

June 30, 2008

Advisory Committee on the Auditing Profession
Office of Financial Institutions Policy
Room 1418
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: PricewaterhouseCoopers' Comments on the Draft Report and Addendum of the Advisory Committee on the Auditing Profession

Dear Committee Members:

PricewaterhouseCoopers appreciates the opportunity to comment on the Draft Report issued by the Department of the Treasury's Advisory Committee on the Auditing Profession (the Committee) on May 5, 2008, and the Addendum to Chapter VI of the Draft Report distributed on May 30, 2008.

We strongly support the goals Secretary Paulson outlined in announcing his Capital Markets Action Plan in November 2006: "A transparent financial reporting system and vibrant auditing profession form the backbone of a marketplace investors can trust. Any plan to strengthen our capital markets must be based upon this principle."¹ Maintaining the strength of the auditing profession and ensuring the reliability of the financial reporting system are crucial contributors to the United States' competitiveness in the global economy.

At the outset, we think it important to put our comments—and the Committee's efforts—in the proper context. In assessing the auditing profession, we think it is vital first to acknowledge the dramatic changes that have taken place in the profession over the past few years. In particular, we believe that the changes brought about by the enactment of the Sarbanes-Oxley Act of 2002 have improved the quality of both financial reporting and public-company audits. With that said, our comments and perspectives are forward-looking with regard to the sustainability of the auditing profession, and thus the work of the Advisory Committee.

In testimony before the Committee on December 3, 2007, PwC's U.S. Chairman and Senior Partner, Dennis Nally, highlighted forces that we believe will lead to an "acceleration in the

¹ "Paulson Announces First Stage of Capital Markets Action Plan" (May 17, 2007), available at <http://www.ustreas.gov/press/releases/hp408.htm>.

pace of change”: “[t]he growth rates of emerging economies around the world, the use of technology to draw populations and information instantaneously closer and closer together, and the increasing mobility of a global workforce.”² Some of these developments are already playing out in the audit-services market and we expect the impact of these trends to grow in the next few years.

Of particular importance, given the movement toward adoption of globally-recognized accounting standards, is the increasing recognition that a principles-based accounting regime has significant advantages. By integrating accounting outcomes with economic structures, a principles-based system should result in financial statements that better reflect the economic substance of transactions and reduce the incidence of transactions being structured in a way that complies with technical rules but does not depict economic substance.

Capital-market participants must adjust, however, to a principles-based system that places significantly more reliance on the exercise of professional judgment by financial statement preparers, and in particular by the auditors of those financial statements. For that reason, we believe it is vital for the legal and regulatory framework to adapt to support the change in the system that a move to a more principles-based regime would entail. For that reason, we also support the related recommendation made by the Securities and Exchange Commission’s Advisory Committee on Improvements to Financial Reporting that a professional judgment rule for preparers and auditors be implemented. We believe that the success of movement in the United States to a more principles-based financial reporting system would be enhanced by recognition that our litigation environment must also change.

As we considered the Committee’s work, we did so in light of these developments and challenges, which we believe inform some of the most critical public policy considerations the auditing profession faces as it works to deliver consistent, high-quality audits in an increasingly globalized economy.

In addition to the discussion above and our previous testimony,³ we respectfully provide the following comments on the Draft Report and Addendum.

Human Capital⁴

The auditing profession is, by definition, a professional services business. As such, firms will succeed or fail based on the quality of their human capital and their ability to deploy that capital effectively. As Mr. Nally pointed out in his testimony, “no issue is more important

² Written Testimony of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP at 1, Dec. 3, 2007.

Testimony by Dennis M. Nally, Chairman, PricewaterhouseCoopers LLP, December 3, 2007; testimony by Charles W. Gerdtz, III, General Counsel, PricewaterhouseCoopers LLP, June 3, 2008.

⁴ Draft Report May 5, 2008, Article V., the Treasury Advisory Committee on the Audit Profession.

than our ability to attract and retain talented professionals from diverse backgrounds who can be deployed efficiently in an increasingly global marketplace.”⁵

We agree with the Draft Report’s recognition that “the accelerating pace of change in the global corporate environment and capital markets and the increasing complexity of business transactions and financial reporting [are] among the most significant challenges facing the profession[.]”⁶ For firms such as PricewaterhouseCoopers, which serve multinational public companies, recruiting and retaining individuals with specialized knowledge and expertise that complement the work of the auditors has increasing importance.

