest firms,[9] and an even higher multiple of these firms' available liquid assets, it is not surprising that many audit firms consider litigation exposure to be the greatest single threat to their long-term survival.

This catastrophic liability threat is in addition to the ongoing annual litigation-related costs borne by the six largest firms, constituting 6.6% of the firms' total revenues (second only to personnel-related costs) and 15.1% percent of audit-related revenues.[10] Moreover, this threat is faced largely without insurance, particularly for the largest firms, leaving the firms dependent upon capital contributed by their partners to satisfy any judgments.[11] If a firm were to face a catastrophic damage award, it is unclear whether enough partners would be willing to remain with, and invest increasing amounts into, that troubled firm to satisfy the judgment and also provide the firm with replacement operating funds.[12]

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[6] *See*, The American Assembly, *<u>The Future of the Accounting Profession</u>* at 6 (Nov. 2003) ("[C]harging auditors with faulty judgment can be a surefire way of securing large monetary settlements. Sometimes, the auditors bore little or no responsibility for the problems, but the potential for a 'runaway jury,' grappling with a complex set of facts, to make enormous awards to plaintiffs was too great a risk for the accounting firms to run.").

[7] *See, e.g.*, Written Submission of Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, (June 3, 2008) at 5-6 (noting that a catastrophic claim against an audit firm "effectively den[ies] audit firms access to the judicial system even when they've done the quality work expected of them" and that "[n]o firm has insurance coverage for the largest of claims, no firm has the capital to pay the largest of claims, and no firm could retain its partners by slashing future earnings by an amount necessary to pay the largest of claims").

[8] Center for Audit Quality, *Report of the Major Public Company Audit Firms to the Department of Treasury Advisory Committee on the Auditing Profession* (January 23, 2008) (hereinafter "January 23rd Report"); Center for Audit Quality, *Second Supplement to Report of the Major Public Company Audit Firms to the Department of Treasury Advisory Committee on the Auditing Profession* (April 16, 2008) (hereinafter "April 16th Supplemental Report").

[9] January 23rd Report at 24, 27; April 16th Supplemental Report at 1.

[10] January 23rd Report at 27-28.

[11] Written Submission of Barry Mathews, Deputy Chairman AON Corporation (June 3, 2008) at 3 ("The captives in question were formed in direct response to the inability of the commercial insurance market to supply necessary coverage at a reasonable price. From a financial management perspective, such captives are usually viewed negatively, because capital committed to the captive reduces capital that would probably be used more profitably elsewhere within the member firm, for example, to hire additional auditors.").

[12] *See supra* note 7.

The level of risk faced by the firms is not attributable to any factor within the control of the firms, but rather results from the nature of the auditor's work: liability from each public company audit engagement could potentially reach the full market capitalization of *each client*, no matter the size or capitalization of the audit firm. Auditors must bear this risk for each of their hundreds or thousands of public company audit clients, despite the fact that the fees earned from these engagements are a small fraction of the potential liability. Audit firms are unique in the level of liability risk they face, because that risk is not based on their own capitalization but rather on the market capitalization of their many clients. Thus, because the level of risk the firms face is not based on factors within their control, but on factors inherent in our litigation system, a systemic solution must be found to mitigate the risk.

In addition to the testimony of the public auditing firms themselves,[13] the Committee has heard other substantial independent testimony about the overwhelming nature of this threat. As Michael Young of Willkie Farr & Gallagher testified, "[t]he problem is that our system of justice doesn't work with regard to the auditing profession. The problem is that . . . the potential damages are so staggering that the profession cannot take advantage of its day in court."[14]

As Peter Christie, an insurance professional, testified in December 2007, "few will believe such mega claims cannot happen, and indeed most would speculate it is only a matter of time before they do."[15] He went on to note that increased availability of insurance is not the answer: "even if insurance were available to the Big Four, it would not remove the possibility of the failure of a Big Four firm due to liability exposure."[16] Indeed, to the extent that more insurance becomes available, so long as "there is no realistic limit to the potential loss amounts, the existence of more insurance will only increase the loss amounts paid. As the largest source of funds after an audit failure, audit firms would become even more attractive targets."[17] This is "likely to be counter-productive, aggravate the current problem, and will not improve the audit profession's viability."[18]

Lewis Ferguson, the former General Counsel of the Public Company Accounting Oversight Board (PCAOB), noted that the risk of liability may be preventing second-tier firms from even attempting to reach the market serviced by the Big Four firms, "feeling that auditing the largest companies not only may greatly increase infrastructure costs but disproportionately increases litigation risk and defense costs."[19]

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[13] *See, e.g.*, Written Submission of Barry Salzberg, CEO of Deloitte LLP (Feb. 4, 2008) at 2 ("The most serious threat to the long-term sustainability of a strong and vibrant auditing profession is the risk of another large firm failure. In our view, if a firm fails, it most likely will result from the consequences of private litigation or a regulatory action, the cascading effect of which are disproportionate to the conduct at issue.").

[14] Written Submission of Michael R. Young at 1.

[15] Written Submission of Peter Christie, Friemann Christie LLC at 2 (Nov. 26, 2007).

[16] *Id.*

[17] *Id.* at 5.

[18] *Id.* at 6.

[19] Written Submission of Lewis H. Ferguson III, Gibson, Dunn & Crutcher LLP at 2 (Dec. 3, 2007).

ii. European Commission

The testimony and submissions received by the Committee regarding catastrophic litigation risk is reinforced by the European Commission's June 5th *Recommendations Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms* ("June 5th Recommendations"), which clearly identifies the threat facing the profession. The June 5th Recommendations note that "increasing volatility in market capitalization of companies has led to much higher liability risks, whilst access to insurance coverage against the risks associated with such audits has become increasingly limited."[20] It also notes that the liability risk facing audit firms could "deter audit firms and networks from entering the international audit market for listed companies in the [EU]."[21] After its thorough study of this issue, the European Commission (EC) has recommended that "[t]he civil liability of statutory auditors and of audit firms arising from a breach of their professional duties should be limited except in cases of intentional breach of duties by the statutory auditor or the audit firm."[22]

The EC's June 5th Recommendations build on external studies and a public consultation in 2007; the EC report accompanying the public consultation noted that the situation in the U.S. is even more dire because there is the same lack of availability of insurance, and there is the potential for more significant damages awards in the U.S.[23] This disparity between the U.S. and European environment will only grow more marked as EU member states act on the EC's recommendations.

This potential disconnect would happen at a time when the U.S. can ill-afford to fall behind the global markets. For audit firms in particular, as our markets have become more global, the firms' clients have become more global, and it has become increasingly important for firms to have global capabilities and resources.[24] As one Committee member noted, if the system in the U.S. does not adapt, the

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[20] Commission Recommendation of 5/VI/2008 concerning the limitation of the civil liability of statutory auditors and audit firms (June 5, 2008) at 2 (*available at* http://www.iasplus.com/europe/0806auditorliabilityrecommendation.pdf).

[21] *Id*.

[22] *Id.* at 3. The EC set out three recommended approaches: limits by contract with the audit client, caps or formula limitation, and adoption of proportionate liability. It noted that different options may be appropriate for different member states, due to the variation in legal regimes. For example, limitation by contract between auditor and client works in the UK because there is no third party liability in the UK.

The third option, proportionate liability, is similar to what has existed in the U.S. federal securities law cases since 1995. While it has been generally helpful, however, proportionate liability has proven insufficient to mitigate the risk for audit firms in the U.S. because of limitations on the scope of the mechanism and the growth in size of damage claims. For example, a firm that is found to be 10% liable on a $20 billion claim would still be in jeopardy. Moreover, proportionality only applies to claims made under the Securities Exchange Act of 1934, and does not apply for common law claims or claims brought under the Securities Act of 1933.

See infra note 28 and accompanying text.

[23] European Commission, Directorate General for Internal Market and Services, *Commission Staff Working Paper: Consultation on Auditors' Liability and its Impact on the European Capital Markets* at 6-8 (Jan. 2007). This report similarly noted the amount of auditors' risk exposure, and that insurance is of little to no value to the networks, as the "current level of commercial insurance . . . would cover less than 5% of the larger claims some firms face nowadays in some European Union member States." It also found that the mid tier networks are unable to perform many audits because the risk of liability makes them essentially uninsurable in the commercial market, and their limited size makes them too small to form their own captive insurers.

[24] *See, e.g.*, U.S. Government Accountability Office, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action* at 17 (Jan. 2008) (hereinafter "January GAO Report") ("as U.S. corporations have increasingly expanded into global markets, their need for accounting firms with

profession's ability to adapt and become part of a global services firm will be greatly impeded.[25] The Committee, seemingly recognizing the need to become more aligned with the EU, points to the EU's requirements to support its call for change in many different areas; it is therefore even more imperative that it recognize the need to align with the EU on the issue of meaningful limitation of liability.

iii. U.S. Studies

It is not only the EC, however, that has recognized the risk facing the audit profession. A number of U.S. groups have studied this issue recently and have come to the same conclusion. For example, a recent report by the **Government Accountability Office** on the auditing profession concluded that audit firm concentration could become problematic if one or more audit firms were adversely impacted by litigation: "Although the current level of concentration does not appear to be having a 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."[26]

The **Scott/Hubbard Committee**, formed with the support of Secretary Paulson, also issued a report, which concluded that "the prospect of the failure of another major auditing firm troubles public officials in many market centers. The prospect of such a failure can have a significant impact on auditing costs through adoption of overly conservative practices."[27] The Scott/Hubbard Committee noted further that the current level of liability exposure at risk in several pending lawsuits "exceeds the combined partner capital of the Big Four firms" and that the Private Securities Litigation Reform Act of 1995, which ended joint and several auditor liability, has been insufficient to mitigate the litigation risk because "even a relatively small share of proportional liability exposes the largest firms to financial failure."[28] In other words, even ten percent of a $10 billion judgment is still potentially catastrophic.

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greater global reach also increased."). *See also* written testimony of Neal Spencer, Managing Partner BKD LLP (Feb 4, 2008) at 2 ("Many regional and local firms, including BKD, do not have robust international affiliations to draw upon to audit multinational companies. While many such firms belong to international affiliations or alliances of firms, these international affiliations do not generally provide the breadth or depth of expertise necessary to audit large multinational companies.").

[25] Alan Beller, Advisory Comm. Meeting Webcast at 4h:25m (June 3, 2008) ("Five years from now, it is I think a certainty that the U.S. capital markets will be less than 30% of the market cap of the global markets. . . . Second point, I think it is quite likely that one or more of the Big 4 will have established real global operating—not networks—but real global operating entities that function as single entities with single systems of corporate governance. It is 100 percent certain to me, point three, that if we do not find a better path—or let me not say a better path—but a different path than the one we are on, then the chances are precisely zero that the American firms will be part of those global networks. And I guess the question, having looked around that corner, is how satisfied are we going to be with the status quo five years from now?").

