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Mr. Don Nicolaisen
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

June 27, 2008

Comment Letter of Ernst & Young LLP on the Draft Report of the U.S. Treasury Advisory Committee on the Auditing Profession

Dear Mr. Levitt, Mr. Nicolaisen, and Distinguished Members of the Advisory Committee:

Ernst & Young LLP ("EY") is pleased to respond to the request by the U.S. Treasury Advisory Committee on the Auditing Profession (the "Committee") for comment regarding its Draft Report published May 15, 2008[1] and the Structure and Finance Subcommittee addendum published on June 12, 2008 ("Draft Report").

We appreciate the time and effort of the Committee and its staff. As our Chairman, James Turley, stated in his December 3, 2007 testimony before the Committee, we believe wholeheartedly in the work of the Committee to "promote and encourage prosperity and stability by both improving the quality of the audit process and audits and ensuring the viability and resilience of the public company auditing profession."[2]

Many of the recommendations included in the Draft Report are important, worthwhile, and consistent with our previous input. For example, we support the proposal for firms to publish a transparency report consistent with the transparency requirements of the EU Eighth Directive to provide increased public insight into a firm's commitment to audit quality and the way it is governed. We support the proposal for the PCAOB to obtain and evaluate information about the financial resilience, potential catastrophic risks and viability of the firms and profession it regulates in order to inform public policy considerations. We support the adoption by all states of the mobility provisions of the Uniform Accountancy Act. We support harmonization of auditor independence rules established by a variety of regulatory and professional bodies, beginning with a clear understanding of the differences in requirements. All of these proposals are consistent with Mr. Turley's December testimony, as are many other Committee recommendations which we note elsewhere in our comments.[3]

However, many of the recommendations in that testimony are not reflected in the Draft Report and we seek to address them in various aspects of this comment letter. Chief among them, and the principal focus of our commentary, is the insufficiency of the Draft Report relative to the ramifications resulting from the accounting profession's liability crisis.

1 Draft Report for the Advisory Committee on the Auditing Profession, 73 Fed. Reg. 28,190, 28,199 (May 15, 2008)

2 James S. Turley, Chairman and CEO, Ernst & Young LLP, written testimony December 3, 2007, at 1.

3 Id.

Thus, before offering our comments on the Committee's specific recommendations in the Draft Report, we begin by emphasizing the critical nature of the catastrophic litigation risk faced by audit firms. In our view, the Draft Report does not adequately assess or address the accounting profession's most significant threat to its overall business model—the catastrophic risk arising from the U.S. litigation system. In doing so, we offer evidence from submissions and testimony received by the Committee, as well as independent reports, that illustrates the seriousness of this risk, and the need for the Committee to address it in order to fulfill its mandate to "develop recommendations relating to the sustainability of the auditing profession."

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The Committee Must Address the Catastrophic Liability Risk—It Is Real and the Collapse of Another Firm Would Have Grave Consequences

To fulfill its charge, the Committee must take action on the issue of catastrophic liability risk. In our litigation related comments that follow, we review the input received by the Committee related to the severity of the threat, as follows:

- The threat is real:
  - The quantitative evidence shows that the firms' liability exposure far exceeds their financial capacities
  - Numerous witnesses support this position
  - The European Commission, as well as panels and commissions in this country, have reached similar conclusions
  - The liability risk leads to greater concentration and less competition among the firms and undermines the firms' ability to attract the highest caliber personnel
- A collapse would have grave consequences:
  - At some point, a major firm is likely to collapse from the weight of litigation, a result that would cause significant damage to capital markets and investor interests
- Action must be taken:
  - Liability caps are needed at the mega-claim level
  - Other incremental reforms to address the liability crisis should also be considered, including the Committee's recommendations

The Committee has received a great deal of input on catastrophic litigation risk. Many diverse parties have expressed concerns regarding the risks posed to markets and investors, the inability of firms to take cases to trial in light of the size of the claims, the impact on personnel retention, the uninsurability of firms relative to catastrophic claims, the impact of litigation risk on profession concentration and competition, and the impact on the competitive and leadership position of the United States in a dynamic global market.

Notwithstanding the considerable evidence before the Committee regarding the seriousness of this risk, the Structure and Finance Subcommittee appears unable to agree amongst its members on relatively modest and incremental reforms recently under their consideration. Furthermore, while the Concentration and Competition Subcommittee has advanced a proposal that may have a salutary effect in certain situations, it would not directly address catastrophic litigation risk—the "mega-claims" that threaten the future of private sector public company auditing in the United States.

We urge the full Committee to address this issue. We note the challenging comment of Committee Co-Chair Nicolaisen at the June 3, 2008 meeting, "If litigation catastrophic risk by itself is an important topic to the Committee, then the Committee members should speak up to that, because at the subcommittee level there has not been an ability to identify what that solution would be."[4]

As the Committee considers modifications to its Draft Report, we encourage its members to utilize the considerable record that has been put before the Committee and to speak out in support of recommendations regarding catastrophic litigation risk.

At the end of the day, it may well be that the Committee will not be able to reach a consensus on precisely what can, or should, be done about the problem. However, that should not prevent the Committee from, at a minimum, describing the input it has received, observing the relevant global developments, and recommending further consideration and action by appropriate government authorities to protect the interests of participants in U.S. and global capital markets.

Witnesses agree that sustainability of the profession is central to the Committee's efforts.

Many witnesses spoke to the central importance of the Committee addressing this risk.

- "The ability to deal with the withdrawal of one of the major firms is, in my view, absolutely the top issue you should deal with."[5]

  —Paul Boyle, Chief Executive of the UK Financial Reporting Council

- "Could the market sustain another loss? I would say no."[6]

  —Brian O'Malley, Senior Vice-President and General Auditor, NASDAQ

- "[W]e find the seeming hesitancy by the Committee to speak unequivocally and emphatically about the unlimited liability threat to run counter to the Committee's efforts to address the long-term sustainability of private sector auditing."[7]

  —Barry Matthews, Executive

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4 Don Nicolaisen, Co-Chair, Treasury Advisory Committee on the Auditing Profession, webcast of June 3, 2008 Advisory Committee public meeting, at 7h:22m. We note that this quote, as well as other quotes from the June 3, 2008 meeting are based on our transcription of the archived webcast.

5 Paul Boyle, Chief Executive of the Financial Reporting Council, United Kingdom, transcript of December 3, 2008 Advisory Committee public meeting, at 189.

6 Brian O'Malley, Senior Vice-President and General Auditor, NASDAQ Stock Market, webcast of June 3, 2008 Advisory Committee public meeting, at 5h:20m.

7 Barry Matthews, Executive Committee Member, Aon, written testimony June 3, 2008, at 2.

- "There are a number of pending cases where accounting firms face damages sought in the billions of dollars. And when punitive damages are added, a judgment can be a multiple of the plaintiff's proved loss. In these situations the size of the trial court's judgment may not only be beyond the firm's ability to survive, but may cripple an audit firm's ability to obtain an appeal bond, and that's not fair or appropriate. That's why the largest accounting firms may be well capitalized; even they cannot survive excessive civil judgments."[8]

  —Lewis H. Ferguson III, Gibson Dunn & Crutcher LLP, and former PCAOB General Counsel

- "[T]he availability of high quality independent audit is taken for granted in the economy just as much as the availability of electricity or clean water. And this is important not just for the securities markets, but for other sectors of the economy, too. Now, it would be possible to contemplate an economic model in which high quality independent auditing was not available. But it would be significantly less efficient that the current model. And an interruption to supply of audit would be as damaging as the interruption to the supply of electricity or clean water. Now, there are a large number of events which could trigger a disruption in the supply, however in my judgment the most serious risk is the possible withdrawal, either voluntarily or involuntarily of one of the major firms from the market."[9]

  —Paul Boyle, Chief Executive of the UK Financial Reporting Council

- "No firm has—or can purchase—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."[10]

  —Kathryn Oberly, Vice Chair and General Counsel, Ernst & Young LLP

The European Commission is acting on the issue.

In addition to the testimony before it, the Committee's considerations should be informed by recent actions by the European Commission ("EC") relevant to market risks resulting from unlimited profession liability.

On June 5, 2008, the EC issued a recommendation on limiting auditors' civil liability which "aims to protect European capital markets by ensuring that audit firms remain available to carry out audits on companies listed in the EU."[11]

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[8] Lewis H. Ferguson III, Gibson Dunn & Crutcher LLP, and former PCAOB General Counsel, transcript of December 3, 2007 Advisory Committee public meeting, at 151-152.

[9] Paul Boyle, Chief Executive of the Financial Reporting Council, United Kingdom, transcript of December 3, 2007 Advisory Committee public meeting, at 142-143.

[10] Kathryn Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, written testimony June 3, 2008, at 6.

[11] Press Release, The European Commission, Auditing: Commission issues Recommendation on limiting audit firms' liability (6 June 2008), *available at* http://ec.europa.eu/internal_market/auditing/liability/index_en.htm#recommendation.

The EC explained its rationale as follows:

> Liability reform is an international issue where Member States should take action. It is in the public interest to ensure sustainable audit capacities and a competitive market for audit firms at international level. In the light of the current audit market structure, liability risks arising from the increasing litigation trend combined with insufficient insurance cover may deter auditors from providing audit services for listed companies. If these structural obstacles (liability risks/lack of insurance) persist, mid-tier audit firms are unlikely to become a major alternative to the "Big 4" audit networks on European capital markets. But there is also a risk of losing some of the existing players. One of the reasons might be that catastrophic claims cause the collapse of one of the major audit networks.[12]

The EC believes that strengthening regulatory supervision diminishes the need for private litigation as a means of maintaining audit quality:

> [A]udit regulators—not judges or courts—will in future play a pivotal role in maintaining the high audit quality which companies and investors deserve. In this regard, in addition to the requirements of the recent Directive on Statutory Audit, the Commission adopted on 6 May 2008 a Recommendation strengthening the robustness and independence of inspections of firms auditing listed companies. Such regular inspections provide better guarantees for the quality of the audits compared to unlimited civil liability rules which constrain access to this highly concentrated market. Audit quality should be driven more by sound regular inspections whilst liability should complement such efforts but not make the audit business unattractive.[13]

The EC also noted there are practical limits on liability that are based on a firm's ability to pay:

> Even without any existing method of limiting liability, the expectations of third parties to obtain compensation face practical limits, corresponding to the financial capacities of the audit firms. In this respect, the advantage of limiting auditors' liability would be that the rules are fixed in advance and hence potential plaintiffs would not expect audit firms to be able to compensate them for unlimited amounts.[14]

As Internal Market and Services Commissioner Charlie McCreevy said: "After in-depth research and extensive consultation, we have concluded that unlimited liability combined with insufficient insurance cover is no longer tenable. It is a potentially huge problem for our capital markets and for auditors working on an international scale."[15]

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[12] The European Commission, Commission Recommendation on limitation of auditors' liability: Frequently asked questions (6 June 2008), at 1, *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/366&format=HTML&aged=0&language=EN&guiLanguage=fr.