As Mr. Nally observed, “Areas such as tax, enterprise information technology applications, finance, treasury management and the use of complex financial instruments, among others, [not only] require that auditors have a fundamental understanding of these issues to conduct an audit and make reasoned judgments regarding controls and accounting, but [also] increasingly require additional and more specialized expertise by individuals specially trained in these areas. Those specially-trained individuals help the audit engagement team to ensure the highest audit quality.”⁷

Such subject and industry experts are not necessarily trained as auditors, in part because training and maintaining highly specialized skills and knowledge involve significant costs. Rather, these individuals provide services to non-audit clients but are also able to bring their expertise to assist with and enhance the quality of audits. Thus, successful firms must leverage the ideas, knowledge, expertise, and experiences of audit and non-audit professionals alike to provide a variety of non-audit services and to deliver specialized understanding and higher quality to the audit engagement.

Mr. Nally noted that “the ability to draw upon this specialized knowledge of a broad range of subject matter experts and the need to deploy that knowledge and expertise effectively in the context of a complex, global audit will also change the requisite skill set of the audit engagement partner. For example, the move to ‘fair value’ measurement requires that engagement partners are well-versed in sophisticated valuation techniques. At the same time, determining how to deploy an increasingly global, multi-cultural workforce and coordinating work that could lead to reporting on information generated under evolving global accounting standards promises to increase the degree of difficulty on what is already a challenging responsibility. In that context, an engagement partner should be able to draw upon process improvement experts to design an audit that is both effective and efficient.”⁸

The future promises even greater complexity and will demand increasing sophistication from audit firms. Thus, ensuring the necessary human capital for the audit profession goes beyond

⁵ Nally Written Testimony at 3.

⁶ Draft Report at V:1

⁷ Nally Written Testimony at 3.

⁸ Nally Written Testimony at 4.

training, recruiting, and retaining skilled auditors. We must also enhance the profession's ability to recruit and retain individuals from a variety of educational backgrounds and professional experiences to meet these challenges.

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

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

We agree with the Committee's emphasis on modernization of auditor education, standards, and training. Specifically, we concur with the Draft Report's recommendation that "the accounting certification examination [be updated] to reflect changes in the accounting profession, its relevant professional and ethical standards, and the skills and knowledge required to serve increasingly global capital markets." We further believe that the 150-credit-hour requirement should be reviewed to ensure that in its current form it adequately contributes to the quality of preparatory education, skills, and certification.

We also support the recommendations to "reflect real world changes in the business environment more rapidly in teaching materials" and to "require that schools build into accounting curricula current market developments." In particular, we believe that university accounting curricula should be modernized and enhanced to include consideration of other teaching models from around the world. This would serve to increase knowledge of International Financial Reporting Standards (IFRS), finance and economics, and process controls.

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

- a) **Recruit minorities into the auditing profession from other disciplines and careers.**
- b) **Emphasize the role of community colleges in the recruitment of minorities into the auditing profession.**
- c) **Emphasize the utility and effectiveness of cross-sabbaticals and internships with faculty and students at Historically Black Colleges and Universities.**
- d) **Increase the numbers of minority accounting doctorates through focused efforts.**

We agree with the Committee regarding the importance of diversity in the audit profession and audit firms. Ensuring that individuals from all backgrounds and perspectives have equal

opportunities in the profession is an important and singular goal. Equally compelling, it is our experience that diversity strengthens audit quality by expanding the pool of human talent and allowing firms to draw on different backgrounds and experiences. For that reason, we believe that the Committee should consider compiling and publishing a set of best practices related to diversity recruiting and retention.

PwC believes improving diversity will be best accomplished when all of the key stakeholders work together to develop a long-term solution. With this in mind, we believe the Final Report of the Advisory Committee should place emphasis on the importance of attracting a more diverse pool of accounting students, as well as on the responsibility the higher education community bears, in conjunction with firms and practitioners, to achieve the levels of diversity we would all like to see in the profession. While African-Americans and Latino Americans make up 13 percent and 15 percent of the general population, respectively, African-Americans make up only 7 percent of accounting graduates and Hispanics only 5 percent.⁹ The problem is not a lack of demand within the profession for recruits from all communities and backgrounds, but a lack of minority graduates to fill the existing demand for accounting professionals. We agree with the Draft Report's recognition that community colleges are a potentially fertile source of prospective students for four-year accounting programs. We hope the Committee's Final Report will recommend steps that colleges and universities could take to transition students beginning higher education in two-year programs into bachelor's degree programs.