[26] January GAO Report at 32-33.

[27] Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* at xii (Nov. 2006).

[28] *Id.* at 87-88.

The **American Assembly**, in its report on *The Future of the Accounting Profession*, echoed this same theme:

> [T]he auditing profession has become a favored target of trial lawyers, who have found charging auditors with faulty judgment can be a surefire way of securing large monetary settlements. Sometimes, the auditors bore little or no responsibility for the problems, but the potential for a "runaway jury," grappling with a complex set of facts, to make enormous awards to plaintiffs was too great a risk for the accounting firms to run.[29]

The American Assembly's report also emphasized the urgent need for greater liability protection in a system moving towards judgment-based auditing, rather than rule-based auditing. "Specifically, if auditors are allowed, even required, to use more judgment, to change the format of financial statements and the nature of attestation standards—not to mention making changes in their audit opinions—regulators must bring a greater degree of rationality to the issue of auditor liability."[30]

iv. <u>Academic Opinions</u>

Academics who have examined this issue have also recognized the catastrophic litigation risk facing the profession. For example, Columbia University Professor John Coffee has noted that the "risk of catastrophic loss is the factor most likely to cause the market for [audit services] to unravel"; and that "sooner or later . . . there will be a financial disaster that will impair the solvency of one of these [Big Four] firms without some change."[31]

James Cox, a professor of law at Duke University, presented testimony to the Committee that it "is not unthinkable that one or more Big Four accounting firms could suffer fatal liability blows in yet to surface financial frauds of their audit clients."[32] Lawrence Cunningham, a professor of law at George Washington University, seconded Professor Cox's comments, noting the "valid concern" that one of the remaining Big Four would face the same fate as Arthur Andersen and that, "with only three such firms left, a crisis would occur."[33] As perilous as we believe this threat to be with respect to the largest four firms, Professor Cox commented that the threat of liability could derail the Committee's goals of increased competitiveness in the market for audit firms: "while liability might not cause the

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[29] The American Assembly, *The Future of the Accounting Profession* at 6 (Nov. 2003).

[30] *Id.* at 15. *See also* Comments of the Honorable Roderick M. Hills, Chairman of the Center for Strategic & International Studies, regarding the Draft Report of the Advisory Committee on the Auditing Profession at 2 (June 5, 2008) (directing the Committee's attention to the American Assembly's work, and stating "Given the potentially catastrophic risk that one or more of the remaining Big 4 firms can be destroyed by litigation I urge the Committee to set forth a greater urgency in its report.").

[31] *See* U.S. Chamber of Commerce, Commission on the Regulation of U.S. Capital Markets in the 21st Century, *Report & Recommendations* at 104 (Mar. 2007) (*quoting* John C. Coffee, Jr., "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms," 84 B.U. L. REV. at 301, 342 (2004) and "Coffee Advises Paulson Panel of Ways to Mitigate Securities Litigation Threat," BNA Daily Report for Executives (Oct. 16, 2006)).

[32] Written Submission of James D. Cox, Brainerd Currie Professor of Law, Duke University at 2 (Dec. 3, 2007).

[33] Written Submission of Lawrence A. Cunningham, Professor of Law, George Washington University at 12 (Nov. 26, 2007) (noting that such crisis would include the inability of many issuers "to engage an independent auditor, either because of conflicts due to non-attest work or lack of expertise within the survivors").

disappearance of a second-tier firm it could nonetheless break its stride toward achieving the capital to support audits of larger clients."[34]

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Faced with this expansive body of data, witness testimony and outside authoritative studies acknowledging and presenting possible solutions to the catastrophic risk facing the profession, we do not believe the Committee's final report can fail to do the same. Later in this letter we address some specific recommendations that the Committee should consider. At a minimum, however, if it cannot agree on comprehensive solutions, the Committee must identify the scope and potential impact of the risk in a way that allows other policy makers to address it. The need to recognize this risk and address it becomes even more critical as the globalization of our markets demands more global consistency. Given the mission of the Committee, addressing this fundamental issue head on is necessary to ensure the credibility and durability of the Committee's work.

THE COMMITTEE'S RECOMMENDATIONS AND REQUESTS FOR COMMENT

Although we believe that the catastrophic litigation risk facing the profession is the most critical issue for the Committee to address in considering the sustainability of the profession, we commend the Committee for recognizing a number of other important issues the profession currently faces. While we support many of these recommendations from the Committee, we have concerns about others. Our comments on the specific recommendations and requests for views in the May 5th Draft Report and June 3rd Addendum are set forth below.

I. Human Capital

As a professional services firm, people are our primary asset, and the ability to attract and retain talent is therefore very important to the sustainability of the profession. Because having the best talent is so critical to our business we, and indeed the profession as a whole, have put a great deal of effort into attracting, retaining and developing talent, with some of the most progressive programs in this area among all businesses. We commend the Committee for taking time to focus on recommendations in the Human Capital area, and we wholeheartedly agree with its conclusion that the profession must "continue to attract and develop professionals at all levels who are prepared to perform high quality audits in [today's] dynamic environment."[35]

We believe that the Committee could make the greatest impact on the profession's ability to attract and retain talent by making recommendations to improve the general respect for and attractiveness of the auditing profession, including by addressing the catastrophic risk facing the profession, discussed above. We also welcome the Committee's more targeted recommendations in this area and provide comments and observations on those below.

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[34] Written Submission of James D. Cox at 2-3.

[35] Draft Report of the Advisory Comm., 73 Fed. Reg. 28,190, 28,199 (May 15, 2008) at V:1 (hereinafter "May 5th Report").

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

(a) Regularly update the accounting certification examinations to reflect changes in the accounting profession, its relevant professional and ethical standards, and the skills and knowledge required to serve increasingly global capital markets.
(b) Reflect real world changes in the business environment more rapidly in teaching materials.
(c) Require that schools build into accounting curricula current market developments.

We invest extensive resources, including on-the-job and formal training opportunities, to ensure that our professionals have the level of expertise necessary to meet audit requirements, serve our clients, and compete in the global marketplace. If adopted, the Committee's recommendations to improve preparation of these professionals before they join us will be of tremendous benefit. Although this recommendation is primarily directed to academia and the state licensing bodies, we are committed to continuing to do what we can to assist in achieving these goals. In fact, we have a number of efforts already underway.

For example, Deloitte has formed an International Financial Reporting Standards (IFRS) University Consortium, through which we will contribute time, experience and resources to address the urgent need to help bring IFRS curricula into college classrooms. The Consortium is directly contributing resources to Ohio State University and Virginia Polytechnic Institute and State University (Virginia Tech). Other participating schools can benefit through giving input on the direction, goals and resources available from the Consortium; participating in periodic web casts; sharing of best practices used in the classroom; involvement in the development of materials; and accessing the support and guidance available from Deloitte professionals, as well as Deloitte IFRS information resources, publications and training sessions.

The Committee's recommendation recognizes several important topics for inclusion in standard curricula, such as IFRS, auditing and professional standards, risk-based judgment, and technological innovations in financial reporting. We believe that students would be better prepared for the demands of the profession if they also had coursework in other key areas such as ethics, fraud examination and forensic auditing, problem solving, finance, negotiation and communication skills, financial risk management, global business, taxation, and valuation. Although some of these areas are not those traditionally considered part of the core accounting curriculum, they are critical to a robust accounting education. The Committee could assist in emphasizing the importance of these skills by acknowledging them in its recommendations.

Moreover, practical experience and the ability to work with seasoned professionals will help provide a learning environment in which students can develop the necessary professional knowledge and judgment. Although the Committee acknowledges the importance of internships in the context of other recommendations, we believe it should add that concept to this recommendation. In fact, we urge the Committee to consider expanding this recommendation to advocate that universities grant substantive credit for internships in public accounting, and that states allow some of the minimum hours requirement to sit for the examination to be met by internships or similar programs. Details of such programs would have to be worked out to ensure that the interns' work experience merited substantial credit, but we are confident that the profession and academia can work together to develop a meaningful program.

<u>Recommendation 2</u>. Improve the representation and retention of minorities in the auditing profession so as to enrich the pool of human capital in the profession.
(a) Recruit minorities into the auditing profession from other disciplines and careers.
(b) Emphasize the role of community colleges in the recruitment of minorities into the auditing profession.
(c) Emphasize the utility and effectiveness of cross-sabbaticals and internships with faculty and students at Historically Black Colleges and Universities.
(d) Increase the numbers of minority accounting doctorates through focused efforts.

We agree wholeheartedly with the goal of this recommendation. Deloitte has worked hard to improve its recruitment and retention of minority professionals. In fact, we and other large accounting firms have some of the most progressive programs designed to attract and retain minorities and other diverse classifications of workers. The results of the profession's efforts have been recognized widely, including by such national publications and organizations as BUSINESS WEEK, FORTUNE, Catalyst, Diversity Inc., and The Human Rights Campaign.

One example is Deloitte's Future Leaders Apprentice Program, which is part of the overall effort to recruit highly qualified and diverse talent across the country. This program targets college juniors and seniors who are working toward a degree in accounting or related discipline. Select candidates receive a scholarship to assist with their fifth year of school and agree to join Deloitte for a minimum of two years after graduation. Once scholars graduate, they start full-time and enter a two-year professional leadership development program.

We are very supportive of the Committee's recommendations regarding developing programs specially focused on minority academics, in addition to recommendations focused on developing audit professionals. As discussed in more detail below, under Human Capital Recommendation 3(b), we currently have an effort underway in this area. We also are continuing to expand the number of community colleges with which we have a relationship; we are identifying promising candidates, providing them with internships, and working with them as they finish their remaining requirements for a Bachelor's or Master's degree.

Despite all of the profession's efforts, however, we are not satisfied with the results related to attracting and retaining minorities. As such, we welcome the Committee's specific recommendations in this area. Although we are in general agreement with them, there are a few specific areas where additional discussion or clarification would be helpful.

Regarding recruitment from other disciplines and careers, we agree that there are many professionals well suited to work on today's audits who did not choose accounting as an undergraduate major. Today's certification requirements, however, may serve as a barrier in recruiting such professionals into the profession. We therefore reiterate our suggestion, made in Barry Salzberg's February 4th testimony, that the Committee recommend further study be done on alternative academic preparation that might allow a wider range of talented individuals to enter the profession. Such a recommendation would assist the firms in fulfilling the goals of part (a) of this recommendation.