[13] Id. at 2.

[14] Id. at 3.

[15] Press Release, The European Commission, Auditing: Commission issues Recommendation on limiting audit firms' liability (6 June 2008), *available at* http://ec.europa.eu/internal_market/auditing/liability/index_en.htm#recommendation.

Mr. McCreevy further noted that the conditions of unlimited and uninsured liability are "not only preventing the entry of new players in the international audit market, but are also threatening existing firms." This "could lead to damaging consequences for European capital markets," he said.[16]

Reform is in the public interest.

It would be a disservice to U.S. capital market stability and the public interest if the Committee, whose mandate is to examine ways of "ensuring the viability and resilience of the public company auditing profession," were to sidestep what many others believe is the most significant threat to the profession's sustainability. We respectfully submit that the evidence before the Committee on these points is overwhelming. Below, we review much of this evidence and make specific recommendations, including recommending that appropriate regulatory authorities should undertake additional information gathering and analysis to inform public policy considerations.

Before doing so, we would like to emphasize several points:

- First, we do not believe that needed liability reforms run counter to the deterrence goals that underlie the antifraud provisions of the federal securities laws or similar state laws. We agree with investor advocates and others who argue that private enforcement of the securities laws can have a salutary effect on accountants in the performance of their professional duties, and we are not advocating that private plaintiffs be denied access to the courts. But, given the strengthened regulatory and inspection regime created by the Sarbanes-Oxley Act and similar measures in other countries, the imposition of catastrophic risk on the profession is simply not needed in order to achieve appropriate deterrence. As the EC recently commented, "Audit quality should be driven more by sound regular inspections whilst liability should complement such efforts but not make the audit business unattractive."[17] With the independent regulatory and inspection regime now in effect, the current private enforcement rules in the U.S. need substantial reform.

- Second, we believe that reforms would be in the best interest of the U.S. capital markets, making the markets more consistent with their global counterparts, protecting U.S. interests through a robust domestic private sector auditing function, and facilitating global integration of the accounting firms. As Committee member Alan Beller noted during the Committee's June 3 hearing, the accounting firms are increasingly becoming more integrated, moving towards "real global operating entities that function as single entities with single systems of corporate governance." He stated: "It is 100 percent certain to me . . . 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

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[16] Id.

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

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?"[18] We believe Mr. Beller's question poses a fundamental challenge to the Committee.

- Third, we believe that reforms are also in the best interests of U.S. investors and market stability. The collapse of another major accounting firm due to litigation—a question of when, not if unless something is done—would be seriously disruptive to investors' interests by endangering the existence of the private sector audit function. In our view, the overriding public policy issue is a question as to how investors' and the public interest are best served. Is the public interest best served by the current unlimited liability system wherein a single class of plaintiffs can maximize their recovery, but by doing so cause the permanent loss of an audit firm which provides valuable services to the public? Or is the public interest best served by imposing a liability limit which allows a particular class of investors or other plaintiffs to obtain substantial recovery, but in an amount that allows the audit firm to continue its provision of services upon which the public, markets, and economy rely? As it relates to the accounting profession, the current U.S. liability system makes the peculiar interests of a limited number of individuals paramount, risking denial of the broader interests of the general public. We believe remedying this situation is the overriding public policy challenge before the Committee and one it is insufficiently confronting.

The threat is real: the quantitative evidence shows that the firms' liability exposure far exceeds their financial capacities.

Accounting firms that perform public company audits are organized as private partnerships, as required by state law. Those who are not partners in these firms have not generally been privy to detailed financial and litigation information that would demonstrate the threat that large litigation exposures pose. To demonstrate this threat and inform the Committee's considerations, the six largest auditing firms provided significant amounts of financial and other data relating to liability issues to the Committee.[19]

The data clearly demonstrates an enormous liability threat to the profession. The six largest auditing firms were named as defendants in 90 pending lawsuits with potential claims in excess of $100 million ranging to $10 billion.[20] The aggregate of potential claims in these 90 lawsuits is more than $140 billion. Included in the 90 lawsuits are 41 lawsuits with potential damages in excess of $500 million, 27 with potential damages in excess of $1 billion, 21 with potential damages in excess of $2 billion each, and 7 with potential damages in excess of $10 billion each.[21]

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[18] Allan Beller, Partner, Cleary Gottlieb Steen & Hamilton LLP and former Director of the Division of Corporation Finance, U.S. Securities and Exchange Commission, webcast of June 3, 2008 Advisory Committee public meeting, at 4h:25m.

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

[20] See Supplemental Report.

[21] Id.

No firm could withstand judgments at the height of these levels. Neither insurance coverage, nor capital nor earnings would be adequate to fund the size of such claims.

Insurance: Insurance for these lawsuits does not come close to covering the firms' litigation exposure. Insurance broker Aon provided a detailed description of this situation, attached as Appendix C to the January 23 Report from the firms. Aon observed that commercially available insurance is "becoming somewhat irrelevant" with a growing number of claims exceeding insurance limits by ever-increasing margins. Aon estimated that the total costs incurred in the settlement of some recent claims—far less than the potential damages claimed in many pending cases—are suspected to be "three to four times" the amount of available insurance coverage.[22]

Here is Aon's summary of the situation:

> The loss experience of the Big 4 US accounting firms has been such that sufficient commercial risk transfer insurance limits are unavailable to protect these firms from the frequency and severity of professional liability claims that can be anticipated, given the recent claims experience of their clients and others. The limits available are, in the views of actuaries and other experts we have consulted, insufficient to pay the possible maximum losses to which major accounting networks are subject. This severely constricted market has required that these firms increasingly rely on "self-help" measures to fund their professional indemnity risk, consisting primarily of substantial each claim deductibles and network captive insurers. It is apparent that the self funded, "network" captive insurance programs have insufficient capital to support the underwriting of the limits that would be required to protect these firms. These self-help measures have resulted in risk financing mechanisms that require accounting firms that are part of an international network to share available limits of liability with each other. The unfortunate result of this is that member firms do not have their "own" insurance limits and may well find that the coverage capable of being underwritten in the captives has been exhausted by claims made against other members of the network that were presented, and paid, in an earlier timeframe.[23]

Peter Christie, an insurance broker and advisor at Friemann Christie LLC, testified to the Committee as follows:

> The problem with professional liability claims arising from audits of the world's largest companies is that there is no ability to realistically compute either the amount of a possible future claim or the likelihood of it happening. At the same time few will believe such mega claims cannot happen, and indeed most would speculate it is only a matter of time before they do. I believe that if one fixed a figure of insurance protection that would ensure, or materially enhance, the probability of a firm surviving one or a number of such events the amount of insurance required would exceed the risk capacity of the insurance markets, by multiples.[24]

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[22] See *Big 4 US Professional Indemnity Insurance Programs* (Aon), at 3, attached as Appendix C to the January 23rd Report.

[23] Id. at 1.

[24] Peter Christie, insurance broker and advisor, Friemann Christie, LLC, written testimony December 3, 2007, at 2.

Partner capital: The six largest audit firms' partner capital totals approximately $5.8 billion, in the aggregate, or $964 million each on average.[25] However, this figure includes $2.1 billion in undistributed earnings, or an average of approximately $348 million per firm. Thus, on a per firm basis, the average amount of partner capital contributions is approximately $663 million, in the aggregate, or approximately $418,000 per partner.[26] This would generally not be enough money to satisfy many "mega-claim" judgments, and, in any event, such a payment would exhaust the firm's capital. For many partners, their capital contribution is their largest asset. At some point—depending on the level of capital erosion and the risk of repeat occurrences—partners will leave the firm and the profession.

Partner earnings: The amount of partner earnings or profitability for the six largest firms' most recent fiscal year was approximately $7.4 billion, in the aggregate, while earnings on a per firm basis stood at $1.24 billion, or $780,000 in pre-tax earnings per partner.[27] The entirety of a firm's annual earnings would not satisfy an adverse judgment entered against a firm in many "mega-claim" lawsuits. Furthermore, Korn Ferry's executive compensation analysis, provided as an appendix to the firm's January 23 data submission, shows compensation is two to three times as much in alternative careers competing for partner talent.[28] At some point, depending on the level of earnings erosion and the risk of repeat occurrences, partners will leave the firm and the profession.

The previously noted comments of EY's Vice Chair and General Counsel, Kathryn A. Oberly, aptly summarize the situation as follows: "[N]o firm has—or can purchase—insurance coverage for the largest of claims. No firm has the capital to pay the largest of claims. And no firm could retain partners while slashing future earnings by an amount necessary to pay the largest of claims."[29]

Numerous witnesses addressed the threat of "mega-claims."

The Committee's Report should reflect the testimony of the many witnesses who commented on the litigation crisis faced by the profession.

Many statements addressed the overall problem. For example, EY Chairman James Turley stated: "The unlimited, uninsured, and potentially catastrophic top-side liability risk facing firms in the U.S. threatens the long-term sustainability of private sector auditing of public companies. Because of this, it should be a concern not just to the U.S. but to the global economy."[30]

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[25] See January 23 Report at 24 (showing $964 million partners' capital per firm).

[26] See January 23 Report at 25 (showing $418,365 as the average capital contribution per partner as of the most recent fiscal year end).

[27] See January 23 Report at 25-26 (showing $780,051 the average pre-tax per-partner compensation).

