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July 9, 2008

Advisory Committee on the Auditing Profession
Office of Financial Institutions Policy
Room 1418
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Comment on Addendum to Section VI of Draft Report of Advisory Committee on the Auditing Profession (Firm Structure and Finances)

Dear Chair Levitt, Chair Nicolaisen and Members of the Committee:

As General Counsel to New York State Comptroller Thomas P. DiNapoli, sole Trustee of the New York State Common Retirement Fund ("Fund"), I am submitting these comments to the May 30, 2008 Addendum to Section VI of the Draft Report of the Department of the Treasury Advisory Committee on the Auditing Profession (the "Committee") concerning Firm Structure and Finances.

Our Office appreciates and supports efforts to enhance transparency and reliability in our capital markets so that investors and other users of financial statements may make investment and business decisions with confidence in the financial information presented by issuers. We do, however, have comments about the Addendum that we wish to share with the Committee.

Auditor's Report

We support efforts to enhance the auditor's report with more detail and substantive information so that it may serve a more useful purpose to users of financial statements. The auditor's report is the primary means by which the auditor communicates to the users of financial statements regarding its audit. The auditor's standard report identifies the financial statements audited in an introductory paragraph, describes the nature of an audit in a scope paragraph, and expresses the

auditor's opinion in a separate opinion paragraph.¹ Investors pay particular attention to an auditor's report "to gain assurance and confidence in the reliability of financial statements they rely upon to make significant business decisions."² Users of financial statements appreciate that auditors must adhere to auditing standards of reporting.³

The Committee recommends in the Addendum that the PCAOB undertake a standard-setting initiative "to consider improvements to the auditor's reporting model." We agree that an "improved auditor's report would likely lead to more relevant information for users of financial statements and ... would clarify the role of the auditor in the financial statement audit." Therefore, we support an initiative to require that the standard auditor's report contain more useful information for users of financial statements. We would oppose, however, any new standard that would result in diminishing an auditor's responsibility or liability in any way.

A new reporting standard must be narrowly tailored in order to require only useful information in the auditor's report and avoid the inclusion of redundant or excessive information that would detract from the clarity the report. The current reporting standard provides a useful framework for creating a new standard. For example, traditional elements of the auditor's report already

¹ AU § 508.08. References to "AU" sections herein are to the interim standards adopted by the Public Company Accounting Oversight Board ("PCAOB"), except as superseded or amended by the PCAOB.

² *Fraudulent Financial Reporting: 1987-1999*, The Committee of Sponsoring Organizations of the Treadway Commission, p.48.

³ Generally accepted auditing standards contain the following four standards of reporting:

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

AU § 150.02; *see also* AU §§ 400, *et seq.* (the first, second and third standards of reporting); AU §§ 500, *et seq.* (the fourth standard of reporting).

include statements similar to those called for in the Addendum, such as a “more ‘narrative’ report” identifying certain audit procedures.⁴ The existing standards of reporting also require stated reasons when an overall opinion cannot be so expressed, and they require a “clear-cut indication of the character of the auditor’s work, . . . and the degree of responsibility the auditor is taking.”⁵ In addition, the standards of reporting address the issues identified by the National Commission on Fraudulent Financial Reporting (Treadway Commission), that management has the “primary responsibility for financial statements” and that the audit process is designed to provide a basis for “reasonable” assurance as to the *bona fides* of financial statements.⁶ We suggest that any new reporting standard require amplification and elaboration of these traditional subject matters that are appropriate for more detail in an auditor’s report.

The Addendum notes that many consider the standard auditor’s report a “pass/fail” model with little detailed information. We believe that a narrowly tailored standard-setting initiative, complemented by enhanced professional training and education concerning increased levels of detail about the substantive areas of disclosure will lead to a more detailed auditor’s report. Thus, we support a recommendation that the PCAOB undertake a standard-setting initiative to consider improvements to the auditor’s reporting model. Any such initiative should consider the benefit of enhanced education and professional training within the auditing profession.⁷ We reiterate that a standard-setting initiative must not result in a lessening of an auditor’s responsibility and liability in any way.

Engagement Partner Signature

We agree with the position expressed in the February 16, 2005 PCAOB Standing Advisory Group meeting minutes on the auditor’s reporting model that an auditing firm should expressly

⁴ The standards of reporting require that an auditor’s report include statements concerning its audit procedures, such as that the audit included “examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,” “assessing the accounting principles used and significant estimates made by management,” or “evaluating the overall financial statement presentation.” AU § 508.08(f).

⁵ See e.g., AU §§ 508.10-508.63 (addressing explanatory language to be added to auditor’s standard report and departures from unqualified opinions).

⁶ See AU §§ 508.08(c) (“financial statements are the responsibility of the Company’s management” and the auditor’s responsibility is to express an opinion on the financial statements based on an audit), 508.08(e) (generally accepted auditing standards only “require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement”). See also AU § 316.12. *Accord* Report and Recommendations of the Public Oversight Board Panel on Audit Effectiveness (August 31, 2000), ¶¶ 1.3.

⁷ See, e.g., Draft Report of the Department of the Treasury Advisory Committee on the Auditing Profession concerning Human Capital, at V:1-2 (“The Committee believes that the accounting curricula in higher education are critical to ensuring individuals have the necessary knowledge, mindset, skills, and abilities to perform quality public company audits.”).

take overall responsibility for the audit and resultant audit report.⁸ We note that traditionally an auditing firm expresses its overall responsibility for the audit through its execution of the audit report with the signature of the auditing firm's name, not any individual auditor. We believe that an audit engagement partner should take personal responsibility for the audit he supervises and for any resulting auditor's report. We support a recommendation that the PCAOB revise its auditor report standard to mandate that the engagement partner either sign or be identified in the auditor's report, in addition to the traditional auditing firm's signature.⁹ We believe such a requirement will reinforce the importance of performing the audit diligently.