We are also intrigued by the Committee's idea to increase our outreach at community colleges, as this could be an extension of work we currently have underway. However, we believe that the component of the Committee's recommendations related to improving the academic environment for community college students who transfer to a four year accounting program must be acted upon to ensure the success of the overall recommendation. During the Committee's March 13th public meeting, Dr. Palmrose emphasized the need for better transitions to four year colleges.[36] This is especially noteworthy coming from someone who started her education at a community college and went on to receive a PhD and teach at a four year college. Improvements in the transition process for community college students will allow for the appropriate balance between opening new avenues for entrance to the profession, and necessary academic preparation. We believe the Committee should emphasize this need in its final report.

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

(a) Increase the supply of accounting faculty through public and private funding and raise the number of professionally qualified faculty that teach on campuses.
(b) Emphasize the utility and effectiveness of cross-sabbaticals.
(c) Create a variety of tangible and sufficiently attractive incentives that will motivate private sector institutions to fund both accounting faculty and faculty research, to provide practice materials for academic research and for participation of professionals in behavioral and field study projects, and to encourage practicing accountants to pursue careers as academically and professionally qualified faculty.

We welcome these recommendations aimed at ensuring a robust supply of accounting faculty to teach future professionals; we believe these recommendations will help to focus and support current efforts in these areas.

Our firm, and the profession as a whole, is keenly aware of the increasing shortage of academically qualified accounting faculty, and we have taken a number of steps to address the shortage. Descriptions of some of these efforts are described in Appendix A of Barry Salzberg's February 4th testimony. These include programs focused on supporting current and potential PhD candidates, faculty conferences and internships, programs to stimulate academic research, and monetary support such as matching gift programs, scholarships and awards, and endowed professorships. Currently, the AICPA Foundation[37] is leading a profession-wide initiative called the Accounting Doctoral Scholars Program. With over $17 million in funding from most of the 80 largest accounting firms and state CPA societies, the Foundation will provide a new source of funding for PhD candidates, with the goal of increasing the current number of PhDs who will go on to teach in undergraduate and graduate accounting programs.

We also have ongoing projects related to other parts of this recommendation. For example, we have formed a task force to develop specifics around a program of cross-sabbaticals with accounting faculty, including those at Historically Black Colleges and Universities. We also are actively working with academia to find ways to increase the profession's ability to overcome confidentiality and other

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[36] Advisory Comm. Meeting Minutes at 94 (May 13, 2008) ("I'm very proud to say I started at the community college. . . . The first semester when you transition to the four-year university is one that really needs a little bit of help to make that transition, and it's not just the university, it actually means the professor in the classroom needs to help a little, too.").

[37] The AICPA Foundation, Inc. is a major body of the American Institute of Certified Public Accountants (AICPA) whose core purpose is to benefit the public by supporting financial education and ethical business behavior and promoting a culturally diverse profession. More information on the AICPA Foundation can be found at http://www.aicpa.org/About+the+AICPA/Understanding+the+Organization/AICPA+Foundation+Inc.htm.

concerns in order to provide more data for academic research, and commit to continue to work with academia and others in the profession to support programs that arise from this recommendation.

In addition, we have many professionals currently teaching in colleges and universities as professional qualified faculty, and we would be willing to encourage even more of our professionals and retired partners to do the same. The Committee could assist by making a recommendation to ease national accreditation requirements—even if only temporarily—to permit universities to use more adjunct professors. This would allow an increase in qualified instructors without the universities risking loss of accreditation, while longer term efforts to increase the number of academically qualified faculty are underway.

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

We agree that the efforts of the firms to compile data for the Committee on profession demographics and recruiting have been useful to highlight the challenges facing the profession. We also agree that regular access to such data could help to encourage research and examination of human capital issues facing the profession. Nevertheless, we urge the Committee to provide more detail on the intent behind this recommendation, including who it believes should collect and maintain such data, and how it anticipates that such data would be used, and by whom. Such additional details could help alleviate concerns about the practicality and costs of maintaining such data, as well as potential privacy concerns. The Committee could also aid in the timely and accurate formation of this database by suggesting what it believes would be the mechanism by which common definitions and reporting formats for this data would be developed.

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

We welcome the opportunity to participate in the dialogue with the AICPA and the AAA, exploring a different higher education model for accountants. It will be important for those considering this issue to keep in mind the myriad of other human capital issues the Committee has identified (*e.g.*, the need to recruit from other disciplines), as well as other considerations (*e.g.*, the additional cost and time that could serve as barriers to entry for some candidates).

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Additional Human Capital-Related Issues

At its May 5th meeting, the Committee made available a list of items that it intended to further deliberate. We provide the following observations on two of these that fall in the area of Human Capital, for your consideration.

***Partner Rotation*:** As Barry Salzberg observed in his February 4th testimony, the required frequency of partner rotation put in place by the Sarbanes-Oxley Act and related Securities and Exchange Commission (SEC) and PCAOB rules has had a significant negative impact on the desirability of serving as an audit partner. For example, reducing the rotation period to five years has increased the number of times a partner’s family must relocate by one or two moves over the course of a professional career. Moreover, especially when combined with the mobility impediments created by the current licensing regime, the shortened rotation period can impede a firm's ability to deploy partners optimally on audit engagements. The justification for frequent partner rotation is even less compelling for concurring partners, because the nature of their role does not present the same risk to independence as does that of a lead partner. As Brian Jennings, Chief Financial Officer of Energy Transfer Partners LP testified before the Committee, the partner rotation requirements also negatively impact companies—especially smaller companies.[38] Other elements of Sarbanes-Oxley, including the expanded role of the audit committee and the formation of the PCAOB, provide more than adequate safeguards for a seven year rotation regime, which would assist the firms (especially smaller firms) to optimally deploy professional resources.

The benefits of partner rotation could be maintained and audit quality enhanced by also easing the SEC's "other partner" rules, including by eliminating the 10 hour rule and increasing the size of subsidiary for which other partners can work without becoming subject to the rotation requirements.[39] Such changes would allow for better transitions between lead partners and increase the pool of future lead partners. These changes, as well as reducing the length of time a partner must remain off an audit, could be achieved without congressional action to change the five-year rotation period.

***Visas*:** As Barry Salzberg noted in his February 4th testimony, the Committee could assist in increasing the talent pipeline by making recommendations to improve the immigration system for legal, highly-educated workers. This is not a matter of hiring foreign professionals in preference to U.S. professionals; we need both, especially in fields where shortages exist and as the U.S. moves towards convergence with IFRS. Deloitte and other public accounting firms utilize the U.S. Government's various visa programs, including H-1B and L-1 visas, to overcome the shortages experienced by our profession in the number of qualified university graduates. These highly educated workers, from both within and outside the U.S., allow us to provide the best and most efficient services to our clients. Each year, however, quotas for these visas are reached before the start of the respective fiscal year, leaving large gaps of time before new visas are available for employers to secure top foreign talent not available in the U.S. The Committee could assist the profession by advocating that the number of visas made available each year be increased, as well as by advocating a pre-certification program (described in more detail in Barry Salzberg's February 4th Testimony) that would streamline the visa process and enable employers with approved immigration programs to obtain work-related visas in a more efficient and timely manner.

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[38] Advisory Comm. Meeting Minutes at 22-23 (Feb. 4, 2008) ("Our partnership as consumers of audit services, and the accounting profession as the provider of audit services, face two critical challenges related to ensuring the continuity of the external audit team. The first challenge to the audit team continuity relates to the five-year lead audit partner rotation . . . The second challenge to external audit continuity is the consequence of mandatory rotation on audit partner retention and career development. In two of the three audit situations I have been involved in the past four years, I have experienced lead audit partner reassignment. In each case, we are very pleased with the lead audit partner's leadership skills, technical capabilities, and professional integrity. The reassignment decision in both circumstances was mandated by PCAOB lead partner rotation requirements. . . . For companies located in smaller markets, or companies in specialized industries such as energy, the rotation requirement may cause a significant gap in technical and sector experience. The rotation requirement, while well intended, may place the small market companies at a significant disadvantage in securing for their investors the highest quality external audit services.").

[39] The partner rotation rules apply to "other partners" who either provide ten or more hours of service to an audit client or serve as lead partner on a subsidiary of the client that constitutes over 20% of the assets or revenues of the client. These "other partners" may serve seven years before they are required to rotate off of the audit for two years.

II. <u>Firm Structure and Finance</u>

As discussed above, we are concerned that the Committee has not addressed certain key issues under consideration by the subcommittee on Firm Structure and Finances, including the current litigation environment. We do, however, commend the subcommittee for its work in identifying several other important issues facing audit firms in this area. Although we agree with many of the Committee's recommendations, we have questions or concerns about others. We offer specific comments below.

<u>Recommendation 1</u>. Strengthen auditing firms' fraud detection and prevention skills and clarify communications with investors regarding auditing firms' fraud detection responsibilities.
(a) Urge the creation of a national center to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies, and commission research and other fact-finding regarding fraud prevention and detection, and further, the development of best practices regarding fraud prevention and detection.
(b) Urge that the PCAOB and the SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards.

We agree with the Committee that continually improving methods of fraud prevention and detection can enhance financial reporting, audit quality, and investor confidence. We do, however, suggest that the Committee clarify several aspects of this recommendation.

As a preliminary matter, the Committee should clarify that when it refers to fraud it is referring to intentional misdeeds associated with financial statements, and not errors.[40] Citing AU Section 316, the Committee states that "fraud *may* involve deliberate concealment and collusion with third parties."[41] We assume that the Committee simply intends to highlight why it is so often difficult to detect fraud. This statement could be interpreted, however, to mean that in the Committee's view fraud may *or may not* involve "deliberate" concealment. The Committee also should clarify that the auditor's primary role is to detect, rather than prevent, fraud.[42] Prevention is primarily the responsibility of management, subject to the oversight of the audit committee.[43]

We strongly support the Committee's recommendation that a national center for fraud prevention and detection be established, and we believe that the Center for Audit Quality (CAQ)—with its commitment to fraud detection—is particularly well suited to fill this role. Indeed, the Committee's conception of the national center as an information-sharing facilitator and research organization is

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[40] *See* AU Section 316, ¶ .05 ("The primary factor that distinguishes fraud from error is whether the underlying action is intentional or unintentional.").

[41] May 5th Report at 28,199 (emphasis added).

[42] *Report of that National Commission on Fraudulent Financial Reporting* (the "Treadway Commission") (Oct. 1987) at 6 ("Independent public accountants play a crucial, but secondary role. They are not guarantors of the accuracy or the reliability of financial statements. Their role, however, can be enhanced, particularly with respect to *detecting* fraudulent financial reporting." (emphasis added)).