[28] See *Assessment of Audit Partner Compensation vs. Alternative Careers*, Executive Compensation Advisors (Korn/Ferry) (January 18, 2008), attached as Appendix B to the January 23rd Report.

[29] Kathryn Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, written testimony June 3, 2008, at 2.

[30] James S. Turley, Chairman and CEO, Ernst & Young LLP, written testimony December 3, 2007, at 12.

Similarly, Barry Matthews, the Deputy Chairman at Aon, made the following statement:

> Assuming the Committee is in agreement on the importance of private sector public company auditing to the capital markets, investors and the economy, I urge you to be unequivocal and emphatic on the need for policymakers to address the unlimited nature of litigation risk. As I stated at the outset, at no time have we encountered a situation in which there existed as substantial a threat to the continued viability and sustainability of the audit firms as that created today by the potential for mega professional liability claims brought in US courts.[31]

Along these lines, several witnesses made the important point that the enormity of the liability risk means that, first, firms cannot really afford to chance litigating the "mega-claim," and second, if it becomes impossible to settle such a claim, the firm will be unable to survive an adverse judgment.

EY Vice Chair and General Counsel Kathryn Oberly said the following in her testimony:

> I want to be clear about what keeps me up at night. It is not the run-of-the-mill lawsuit which, rather shockingly, in my world means a lawsuit with potential exposure for anything less than, says, 50 or 100 million dollars. We understand that auditing carries a risk of lawsuits, and, like other sectors of the economy, we understand that we will inevitably have liability exposure. The real issue is uninsurable catastrophic risk. It is the mega-case—for our firm, a lawsuit for $500 million, or a billion dollars, or two billion dollars or more—that prompts me to toss and turn. These cases are very difficult to settle, and yet we generally have no choice if we can't get them dismissed on motion. It would be quite foolhardy for us to go before a jury on a "bet-the-firm" case. I worry too much about the well-being of my 2400 Ernst & Young U.S. partners, and of their spouses and their children, and the well-being of our 30,000 employees, to rely entirely on the hope that a jury of laypersons will understand the complexities of claims asserted against us and the validity of defenses when the survival of the firm is at stake.[32]

Michael Young, a partner at Willkie Farr and Gallagher in New York who represents accounting firms in litigation, made the same point: "The problem for the auditing profession in a large-scale securities class action is that it simply cannot accept the inherent risk of losing at trial. The damages are just too high."[33]

Moreover James Doty, former SEC General Counsel and a partner at Baker Botts LLP, stated:

> I think the gaming of the system of litigation involves threatening the existence of the firm or creating demands in negotiating which are now not really subject to anything more than the clash of parties in litigation… The compensatory system is now

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[31] Barry Matthews, Executive Committee Member, Aon, written testimony June 3, 2008, at 3.

[32] Kathryn Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, written testimony June 3, 2008, at 5.

[33] Michael R. Young, Partner, Willkie Farr & Gallagher LLP, written testimony June 3, 2008, at 1.

focused on whether or not a firm can afford to fight. And I am simply respectfully suggesting that's the wrong emphasis…. The risk is that one day we'll have a public accounting board and no accounting firm.[34]

Finally, Professor James Cox of Duke University explained the situation in this fashion:

> There are really two things [ ] in the liability regime that's going on. One is catastrophic liability because you have huge clients and melt down, et cetera. And what's going to happen in those cases is that no one would ever take those to trial. And so once you accept that, then the other thing steps in and that is as long as you have proportionate liability of a large cap firm, it's always going to have catastrophic proportions to you and you'll always settle. And you'll never be able to have your "day in court" defending on those rights. And so to some extent caps would be a way of trying to even the playing field a little bit. You know once the complaint has withstood the motion to dismiss, there really isn't when you have a large cap issue much choice for the defendants other than to settle the case.[35]

Other groups, panels, and commissions have decisively concluded on the threat and need for litigation reform.

The Committee should recognize that the profession's liability crisis has been widely acknowledged by others who have examined the issue. An outline of their conclusion follows.

The London Economics Group Study, Prepared for the EC: The EC's Recommendation noted above flows from an independent study on the economic impact of current auditors' liability regimes and on insurance conditions in EU Member States. According to that January 2007 study, performed by the London Economics Group:

- The current concentration and lack of choice in the audit market would be exacerbated further if one of the Big 4 were to collapse. This could result in a major increase in the audit fees for listed companies.

- The huge liability risks might make the audit profession less attractive.

- The adjustment to a Big 3 market structure would be very challenging. The completion of statutory audits might be delayed, especially if the failure occurred close to the company's year end.

- Financial institutions could face more serious transition problems because the special skills their audits require might severely restrict their range of choice for a new auditor.

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[34] James Doty, former General Counsel of the U.S. Securities and Exchange Commission, transcript of December 3, 2007 Advisory Committee public meeting, at 96, 108, 135.

[35] Professor James D. Cox, Duke University, transcript of December 3, 2007 Advisory Committee public meeting, at 259-260.

- The overall cost of capital is unlikely to be directly affected even if audit fees increase sharply because the share of audit fees in total operating costs is small. But the cost of capital could be affected indirectly if the loss of one of the Big 4 were to make investors lose confidence more generally in capital markets.

- Given the limited availability of insurance and the large claims faced by all Big 4 firms, a second major audit network could also fail at the same time. A scenario in which the international audit market is dominated by only two firms is as realistic as the Big 3 scenario. In this situation, investor confidence would fall significantly and capital markets would probably react much more negatively than in the case of the disappearance of one major network.

- There is currently no possibility for mid-tier firms to enter the international audit market in a meaningful way. There are no prospects that this will change in the near future.[36]

The Schumer-Bloomberg Report: On January 22, 2007, New York City Mayor Michael Bloomberg and New York Sen. Charles Schumer released a report outlining regulatory, legal, and accounting changes they believe are necessary to maintain the city's status as a leading global financial center. The report, prepared by McKinsey & Co., stated among other things:

> [I]mposing a cap on auditors' damages for securities-related infractions that is sufficient to deter wrongdoing in accounting would also lessen unnecessary and costly risk-averse behavior on the part of auditing firms. It would do so by making auditing firms once again insurable, which would have the added benefit of reducing the likelihood that the highly concentrated US auditing industry will lose another major player.[37]

Committee on Capital Markets Regulation—Interim Report: The Interim Report from the Committee on Capital Markets Regulation was released November 30, 2006. The committee is an independent group of U.S. business, financial, investor, legal, accounting, and academic leaders. The Committee concluded that U.S. capital market competitiveness can be improved by reducing excessive regulation and litigation, and by refocusing on the needs of shareholders. It stated:

> Currently there are more than three dozen pending suits involving tens of billions of dollars of claimed potential damages. Claims under state law also seek recoveries of billions of dollars. This liability exposure substantially exceeds the combined partner capital of the Big Four firms. Any future lawsuits would only aggravate the exposure problem. Large audit firms self-insure because third party insurance is unavailable…

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[36] Directorate General for Internal Market and Services, Commission Staff Working Paper: Consultation on Auditors' Liability and its Impact on the European Capital Markets 9-10 (2007).

[37] Mayor Michael Bloomberg & Sen. Charles Schumer, Sustaining New York's and the US' Global Financial Services Leadership 102 (2007), available at http://www.schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf.

> The United States and the rest of the world are highly dependent on audit firms. They play a key role in ensuring the integrity of financial statements and the effectiveness of internal controls of public companies. The demise of another U.S. audit firm would impose huge costs to U.S. shareholders. Also, the prospect of catastrophic liability can have a significant impact on auditing costs through the adoption of overly conservative practices. Taken to an extreme, these practices will continue to impact the competitiveness of the U.S. markets versus say, the European Union, even when worldwide accounting principles converge.
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> There are various approaches Congress could take in addressing this problem. One would be to create a safe harbor for certain defined auditing practices. Another approach would involve setting a cap on auditor liability in specified circumstances, an approach that some European countries already take and that the EU Commissioner for Internal Markets, Charlie McCreevy, has recommended that the EU pursue. Any protection from catastrophic loss should be premised on a firm's satisfying minimum capital levels as a condition for receiving this protection. After all, the purpose of this protection is removing the risk of catastrophic loss, not all liability.
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> Preventing damage awards against audit firms and their employees at a level that could destroy a firm would allow insurers to reenter this market. Insurance would be in the interest of both audit firms and shareholders. It would allow audit firms to price risk and create a source of recovery for shareholders.[38]

U.S. Chamber of Commerce—Auditing, a Profession at Risk: A white paper from the U.S. Chamber of Commerce entitled, *Auditing, a Profession at Risk*, was released in January 2006. The report was intended to promote awareness of the legal environment affecting the profession and to stimulate discussion by policy makers and business leaders. Among other things, it stated:

> The auditing profession faces a number of significant legal challenges… [T]he profession finds itself the target of a difficult litigation and regulatory enforcement environment, where business losses by a client can result in lawsuits and a single indictment—even without a conviction—could result in the destruction of thousands of jobs.[39]
>
> [A]ny further contraction in this industry would present a major challenge to the viability of the profession, with potential for a negative effect on public confidence in our markets. William McDonough, former chair of the PCAOB, was quoted as saying "None of us [regulators] has a clue what to do if one of the Big Four failed." He also said that if one of the Big Four were to collapse, the best accountants could choose to quit the profession.[40]

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[38] *Interim Report of the Committee on Capital Markets Regulation* 87-89 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

[39] U.S. Chamber of Commerce, *Auditing: A Profession at Risk* 4 (2006), *available at* http://www.uschamber.com/NR/rdonlyres/ewj43d74z5pemtshnkdi3fvko6azefuio2npyjeicyanm3hj4spkg7ivliac62faaieqewp4vdktk4ozqfv4ucilwpe/0601auditing.pdf.

[40] Id. at 5.