PricewaterhouseCoopers emphasizes the value of diversity among our partners and professionals. PwC's Chief Diversity Officer (CDO) is a practice partner who reports directly to the U.S. Senior Partner, focuses on diversity full-time, and is a member of the US Leadership Team and the firm's Extended Leadership Team. The Office of Diversity staff is comprised of six subject matter experts, who develop initiatives related to race, gender and sexual orientation, and nine local diversity managers who drive diversity activities in our largest markets. In addition, the firm has three full-time directors dedicated to minority sourcing, supplier diversity, and equal employment opportunity compliance, respectively. Finally, each line of service (audit, tax, and advisory) features partner champions who spend 20 percent of their time driving diversity, particularly with respect to succession planning.

While improving diversity is a goal for many in the corporate community, we believe the accounting profession faces additional obstacles because of a lack in diversity among the pool of candidates seeking an accounting degree. At PwC, we have made an effort to increase the awareness of the attractiveness of the accounting profession as a career at both the high school and collegiate levels. In 2007, we launched Impact, an educational community outreach program designed specifically for African American junior and senior high school students. Participants are matched with PwC professionals who serve as mentors and provide the students with guidance on educational and career choices.

⁹ Dennis R. Reigle, 2008 Trends in the Supply of Accounting Graduates and the Demand for Public Accounting Recruits, at 8.

The students attend dedicated workshops on college preparation and are invited to seminars to enhance their understanding of career opportunities in business. This three-year program is a \$5 million investment which we believe will help build a pipeline of minority talent for our profession. On college campuses, PwC is also working to expand the pool of accounting graduates by recruiting minorities with liberal arts degrees and then helping them to obtain a masters in accounting, and by launching our own pipeline program, “eXplore,” in 2007, which involves partnering with accounting departments to educate minority, non-accounting majors about the benefits of a career in accounting. PwC also has strategic partnership with INROADS, a program focused on placing minority interns, and with professional associations dedicated to diversity, including the Association of Latino Professionals in Finance and Accounting (ALPFA), the National Association of Black Accountants (NABA), and ASCEND, for Asian professionals.

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

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

Like the Committee, we view with concern the shortfall in doctoral accounting faculty. Testimony by academics and practitioners alike emphasizes the challenges that faculty, particularly newer faculty, face in gaining practical experience. Particularly troubling is the American Accounting Association’s determination that only 22 percent of the projected demand for doctoral auditing faculty, and only 27 percent of the projected demand for doctoral tax faculty, will be met by expected graduates.

We support the recommendation to increase “the supply of accounting faculty through public and private funding and raise the number of professionally-qualified faculty that teach on campuses.” As the Committee’s Draft Report recognizes, the profession currently provides significant private investment in this area; however, more could be done to involve other private-sector participants, such as public companies and investors, who also have a significant interest in ensuring the supply of the human capital necessary to perform high-quality audits, both from an internal and external perspective. Moreover, the public interest in the efficient functioning and competitiveness of U.S. capital markets calls for Congress, together with state and local officials, to review and consider increased public investment in this area to further complement the Committee’s recommendation that “a variety of tangible

and sufficiently attractive incentives” be created to motivate the private sector to fund accounting faculty and faculty research. We agree with the Committee that Congress should adopt measures “sufficiently attractive ... to effect rapid behavioral change.”

With regard to the recommendation to “emphasize the utility and effectiveness of cross-sabbaticals,” we support efforts to improve practice knowledge among faculty members, as well as efforts to expand opportunities for sustained reflection by practitioners. Given the shortage of Ph.D. candidates and the need for more classroom expertise, we believe the Committee should encourage academic institutions to include practice professionals—retired and practicing, alike—to improve the overall expertise provided in the classroom. Cross-sabbaticals can be an important tool in this regard. We also agree with the Draft Report’s recommendation that efforts be made to reduce the costs and disincentives that sometimes discourage individuals from participating in such exchanges.

We hope, however, that the Committee’s Final Report will include consideration of, and suggestions to mitigate, the other obstacles to such sabbaticals—such as the costs and challenges to academic institutions and firms that must forgo the services of critical professionals. This problem may be particularly acute in certain areas, such as tax and audit. Furthermore, as some on the Committee have pointed out during public hearings, cross-sabbatical opportunities can be more difficult for colleges and universities that are not located in large cities. Since such institutions represent a large portion of the relevant pool of candidates, consideration should be given as to how best to afford them the ability to participate in exchanges.