[43] *Id*. ("The responsibility for reliable financial reporting resides first and foremost at the corporate level . . . Therefore, reducing the risk of fraudulent financial reporting must start within the reporting company. . . . One key practice is the board of directors' establishment of an informed, vigilant and effective audit committee").

reflected in the CAQ's mission and priorities.[44] As the Committee notes, this is a complex topic and will require input from a variety of professionals in order to be sure that such issues as the cost and benefits of different models, necessary experience for professionals, the roles of management and the audit committee, investors' understanding, and other issues are fully considered. The CAQ already has substantial institutional experience and resources in place to allow for efficient and effective implementation of the Committee's mandate for this national center. The Committee could facilitate quick action on this recommendation by specifically encouraging the CAQ to take the lead in implementing this recommendation.

With respect to the national center's duty to develop "best practices," the Committee should consider including a caution that "best practices" should not become *de facto* professional standards—a caution noted by Chairman Olson.[45] Moreover, by clarifying that the terms are not interchangeable, the Committee would help to ensure that the new national center is not viewed as yet another standard setter.

We also believe the Committee should make clear that it intends that the second component of this recommendation—that the auditor's role in detecting fraud be clarified, and that the PCAOB periodically review and update its standards related to fraud—take place within the existing reasonable assurance model. As the Committee notes, "auditors provide reasonable assurance . . . they cannot be expected to provide absolute assurance that all material fraud will be found. Cost-benefit constraints . . . make absolute assurance impossible."[46] Any changes to the language in the auditor's report related to the auditor's fraud detection role must be chosen carefully to avoid either confusing investors about the current applicable standards, or impacting private litigation.

Care must also be taken so that any changes in the auditor's report do not serve to emphasize the auditor's role over those who serve as the true front line in preventing and detecting fraud—management and the audit committee. As noted above, preventing, deterring and detecting fraud requires a collaborative effort by auditors and company management.[47] Management is responsible for setting the tone at the top, as well as for implementing a system of internal control that combines prevention, deterrence, and detection measures. Equally important, an active audit committee and board must oversee management's work in creating the internal control system. Over-reliance on the auditor to detect and deter fraud is not appropriate.[48] A comprehensive view of the fraud prevention and detection programs in place at a company would do much more to help investors understand the various components of the system and how they interact than would information focused only on the auditor's role.

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[44] *See* The Center for Audit Quality, *Frequently Asked Questions*, available at http://www.thecaq.org/about/faqs.htm.

[45] *See* Mark W. Olson, Advisory Comm. Meeting Minutes at 155-56 (Mar. 13, 2008) (expressing need to address the tendency to "confuse the regulatory requirement with best practices," which would appropriately "limit[] . . . the potential for liability.").

[46] May 5th Report at n. 83.

[47] *See* Press Release, AICPA, *AICPA Issues New Audit Standard for Detecting Fraud* (Oct. 15, 2002) ("[T]he auditor is not the only party responsible for dealing with financial statement fraud . . . . It's important that corporate boards of directors and audit committees assume a greater role in fighting fraud . . . .").

[48] *See supra* note 42. *See also* Treadway Commission at 6 ("Prior efforts to reduce the risk of fraudulent financial reporting have tended to focus heavily on the independent accountant, and, as such, were inherently limited.").

Finally, we agree that the PCAOB should consider fraud detection enhancements as it periodically reviews and updates its existing standards within the "reasonable assurance" model,[49] and keeping in mind the need for investors to understand the limits of auditors' ability to detect *all* fraud. We do not know which standards the Committee believes the PCAOB should review in response to this recommendation, but we note that in its *Strategic Plan* the PCAOB reports that it intends to focus first on standards related to fraud risk assessments, audit confirmations and related party transactions.[50] We believe these are appropriate areas of focus.

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

(a) Institute the following mechanism to encourage the states to substantially adopt the mobility provisions of the Uniform Accountancy Act, Fifth Edition (UAA): If states have failed to adopt the mobility provisions of the UAA by December 31, 2010, Congress should pass a federal provision requiring the adoption of these provisions.
(b) Require regular and formal roundtable meetings of regulators and other governmental enforcement bodies in a cooperative effort to improve regulatory effectiveness and reduce the incidence of duplicative and potentially inconsistent enforcement regimes.
(c) Urge the states to create greater financial and operational independence of their state boards of accountancy.

We applaud the Committee for recognizing the potential problems caused by the current system of multiple regulation and oversight of the auditing profession. While we generally support the first two components of this recommendation, we urge the Committee to consider enhancing them. We also have a few recommended additions and clarifications.

We support the first part of this recommendation, and urge the Committee to go even further. We have consistently supported the Uniform Accountancy Act (UAA), and the AICPA and the National Association of State Boards of Accountancy in their joint role as the developers of the UAA. We have expended substantial time and effort to help persuade many of the fifty-five states and jurisdictions that regulate the practice of accountancy in the U.S. to adopt all of the provision of the UAA, including the "no notice, no fee, no escape" model of mobility embodied in the UAA's Fifth Edition. These efforts have achieved important changes: twenty-six states now permit cross-border practice without the provision of a notice or payment of a fee. But even with this progress, in today's global workplace our current state-based system can be an impediment to mobility of qualified persons practicing across national borders.

Moreover, the UAA was developed as a comprehensive regulatory blueprint for an efficient state-based regulatory system. Piecemeal adoption of individual provisions of the UAA without other supporting sections and the individualization of the UAA language to a particular state's views, have created a patch-work of inefficient and ineffective state-based regulations. Given that the modern

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[49] *See* Letter from Christianna Wood, Senior Investment Officer, Cal. Pub. Employees' Ret. Sys., to the Advisory Comm. at 7 (Feb. 4, 2008) (identifying SAS 99 as the foundational fraud detection standard, and suggesting that incremental efforts to improve fraud detection be based on SAS 99).

[50] Public Company Accounting Oversight Board STRATEGIC PLAN 2008 – 2013 (Mar. 31, 2008) at 24.

practice of accountancy is predominantly multi-state in nature, the need for greater uniformity in licensing laws has become more critical.

Therefore, we believe that the issues addressed in the UAA would be best addressed by adopting a national licensing system for firms and individuals as an alternative for those that practice in more than one state. A national licensing program would ease the current numerous and significant burdens placed on firms and individual professionals related to state licensing. These burdens include the increasing cost for deployment on various audits that arise from the multiple and divergent state-required continuing professional education requirements for initial and renewed licensing, and multiple disciplinary and ethics regimes, among other compliance issues. Unfortunately, these burdens do not seem to be easing.

For example, although the creation of the PCAOB was intended to centralize the oversight of the profession, some states have begun to piggyback on PCAOB actions, including by using information from its inspection reports to engage in duplicative oversight and discipline. Increasingly, matters which arise based on the work of a firm and its people in only one state are being investigated by multiple other states that have no nexus to the matters in question. Such actions are not only an inefficient use of regulatory resources, but also are overly burdensome to audit firms, impugn their reputations unfairly, distract their personnel, and create unnecessary legal and other costs, without regard to whether the audit firm has been found to have engaged in any wrongdoing.

We also support the second component of the Committee's recommendation—to urge regulators to improve their effectiveness and reduce the number of duplicative and potentially inconsistent enforcement regimes. We believe the Committee should go even further in advocating such coordination and cooperation. We do not believe that regular meetings of regulators are sufficient to address the potential for unintended detrimental effects of regulatory action on a firm or the profession as a whole, including duplicative follow-on regulatory actions.

Auditors are currently regulated at many levels and by many entities. The PCAOB, the Department of Justice, the SEC, and the state boards of accountancy all directly oversee the regulation of audit firms in this country, and similar regulatory entities from other countries may have regulatory oversight roles over some U.S. audit firms and their international network affiliates. In addition, many other federal and state governmental agencies regulate the manner in which an audit firm may practice, including the Department of Labor (DOL), the Department of Housing and Urban Development (HUD), and various banking regulators and state health care agencies. A robust system of coordination among regulatory entities is needed to prevent unnecessarily duplicative actions by multiple regulators, or an action taken by one regulator, without consulting other regulators, that could have cascading effects that are disproportionate to the conduct at issue.

In order to encourage true coordination, we urge the Committee to make stronger recommendations in this area. First, the Committee should recommend that in the U.S., the SEC and PCAOB enter into a Memorandum of Understanding with the Department of Justice and state regulators that would accord to the SEC or the PCAOB, or both, an organizing role in decisions regarding actions taken against audit firms. Second, the Committee should recommend that the SEC stimulate discussion about similar coordination with regulators of other nations—perhaps through the vehicles of the International Federation of Independent Audit Regulators or the International Organization of Securities

Commissions—with a goal of rationalizing the impact of investigations and decisions in one country that could impact a firm in another.

The third component of the Committee's recommendation appears to be inconsistent with the first two components, which recommend a move towards more coordinated national and international regulation. Further independence of operations of individual state boards of accountancy we believe will lead to less, not more, uniformity and consistency of the state-based regulatory system. We therefore urge the Committee to reconsider this recommendation.

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

Effective governance is key to the success of audit firms. Deloitte, like many firms, is dedicated to the concept of good governance, and has adopted best practices in our governance structure, including separating our CEO and Chairman positions.[51] Moreover, in 2006, we proactively studied the possibility of involving outsiders in our governance process. While we found definite potential benefits to an outside perspective, we also found significant obstacles to effectively bringing qualified outsiders into our governance structure—primarily independence requirements, legal liability issues, and state rules regarding board membership.[52] In large part because of the challenges in recruiting qualified, independent external members, we have instead chosen to seek input from outsiders with specific and relevant topical expertise by inviting them to participate in our board meetings and strategy sessions on an *ad hoc* basis.

Although we explored this issue on our own and did not adopt the models specified in the Committee's recommendations, we would be willing to explore further changes in this area. But it will be important that the goal of the changes be clear. First, the public company model for independent directors should not be applied to a private partnership without considering the fundamental differences between those types of organizations. Independent directors of a public company have fiduciary duties to the owners of the company—the shareholders—and consequently help ensure that managers do not abuse the important trust that has been vested in them by passive shareholders. As the Committee has recognized, in the case of audit firms the fiduciary duties of outside directors would similarly flow to the owners of the firm—the partners.[53] Many of these duties would relate to firm operational and business matters that are not directly related to the conduct of audits.

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[51] In addition, we have incorporated executive sessions into every board agenda; conduct annual board/member assessments; have a robust committee structure; and proactively seek input on agenda topics from the partnership. We also have an independent nominating committee that recommends the members of the Board; the members are elected by the partners to serve in three-year staggered terms.