> Losing another auditing firm—or making auditing so unattractive that firms or their partners no longer want to provide the service—would have very negative consequences for the U.S. capital markets and the U.S. economy as a whole.[41]

The American Assembly—The Future of the Accounting Profession: Auditor Concentration: A report issued by The American Assembly in May, 2005, identified and described key issues put forth by fifty-three leaders from the worlds of accounting, finance, law, academia, investment banking, journalism, and corporate board members and audit committee chairs during a discussion regarding concentration in the audit profession. The report, a follow up to the 2003 report *The Future of the Accounting Profession*, stated in part:

> The current degree of concentration in the profession raises the specter that the collapse of a Big 4 firm would be a threat to the continued existence of the profession. An audit environment with only three large firms may be too small a number to maintain audit quality and independence, and any event that causes another firm's collapse would automatically call into question the viability of the survivors. [42]
>
> The consequences of losing another member of the Big 4 to civil and/or criminal litigation could potentially include the end of the public company audit profession.[43]
>
> The current pattern of litigation involves huge claims…the extent of which prevents firms from even bringing their cases to trial, forcing them to settle to avoid potentially debilitating damages. Jury trials pose a significant hurdle for defendants, as the complex, technical issues that fraud and other cases often involve are difficult to explain to those with limited financial background, especially in the face of unrelenting publicity and sympathetic plaintiffs.[44]
>
> Moreover, there is no potential for a functional insurance product to deal with the problem of excessive litigation. While insurance covering routine business risks is available, the Big 4 are essentially unable to obtain any catastrophic risk coverage. Catastrophic risk is so unpredictable, akin to lightening striking, that it is nearly impossible to determine what premium to charge.[45]

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[41] Id. at 19.

[42] The American Assembly, *The Future of the Accounting Profession: Auditor Concentration* 15-16, available at www.americanassembly.org/programs.dir/prog_display_ind_pg.php?this_filename_prefix=AUDIT&this_ind_prog_pg_filename=report.

[43] Id. at 16.

[44] Id. at 19.

[45] Id.

The liability burden leads to greater concentration and less competition among the firms and undermines the firms' ability to retain the highest caliber personnel.

Several of the studies noted above have raised concerns about the competitive impact of the liability crisis. The point seems self-evident: the greater the risk of "mega-claims," the less interest mid-tier accounting firms will have in pursuing large public audit clients. Witnesses before the Committee confirmed that point as follows:

- "The single most significant deterrent to many accounting firms taking on more public company audits is liability…. In our current litigation environment, many firms may decide that the risk/reward equation is simply out of balance, and they are therefore unwilling to expand their public company audit practices in any meaningful way."[46]
- "We believe a limitation of the dollar amount of professional liability claims, such as a multiple of audit engagement fees, would encourage more firms to expand their public company audit practices, be less conservative in their client acceptance, and be more willing to audit larger public companies."[47]
- "[T]oday large accounting firms find themselves unable to obtain insurance to protect themselves against such catastrophic judgments. And while I'm not an insurance expert, I know that insurance for these types of civil judgments is simply not available. Insurers perceive the risk as too great. Such risks help explain why many smaller firms decide not to try to enter the ranks of the largest accounting firms."[48]

Witnesses also described the human resource impact of the liability exposure. For example, Julie Wood, Chief People Officer, Crowe Chizek and Company LLC, stated, "I hope policymakers will also help us retain quality people in the profession by finding ways to reduce the professional risks that may drive veteran auditors out of the profession early."[49]

At some point, a firm is likely to collapse from the weight of litigation, which would cause significant damage to the nation's capital markets.

The litigation data and testimony discussed above makes clear the extent of doubt as to the sustainability of the major accounting firms, a concern that is consistent with the overwhelming consensus of experts who have examined the issue.

The major risk, as Ms. Oberly described it, is that "either by design or by miscalculation, a plaintiff may demand a settlement payment a firm cannot afford, leaving no option other than trial. A jury could easily return a verdict much larger than what the audit firm could afford to pay."[50] This is

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[46] Neal Spencer, Managing Partner of BKD LLP, written testimony February 4, 2008, at 3,4.

[47] Id. at 4.

[48] Lewis H. Ferguson III, Gibson Dunn & Crutcher LLP and former PCAOB General Counsel, transcript of December 3, 2007 Advisory Committee public meeting, at 152.

[49] Julie Wood, Chief People Officer, Crowe Chizek and Company LLC, transcript of December 3, 2007 Advisory Committee public meeting, at 27.

[50] Kathryn Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, written testimony June 3, 2008, at 6.

because, as discussed above, neither insurance, nor capital, nor partner earnings would be sufficient to withstand a “mega-claim” legal judgment. This would almost certainly result in the collapse of the firm as clients look elsewhere for audit services and partners leave with them.

Even more seriously, it is likely that many partners would decide to leave the profession altogether. Charles W. Gerdts, the General Counsel of PricewaterhouseCoopers, addressed this broader concern during his testimony. He described the situation where the collapse of another major firm would have a “domino effect” on the remaining firms: “[S]ome of your leading engagement partners [would] say 'I'm done with this’ because as we all know the leading engagement partners in the audit practice are the people who are going to be the most desirable and therefore have the most opportunities to go into things like industry.”[51]

It seems unlikely that partners who leave a distressed firm—whether by choice or due to its demise—would choose to join another public company audit firm that is exposed to the same risk of lawsuits that resulted in the loss of his or her capital in the original firm. At some point, partners will not be willing to reinvest their finances and economic future in a distressed firm, or in another firm with the same financial exposure. As Mr. Turley testified during the December 3, 2007 hearing, “[T]here's been a lot of discussion today of moving from four firms to three. My big fear is that that would never happen—that the people in the other three firms would say this is not a profession that I want to stay in, and would actually see an unwind from four to a government audit sector."[52]

Moreover, as the Korn/Ferry compensation analysis that the firms provided to the Treasury Committee shows, there are alternative careers competing for talent where compensation is much higher.[53]

Action must be taken: liability caps are needed to address the “mega-claim” risk.

As Ms. Oberly testified, the only solution that directly and substantially addresses the catastrophic risk issue is some type of liability limitation or cap. A cap could be established through a fairly straightforward multiple of the registrant’s audit fees. This could be coupled with a maximum “not to exceed” amount, calculated without regard to the particular registrant’s fee multiple, based on a larger multiple of the mean or median fee for the size category of registrant that includes the company in question.

Obviously, a determination of the precise amount of the cap and other considerations to make it effective would need to be addressed by policymakers.[54] Setting the cap in order to address the risk

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[51] Charles W. Gerdts, III, General Counsel, PricewaterhouseCoopers LLP, webcast of June 3, 2008 Advisory Committee public meeting, at 6h:11m.

[52] James S. Turley, Chairman and CEO, Ernst & Young LLP, transcript of December 3, 2007 Advisory Committee public meeting, at 229.

[53] See *Assessment of Audit Partner Compensation vs. Alternative Careers,* Executive Compensation Advisors (Korn/Ferry) (January 18, 2008), attached as Appendix B to the January 23rd Report.

[54] A cap should apply to all categories of private legal claims against a PCAOB-registered auditor arising out of audits of public companies filed with the SEC or with other federal agencies. Additionally, a single cap should apply to all claims arising out of a single audit or set of related audits. Claims arising out of a “common nucleus of operative facts” the—language used by insurers to define single “claim” would provide precedent here.

of “mega-claims” would seem to make such a proposal much less controversial than is sometimes believed. Indeed, at the Committee’s hearing on June 3rd, a strong investor advocate, Rex Staples, the General Counsel of the North American Securities Administrators Association, stated after the issue was raised by Ms. Oberly: "That brings up the idea of caps. Am I in favor of caps? Sure. I am in favor of caps. But it has to be at a catastrophic level."[55]

A liability cap designed to address “mega-claim” risk would not undermine, even in the slightest, the deterrence goals of the existing litigation regime. Ms. Oberly addressed this point as follows:

> The U.S. regime of private litigation is generally defended based on a deterrence argument—the theory is that private lawsuits are a “necessary supplement” to SEC enforcement. But the current regime of PCAOB and SEC inspections and enforcement cases by itself provides deterrence to poor auditing, and even more deterrence exists when such regulatory actions are coupled with some level of private enforcement. The question is whether any deterrence is added by keeping a nuclear bomb in the arsenal. I do not think it can plausibly be said that an auditor will do a good job auditing only when there is a threat of a multi-billion dollar lawsuit, and he or she won’t do such a good job when the liability threat is quite real but at an amount that the accounting firm can actually withstand.[56]

The view expressed by Ms. Oberly is much like that stated by Richard Fleck, Chairman of the UK Auditing Practices Board and Member of the Financial Reporting Council, the UK accounting profession oversight body. He stated to the Committee:

> [T]here needs to be a balanced approach to liability reform that would ensure appropriate financial exposure, which is proportionate to ensure the necessary self-interest in quality on the part of the audit profession, but which on the other hand would remove a level of exposure that is unlimited and wholly unrealistic, but more importantly has the potential to destroy firms that are critical to the effective operation of our financial and commercial markets.[57]

We recognize that the Committee heard some contrary views. In particular, John P. Coffey, a prominent plaintiffs’ attorney, testified that “[a]rtificially limiting auditor liability would reduce auditor accountability, reduce audit quality, and ultimately harm the capital markets as investor confidence in the accuracy and transparency of financial statements is called into question.”[58]

But what is the basis for his conclusion? The only conceivable empirical basis offered by Mr. Coffey (and others who express a similar view) is an assertion that audit quality declined after enactment of the Private Litigation Securities Reform Act of 1995 (“PSLRA”). We do not think that is true, but even

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[55] Rex Staples, General Counsel, North American Securities Administrators Association, webcast of June 3, 2008 Advisory Committee public meeting, at 3h:22m.

[56] Kathryn A. Oberly, Americas Vice Chair and General Counsel, Ernst & Young LLP, written testimony June 3, 2008, at 8.

[57] Richard Fleck, Chairman of the UK Auditing Practices Board and Member of the Financial Reporting Council, transcript of February 4, 2008 Advisory Committee public meeting, at 113-114.

[58] John P. Coffey, Partner, Bernstein Litowitz Berger & Grossmann LLP, written testimony January 22, 2008, at 8.

if it were, the argument overlooks the monumental changes made by the Sarbanes-Oxley Act. Most significantly, it overlooks the creation of the PCAOB—a new regulatory body with a budget exceeding $100 million per year, with a substantial and skilled staff, and with broad statutory authority over the accounting profession. The PCAOB conducts annual inspections of the major accounting firms and has sweeping enforcement powers.