Committee Recommendation 4: Develop and maintain consistent demographic and higher education program profile data & Committee Recommendation 5: Encourage the AICPA and the AAA to jointly form a commission to provide a timely study of the possible future of the higher education structure for the accounting profession.

We support the Committee’s draft recommendation that the AICPA and AAA jointly study the future of the accountancy higher education structure, and maintain consistent demographic profile data. While the Draft Report specifically references “free-standing, post-graduate professional schools” for accounting and auditing as one potential subject for evaluation, we believe that the review should be broad-based and not limited to any one method or type of institution. The capital markets will be better served by more and broader portals to the auditing profession, and we believe much can be gained by integrating accounting education with other business and technology subjects.

A further proposal we urge the Committee to consider is reform of U.S. immigration law to allow for admission into the United States of greater numbers of highly qualified foreign students, professionals, and faculty for long-term residency. One mechanism would be expansion of the H-1B visa program. We believe such reforms would, with little cost relative to alternatives, constitute an important step toward increasing the supply of accounting teachers and professionals, enhance the international capability of audit teams and the U.S. profession in general, and provide another avenue for boosting diversity in the profession.

Firm Structure and Finances¹⁰

There is no question that the viability and quality of the U.S. audit profession directly reflect the vitality and quality of private audit firms. We therefore welcome the Committee's attention to issues related to the audit firm itself, including firm governance, regulation, and quality. The changes sweeping the profession in areas of technology, standards harmonization, business complexity, and oversight pose both challenges and opportunities to firms of all sizes. The methods and structures firms adopt to embrace and adapt to these changes will significantly affect the future of the profession.

Committee Recommendation 1: Strengthen auditing firms' fraud detection and prevention skills and clarify communications with investors regarding auditing firms' fraud detection responsibilities.

- a) **Urge the creation of a national center to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection experiences, practices, and data and innovations 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 SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards.**

We support the Draft Report's recommendations that the PCAOB and SEC "clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards" and that the PCAOB review those standards with appropriate input from the auditing community and capital-market participants. Auditors are charged with planning and performing audits to obtain reasonable assurance that financial statements are free of material misstatements, whether caused by error or fraud. This fundamental mission of the independent auditor makes it unrealistic to expect auditors to determine with absolute assurance that fraud has been in all instances detected; attempting to achieve this would make the audit process unwieldy, unworkable and prohibitively expensive. However, there will always be opportunities for improvements in identifying fraud risk factors. The goal should be for management to be more effective in preventing fraud and for both management and auditors to be more effective in detecting fraud.

To that end, we also support, through the Center for Audit Quality, the creation of a national center to facilitate a full exchange of ideas and best practices around fraud prevention and detection. Consistent with the Committee's draft recommendation, we believe the Center for Audit Quality would be the ideal place to continue this important effort and dialogue.

¹⁰ Draft Report of the Treasury Advisory Committee, Article VI.

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

- a) **Institute the following mechanism to encourage the states to substantially adopt the mobility provisions of the Uniform Accountancy Act, Fifth Edition (UAA); if states have failed to adopt the mobility provisions of the UAA by December 31, 2010, Congress should pass a federal provisions 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 findings that “enhancing regulatory cooperation and reducing duplicative oversight of the auditing profession by federal and state authorities ... are in the best interest of the public and the effective operation of capital markets.”¹¹ The recommendations for increased uniformity of state licensing and regulatory regimes, and for greater cooperation and coordination between the SEC, the PCAOB, and state regulators, are especially critical and welcome. Greater uniformity and coordination would reduce unnecessary compliance burdens on audit firms, enhance efficiency in the public company audit market, and reduce the cost of audits. At the same time, greater consistency and coordination should only improve the effectiveness of appropriate public oversight. That said, we applaud efforts already underway by individual states that recognize the importance of enhanced regulatory coordination, as well as the leadership of the National Association of State Boards of Accountancy (NASBA) to achieve this objective. We also recognize that Congress may be needed to assure any outlying states’ adoption of uniform mobility provisions and believe the December 31, 2010 deadline is appropriate given the significant progress being made to date with mobility.

Committee Recommendation 3: Urge the PCAOB and 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.

¹¹ Draft Report at VI:4

We agree with the Draft Report’s recognition that independent, external perspectives can be highly beneficial to an organization. For public companies, where the majority of owners (*i.e.*, shareholders) have little or no direct involvement in the management and direction of the company, independent members of boards of directors are an important component of good corporate governance. Likewise, in PricewaterhouseCoopers’ experience, the institution of independent audit committees of public company boards of directors has made important contributions to increasing audit quality.