[52] SEC and other independence rules would likely require any firm board members to observe all of the firm's independence requirements with respect to financial interests and advisory board members to comply with independence requirements similar to those applicable to retired partners with no voting power. Also as many firms are unable to provide liability insurance for their own personnel; similarly, directors and officers and other insurance may not be available for independent board members. State rules regarding firm governance also must be considered.

[53] May 5th Report at VI:9 ("duties run to the auditing firm and its partner/owners").

We therefore believe an advisory committee composed of independent members, with a clear charter to focus on audit quality, could be more effective in providing insight on matters of audit quality than would a requirement to have independent members on a firm's board. Moreover, while there also are regulatory hurdles to recruiting advisory committee members, these may be easier to overcome than those for board members, both because independence requirements would be less stringent and because there would be less of a perceived litigation risk. Advisory boards would also allow for more latitude in adjusting the model based on firm size and differing firm governance models, as the Committee notes would be important.

We recommend that, in light of the issues discussed above, the Committee's recommendation be less limiting with respect to the models that should be studied, including by noting that the current regulatory hurdles and firm structures may call for a less formal model of outside governance input than the two mentioned in the Committee's draft report.

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

The profession has long supported increased transparency of the circumstances surrounding a public company's change of auditor, and we are pleased that the Committee has put forth this recommendation. We offer the following comments to assist in clarifying the scope of events that will trigger this enhanced disclosure.

First, the Committee's current recommendation would seem to require open-ended disclosure after every resignation or termination of an auditor, or failure of an auditor to seek reappointment.[54] In light of concerns raised by the corporate community and others about the open-ended nature of this obligation, we recommend that the Committee instead set forth the specific items to be disclosed. Providing more objective requirements would also help ensure that open ended disclosure not become boilerplate disclosure that is not meaningful to investors.

Specifically, the Committee should recommend that the SEC retain the auditor disclosure requirements under Item 304(a)(iv) of Regulation S-K, which require a statement of whether the auditor's resignation, declination, or dismissal involved certain disagreements between the registrant and the auditor. In addition, the list of objective criteria should be expanded to include five additional disclosures: (1) whether there were any material unresolved accounting or auditing issues pending at the time of the change, and the specifics of any such unresolved issues; (2) whether the auditor, or the audit committee of the registrant, concluded that the auditor is no longer independent of the registrant; (3) whether in the two years leading up to the change the Company requested a change in the audit partner; (4)whether within the two years leading up to the change the audit firm determined it could no longer rely on the representations of one or more members of management; and (5) whether, during the registrant's two most recent fiscal years or any subsequent interim period, the registrant has restated audited or interim financial statements for a correction of an error or other circumstances requiring Form 8-K disclosure or has amended prior filings for reasons that relate to the auditors' report and are material to the financial statements.

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[54] May 5th Report at VI:11.

In addition, disclosure should be required of any conditions imposed by the successor auditor as a condition accepting the engagement, as these could provide investors with important information about the views of the successor auditor. We also support the Committee's recommendation that the SEC require the predecessor auditor to respond in a letter to the SEC stating whether it agrees with the company's disclosure, and if it does not agree, stating why.

With respect to the requirement to notify the PCAOB of any "premature engagement partner changes on public company audit clients,"[55] we note that any number of circumstances could trigger reporting under this requirement, many of which would have little or no relationship to audit quality or circumstances that would be of legitimate interest to investors. The Committee should therefore consider explicitly recognizing in its report that disclosure requirements along these lines should be specific enough to avoid unwarranted concern.

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Recommendations and Requests for Comment in June 3rd Addendum

Auditor's Report. Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's reporting model.

As the Committee notes, the effectiveness of the standard auditor's report has long been the subject of debate. Because of this, we agree that it will be important for the PCAOB to consult with others who have a vested interest in this subject, including other regulators. To this end, we note that the International Auditing and Assurance Standards Board (IAASB) and the Auditing Standards Board (ASB) have undertaken a joint project to evaluate and reconsider the language and format of the auditor's report. This effort includes joint research projects by the IAASB and ASB, being conducted by several universities, into investor interest in adding information to the auditor's report, including information about management's responsibilities.[56] The Committee should explicitly recommend that the PCAOB coordinate its efforts with those of these other standard-setting bodies. We believe one reporting model should be developed after careful consideration of users' needs, as well as the potential legal and other ramifications to auditors and companies.

As the Committee notes, different global jurisdictions have taken different approaches to the audit report. While we believe that many of these existing alternative models are worthy of study, the different liability systems where these reports exist must be taken into account when assessing the standard language included in the auditor's report in the U.S. and the U.S. litigation system, including that some jurisdictions have damage caps in place.

Other issues that should be addressed when examining possible changes in the auditor's report include: potential additional costs weighed against potential benefits; whether investors would use and understand an expanded auditor's report; whether expanded disclosures also should be made by the

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[55] May 5th Report at VI:10.

[56] The universities are: University of Southern California at Los Angeles; Victoria University of Wellington (New Zealand), University of Florida at Gainsville, Boston College, University of Muenster (Germany), and RSM Erasmus University (The Netherlands).

company; whether liability issues would drive the report to become boilerplate; and whether an expanded auditor's report should be preceded by litigation and other reforms.

Engagement Partner Signature. The Committee is considering recommending that the PCAOB revise its auditor's report standard to mandate the engagement partner's signature on the auditor's report. The Committee notes the signing partner should face no additional liability than that under the current liability regime. The Committee is seeking commentary on this potential recommendation, and in jurisdictions where signatures are currently required, their impact on audit quality.

We do not believe that this requirement has any close nexus to audit quality, especially when weighed against its potential for unintended adverse consequences in the U.S. environment. Therefore, we do not understand the goal behind this recommendation—regulators and others currently can readily identify those involved in audits, if necessary.

We understand that some support this recommendation by noting that the practice is common in the EU, and in fact is included in the Eighth Company Law Directive. This practice in Europe, however, was not established out of consideration of providing incentives for higher quality audits; rather, it is a long-standing historical practice under the statutory audit system, which is rooted in advice given in connection with fiscal planning or tax. Moreover, the liability system in Europe is significantly different from that in the U.S. For example, six EU member states have damages caps in place and none of the others has the large civil suits common in the U.S. The Committee should not, therefore, recommend this change based on a comparison with the EU system without adopting a more comprehensive approach to parity with the EU, including liability reform.

Some have also pointed to the fact that CEOs and CFOs of public companies must personally sign their financial statements. This comparison is inappropriate. Management of a public company has primary control and responsibility for their own financial statements; implying that an individual partner in an audit firm has the same degree of control and responsibility over the company's financial statements as the CEO and CFO may be misleading to those reviewing the statements.

We believe that, rather than focusing on an individual partner, investors should take more comfort in the consultative process used to determine a *firm* position on an audit, which is one of the most significant components of a high quality audit.[57] At Deloitte, we have spent much time emphasizing this consultative approach, which is increasingly important as companies become more international and more complex. All clients, especially audit clients, are viewed as clients of the firm and not of the individual partner who is assigned responsibility to complete the audit of a particular client at a particular time. Changing the current practice, which emphasizes the responsibility of the firm as a whole, to a practice which highlights a particular partner, could undermine the consultative approach, and result in an improper emphasis on the opinions of an individual auditor over those of other experts within the firm.

Moreover, there are some practical issues that should be considered. For instance, if an individual partner signs the report, this may raise security concerns. In addition, individual investors could believe that specific questions about the company are appropriately directed to the individual partner,

[57] We understand that, similarly, a signature by a law firm, rather than an individual attorney, involves more internal processes and is therefore generally required when issuing a legal opinion that is to be relied upon in a business transaction.

where in fact, the audit partner would not be in a position to, nor would it be appropriate to, answer such questions.

Finally, although we appreciate that the Committee does not intend to change the partners' liability exposure by this requirement, we are concerned that there nonetheless could be unintended adverse consequences, outside of the federal securities laws, of requiring an individual's signature. These must be well understood and addressed before any requirement is adopted. For example, the signature requirement makes it much more likely that an individual partner will be named as a defendant in civil litigation. This could have such adverse consequences as affecting that partner's title to real estate or triggering reporting requirements to state regulatory authorities.

Transparency. The Committee recommends that the PCAOB require that, beginning in 2010, larger auditing firms…produce a public annual report incorporating: (a) information required by the Article 40 Transparency Report deemed appropriate by the PCAOB in consultation with investors, other financial statement users, auditing firms, public companies, academics, and other market participants, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VII of this Report.

The Committee is also considering recommending one of the following two approaches to audited financial statements: The PCAOB should require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements prepared in accordance with generally accepted accounting principles or international financial reporting standards and the PCAOB will then either:
Alternative 1: Determine, based on broad consultation, whether these audited financial statements should be made public in consideration of their utility to audit committee members and investors in assessing audit quality, impact on firm sustainability, firm comparability, and other considerations relevant to the public interest, or
Alternative 2: Make these audited financial statements publicly available.

The Committee's Working Discussion Outline stated that the Committee would "[c]onsider 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."[58] We believe that this focus on audit quality is appropriate, and we would support additional disclosures along those lines.

As the Committee notes, much of the information required by Article 40 of the European Union's Eighth Company Law Directive[59] is appropriately focused on audit quality. Therefore, as Barry Salzberg testified on February 4th, we stand ready to make equivalent public disclosures. Moreover, we believe that, as investors, audit committees and other users gain familiarity with these types of disclosure, they can be tailored and expanded in ways that will better inform various stakeholders about audit quality.

We urge the Committee to reconsider, however, the two options regarding financial disclosures it put forth in the June 3rd Addendum. First, we believe such disclosures bear little, if any, relation to audit quality, a fact that Chairman Nicolaisen conceded.[60] Second, in light of the lack of clear benefit of such disclosure, it is premature to make specific recommendations in this area, especially given the

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[58] Advisory Committee on the Auditing Profession, Working Discussion Outline § 3.6.3.

[59] European Union, Eighth Company Law Directive, Directive 2006/43/EC.

[60] *See* Chairman Donald T. Nicolaisen, Advisory Comm. Meeting Webcast at 7h:03m (June 3, 2008) (stating that publicly available audited financial statements from audit firms is "not an audit quality thing").

potential adverse unintended consequences, including increased litigation risk and the potential impact on audit firm concentration.

The PCAOB currently has access to a broad scope of non-public information about the firms, including financial information, as well as the context necessary to assess any relation that information may have to audit quality. Without the correct context, this information would be of little, if any, value to the public, and in fact could easily be misinterpreted or misused.