The argument also ignores the broad new rules imposed by the Sarbanes-Oxley Act, including restrictions on the provision of non-audit services to audit clients, audit partner rotation requirements, “cooling-off” restrictions on the hiring of audit personnel by audit clients, and new auditor supervisory responsibilities for the audit committee (as opposed to management).

Moreover, the argument disregards the auditor independence rules championed by Chairman Levitt when he headed the SEC in 2000—at that time, those rules by themselves were thought to have a dramatic positive impact on auditor performance and audit quality.

Thus, with due respect to Mr. Coffey and his colleagues, the PSLRA-based argument simply ignores developments over the last several years, including the establishment of independent oversight and regulation of public company audits. We urge the consideration of recent regulatory developments when assessing the appropriateness of litigation reforms.

Other incremental reforms to address the liability crisis should also be considered, including the Committee’s recommendations.

Although we strongly urge the Committee to recommend liability caps set at a “mega-claim” level, we acknowledge that other reforms could alleviate some of the litigation pressure on accounting firms.

EY testimony previously identified incremental reforms.

Mr. Turley identified several such changes, such as amending federal tax policy to facilitate greater use of captive insurers and changing the Federal Rules to permit firms to make interlocutory appeals from denials of motions to dismiss in private actions. Also, Ms. Oberly testified about reforms such as caps on appeal bonds and requiring a showing of actual knowledge or intent, rather than mere recklessness, in order to make a recovery under Section 10(b) and Rule 10b-5. She also urged that the increased fragmentation of class action litigation be addressed and that, in the context of lawsuits brought by trustees or receivers of bankrupt entities, legislation should be passed to codify the imputation doctrine.

We also believe that the various proposals discussed in the Committee’s Draft report warrant serious consideration. Our views are presented below.

Recommendation 2(a), dealing with Concentration and Competition, recommends that, as part of its current oversight over registered auditing firms, the PCAOB should monitor potential sources of catastrophic risk which would threaten audit quality.

We support this proposal and believe, if clarified and implemented, it could offer a meaningful contribution to policy considerations. As was noted in Mr. Turley's December testimony and subsequent commentary, we believe that regulators should assess auditing firms' financial and risk-related information and utilize their understanding to inform public policy considerations that would serve to protect markets and investors and maintain audit quality.

The PCAOB has the power to collect this information from registered firms and already inspects firms' quality control practices, so new legislation is not necessary to support this recommendation. By law, as part of its registration and annual reporting requirements, the PCAOB may obtain whatever information it deems "necessary or appropriate in the public interest or for the protection of investors."[59] The Committee should be clear, however, that it expects the PCAOB to monitor such potential risks—including catastrophic litigation risk—on a profession-wide basis, and to report to the SEC, Congress and other relevant policy-makers, as appropriate. The PCAOB, under its Rule 4010, already has a mechanism for publishing such reports on the profession without identifying specific firms.

The significance of such a recommendation would be to provide a mechanism that assures Congress and investors that an appropriate regulatory authority is monitoring such risks and gathering information to enable the PCAOB, the SEC and the President's Working Group on Financial Markets to recommend regulatory, legislative or other policy responses and actions; and also to demonstrate that the regulatory system will be ready to act if and when these potential sources of catastrophic risk strike any particular firm. Obviously, control over litigation, approaches to settlement and other case-specific matters remain the responsibility of the individual audit firm. In any event, the PCAOB can fulfill its regulatory function without making itself responsible for particular litigation outcomes.

As we noted previously, we would understand the difficulty—perhaps the impossibility—of achieving consensus amongst the Committee members on specific detailed measures that could constitute a definitive solution to the particular public policy challenge posed by unlimited liability exposure. However, we do not believe a lack of consensus as to particular solutions among the Committee members or external commenters should dissuade the Committee from speaking to the concern "unequivocally and emphatically" as a matter for further consideration and action by policymakers, and we see this recommendation as an appropriate place for the Committee to focus such efforts.

Thus, as outlined above, we urge the Committee to make this recommendation more specific, directing the PCAOB's attention to profession-wide risks and policy consideration such as that related to unlimited liability exposure. At the same time, the Committee should make clear that it is not appropriate for the PCAOB to attempt to exercise detailed oversight of particular litigation matters.

Recommendation 2(b) urges establishment of mechanisms to assist in the preservation and rehabilitation of a troubled larger auditing firm. The recommendation envisions a first step under which auditing firms would adopt a "streamlined internal governance mechanism" that could be triggered in the event of threatening circumstances. If the governance mechanism failed to stabilize

[59] The Sarbanes-Oxley Act § 102(b)(H), 15 U.S.C. § 7212 (2006).

the firm, the recommendation envisions a second step which 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 Mr. Turley stated in EY's December 3, 2007 testimony before the Committee, EY believes the SEC should have the authority to take emergency action it deems necessary in the public interest and for the protection of investors in the case of a development that threatens the ability of a registered public accounting firm to continue to provide audits to its issuer clients. Additionally, some benefit could result from amending the bankruptcy code to facilitate the audit firm's reorganization.

We applaud the Committee for recognizing that the risk of losing another large accounting firm in the United States is real, and that such loss would likely cause significant global market disruptions and limit consumer choice. However, we do see problems with the approach as outlined. To sustain the private sector public company auditing function, there must be a focus on preventing the catastrophic event *before* it happens, not containing it after it happens. A "preventive" plan addressing the threat of unlimited liability exposure will prove more useful to investors, the markets and audit firms than a "rehabilitation" plan that does not address the litigation threat. Thus, as Barry Mathews of Aon testified, the Committee should examine liability relief "as an integral part of any reform strategy, not as an afterthought."[60]

As outlined, the Committee's "preservation and rehabilitation" mechanism is more suitable for a situation in which a firm becomes unstable due to systemic internal quality issues, rather than a situation where it is imperiled due to catastrophic private litigation. In the latter case, it is questionable if the recommended mechanism will be sufficient.

For example, Step 2 of the recommended mechanism suggests that the SEC should be permitted to appoint a court-approved trustee to seek to preserve and rehabilitate the firm by "addressing the threatening situation, or if such a step were unsuccessful, to pursue a reorganization." Presumably, the Committee believes that bringing in a new managerial authority would be viewed positively by the firm's people, clients, and network member firms, thus, forestalling the demise of the firm. It is equally possible, however, that in the case of catastrophic litigation, absent evidence that management is at fault, bringing in new managerial authority might be viewed as a red flag and speed the demise of the firm by causing partners, staff, clients, and network member firms to depart.

Moreover, these recommendations relate only to the audit firm's decision-making process. As we saw in the case of Arthur Andersen, other significant players can contribute to the demise of a firm facing catastrophic litigation or government action. In the enforcement context, the actions of the enforcement agency and other government actors can contribute to the fall of a firm. In the private litigation context, the plaintiff and plaintiffs' lawyers can be determinative. And in both contexts, the SEC and PCAOB have enormous influence. It is not clear how the Committee's recommendation would affect the activities of these third parties.

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[60] Barry Matthews, Executive Committee Member, Aon, written testimony June 3, 2008, at 2.

The Committee's Addendum states that it 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."

We would support a recommendation that provides for exclusive federal court jurisdiction for all claims brought against PCAOB-registered accounting firms. Indeed, this is a proposal that Ms. Oberly endorsed during her testimony. She stated: "Federal courts generally offer more predictable procedures and outcomes than do state courts. The accounting firms are now subject to a pervasive scheme of federal regulation, and, accordingly, it seems quite sensible that lawsuits involving matters relating to professional services should be litigated in federal court."

As for the appropriate standard of care, we believe that in non-privity lawsuits (i.e., shareholder claims), the standard should be higher than exists today—as discussed above, we would support an actual knowledge standard. We also support careful examination of the appropriate standard or standards for state law claims such as negligence or negligent misrepresentation brought by those in privity with the audit firm.

Commentary on Non-Litigation Matters

Recommendations on Human Capital

We believe the Committee's recommendations on human capital issues will further efforts to attract, retain, and mobilize talented professionals who have the highest standards of integrity, professionalism, and sense of public purpose, which is fundamental to our ability to succeed and deliver on our promise of providing seamless, consistent, high quality service worldwide.

Updating the curriculum for accounting students to reflect real-world developments, growing the pipeline of accounting, audit, and tax faculty, and improving minority representation in the profession will enrich the work we do and ultimately benefit investors and the capital markets.

Globalization creates an absolute business imperative that we have a diverse work force full of different perspectives, experiences and ways of thinking. Collaborating in a way that is inclusive of ideas regardless of culture, gender, sexual orientation or other differences is crucial to our success and a central element in EY's own culture.

Global mobility needs

Firms serving public company clients face increasing demands for professionals with international experience. While many U.S. colleges and universities offer international internships, these don't provide the same experience as spending time in a foreign country serving a mix of local companies and U.S. subsidiaries of multinational corporations. Companies need auditors, tax advisors and other professionals with international experience who understand the complexities of reporting and recording financial transactions across countries and continents.

Many H1-B visa candidates possess the experience we need, but the accounting profession sees approximately 35-40% of these applicants denied each year because of the visa cap. Increasing the number of H1-B visas allotted each year will allow many of the accounting firms to tap into additional international talent from all parts of the globe.

This global mobility issue has a clear connection to the performance of quality audits. The Committee should urge an increase in the H1-B visa cap, or at least acknowledge it as a matter of concern in the report.

1. *Recommendation: 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.*

EY understands and agrees that accounting certification requirements should be updated regularly to reflect changes in the accounting profession, relevant professional and ethical standards, and the skills and knowledge required to serve increasingly global capital markets. When teaching materials reflect real-world changes in the business environment, specifically in the accounting programs, we are better able to inspire the best and brightest to join the profession. However, EY recognizes that the curricula already are quite full with the requisite theory and skills courses. We are prepared to work creatively with colleges and universities so that they can integrate the most current topics into the syllabi appropriately. To this end, the firm's Foundation recently announced the creation of the Ernst & Young Academic Resource Center which will bring together faculty and professionals to develop publicly available accounting curricula materials on current topics (e.g. International Financial Reporting Standards).

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

EY has long been committed to increasing diversity in the accounting profession, dedicating partner resources to this effort for almost 15 years. While we are proud of the leadership EY and the auditing profession have provided on this very important topic, more can be done.