Recognizing the value that independent perspectives bring, PricewaterhouseCoopers created an outside advisory committee that provides an important independent perspective and often offers keen insights into the operations of the firm. However, as the Committee’s draft report acknowledges, rules governing audit firm independence, state partnership laws, and the difficulty of getting insurance creates obstacles to attracting outsiders to serve on audit firms’ boards of directors. Unless and until those impediments to service by outside directors are removed, it will continue to be impossible for firms to have the option of providing those members of the firm with meaningful partnership governance roles.

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

Form 8-K’s existing disclosure requirement when a registrant changes auditors provides valuable information to capital markets. However, many such events are not required to be reported under existing regulations. We agree with the Draft Report’s finding that “explicitly stating the reason for [any] auditor change will assist investors in determining the quality of financial reporting and subsequent investment decisions.”¹² We believe that disclosure could usefully be expanded to include additional, objective facts regarding a change in auditor, but also believe the recommendation should be more specific and address whether a change was requested by the company or audit committee. As to the second component of the recommendation, we do not see a benefit to layering additional reporting requirements by mandating that any audit engagement change short of a full five-year rotation be reported to the PCAOB. Individual audit engagement partner assignments can change for a number of personal as well as professional reasons. From an audit quality standpoint, the issue is whether the firm has the appropriate quality control processes in place to manage those personnel moves. That is precisely the kind of issue that is the subject of the PCAOB’s annual inspection process, and we do not believe that either audit quality or sustainability would be enhanced from this additional reporting requirement.

¹² *Id.* at VI:10.

Addendum to Chapter VI

On May 30, 2008 the Committee released an Addendum to Chapter VI of the Draft Report setting forth certain further recommendations on firm structure and finances and describing certain additional recommendations still under consideration but not yet adopted.

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

We support this recommendation and the related suggestion that the PCAOB should “take cognizance of the proposal’s potential legal ramifications ... to auditors.”¹³ As Mr. Nally observed in his written testimony, “the combination of single reporting standards, more comprehensive global auditing standards, as well as other changes ... such as trend to fair value measurement ... leads one to consider whether it is necessary to change the content of the auditor’s report to be more relevant to the capital markets and various stakeholders.”¹⁴

As audits themselves evolve toward a more principles-based system on a uniform global basis, we believe it makes eminent good sense for the PCAOB and the SEC to evaluate whether audit reports convey as much information as the capital markets would find useful in making investment decisions. Such information likely goes beyond what is provided under the current “pass/fail” model for audit reports. Obviously, such an effort must be undertaken with the participation of relevant stakeholders, such as public companies, investors, public-company auditors, and other users of financial statements, as the Addendum correctly acknowledges. And finally, not unlike the move to a more principles-based financial reporting system, consideration of a more normative auditor’s report needs to be accompanied by consideration of whether the U.S. regulatory and litigation environment also should be reformed to accommodate that change.

Engagement Partner Signature

The Addendum states that “[t]he Committee is considering recommending that the PCAOB revise its auditor’s report standard to mandate the engagement partner’s signature on the auditor’s report.”¹⁵ We can discern no clear benefit from such a change, and, indeed, we believe that implementing this recommendation could undermine audit firm accountability and audit quality.

¹³ Addendum to VI at 3-4.

¹⁴ Nally Written Testimony at 7.

¹⁵ Addendum to VI at 5.

For example, while the Addendum cites supporters of such a change who believe that requiring engagement partners' signatures would enhance accountability, the Addendum provides no explanation of how such a change would do so. We are unaware of any instance in which a public-company audit committee did not know the identity of the engagement partner. Nor are we aware of situations in which a regulator (or private claimant, for that matter) was unable to determine who the responsible partner was in the event of an oversight inquiry or during the course of litigation. Indeed, we find it hard to conceive of such an event occurring. Since audit committees, regulators, and private claimants are the parties that ultimately hold an engagement partner accountable for an audit failure, requiring the engagement partner's signature on the audit report would not measurably increase his or her accountability. Nor does it seem likely that the name of the individual engagement partner is useful information from the perspective of investors.

More importantly, we believe this proposal is inconsistent with having the entire firm stand behind its audit reports. Successful, high-quality audits are the product of teams of individuals, and depend to a large extent on factors such as a firm's quality control system, its training program, and its professionals' expertise and judgment. On our largest audit assignments for multinational enterprises, it is not unusual for the global engagement team to include hundreds of partners. In addition, meaningful consultation within the audit team is a core component of high-quality auditing, especially in complex areas. By contrast, a singular focus on the signing partner's role could have the unintended consequence of fostering a "go it alone" mentality among lead engagement partners. We therefore discourage the Committee from adopting this recommendation in its Final Report.

