

Mr. Arthur Levitt, Jr.
Mr. Donald 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

August 26, 2008

Comment Letter of Ernst & Young LLP on the Second 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 comment on the Second Draft Report of the U.S. Treasury Advisory Committee on the Auditing Profession (“Committee”), as published on July 30, 2008.¹ We previously offered our comments on the Committee’s Draft Report published May 15, 2008, and the Structure and Finance Subcommittee addendum published on June 12, 2008 (collectively “Draft Report”).²

We appreciate the Committee’s efforts to achieve its important objective of “provid[ing] informed advice and recommendations . . . on the sustainability of a strong and vibrant public company auditing profession.”³ EY has assisted the Committee by offering its views through testimony and written submissions from James S. Turley, Chairman and Chief Executive Officer, and Kathryn A. Oberly, Americas Vice Chair and General Counsel, on December 3, 2007 and June 3, 2008 respectively, and through our previous comment letter on the Committee’s Draft Report, submitted June 27, 2008.

On issues where the Draft Report and the Second Draft Report take the same approach, the comments in our June 27 letter remain relevant and we refer you to that submission. In particular, we would draw your attention to our commentary on the catastrophic litigation threat facing the profession. Among other things, our letter summarized significant aspects of the record before the Committee on this issue.

We are concerned about the Committee’s continued failure to address the public interest implications that arise from the catastrophic liability risks faced by audit firms. Our comment letter explained the reality of such risks, as well as the grave consequences that are certain to follow the collapse of another audit firm. It would be a disservice for the Committee to

¹ Second Draft Report of the Advisory Committee on the Auditing Profession, 73 Fed. Reg. 44,315 (July 30, 2008).

² Draft Report of the Advisory Committee on the Auditing Profession, 73 Fed. Reg. 28,190 (May 15, 2008); Structure and Finance Subcommittee Addendum to the Draft Report of the Advisory Committee on the Auditing Profession, 73 Fed. Reg. 33,487 (June 12, 2008).

³ Charter of the Advisory Committee on the Auditing Profession, at 1 (July 3, 2007), *available at* <http://www.treas.gov/offices/domestic-finance/acap/charter.pdf>.

issue a final report on the subject of audit firm sustainability without addressing the significant threat posed by catastrophic litigation.⁴ It is clearly in the public's interest for the Committee to confront directly the existence of this threat. The risks from catastrophic lawsuits significantly impact the competitiveness and viability of the U.S. capital markets. The Committee should recognize these risks and seek solutions that would better protect investors and market participants.

We believe the uninsurable and unlimited nature of litigation risks faced by audit firms poses a significant threat to the public interest. Investors and markets rely on a healthy and stable accounting profession. The possibility of a firm failure due to circumstances beyond its control is real, and the consequences to investors and the markets of such a failure due to repercussions throughout the profession should be recognized as a global economic concern.

The need to address what is a systemic risk on behalf of market participants is high. We respectfully request that the Committee reconsider the complete record before it, and the proposals set forth in our June 27 letter.⁵ It may be that the Committee is unable to decide upon which litigation reforms to recommend. At a minimum, the Committee should advise the government that the catastrophic litigation risks be considered and addressed directly by Congress, the Securities and Exchange Commission, the Department of Treasury, or another appropriate government entity. Indeed, it would be a natural next step for the government to build upon the Committee's work and that of other recent private sector committees and commissions to address litigation risks. But the government would benefit from a clear message from the Committee, calling for reform and outlining the public interest implications that could result from a continued failure to address such risks. Such a step would be consistent with the Committee's acknowledgment that the litigation risk is "real."⁶ Thus, we strongly encourage the Committee to endorse the need for government action to address catastrophic litigation risks facing the profession in light of the systemic risk to markets, economic stability and investor interests.

In addition, as stated in our June 27, 2008 comment letter, we support the Committee's recommendation that "the PCAOB should monitor potential sources of catastrophic risk that would threaten audit quality." We believe the PCAOB's assessment of audit firms' financial and risk-related information can ultimately serve to protect the capital markets and investors and maintain audit quality.⁷

However, we believe the Second Draft Report's new language suggesting that PCAOB efforts in this area should focus on identifying "situations in which auditing firm conduct is

⁴ See *also, e.g.*, Comment Letter of David T. Hirschmann, President and Chief Executive Officer of the Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce, July 9, 2008, at 2 ("the Committee's efforts will fall short of the broader Committee mandate if stronger recommendations, aimed at preventing catastrophic audit firm failure, are not proposed").

⁵ Comment Letter of Ernst & Young, LLP, June 27, 2008, at 2-21.

⁶ Second Draft Report, 73 Fed. Reg. at 44,344.

⁷ Comment Letter of Ernst & Young, LLP, June 27, 2008, at 19.

resulting in increased catastrophic risk which is impairing or threatens to impair audit quality” is misplaced.⁸ We recognize—and believe the Committee should also recognize—that the PCAOB already performs the task of identifying questionable firm conduct that threatens to impair the quality of audits. In order to successfully monitor potential sources of catastrophic risks, there must be consideration of factors beyond firm conduct. The threat of catastrophic loss to audit firms arises in large measure from external forces largely found in the litigation and regulatory environment, including the market capitalization of a firm’s audit clients. It is such external forces that yield an unlimited and uninsurable level of litigation risk that warrant informed policy considerations as we discussed in our June 27, 2008 letter.

Again, we appreciate the time and efforts put forth by the Committee and its staff and hope the totality of our input will prove useful to the Committee or to the efforts of those that follow.



⁸ Second Draft Report, 73 Fed. Reg. at 44,345.