As a result of our numerous diversity efforts EY is rated among the top U.S. employers for African Americans, Asians, Hispanics, multicultural women, and the lesbian, gay, bisexual, and transgender community.

We agree with the Committee's recommendations to (a) recruit minorities into the auditing profession from other disciplines and careers where appropriate and emphasize the utility and effectiveness of cross-sabbaticals and internships with faculty and students at Historically Black Colleges and Universities.

3. *Recommendation: 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.*

We agree that accounting faculty play a critical role in developing students for the increasingly complex global auditing profession, and supports the Committee's recommendations to increase the supply of accounting faculty through public and private funding as well as through raising the number of professionally qualified faculty that teach on campuses. To that end, we are very active with the profession in pledging money and developing the process for recruiting people within the firms who have an interest and capability to earn a PhD and to help them by providing financial support. We also are very supportive of the recommendation to create a variety of tangible and sufficiently attractive incentives that will motivate private sector institutions to fund both accounting faculty and faculty research relevant to the profession. We also actively encourage practicing accountants to pursue careers as academically and professionally qualified faculty.

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

We support the Committee's recommendation in this regard.

5. *Recommendation: Encourage the AICPA and 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 appreciate the challenges of our current educational model and support the AICPA and the AAA working together to study the implications.

Subcommittee on Firm Structure and Finances

Strengthen fraud detection and prevention skills, clarify responsibilities

Subcommittee Recommendation 1 includes a recommendation to strengthen auditing firms' fraud detection and prevention skills and clarify communications with investors regarding auditing firms' fraud detection responsibilities including the following specific recommendations:

(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.*

EY supports the creation of a center for auditing firms and other market participants to develop best practices, conduct research, and engage in other activities in furtherance of fraud detection and prevention. As stated in Mr. Turley's testimony to the Committee, we believe a shared commitment across the profession to pooling audit firm resources to develop certain audit tools, techniques, and methodologies—such as anti-fraud initiatives—would help all firms in the performance of audits and could strengthen smaller firms in the profession without requiring a commensurate level of investment on their part.[61] However, as we and others have noted, there is some uncertainty as to anti-trust implications of such efforts. The Committee's Draft Report does not currently address this

[61] James S. Turley, Chairman and CEO, Ernst & Young LLP, written testimony December 3, 2007, at 7.

issue. Therefore, the Committee should recommend that regulators explore with the profession and aid in resolution of any anti-trust issues that may impede such efforts. *One approach, which EY strongly supports, is that the Committee recommends that such a center be led by the Center for Audit Quality (CAQ). The CAQ currently serves as an information clearing house for the profession and has the necessary research capabilities to lead such an effort. Additionally, the CAQ has demonstrated its commitment to fraud detection and prevention and could quickly and proficiently take on this task.*

We support continual improvements in the auditing and financial reporting process and believe the Committee's recommendations relative to clarifying the auditor's role in detecting fraud and reviewing and updating fraud related audit standards could have beneficial effect. To reduce the gap between the incidence of fraud and investors interests and expectations, we believe it is appropriate to consider potential means of clarifying the auditor's role in detecting fraud but believe it is also important to clarify management's role in preventing and detecting financial fraud. The auditor's role should be understood in the context of the roles of other stakeholders in the capital markets.

Furthermore, greater understanding of the meaning of "reasonable assurance" in the detection of fraud could prove beneficial. We would caution that significant legal issues could be associated with any changes to auditors' role or obligations in this area. For further commentary on these recommendations, please see the comment letter of the Center for Audit Quality.

Greater regulatory cooperation

Subcommittee Recommendation 2 encourages greater regulatory cooperation and oversight of the public company auditing profession by regulatory authorities within the U.S. to improve the quality of the audit process and enhance confidence in the auditing profession and financial reporting with the following specific recommendations:

- *(a) Institute the following mechanism to encourage the states to substantially adopt the mobility provisions of the Uniform Accountancy Act, Fifth Edition (UAA)10: 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 agree with the Committee's conclusion that "given the multi-state operations of many public companies and the multi-state practices of many auditing firms, practice mobility will foster a more efficient operation of the capital markets." EY supports the adoption, in all states, of the 2007 interstate CPA mobility provisions of the Uniform Accountancy Act. We applaud the rapid progress toward adoption of these mobility provisions around the country, and the intensive efforts by NASBA and the AICPA to demonstrate that enhanced CPA mobility is in the public interest. The benefits of the new UAA mobility system will not be realized unless it is adopted in all U.S. jurisdictions, including large commercial states such as California and New York. The Committee's strong endorsement of the benefits of that system will greatly assist the effort to achieve universal adoption by the states in a timely manner.

We agree with the Committee's Draft Report when it states that "enhancing regulatory cooperation and reducing duplicative oversight of the auditing profession by federal and state authorities and enhancing licensee practice mobility among the states are in the best interest of the public and the effective operation of the capital markets."[62] We support cooperation and coordination among regulators as a means to avoid redundancies, inconsistencies and inefficiencies.

Regarding the third element of this recommendation, we support appropriate operational support for any regulatory body so that it can fulfill its mandate and in doing so would underscore the importance of the second recommendation relative to cooperation and coordination among regulatory bodies.

Independent members on firm boards and/or advisory committees

Subcommittee Recommendation 3 urges 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.

EY supports the Committee's recommendation to urge the PCAOB and the SEC to explore the possibility and feasibility of firms appointing independent board members, "whose duties run to the auditing firm and its partners/owner,"[63] and/or advisory boards.

However, there are substantial impediments related to independence requirements, insurability and liability that must be addressed if the recommendation is to have significance. As noted in Mr. Turley's December testimony, current SEC independence rules can present uncertainties and challenges to the ability of firms to utilize individuals in such capacities.[64] In particular, the definition of "covered persons" and the associated financial interest restrictions, as well as the business relationship rules, diminish the pool of candidates that could assume such positions, and raise difficult independence issues.

Furthermore, litigation risk facing firms would likely serve as a significant deterrent to any outside individuals joining the board of a firm and yield insurability impediments.

As Mr. Beller said during the May 5, 2008 Committee meeting:

> I think this recommendation is fraught with practical difficulties. I'll throw one more on the table not only do you have the liability difficulty but you have the liability difficulty for a director in an industry which certainly if you're talking about the Big 4, the

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[62] Draft Report, 73 Fed. Reg. 28,190, 28,199.

[63] Draft Report, 73 Fed. Reg. at 28,201.

[64] James S. Turley, Chairman and CEO, Ernst & Young LLP, written testimony December 3, 2007, at 10 (expressing support for changes to facilitate consideration by firms of the use of independent board members and advisors).

> companies [firms] are uninsurable and there is no reason to believe that the directors are going to be any more insurable than the companies [firms] are and that's a very big difference from the rest of public corporate America and I think has to be confronted specifically.[65]

During the same meeting, the current SEC Chief Accountant, Conrad Hewitt, commented as follows:

> [O]n the independent boards, I think it's a great concept, I served on 10 corporate boards, four of those public, and I think a lot of good things can come out of board governance. However the liability issue is insurmountable, I mean, why would any individual knowing the litigation history of the public accounting profession want to serve on the board without any liability coverage? It just doesn't make sense.[66]

Indeed, the Committee's Draft Report states, "The Committee recognizes the multiple challenges that instituting a governance structure with independent board members might entail, including compliance with state partnership laws and independence requirements, insurance availability for such directors, and liability concerns."[67]

In this light, we are puzzled by the Draft Report suggesting the PCAOB and SEC efforts to potentially enable the use of outside individuals in such capacities should be conducted "within the current context of independence requirements and the liability regime." This limitation effectively makes the recommendation inconsequential.

We note that a member of the Committee observed during the March 13, 2008 meeting that the recommendation is not intended to change the current independence and liability regimes "in any way, fashion, shape or form"[68] while the chairman of the relevant subcommittee indicated liability issues that would face any such outside members "have to be dealt with."[69] We believe it is important that the Committee be clear in its guidance to the PCAOB and the SEC. If the Committee determines that potential modifications related to independence, insurability and liability should not be considered then we would suggest the recommendation will not be achievable. If the Committee wants to facilitate the use of independent board members it should remove the "current context" limitations and include language encouraging the PCAOB and the SEC to explore measures to address the independence, liability, and other impediments that the Committee recognizes in the Draft Report.

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[65] Alan Beller, Cleary Gottlieb Steen & Hamilton LLP, webcast of May 5, 2008 Advisory Committee public meeting at 2h:02m.

[66] Conrad Hewitt, U.S. Securities and Exchange Commission Chief Accountant, webcast of May 5, 2008 Advisory Committee public meeting, at 2h:11m.

[67] Draft Report, 73 Fed. Reg. at 28201.

[68] Lynn Turner, Member, Advisory Committee on the Auditing Profession, transcript of March 13, 2008 Advisory Committee public meeting, at 210.

[69] Robert Glauber, Chairman, Subcommittee on Firm Structure and Finances to the Advisory Committee on the Auditing Profession and Lecturer at Harvard Kennedy School of Government, transcript of March 13, 2008 Advisory Committee public meeting, at 190.

8-K disclosure requirements

Subcommittee Recommendation 4 urges 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.

We support the SEC amending Form 8-K to provide investors with important additional information by increasing the transparency of the auditor change process. However, we believe that building on the current approach by providing additional objective criteria related to the change in auditor may be preferable and more beneficial to investors than an approach that relies on a subjective "reason or reasons" for changing auditors. We are concerned that disclosure of subjective reasons for such a change likely will result in boilerplate disclosure that is of little benefit to investors while an expansion of the list of objective criteria could be more useful.

The recommendation also proposes that auditing firms notify the PCAOB of any engagement partner changes on public company audits if made before the normal rotation period and, other than for retirement, the reasons for those changes. Unscheduled changes in an engagement partner are often due to circumstances that have no impact on the relationship between the client and the auditor. In many respects, we believe the broad effect of the proposal would not provide meaningful information to the PCAOB. Accordingly, we recommend that this proposal be modified by suggesting the PCAOB consider the extent to which there are specific circumstances where a change in the engagement partner would be of sufficient interest to warrant a reporting requirement. Such an approach would strengthen the current auditor change reporting process and continue utilization of objective criteria.