Transparency

We believe the PCAOB has a critical role to play in promoting the reliability of financial information and in developing appropriate measures of audit quality. Through the PCAOB's oversight authority and annual inspection process, public company auditing firms now provide significantly increased transparency into their internal operations. This increased transparency and oversight provide an important safeguard to audit quality and independence, which is critical to all stakeholders in the marketplace.

The Addendum recommends that the PCAOB require that "larger auditing firms ... produce a public annual report incorporating (a) information required by the Article 40 Transparency Report deemed appropriate by the PCAOB ... and (b) such indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VII of this Report." As Mr. Nally testified before the Committee, and as we note below in our comments on that recommendation, PricewaterhouseCoopers supports the development and reporting of objective measures of audit quality.¹⁶ While we recognize that such reporting would impose burdens on firms, and that such burdens may lead the Committee to propose a "larger firm" threshold for such reports, we believe such information will be most useful when they are adopted and reported by the largest number of firms possible.

¹⁶ Nally Written Testimony at 6.

The Addendum also states that the Committee is “considering recommending ... [that] the PCAOB should require that ... the larger auditing firms file with the PCAOB on a confidential basis statements prepared in accordance with [GAAP] or [IFRS] and that the PCAOB will then either ... (1) determine, based on broad consultation, whether these audited financial statements should be made public ... or (2) make these audited financial statements publicly available.”¹⁷ For a number of reasons we urge the Committee not to adopt this recommendation.¹⁸

First, we would note that the PCAOB has broad, existing authority to gain access to audit firm proprietary information for purposes of carrying out its oversight functions. This is as it should be, as the PCAOB is the primary entity charged with maintaining the quality of audits performed by audit firms, which are private entities. To the extent that regulators seek to ensure the soundness of larger firms within the profession—the loss of one of which might be challenging for the market to absorb—the PCAOB or the SEC can demand access to information needed to gauge the likelihood of that eventuality, and recommend appropriate mitigating steps, whether by the firm or by regulators or legislators. By contrast, we do not see how public disclosure of audit-firm financials would advance the goal of avoiding the failure of one of the large public-company audit firms.

Second, no compelling affirmative case for public disclosure of proprietary firm financial information has been made. Some have suggested that because public companies must report audited financial information, public-company auditors should do so as well. That is a non sequitur. As PwC’s Chet Gerdts explained in his testimony, “for public registrants, financial disclosure is essential to let their owners—public shareholders—understand and monitor how the companies are performing. For audit firms, the equivalent disclosure would involve the metrics that provide the government and the capital markets confidence that audit firms are providing trustworthy, quality audits. Disclosure of firm financial statements would not meet that objective.”¹⁹

While there is no question that the audit profession has a public mandate to help ensure the soundness of capital markets, the profession is highly regulated at both state and federal levels to ensure that it carries out its obligation to public companies and their shareholders. Audit fee levels are set by the market, and there is strong competition among audit firms for this business.²⁰ There is no evidence that disclosure of audit-firm financial statements would improve price or service competition among audit firms. Indeed, no one has articulated a cognizable basis for the capital markets to need or desire proprietary firm financial

¹⁷ Addendum to VI at 7.

¹⁸ We note that the written testimonies of Charles W. Gerdts, III and Katherine Oberly submitted to the Committee gave extensive treatment to this subject and we commend it to the Committee’s attention.

¹⁹ Gerdts Written Testimony at 12.

²⁰ U.S. Government Accountability Office, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call For Immediate Action* 27 (January 2008); Gerdts Written Submission at 3.

information, nor has there been demand across capital-market participants for such information.

Third, public disclosure of firm financials would likely undermine competition in the audit-services market and reduce audit quality. As Mr. Gerdts observed, “the burdens of public disclosure will deter the entry of smaller firms into the sphere of those larger firms subject to a financial reporting mandate ... [and] auditors who fall outside the reporting regime may face a different problem; the false impression that lack of disclosure means that such firms are less well-regulated than their larger competitors.”²¹

Fourth, we would note that many public-company audit firms provide information on firm financial performance and other important metrics through various mechanisms according to the needs of their owners, the firm partners. Unlike investors in a public company who need such data to make informed investment decisions, no similar objective applies to the financial information of an accounting firm.