We understand that some have tried to bolster their call for increased financial transparency by audit firms by pointing to the financial disclosure system designed for public companies.[61] Although this comparison may be superficially appealing, it is misplaced. Public company disclosure is designed for the benefit of public companies' investor-owners, the vast majority of whom are passive investors with limited access to other information about the company's performance. The investor-owners of the audit firms, however, are its partners, who have ample access to information on the firms' performance. Simply transferring to private partnerships the public disclosure requirements designed for a completely different purpose is not good policy. As Nell Minow put it in her testimony before the Committee "we can't just say well, public companies have to meet GAAP, why don't we apply GAAP to these private partnerships."[62]

Rather than simply adopting a transparency model designed for a different purpose, any additional transparency for audit firms should be tailored to the needs of its intended audience—investors, audit committees and others whose interest is in the firms' commitment to audit quality.[63] Moreover, as the Committee heard in testimony from smaller firm representatives, there is a real risk that financial transparency would exacerbate existing concentration in the marketplace.[64] This could result if smaller firms choose not to enter, or even to leave, the public audit market rather than comply with such requirements. Moreover, smaller firms who do stay could be at a disadvantage with audit committees, who may feel compelled to choose firms with the largest financial and professional resources, at the

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[61] *See, e.g.,* Written Submission of John H. Biggs at 2 (June 3, 2008) ("There is a long standing federal securities interest in having companies make open their books to investors, regulators and the public. Yet, strangely, the professional businesses that assure that openness do not see an obligation to open their own financial records to the public.").

[62] Comments of Nell Minow, Editor and Co-founder of The Corporate Library, Advisory Comm. Meeting Webcast at 2h:24m (June 3, 2008).

[63] *See* Written Submission of John H. Biggs at 2 (listing certain information he would find useful as an audit committee member). Notably, much of the information he lists is not included in, and could not be gleaned from, GAAP financial statements or their footnotes. Rather, it is information that could be provided to audit committees much more directly, if requested.

[64] *See* Written Submission of Kenneth Nielsen Goldman, Capital Markets and SEC Practice Director of JH Cohn LLP, May 27, 2008, at 5 ("disclosure of firm financial statements" would pose "insurmountable difficulties for many smaller CPA firms, causing them to withdraw from the public company audit market"); Comments of Neal Spencer, BKD LLP, Advisory Comm. Meeting Minutes at 283-84 (Feb. 4, 2008) ("It's not that we're opposed to transparency. I think the question is: what do you want to know? Clearly, when you look at BKD, as you just mentioned, less than five percent of our revenue is generated from public company audits. So when we look at transparency, the question of: what is a firm's insurance ability? How much insurance does a firm carry? That would probably be something that we would be willing to share. How much capital we maintain in our firm is probably something that we would be willing to share. But how important is it to share partner compensation? There are so many factors that range when you talk about partner compensation to leverage of a firm, to structure of a firm, that those numbers vary all over the board. And for a firm like BKD, that spends 95 percent of its time outside the public company audit arena, that would cause some competitive disadvantages to a firm like us.").

expense of other more appropriate assessments of quality, experience and fit. These unintended consequences could result even if transparency requirements were technically limited to the larger firms, because smaller firms may feel compelled to comply with the transparency requirements as a "best practice," in order to be competitive for public company audits.

Finally, some have supported the call for additional financial transparency by the firms by pointing to foreign jurisdictions that require financial disclosures from audit firms. The litigation environment in the U.S. is unique, however, and there is a higher risk in the U.S. that financial disclosures would be abused by plaintiffs in determining what damages to seek in civil litigation.[65] With the EC's June 5th Recommendations, in fact, it appears that all of the EU should eventually have the benefit of litigation reform for audit firms. We agree with the Committee's consideration of EU countries' requirements, in light of our increasingly global capital markets, but it must look at that system as a whole. Choosing to adopt the European model when considering possible additional affirmative requirements for audit firms, without the matching protections, will not serve to enhance the sustainability of the profession in the U.S. Therefore, additional financial transparency by U.S. firms should not be considered without addressing the underlying litigation risk faced by the firms.

Litigation. The Committee is seeking commentary on (1) whether it is appropriate to have exclusive federal jurisdiction for some categories of claims and a uniform standard of care; and, if so, (2) what types of claims should be subject to federal jurisdiction; and (3) what should be the uniform standard of care.

As discussed above, we do not believe that the Committee's May 5th Report and June 3rd Addendum, even when read together, sufficiently address the catastrophic litigation risk facing the profession. We appreciate the Commission's consideration of these two modest potential improvements to the U.S. litigation system, but we do not believe that they will make a significant difference in the litigation threat facing the profession. In fact, as drafted, it is unclear what improvement, if any, would result from the Committee's potential recommendation related to the standard of care.

If the Committee cannot agree on a comprehensive recommendation to address the catastrophic liability threat facing the profession, there are other incremental reforms that we believe would be more useful than those put forth by the Committee here. These were discussed in Barry Salzberg's February 4th testimony, and are set forth in more detail in Appendix A to this letter. They include: reasonable appeal bond caps; appeals from denials of motions to dismiss; clarification of imputation in bankruptcy cases; clarification of Rule 10b-5; and support of alternative dispute resolution. Even these reforms, however, will not fully address the risk facing the profession, alone or in combination.

We continue to believe that catastrophic liability caps represent the best method for ensuring the survivability of the audit profession. This is a view supported by many who have studied this issue.[66]

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[65] *See, e.g.*, Written Submission of Kathryn A. Oberly at 15 ("We are not currently required to provide such information in securities class actions or in other types of lawsuits. . . [T]here is no doubt in my mind that providing the plaintiffs' bar with access to such financial data would worsen the litigation crisis that we are dealing with today.").

[66] *See, e.g.*, January GAO Report at 55 (noting that "[a] number of market participants and academics, and a recent report commissioned by Senator Charles Schumer and New York 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 major auditing firm"); John C. Coffee, Jr., "Nobody Asked Me, But. . ." N.Y.L.J. (Jan. 18, 2007) ("It is the prospect of a one-time billion-dollar loss that merits the adoption of ceiling."); Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* at 89 (Nov. 2006) ("Another approach would involve setting a cap on auditor

At a minimum, the Committee should recommend additional study of the feasibility of liability caps. An appropriately structured liability cap would preserve the accountability of the auditing profession, while protecting against failure of an entire firm, and afford audit firms full and fair access to the court system. The exact form of a liability cap would require further study, and should be scaled in such a manner that it would not disadvantage a firm of any size from competing for larger audits. The cap could, for example, be proportionate to the size of the audit or the company audited, perhaps a multiple of the audit fee.

Some maintain that unlimited liability exposure is necessary to motivate audit quality. We strongly disagree. There are much more compelling incentives for audit quality. First and foremost, in addition to having professional and ethical responsibilities to provide quality audits, audit professionals care deeply about the quality of their work. Second, auditors have a strong business motivation to maintain audit quality—reputation is paramount to business success. Third, 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, and they are focused much more directly on audit quality.

As it is, few lessons are learned from allegations of audit failures in private litigation; because most cases settle prior to trial, the circumstances of the audit are almost never examined by a neutral fact finder. Unless firms have a reasonable opportunity to take a case to trial without risking the entire firm and the jobs of thousands of employees, we will never have an actual determination of whether audit quality is or is not influenced by litigation exposure.

The EC explicitly addressed this issue in the Frequently Asked Questions that accompanied the release of its June 5th Recommendations, noting that: (i) liability limitations would not involve intentional breach of auditors' duties (e.g., collusion with management); (ii) existing liability limitations in member states have not been shown to adversely affect audit quality; and (iii) audit regulators will play a pivotal role in maintaining high audit quality.[67] All three of these reasons apply equally to the assessment of the potential impact on audit quality of liability limitations in the U.S.

Nevertheless, to the extent there is any credibility to the notion that the threat of civil liability has an impact in motivating audit quality, we believe that realistic liability caps can be developed that would protect the market against the catastrophic risk of another large firm failure and still be set high enough to maintain that motivation. Further, as noted, litigation-related costs for the six largest firms currently constitute 6.6% of all revenues and 15.1% percent of audit-related revenue. This is dramatically greater as a percentage of revenue than in any other profession or business in the U.S. that we have identified. These ongoing annual expenses would not be impacted by a catastrophic liability cap and would already seem to provide any motivational force deemed necessary.

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liability in specified circumstances, an approach that some European Companies already take and that the EU Commissioner for Internal Markets, Charlie McGreevy, has recommended that the EU pursue.").

[67] The European Commission Press Release, June 6, 2008: *Commission Recommendation on limitation of auditors' liability: Frequently asked questions available at* http://europa.eu/rapid/pressReleasesAction.do?reference =MEMO/08/366&format=HTML&aged=0&language=EN&guiLanguage=fr.

In sum, the auditing profession performs an important function that protects investors and supports the capital markets. Permitting a narrow class of litigants (and their counsel) to put the audit profession at risk without taking into consideration the greater public harm that could result from catastrophic judgments, in matters where the auditor's responsibility is debatable, is inappropriate and unjust. Audit firms should be held appropriately responsible for their failings, but should not simply be a "deep pocket." Accordingly, we strongly urge the Committee in its final report to clearly acknowledge this significant risk and to recommend the adoption of reforms that will effectively address it.

III. Concentration and Competition

We agree with the Committee that the auditing profession benefits from a competitive population of auditing firms. As the Committee notes, the GAO, in its recent report on concentration in the audit market, concluded that, although there currently is concentration in the large public company audit market, there is no compelling need to take any action to address current levels of concentration because it does not correlate to a lack of competition.[68]

The GAO Report also cites, however, litigation risk and lack of insurance coverage as potential barriers to entry for smaller firms.[69] This was underscored by testimony by representatives of smaller firms to the Committee.[70] We agree, and, as discussed previously, therefore believe that it is important for the Committee to at least acknowledge the catastrophic litigation risk facing the profession in this section of its report. There are other risks that we believe the Committee should also discuss in this context, including overly-restrictive auditor independence requirements that can disqualify firms from competing for public company audits even when there is no independence impairment. In addition, we have some specific comments on the recommendations that were put forth by the Committee.

Recommendation 1. Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. . . .
(a) Require disclosure by public companies in their annual reports and proxy statements of any provisions in agreements with third parties that limit auditor choice.
(b) Include representatives of smaller auditing firms in committees, public forums, fellowships, and other engagements.

We believe these recommendations will help improve competition, and therefore we support their adoption. We also urge the Committee to consider more carefully the competitive disadvantage smaller firms may face if some of the Committee's other recommendations were to be adopted. For example, as discussed above, there is a real risk that increased financial transparency could disadvantage smaller firms if audit committees feel pressure to base decisions on the overall size of a firm and its resources, rather than a myriad of more appropriate factors. This pressure can be very real, even if it is not written in any official policy. A regulatory requirement that is limited on its face to

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[68] January GAO Report at 6.