Addendum to Subcommittee on Firm Structure and Finances

On June 12, 2008, the Committee published in the Federal Register the Addendum to the Draft Report with a recommendation and discussion items pertinent to the work of the Subcommittee on Firm Structure and Finances. Our litigation related commentary is reflected in earlier text. *Commentary unrelated to litigation follows.*

Auditor reporting model

The recommendation would urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's reporting model. As noted above in the discussion regarding Subcommittee Recommendation 1, we support continual improvements in the auditing and financial reporting process. We appreciate that the Committee is not precisely identifying what additional information might be useful to investors and other users of financial statements but rather is recognizing the "increasing complexity of global business operations," the "growing use of judgments and estimates," and is encouraging the PCAOB to consult with investors, other financial statement users, auditing firms, public companies, academics, other market participants, and other state, federal, and foreign regulators in order to inform any considerations.[70] Given our strong support for

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[70] Draft Report Addendum of the Advisory Committee on the Auditing Profession, 73 Fed. Reg. 33,487, 33,488-33,489 (June 12, 2008) ("Draft Report Addendum").

global consistency in regulatory approaches and standards where feasible in light of legal regimes, we support the suggested consultation with international regulatory bodies and the need for the PCAOB to “take cognizance of the proposal’s potential legal ramifications”.[71]

Engagement partner signature

In our view, having an individual’s signature appear on a report would not provide any benefit in terms of audit quality and would be counter to the overall thrust of the Sarbanes-Oxley Act, which emphasizes firm-based quality controls.

An audit engagement is signed by the audit firm, not individual partners, and the signing of the firm’s name appropriately demonstrates the weight of the entire firm behind the audit opinion. Public company audits are not simply the work of the engagement partner. Successful audits depend on a firm’s quality control system and its overall training and consultation practices, not on any single person. An audit report represents the work of many individual CPAs and often involves many partners in the field, national offices and foreign affiliated firms.

Some have suggested that requiring an audit engagement partner signature on the audit report is consistent with the policy requirement of the CEO or CFO signing financial statements. But we believe this is a false analogy and that the correct analogy supports the firm’s signature on the audit report. The CEO/ CFO signature for financial reports is evidence that they, at the top of the company, stand behind the information that is being provided and take responsibility for the quality controls and processes that feed into that work product. Requiring the audit firm (and not the engagement partner) to sign the audit report does the same thing. It sends the message that the entire firm stands behind the audit report and that the firm has the necessary quality controls in place to be confident in its signature.

Our consultative process is designed to prevent any individual from making unilateral decisions around critical accounting and other judgments that could significantly affect our firm’s audit opinion. It has been observed that a key distinction in the practice at Arthur Andersen versus other major firms was the degree of autonomy afforded engagement partners versus the expertise resident in that firm’s national office. We believe the signing of an audit opinion by individual partners sends the wrong message about who is ultimately responsible for the report and could have the unintended consequence of undermining best practices.

Transparency

As set forth in previous testimony and public comments by E&Y representatives, we support enhancing the transparency of audit firms in a manner that provides information and disclosures that are relevant to a particular audience.[72] Indeed, we support increased transparency in three key regards.

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[71] Draft Report Addendum, 73 Fed. Reg. at 33489.

[72] See James S. Turley, Chairman and CEO of Ernst & Young LLP, written testimony December 3, 2007, at 10, 11 (expressing support for a public transparency report to provide insight into “our commitment to audit quality and the way we govern ourselves” and expressing support for the PCAOB considering “use of existing authority to obtain and evaluate information about the financial resilience and viability of the audit firms it regulates”); and James S. Turley,

- We support a transparency report to the public modeled after the EU 8th Directive Article 40 requirements. Such a report could provide the public and audit committees with relevant insight into a firm's processes and commitment to audit quality.

- We support providing audit committees the information they need to carry out their responsibilities and support working with the PCAOB and audit committees to identify what, if anything, is relevant, useful and necessary for them that may go beyond the EU Article 40 requirements.

- We support providing the PCAOB whatever information it needs, and in whatever form it needs it. The PCAOB was specifically formed by Congress to be the independent regulator of the public company auditing profession and the public should take comfort in the regulator's full transparency into PCAOB registered accounting firms. As stated elsewhere, we believe it is appropriate for the PCAOB, either itself or in conjunction with other U.S. authorities, to assess a firm's financial resilience compared to litigation and other risks as part of its mission to evaluate the continued ability of a firm to perform quality audits.

We believe that the transparency requirements of Article 40 of the EU Eighth Directive establish an appropriate and useful framework for transparency reporting by the audit profession in the United States and around the world. Article 40 sets out fundamental information of relevance to investors and audit committees regarding the policies, processes, methodologies, and tools that are in place to help maintain audit quality. U.S. markets and the U.S. profession do not operate in isolation. U.S. investors and U.S. audit committees should be able to look at those transparency reports and compare what they learn about one firm's commitment to audit quality against another's. Varying requirements for transparency reporting that contain many distinctions but few differences will not help investors. Rather, a similar baseline benchmark for transparency reporting is more likely to foster competition among the audit firms around audit quality. Therefore, we support a transparency report to the public modeled after the EU 8th Directive Article 40 requirements that could provide relevant insight into a firm's processes and commitment to audit quality.

Furthermore, we believe the audit quality assurances that result from the PCAOB inspection process may be underappreciated and undercommunicated. Inspection results are perhaps the best measure of audit quality. The Sarbanes-Oxley Act requires the PCAOB to publicly report criticisms of or potential defects in the quality control systems of firms if they are not addressed to the satisfaction of the PCAOB. We believe the absence of such reports—indicating any such concerns are being addressed to the PCAOB's satisfaction—should provide meaningful assurance to the public regarding firms' commitment to audit quality.

As indicated in Mr. Turley's December testimony, we believe the Treasury Committee should consider recommending that the PCAOB focus its public reporting of inspection results on the

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Speech at Global Capital Markets Summit, U.S. Chamber of Commerce: The Changing Dynamics of Global Capital Markets (March 26, 2008) ("I want to be clear about what I mean by transparency, because saying that you are for transparency is like saying you are for motherhood or apple pie. When I speak of transparency, I am thinking in terms of the need for information and disclosures that are relevant to a particular audience.")

PCAOB's procedures to evaluate the sufficiency of a firm's quality control system.[73] Also, under our proposed approach, the PCAOB could later describe follow-up procedures to determine whether the firm has taken adequate corrective measures during the 12 months subsequent to the original inspection report and could state how the PCAOB is satisfied with those corrective measures.

There has been much discussion about whether audit firms should provide audited financial statements to the public. We recognize that such a recommendation might have surface appeal. However, making audited financial statements publicly available may be more symbolic than genuinely useful. Regulators, audit committees and the general public do not all have the same needs, and in our view, financial statements—audited or not—are mismatched and unresponsive to information needs of most if not all of these audiences. For example, neither the investing public nor audit committees would be able to discern anything about a firm's commitment to audit quality from the contents of its financial statements. In his June 3 testimony, John Biggs described a variety of audit committee information needs that are not addressed in financial statements. For example, he noted how audit committees are required by the New York Stock Exchange Listed Company Manual to:

> (a)t least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company. [74]

SEC Deputy Chief Accountant for Professional Practice, Zoe-Vonna Palmrose commented on the utility of financial statements informing audit quality considerations, stating: "Just for a second then I'll put on an academic hat and just let you know that as part of my dissertation where I was searching for how to measure audit quality from a market perspective back in my PhD days, I actually had the financial statements that were available from Arthur Anderson from KPMG—then it was Peat Marwick—and Deloitte Touche, and I really struggled to find that there was any connection between audit quality and the audited financial statements provided by Arthur Anderson and the un-audited ones provided by the other firms. So it was difficult to make any connection to audit quality.[75]

While financial statements are a mismatch in terms of yielding insights for the public into a firm's commitment to audit quality, their public disclosure would result in substantial additional litigation risk for firms by serving as an advantage for plaintiffs' lawyers, which both sides of the legal community—plaintiffs and defendants in audit firm lawsuits—have acknowledged.

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[73] See James S. Turley, Chairman and CEO, Ernst & Young LLP, written testimony December 3, 2007, at 11.

[74] John H. Biggs, Chairman of the Boeing Audit Committee, written testimony June 3, 2008, at 3.

[75] Zoe-Vonna Palmrose, SEC Deputy Chief Accountant for Professional Practice, webcast of June 3, 2008 Advisory Committee public meeting, at 6h:59m.

As noted by Professor Joseph Grundfest in his testimony before the Committee:

> Plaintiffs' lawyers obviously would like to get the information, because it gives them an opportunity to calculate a bleeding point. You know, how much can we actually get from this—how much can we actually get from this particular defendant? How far can we push in these negotiations? On the other hand, any defendant in any litigation wants to avoid letting the other side know what the bleeding point is, and they would much rather continue to have the conversation over settlement operate around the notion of comparables that were agreed to in other prior forms of litigation.[76]

As Michael Young of Wilkie Farr stated in his June 3, 2008 appearance before the Committee:

> Well, I can speak to my experience. But the question you asked me is on the issue of transparency and its [financial statement information] usefulness to the plaintiffs. In my cases they don't get it. I can't recall ever once giving to the plaintiffs information, financial information, about my client, the accounting firm. Not for lack of trying by the plaintiffs. They are rapacious in their desire for the information. And part of the reason is, in self evident fashion, they want to know, what is the last drop of blood that I can get. And ironically, the most recent thing I've seen on this is what John Coffey told you in your last session. When he was talking about his desire to get financial information about the defendant accounting firm. And he said, on page 140 of the transcript: "I've had some dealings in my cases with the insurance, even when you're in a settlement context it is extraordinarily difficult to get to the bottom of what's out there. And then he goes on to say how he took Arthur Anderson to trial, and for 5 weeks because he wanted to get the financial information." And on page 151 he said, "We said to Arthur Anderson, you claim to be broke, prove it. And it took 5 weeks of chasing around a courtroom before they finally agreed to show us their books." Right, now that tells you a couple things. One is, he's not getting the information. The second is he wants it. He wants it badly enough to take Arthur Anderson to court for 5 weeks to get it. And the third, he thinks it's going to be of value to him in litigation.[77]

As EY Vice Chair Kathryn Oberly commented before the Committee during her June 3 appearance, accounting firms are not required to provide financial statements to plaintiffs under either federal law or, generally, under state law. Providing such information to plaintiffs would drive up settlement values as plaintiffs would increasingly seek to maximize the payout from a firm.