Finally, putting proprietary financial information into the public is at odds with the Committee’s goal of enhancing the sustainability of the accounting profession because of the effect it will have on litigation. As pointed out below, one of the central criticisms of the current litigation system is that case resolutions too often are driven not by the merits of the claim, but by financial considerations. Requiring firms to make public information that currently is generally unavailable in discovery would move those discussions further from the merits, and push them toward consideration of a firm’s ability to pay. It is hard to see how such a move would promote either audit quality or sustainability.

Litigation

After “[t]aking note that Sarbanes Oxley established a new level of federal regulation over the public company auditing profession,” the Addendum goes on to state that the Committee is “considering whether it should recommend that Congress provide federal courts with exclusive jurisdiction over some categories of claims, which presently may be brought in state courts against auditors, when such claims are related to audits of public company statements.” If Congress were to undertake such an effort, the Addendum notes, it should “develop a uniform standard of care with appropriate and necessary levels of investor protection.”²²

We welcome the Committee’s recognition that liability reform is necessary to maintain the viability of the auditing profession, and is critical to U.S. capital markets’ competitiveness. As Mr. Gerdts noted in his testimony, “[v]irtually every study of the accounting profession in recent years has recognized that the major firms performing public-company audits face the very substantial risk of a catastrophic event ... and a significant component of [that risk] is the current U.S. litigation regime under which auditing firms operate.”²³ As the Draft Report

²¹ Gerdts Written Testimony at 14.

²² Addendum to VI at 8.

²³ Gerdts Written Testimony at 6.

itself states, “civil litigation was the risk most often cited by witnesses before the Committee.”²⁴ Moreover, this exposure not only threatens the viability of the largest firms, it also “deters small and mid-sized firms from expanding their public company audit business or entering the market in the first place.”²⁵ By limiting audit firm choice, liability risk actually undermines competition and therefore audit quality.

As Mr. Nally observed in his testimony, “solutions aimed at insulating the auditing profession from some of the consequences of the U.S. litigation system miss the point that the system itself should be examined. ... [M]uch of the litigation risk for accounting firms stems from the firms’ recurring role as defendants in securities class action litigation.”²⁶ While the Committee’s recommendation appears specific to auditor liability, a recommendation regarding jurisdiction and a uniform standard of care should address “whether the U.S. securities litigation system efficiently accomplishes the goals of compensation and deterrence.”²⁷

Concentration and Competition²⁸

PricewaterhouseCoopers’ experience is that competition in the audit-services market is robust and audit quality is very high. Mr. Gerdtz noted that “we face strong competition from the other largest firms as well as from smaller and mid-sized firms” for prospective audit clients.²⁹ We believe that the testimony before the Committee has confirmed the PricewaterhouseCoopers’ experience, and we believe that Chapter VII of the Draft Report accurately reflects this market reality.

The Draft Report observes that the number of audit firms competing for the business of small and mid-sized public companies has increased markedly between 2002 and 2006. Firms other than the largest four firms now serve 78 percent of public registrants with revenues below \$100 million, up from 56 percent in 2002, and 29 percent of public companies with revenues between \$100 million and \$500 million, up from 10 percent in 2002. While larger public companies are served predominantly by the largest four firms, as the Draft Report correctly acknowledges, “large public companies with operations in multiple countries need auditing firms with global resources and technical and industry expertise to deal with increasingly complex business and financial reporting environment. These needs limit auditor choice to only the largest auditing firms for many large public companies.”³⁰

²⁴ Report at VII:6 n.27.

²⁵ Gerdtz Written Testimony at 7.

²⁶ Nally Written Testimony at 3.

²⁷ *Id.*

²⁸ Draft Report, Treasury Advisory Committee on the Audit Profession, Article VII.

²⁹ Gerdtz Written Testimony at 3.

³⁰ Draft Report at VII:1.

We view as very important the Committee’s draft conclusions that “audit quality ha[s] improved,” and that “higher audit market concentration has not been associated with higher fees.”³¹ This reflects the GAO report’s findings as well as our experience in the market.