[69] January GAO Report at 55 (footnotes omitted).

[70] *See* Neal Spencer, Advisory Comm. Meeting Minutes at 224 (Feb. 24, 2008) ("A number of barriers do exist for smaller firms to expand the participation in public company audits. These include resources, as we've talked about earlier today, institutional bias, insurability, and most importantly liability. While each of these barriers is very real and very significant, the most significant deterrent is clearly liability.").

larger firms can still provide problems for smaller firms, who may feel pressured to follow the rules as a "best practice" in order to compete with larger firms.

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

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

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

As the Committee notes, the catastrophic risks facing the audit profession are "real and . . . over the past two decades two large auditing firms have gone out of existence."[71] Yet despite briefly mentioning this risk, the Committee has not given sufficient consideration to the *sources* of that risk—catastrophic civil liability or regulatory action with disproportionate cascading effects. Addressing these underlying sources is the only way truly to ensure the sustainability of the profession.

Although it does seem prudent to have a regulatory back up plan in light of the very real risks faced by the firms, the mechanisms set out in this recommendation would, in practice, be too little, too late. As the case of Arthur Andersen made clear, the collapse of a major audit firm can happen with astounding speed, based on the confluence of a number of factors. In short, while the PCAOB should be aware of the risks facing the firms it regulates, it would not be appropriate for the PCAOB to trigger the Committee's mechanism until the threat is imminent, lest it lead to the very result it is intended to address. And at that point, we do not think regulatory intervention will be able to save a firm in any meaningful form. By the time a "streamlined internal governance mechanism" could be implemented, or a government-imposed trustee appointed, the damage to a firm would likely be too great to be remedied.

Moreover, the Committee's specific proposal has the potential to be harmful to the markets by giving a false sense that the government views the large public auditing firms as "too big to fail" and that the risks facing the firms should therefore not be a source of concern.

PCAOB Monitoring. We believe that under its current mandate the PCAOB has the authority to monitor the various types of risks the profession as a whole confronts; it also has an in-depth view of specific risks faced by individual firms through its inspection program. If it were to determine it should take action based on these risks, however, it would have to take special care to ensure that its actions were not counter-productive. For example, knowledge that the PCAOB had initiated special monitoring of a certain lawsuit, for example, could be an advantage to the plaintiff in such a suit, as it would indicate that the PCAOB thought that a legitimate liability issue might arise. In addition, such monitoring could lead to precisely the result that it was trying to prevent: flight from the firm, and its resulting collapse.

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[71] May 5th Report, at VII:6.

Streamlined Management and Trusteeship. We strongly urge the Committee to reconsider this portion of the recommendation. Implementation of a "streamlined internal governance mechanism" or appointment of a trustee is almost certain to hasten the very consequences it is meant to prevent. Far from being a true "freeze" or stand-still device that would preserve all the assets of the firm in place pending the resolution of the external threat, the two-step mechanism proposed by the Committee could very well speed the collapse of the audit firm by telegraphing to the public, the audit partners, foreign network affiliates, and the firm's audit clients, that the audit firm is in clear jeopardy—leading the former to lose trust in the firm and the latter three to flee from the firm. The risk of these consequences is even more compelling because we do not believe that the mechanism proposed by the Committee would stop the chain of events that give rise to a firm's collapse in the face of a catastrophic litigation award.

There are further barriers to the success of this mechanism. First, the preemption of the normal decision-making mechanism of the audit firm may hasten the departure of partners, who may view the loss of management control as a threat to their capital investment, and would most certainly discourage remaining partners from investing additional personal assets in order to assure the firm's survival. Salvaging a firm after a catastrophic judgment will require not only discouraging partners from leaving the firm, but also motivating them to recapitalize the firm.

In addition, a proposal that requires the replacement of existing firm management seems to presuppose that a catastrophic event will only come about if current management is somehow incompetent. Such a conclusion is inconsistent with the identification of the core threats to auditing firms: an unfair civil judgment bearing no relationship to the actions committed by the auditors, or a regulatory action the cascading effects of which are disproportionate to the conduct at issue. Because such risks are not ones that can necessarily be prevented by an audit firm's management (even if management does everything it can to encourage quality audits, minimize risk, and defend against allegations), merely replacing management in a time of a crisis would not solve any of the issues that precipitated the crisis.

Moreover, it is not clear what precedent there is for government intervention into a firm that would override the normal federal bankruptcy procedures and potentially take away the rights of the firm, its partners and creditors.

Even if this mechanism had some ability to salvage parts of a troubled firm, the surviving firm would bear little resemblance to the legacy firm. As Chairman Volcker noted, although he believes this mechanism "would have saved [Arthur Andersen], it would have been much smaller, I think. It probably would have emerged as an auditing-only firm. It would have been international, maybe a little less international than when it started."[72] In fact, one of the things that precipitated Andersen's demise was the loss of international affiliates. The remnants of any firm that is "saved" by the Committee's mechanism would likely be incapable of auditing the largest of international public companies with the complex teams that they require, and the impact on concentration in the audit market would be almost the same as if the firm had failed.

In sum, we urge the Committee to re-evaluate the nature of the threat and the nature of the risk facing the profession, and to determine whether the latter—a rapid dissolution of the firm—can be addressed

[72] Paul Volcker, Advisory Comm. Meeting Minutes at 317 (Mar. 13, 2008).

effectively after the former—an extraordinary judgment or disproportionate regulatory action against the firm—has occurred; or whether, as we believe, the only effective way to stave off disaster is to ensure that the threat itself is mitigated at its source.

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

We take our responsibility to provide quality audits very seriously, and we dedicate significant resources to conduct quality audits, including by continually monitoring and evaluating our quality control systems and processes. We promote audit quality through, among other things, extensive training, policies and tools, supervision and review, and a broad consultation network. Individual engagements and our quality control systems are also reviewed by our internal inspection process, the PCAOB inspection process and the peer review process (for non public audits). Because of our commitment to audit quality, we welcome the opportunity to work with the PCAOB to consider the feasibility of developing measures of audit quality.

We agree with the Committee that there is an inherent difficulty in identifying key indicators of audit quality and that a great deal of work must be done to understand the drivers of audit quality. To be meaningful, any audit quality metrics will require a demonstrable relationship to audit quality, must take into account the difficulties of comparability across firms and clients, and should consider both input and output measures, as well as qualitative and quantitative information. As the PCAOB considers the feasibility of appropriately balancing all these and other factors, we agree with the Committee that it should leverage the extensive efforts undertaken by other organizations, such as the Financial Reporting Council (FRC) in the UK, as well as the EU in Article 40 of the Eighth Company Law Directive.

Additionally, although specific inputs on particular engagements might be useful to the audit committees of specific companies, aggregating such inputs may not be as meaningful, as the data may vary significantly among engagements and across audit firms. We therefore suggest that the Committee note in its final report that any audit quality indicators resulting from the PCAOB's feasibility study should take into consideration how these measures might differ based on firm size, ownership model, breadth of audit practice or audit specialty. Because of the likely difficulty in finding metrics that adequately take into account all these factors, ultimately we believe the development of audit quality metrics will be more useful as best practices, than as requirements (which could foster a form-over-substance approach to these issues by firms). Research, study and testing may be necessary before determining whether to publicly disclose such measures, in order to minimize the risk that indicators become misleading or inaccurate in practice.

<u>Recommendation 4</u>. Promote the understanding of and compliance with auditor independence requirements among auditors, investors, public companies, audit committees, and boards of directors, in order to enhance investor confidence in the quality of audit processes and audits.

(a) Compile the SEC and PCAOB independence requirements into a single document and make this document website accessible. The AICPA and states should clarify and prominently note that differences exist between the SEC and PCAOB standards (applicable to public companies) and the AICPA and state standards (applicable in all circumstances, but subject to SEC and PCAOB standards, in the case of public companies) and indicate, at each place in their standards where differences exist, that stricter SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements. This compilation should not require rulemaking by either the SEC or the PCAOB because it only calls for assembly and compilation of existing rules.

(b) Develop training materials to help foster and maintain the application of healthy professional skepticism with respect to issues of independence and other conflicts among public company auditors, and inspect auditing firms, through the PCAOB inspection process, for independence training of partners and mid-career professionals.

We see no harm in the suggested compilation of various independence requirements—such as the one the SEC already provides of its rules applicable to public company audits.[73] The draft Recommendation suggests that the PCAOB and SEC publish compilations of their own rules, leaving the AIPCA and states to note how their standards compare to those of the SEC and PCAOB. We note that in the past, however, when the profession has attempted comparisons between its rules and those of the Commission, it has inadvertently raised concerns with the SEC staff.[74] In short, because there are numerous organizations that promulgate independence-related standards, and no natural forum to create such an overarching document, we are unsure that the Committee's recommendation goes far enough to rectify confusion multiple standards may cause.

If the Committee's intent is to compile *all* the requirements firms must follow, it should go further. For example, a number of other government entities (*e.g.*, the Department of Labor and the GAO) have their own independence requirements, and, perhaps more importantly in today's global market, firms that audit global companies also must be aware of global requirements, including standards issued by the International Federation of Accountants (IFAC) and those of individual countries.

We recommend that, rather than focusing incremental improvements to communications by regulators about the meaning of their rules, the Committee should address the source of recent independence compliance issues. Many of the independence issues that arise today are not due to a lack of understanding of the rules, but to practical impediments to complying with the myriad of independence rules applicable to audits in today's global business environment.

As Barry Salzberg suggested in his February 4th testimony, a movement towards international convergence with the independence standards that are issued by the IFAC could address many of these issues.[75] IFAC follows a "threats and safeguards" approach, pursuant to which possible independence concerns are assessed first by identifying any threats to independence and evaluating whether these

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[73] Office of Chief Accountant, U.S. Securities and Exchange Commission, *Audit Committees and Auditor Independence, available at* <u>http://www.sec.gov/info/accountants/audit042707.htm</u>.

[74] *See, e.g.*, May 21, 2004 letter from Don T. Nicolaisen, SEC Chief Accountant to Bruce P. Webb, Chair of the AICPA Professional Ethics Executive Committee, *available at* <u>http://www.sec.gov/info/accountants/staffletters/webb052104.htm</u>.

[75] *See also* Letter from Barry Salzberg to Advisory Committee on the Auditing Profession (Mar. 31, 2008) (answering questions for the record submitted in follow up to February 4, 2008 appearance before the committee).

threats are clearly insignificant. For cases in which they are not clearly insignificant, the IFAC approach then allows for identification and application of appropriate safeguards to eliminate or reduce the threats to an acceptable level.