As previously stated, we support enhanced transparency of audit firms in a manner that provides information and disclosures that are relevant to a particular audience, including providing the PCAOB with whatever information it needs, in whatever format it needs it. However, we see an increase in litigation risk resulting from public financial statements and a mismatch between the information in financial statements and information that would be relevant to public audiences.

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[76] Joseph Grundfest, Professor of Law and Business, Stanford Law School, transcript of February 4, 2008 Advisory Committee public meeting, at 145.

[77] Michael Young, Wilkie Farr & Gallagher LLP, webcast of June 3, 2008 Advisory Committee public meeting, at 3h:13m.

Subcommittee on Concentration and Competition

Reduction of barriers to the growth of smaller firms

Subcommittee Recommendation 1 has a stated intent of reducing barriers to the growth of smaller firms. Specifically it recommends the following:

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

(b) inclusion by regulators and policymakers of smaller firm representatives in committees, public forums, fellowships, and other engagements.

EY agrees with the Committee's over-arching principle that "[t]he audit market benefits from a competitive and innovative population of auditing firms."[78] We support sensible efforts, such as those outlined in this recommendation, to encourage greater participation by more accounting firms in the public company audit market.

However, we believe there are more significant barriers to the growth of smaller firms that have been identified during the course of the Committee's considerations that are not reflected, or sufficiently reflected, in the Draft Report.

Specifically, barriers to the growth of smaller firms and their ability to compete for audit work include litigation, regulatory complexity and rigidity of certain independence rules. We believe the Subcommittee's recommendations would be improved by addressing these issues directly.

In the U.S., a significant barrier to entry in the audit market is enormous liability exposure and the inability to obtain adequate insurance coverage. As noted in testimony to the Committee from Neal Spencer, Managing Partner of BKD LLP, the 10th largest public company accounting firm in the United States, "The single most significant deterrent to many accounting firms taking on more public company audits is liability…. In our current litigation environment, many firms may decide that the risk/reward equation is simply out of balance, and they are therefore unwilling to expand their public company audit practices in any meaningful way."[79]

Regulatory complexity and the lack of convergence among national regulators can also impact competition. The significant investment in the compliance-oriented infrastructure required to operate in a global environment can act as a barrier to entry for firms.

Another consideration is independence. As was outlined in Mr. Turley's testimony, there are relatively modest changes that could be made to the U.S. independence rules which would enhance

[78] See Working Discussion Outline, Advisory Committee on the Auditing Profession, Department of the Treasury (October 15, 2007).

[79] Neal Spencer, Managing Partner of BKD LLP, transcript of February 4, 2008 Advisory Committee public meeting, at 225.

auditor choice in the immediate and longer term, while not adversely affecting audit quality and auditor independence.[80]

1) Modifying the definitions of "audit client" and "affiliate" to avoid undue limitations on auditor choice without impacting auditor objectivity and integrity;

2) Establishment of a *de minimis* or materiality rule, such as exists in IFAC standards, related to prohibited non-audit services;

3) Allowing for relief from the independence rules through the application of appropriate safeguards where prohibited services or actions occur prior to becoming the auditor;

4) Harmonization of the various independence rules established by regulatory and professional bodies (e.g., SEC, PCAOB, Department of Labor, AICPA, and state boards and agencies) to a single accepted and credible standard for auditor independence. The global harmonization of independence standards on a global level, perhaps evaluating the suitability of the IFAC Code of Ethics, would yield even greater opportunity for auditor choice for companies.

We urge that these significant barriers to the growth of smaller firms as identified during the course of the Committee's considerations be reflected in the Report.

Development of key quality indicators

1. *Recommendation: Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, board of directors, academics, and others, to 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.*

EY agrees that the PCAOB, in consultation with others, should consider the feasibility of developing various means to assess and report on audit quality. We recognize the inherent difficulty, however, in identifying quantifiable indicators of audit quality that might be suitable for uniform reporting and public disclosure. We believe a great deal of work and understanding of the operating model of an audit firm will be required to determine the feasibility of such indicators. We agree with the Draft Report's observation that developing meaningful quality indicators, defining how they should be measured and rolling out the measurement process could take significant time and effort.

As there are a myriad of complex and difficult to measure factors that impact the quality of an audit, we are concerned with the risk that a determination to publish statistical measures could result in an overly simplistic and misleading result. Therefore, we would suggest that it may be premature for the Subcommittee to enumerate any specific indicators in its observations but should consider articulating the overarching objectives of quality indicators to inform the determination of feasibility.

[80] See James S. Turley, Chairman and CEO, Ernst & Young LLP, written testimony December 3, 2007, at 7.

Another avenue to provide more insight to audit committees and others could result from increased communications resulting from the PCAOB inspection process. The PCAOB provides a credible voice to judge how well the accounting profession is living up to our commitment to quality and how effective we are in delivering on investors' expectations. The whole profession has improved as a result of the PCAOB's efforts and investors' confidence in it has justifiably improved markedly.

To have a more positive impact on audit quality and foster greater confidence in the oversight provided by the PCAOB, the PCAOB inspection process could be increasingly focused on evaluating the quality control systems of audit firms and communicating its comfort with corrective measures taken by the firms in response to inspection findings.

The PCAOB and SEC continue to challenge and improve on the original inspection process design. In our view, the current state of publicly reporting deficiencies identified in the review of specific audit engagements doesn't add significant insight into a firm's commitment to audit quality via its processes, systems, and controls to promote audit quality.

We believe there would be greater value to the profession and users of inspection reports if the inspection process increasingly were focused on evaluating and highlighting the quality control system of the firm rather than deficiencies identified in individual audits. Accordingly, we believe there would be value in focusing public reporting of inspection results on the PCAOB's procedures to evaluate the sufficiency of a firm's quality control system. Also, under such an approach, the PCAOB could later describe follow-up procedures to determine whether the firm has taken adequate corrective measures during the 12 months subsequent to the original inspection report and could state how the PCAOB is satisfied with those corrective measures. The reporting model could continue to provide for public reporting of specific quality control deficiencies should a firm not address them to the PCAOB's satisfaction. We believe such changes would enable the public reporting around the PCAOB's inspection process to be more meaningful to users of inspection reports.

Auditor independence compilations and training material

Under Subcommittee Recommendation 4, compilations of various auditor independence standards and development of related training materials requirements are recommended to 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.

Specifically, the Draft Report recommends the following:

(a) Compile the SEC and PCAOB independence requirements into a single document and make this document website accessible. The American Institute of Certified Public Accountants (AICPA) and 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.

EY fully supports the recommendation to continue to promote the understanding of and compliance with applicable auditor independence standards. EY supports the concept in this recommendation that this understanding of and compliance with auditor independence standards be across the larger spectrum of market participants including investors, public companies, audit committees, and boards of directors as well as auditors, of course. There are multiple independence standards applicable to an auditor in the U.S. depending on the circumstance (e.g., those of the SEC, PCAOB, Department of Labor, AICPA, and in certain instances, individual states). The number of these and the fact that there are differences amongst them, make it impractical for an auditor and other market participants to build, manage and train to multiple systems and sets of professional standards. We recommend study, evaluation and development of a roadmap for harmonization or convergence to one accepted, robust standard of independence rules rather than many different rules in the United States and perhaps, globally. Harmonization of independence standards on a global level, perhaps evaluating the suitability of the IFAC Code of Ethics, could potentially lead to the enhanced understanding of and compliance with applicable auditor independence standards.

Auditor ratification by shareholders, naming of partner(s) in proxy disclosures

Subcommittee Recommendation 5 urges adoption of requirements for annual shareholder ratification of public company auditors by all public companies with related disclosure in the company proxy statement to include the name(s) of the senior auditing partner(s) staffed on the engagement.

We understand the Committee believes shareholder ratification of auditor selection can enhance the audit committee's oversight of auditors and serve as a "check" on audit committees as they exercise their audit firm oversight responsibilities. However, we do not believe the recommendation to include the name(s) of the senior audit partner(s) in proxy disclosures will improve audit quality, make a firm or partner more accountable, or have an effect on audit firm choice or competition.

Enhance global regulatory collaboration and coordination

Subcommittee Recommendation 6 urges the PCAOB and its foreign counterparts to continue to improve regulatory cooperation and coordination on a global basis.

We support this recommendation but believe it is important to expand it to include all other regulatory and standard-setting authorities with connections to profession oversight and capital market regulation and stability. Furthermore, we urge that the final report recognize the internationalization of the securities markets and the need for common standards and practices across the world's capital markets in a wide range of areas, including many of the matters under consideration by the Committee.

The EY global organization operates through its member firms in 140 countries. It comprises 130,000 professionals working on many of the most interesting and important issues in business today, for both audit and non-audit clients. Yet none of the jurisdictional authorities has a complete view across the entirety of our organization.

Globalization is fundamentally challenging the structure of businesses, investing, and the markets. Companies operate around the world, investors invest across borders, and what happens in one market can be felt in another on the opposite side of the world nearly instantaneously.

Globalization is similarly impacting our profession. EY must be a truly global organization for it to fulfill its role and satisfy the demands of our stakeholders. As a global organization, our promise to the market, and the promise of our member firms, is “seamless, consistent, high-quality service, worldwide.”

However, this drive towards seamless, consistent, high-quality service worldwide is mismatched against the fractured, inconsistent, and overlapping regulatory environment in which we and our clients operate. This is true not just only within the U.S., but also around the world. We all contend with differing laws, legal environments, regulations, oversight regimes, financial accounting standards, and auditing standards. Such inconsistencies are inefficient, often confusing and increasingly outmoded in today’s global market.

We believe an increase in global regulatory cooperation would enhance the contribution of regulators to sustainable, high quality audits around the world and investor confidence in the audit process. While we applaud the Committee for underscoring the importance of international regulatory cooperation, we urge that the recommendation be expanded beyond the PCAOB to include others that have connections to profession oversight and capital market regulation and stability.

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