However, we are concerned that certain remarks on the record before the Committee indicate some interest in replacing the auditing firm's signature on an auditor's report with the engagement partner's signature in order to obtain new "protections" or "relief" for those who sign audit opinions.¹⁰ We oppose any initiative that would limit the responsibility or liability of the auditing firm, or its partners, for an audit and statements in the auditor's report.

Transparency

We support a recommendation that the PCAOB require large auditing firms to produce a public annual report that would require disclosure of information similar to that required by the European Union's Eighth Directive, Article 40 Transparency Report.

We also support a recommendation that the PCAOB develop audit quality indicators and require auditing firms to publish these indicators. We note, however, that there are risks associated with such an endeavor. Absent traditional guidelines, disclosures of indicia of audit quality in a firm's annual report could be used in litigation to create evidentiary ambiguities and confusion with regard to the objective indicators of audit quality and effectiveness contained in generally accepted auditing standards. Specifically, the general standards¹¹ and standards of fieldwork¹²

⁸ See PCAOB Standing Advisory Group Meeting: Auditor's Reporting Model, p.8 (Feb. 16, 2005).

⁹ See PCAOB Standing Advisory Group Meeting: Auditor's Reporting Model, pp.7-8 (Feb. 16, 2005) (identification of individual auditors in the audit report).

¹⁰ Record of proceedings (March 13, 2008) (oral remarks of Donald T. Nicolaisen, Board Member, Morgan Stanley, 229) ("I, for one, would be supportive of that kind of protection, relief, whatever you want to call it.").

¹¹ The general standards are:

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

are the ultimate indicators of audit quality and effectiveness. These require auditor training and proficiency, independence, exercise of professional due care, adequate planning and supervision, an understanding of internal controls, and the collection of competent evidence to reasonably support the audit opinion.¹³ We do not agree with any proposal that could result in diluting these objective indicators of audit quality and effectiveness.

Litigation

We are strongly opposed to any recommendation that would further limit investors' rights or options in litigating claims against auditors in state court. We note that the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") preempts certain class actions based upon state law that allege a misrepresentation in connection with the purchase or sale of nationally traded securities.¹⁴ SLUSA already addresses the contention stated in the Addendum that federal court jurisdiction may be appropriate for certain "categories of claims against auditors" that have otherwise been brought in state court. State law claims against auditors relate to various activities, such as claims brought by individual investors alleging misrepresentation, or malpractice claims for negligence brought by corporations and executives who prepare financial

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3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

AU § 150.02.

¹² The standards of field work are:

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

AU § 150.02.

¹³ See AU §§ 200, *et seq.* (the general standards), 300, *et seq.* (standards of field work).

¹⁴ See 15 U.S.C. §§ 77p(b), 78bb(f)(1).

statements. Refusing to allow such claims to proceed in state court would weaken the rights of those who seek remedies for harms stated in such individual state law claims against auditors.

We are also strongly opposed to any recommendation that would result in a lessening of the uniform standard of care for auditors.¹⁵ A uniform standard of care already exists in generally accepted auditing standards. The third general auditing standard states:

Due professional care is to be exercised in the performance of the audit and the preparation of the report.¹⁶

This standard requires the independent auditor to plan and perform his or her work with due professional care.

Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the general, field work and reporting standards, including a responsibility to consider the presence of fraud.¹⁷ *Cooley on Torts* is quoted in the auditing literature as "a source from which an auditor's responsibility for conducting an audit with due professional care can be derived."¹⁸ Generally accepted auditing standards require an auditor to possess "the degree of skill commonly possessed" by other auditors and to exercise it with "reasonable care and diligence" (that is, with due professional care).¹⁹

¹⁵ To the extent that the Committee may consider recommending the adoption of a uniform "state of mind" element for claims against auditors, we are likewise strongly opposed to any such recommendation, or any other proposal to lessen the responsibility or liability of an auditor in any way.

¹⁶ AU §§ 150.02, 230.01, 230A.01.

¹⁷ AU §§ 230.02, 230A.02; *see also* AU §§ 316.01-.18 (description and characteristics of fraud, importance of exercising professional skepticism, discussion among engagement personnel regarding the risks of material misstatement due to fraud)

¹⁸ The auditing literature itself quotes from *Cooley on Torts*. *See* AU §§ 230.03-.04, 230A.03-.04 ("Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.")

¹⁹ AU §§ 230.05, 230A.05.

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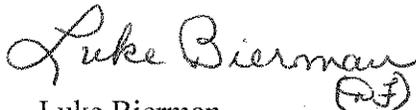
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Due professional care also requires the auditor to exercise professional skepticism, an attitude that includes a questioning mind and a critical assessment of audit evidence; the auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence.²⁰ The exercise of due professional care allows the auditor to obtain “reasonable assurance” to form an opinion about whether the financial statements are free of material misstatement, whether caused by error or fraud.²¹ Due professional care does not guarantee absolute assurance.²²

Further, the existing standard of care is the subject of substantial interpretive literature and case-law, and thereby provides a reliable, uniform standard.

We thank you for your consideration of these comments.

Sincerely,


Luke Bierman

²⁰ AU §§ 230.07, 230A.07.

²¹ AU §§ 230.10-.11, 230A.10-.11 (Absolute assurance is not attainable, and therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement.); *see also* AU §§ 316.01, .12-.13 (a properly conducted audit may not detect fraud).

²² AU §§ 230.07, 230A.07.