Whether or not the movement toward convergence of independence standards progresses, however, there are several changes to the current U.S. system that we urge the Committee to support. These include the following, which are discussed in more detail in Barry Salzberg's February 4th testimony: allowing for *de minimis* exceptions for scope of services violations; amending the definition of "affiliates" of audit clients to reflect currently prevalent business structures; and lengthening partner rotation periods (see discussion on pages 12-13).

Finally, to the extent this recommendation can be read to imply that the profession does not understand the existing independence rules and/or does not adequately focus on training its professionals, we disagree. We do not believe there is currently any widespread misunderstanding of the independence rules, and we are unaware of any demonstrated correlation of independence violations with audit problems. Moreover, we do not understand the Committee's reference to the need for "professional skepticism"—a term having special meeting in the context of an audit—in this context. In the very rules-based independence system in the U.S., it is not clear what this term would mean to someone applying the rules.

Recommendation 5. Adopt annual shareholder ratification of public company auditors by all public companies.

Our experience supports the Committee's conclusion that most large public companies already include shareholder ratification of their audit firm in their annual proxy statement. We have no objection to making this common practice mandatory, although the Committee may want to include a caution that the requirement should not impede a company's ability to change auditors if necessary, or conflict in any other way with the audit committee's duties in this regard.

We are concerned, however, about the recommendation included in the body of the Committee's report, that the name of the lead audit partner be disclosed in the company's proxy statement. We believe naming an individual in the proxy raises some of the same issues as a partner signing the audit report, which we have discussed above on pages 20 and 21.

Recommendation 6. Enhance regulatory collaboration and coordination between the PCAOB and its foreign counterparts, consistent with the PCAOB mission of promoting quality audits of public companies in the United States.

We agree that the PCAOB should coordinate with its foreign counterparts, and we note that it has recently taken positive steps to do this.[76] We believe that the Committee could support these efforts by

[76] *See* PCAOB STRATEGIC PLAN 2008-2013 at 9, 16. *See also* Remarks of PCAOB Member Bill Gradison, "The Case For Converging to a High Quality International Auditing Standard" before the Academy of Accounting Historians and the Public Interest Section of the American Accounting Association (April 11, 20008) ("[I]t is my view that recognizing the negative impact of multiple auditing standards and moving towards a single, high-quality internationally accepted set of auditing standards would be a positive step towards meeting the objective set out in the Preamble of Sarbanes-Oxley: 'To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws'.").

expanding this recommendation to urge the PCAOB to take advantage of its historic opportunity to converge U.S. auditing standards from the outset.

Convergence efforts should not be limited to accounting and financial reporting standards—audit standards must also be converged. The ultimate goal, we believe, should be the development of a single-set of high-quality global auditing standards that are widely accepted and supported. There is a strong case for auditors using the same techniques and methods in all countries to opine on whether public companies' financial statements represent a true and fair view and are free of material misstatement. We believe that the PCAOB should adopt a model of convergence that uses international audit standards as the base, and then adds specific additional requirements the PCAOB finds necessary. True convergence in auditing standards does not just involve the audit standards themselves, but also other professional standards such as ethical and independence standards, as well as enforcement and oversight mechanisms. Such convergence will contribute to enhanced quality and consistency of practice throughout the world, thereby strengthening public confidence in financial reporting and the capital markets.

The PCAOB should also conform its practices on procedural transparency to those of its international counterparts.[77] During a 2001 review of the predecessor to IFAC's IAASB, an independent task force strongly recommended that its business be conducted in a manner of full disclosure to the public.[78] As a result the IAASB has an open process, including permitting public observers at their Board meetings during which substantive issues are deliberated and discussed, thus allowing a first-hand view of the detailed discussions and thoughts of the Board and staff. Increased openness of the PCAOB process along these lines would significantly raise awareness and understanding of Board decisions among interested parties, would facilitate effective and efficient implementation of new requirements, and likely would reduce the number of interpretive questions by constituents.

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If you have any questions or would like to discuss these issues further, please do not hesitate to contact Robert Kueppers at (212) 492-4241. We thank you for your consideration of these comments.

Very truly yours,

/s/ Deloitte LLP

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[77] We note that the processes of the U.S. accounting standard setter—the Financial Accounting Standards Board—also are more transparent than those of the PCAOB.

[78] *See* International Federation of Accountants, *2001 Annual Report*, Comprehensive Review of the International Auditing Practices Committee at 4-5, *available at* http://www.pfadesigns.com/images/pdfs/annual_reports/ifac_annual_report.pdf.

Appendix A

Alternative Incremental Liability Reform Measures

Although the liability reforms described below are only incremental reforms, each could effect some systemic change, thereby helping to lessen the risk of catastrophic judgments. We do not believe that these reforms, individually or in the aggregate, would sufficiently address the catastrophic litigation risk facing the profession, however, and they therefore should not be put forth as a solution to that risk.

Appeal Bonds. In most U.S. courts, a losing litigant who seeks to appeal the judgment against it may obtain a stay of the trial court judgment pending completion of the appeal, but only after posting a supersedeas or appeal bond in the amount of the judgment (plus projected interest and costs, should the litigant lose on appeal). When the trial court judgment is catastrophic, posting a supersedeas bond is, at best, extremely expensive and difficult, and may be impossible if the judgment is sufficiently large. A losing defendant who cannot afford the bond may be forced to declare bankruptcy or settle the case, forgoing that defendant's legal right to an appeal. The mere risk of an enormous judgment without the benefit of appellate review may cause the litigant to settle the case before judgment, regardless of the merits of the underlying case. The *in terrorem* effect of this system is amplified when one considers that a judge's clearly erroneous rejection of a defendant's legal argument cannot effectively be appealed until after the final verdict is rendered. Recognizing the distorted nature of this system, several states have instituted appeal bond caps—13 states at $25 million, and 10 states at $50 million to $100 million—and several other states have capped bonds for punitive damages or for certain defendants (including, for example, small businesses).

Some form of flat or graduated appeal bond cap system could be implemented on the federal level and required of the states. In many states, the appellee has the right to come forward with some proof that the appellant is dissipating its assets in order to justify the imposition of a higher bond requirement. It is possible to fashion a modern, rational appeal bond system that protects the interests of both defendants and plaintiffs. We urge the Committee in its final report to recommend such reform.

Permit Appeals of Motions to Dismiss. As discussed above, the current federal system of civil procedure encourages inequitable treatment of defendants and plaintiffs. That is, a plaintiff is immediately able to appeal the defendant's successful motion to dismiss (as that ends the case with a final judgment on the merits), but a defendant is not able to immediately appeal the denial of that same motion, with the result that the defendant is then forced to incur substantial additional litigation costs, plus the risk of an adverse judgment and the posting of an appeal bond, before the trial court's potentially erroneous legal ruling can be challenged. In reality, the denial of a motion to dismiss will often result in a settlement of the case, which deprives the court of appeals of any opportunity to correct a trial court's erroneous ruling. Giving defendants the opportunity to take an immediate (or "interlocutory") appeal of a denial of a motion to dismiss will ensure that the trial courts are appropriately following the law and will correct the current imbalance between the litigants. We urge the Committee in its final report to recommend this reform.

Bankruptcy Imputation. Audit firms face exposure in cases brought in a bankruptcy regime, where the trustee or receiver of the failed public company may sue the auditor if the failure resulted from an undetected fraud. Often, the auditor's conduct is assessed by a negligence standard (as opposed to a higher recklessness or intentional conduct standard in a suit brought by private litigants). The trustees are typically litigating trusts, paid both hourly and on a contingent basis, which therefore creates both a professional and personal incentive to maximize the audit firm's payout to the bankrupt's estate.

More significantly, these claims often involve insolvency caused by the fraudulent acts of management. Under traditional legal doctrines, a company (or the trustees acting on its behalf) could not recover damages against the auditor when the damages resulted more from management's misdeeds (undertaken for the benefit of the company) than from the auditor's alleged wrongful conduct. Recently, however, some courts have declined to apply this traditional principle, holding instead that management's misdeeds should not be imputed to the company or, even if imputed to the company, then not to the bankruptcy trustee. Thus, some courts have permitted bankruptcy trustees—who are able to sue at all only because they stand in the shoes of the audit client—to avoid any bar to liability arising from management's misconduct.

We believe that the common law imputation approach is the correct one, and that, as a matter of fundamental fairness, a defense that the auditor could have asserted against the company (i.e., that it was management's fraudulent activity that caused any losses) should not be lost simply because management's fraud was sufficiently severe to push the company into bankruptcy. The Committee should recommend that state and federal bankruptcy law be amended to ensure that, when a trustee steps into the shoes of the company in bringing a claim against an auditor, all the defenses that the auditor could assert against the company should be available for assertion against the trustee.

Rule 10b-5. Section 10(b) of the Securities Exchange Act of 1934 prohibits "manipulative or deceptive" conduct. Despite the fact that a plain reading of this standard seems to require specific intent to manipulate or deceive, the federal appeals courts have found that "reckless" conduct is sufficient to meet this standard. As recklessness does not require actual intent, it is often left to a jury to determine the gravity of the defendant's alleged conduct. This judge-made rule risks imposing liability for conduct that Congress never intended to be covered under Section 10(b). The Committee should recommend that the SEC amend Rule 10b-5 to require proof that the defendant had actual knowledge that a statement was materially false or misleading. The amendment could even be limited to private actions, so as not to impinge on the SEC's own anti-fraud authority. As an alternative, the SEC could carefully and specifically define the elements of "recklessness" under the Section 10(b) standard; in so doing, the SEC would provide additional guidance for juries and would permit defendants to move for summary judgment in appropriate cases on the basis of that legal recklessness standard. Such protection, however, would leave open the risk that merely negligent conduct would be deemed reckless by an unknowledgeable jury; a standard that required actual knowledge of a fraud would do much more to protect the profession from conduct that Congress never stated was to be illegal under Section 10(b).

Alternative Dispute Resolution (ADR). The Committee's final report could recommend that the SEC support the use of ADR to resolve claims relating to accounting and auditing issues. By using ADR, the parties can have the benefits of an expert arbitrator in an increasingly complex field, rather than relying on lay juries with no background in these issues. ADR is also less expensive and time-consuming in the discovery stage, and encourages focus on the central issues in the case and settlement when possible. To facilitate ADR, the SEC could make clear that the use of a mandatory ADR provision in an engagement letter with an audit client does not impair independence. The SEC also should 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, underwriters, and lawyers). It would be left up to the companies and their shareholders as to whether to include such provision in their articles of incorporation.