As the Draft Report notes, the Center for Audit Quality recently reported that 82 percent of surveyed audit committee members believe that audit quality has improved over the past several years, 78 percent believe current audit quality is very good or excellent, and another 17 percent believe audit quality is good. Given the direct relevance of this recently gathered information, we believe these findings should be included in the Advisory Committee’s Final Report. Other objective data support this conclusion. The proportion of restatements prompted by fraud has dropped dramatically—from 29 percent of restatements in 1997 to 2 percent in 2006. The proportion of revenue restatements has dropped from 41 percent to 11 percent over the same period.³² Moreover, a recent Glass Lewis analysis notes that restatements overall have dropped in 2007, and predicts this trend will continue going forward.³³

Committee Recommendation 1: Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goals of promoting audit quality. Because smaller auditing firms are likely to become significant competitors in the market for larger company audits only in the long term, the committee recognizes that recommendation 2 will be a higher priority in the near term.

- a) **Require disclosure by public companies in their annual reports and proxy statements of any provisions in agreements with third parties that limit auditor choice.**
- b) **Include representatives of smaller auditing firms in committees, public forums, fellowships and other engagements.**

PricewaterhouseCoopers believes that competition for audit services promotes audit quality. Therefore, we support the Committee’s recommendation that barriers to growth of smaller audit firms be reduced, consistent with maintaining and enhancing audit quality. We have no objection to the Committee’s specific recommendations that public companies disclose “provisions in agreements with third parties that limit auditor choice” and that representatives of smaller audit firms be included in “committees, public forums, fellowships and other engagements.” As to the former, however, we would note that the Committee heard testimony that the largest four firms are perceived by some market participants as the benchmark of audit quality or a “good housekeeping seal of approval” for audits.³⁴ Therefore, we would not expect that greater disclosure in this area would likely promote movement away from the

³¹ *Id.* at VII:2.

³² U.S. Department of the Treasury Department, *The Changing Nature and Consequences of Public Company Financial Restatements* 13 (April 2008)

³³ BNA, *Daily Report for Executives*, “Glass Lewis Analysis Anticipates Continued Downturn in Restatements,” June 5, 2006.

³⁴ February 4, 2008 Tr. 219, 243.

largest four firms. But we view efforts to encourage competition on reputation as quality-enhancing. As to the latter, we suggest that the PCAOB's Standing Advisory Committee, which includes a broad cross-section of individuals with interest in the profession, may provide a useful model.

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

- a) **As part of its current oversight over registered auditing firms the PCAOB should monitor potential sources of catastrophic risk which would threaten audit quality.**
- b) **Establish a mechanism to assist in the preservation and rehabilitation of a troubled larger auditing firm. A first step would encourage larger auditing firms to adopt voluntarily a contingent streamlined internal governance mechanism that could be triggered in the event of threatening circumstances. If the governance mechanism failed to stabilize the firm, a second step would permit the SEC to appoint a court-approved trustee to seek to preserve and rehabilitate the firm by addressing the threatening situation, including though a reorganization, or if such a step were unsuccessful, to pursue an orderly transition.**

We commend the Committee's attention to the problem of catastrophic risk to audit firms. As Mr. Gerdts noted in his testimony, the report "sets forth some useful ideas for preservation and rehabilitation of troubled public-company audit firms after a catastrophic risk has emerged. Both the concept of monitoring potential sources of catastrophic risk and the notion of creating a mechanism for the preservation and rehabilitation of larger firms deserve serious consideration."³⁵

However, as Mr. Gerdts's testimony describes in detail, preservation and rehabilitation will be difficult to achieve in practice due to the "fundamental challenge that the ongoing survival of a troubled firm must necessarily be subject to the disparate (perhaps conflicting) markets interests and duties of regulators, prosecutors, private plaintiffs, firm partners and professionals, other firms in the relevant global network and, most importantly, the public companies themselves."³⁶ Such a maelstrom can damage a firm beyond repair very swiftly, and by the time external preservation mechanisms can be put in place it may simply be too late. Therefore, our view is that the "the better course to maintaining the sustainability of the profession ... would be to take steps to prevent the catastrophic loss in the first place."³⁷

As we noted above in our comments on the Addendum to Chapter VI, we view private litigation as a primary source of catastrophic risk to audit firms. Some have suggested that raising this concern is tantamount to proposing that audit firms not be held accountable for instances of gross negligence or wrongdoing that result in a loss of shareholder value. We

³⁵ Gerdts Written Testimony at 8.

³⁶ *Id.* at 9.

³⁷ *Id.* at 10.

respectfully submit that this is not the issue. No one believes that the capital markets' confidence in public-company audits can be maintained in an environment where auditors are unaccountable. Nor is the issue whether private litigation can be an appropriate mechanism to hold auditors accountable and compensate wronged investors. Most would agree that it can. Rather, as many witnesses before the Committee have emphasized, the problem is that for certain clients with large market capitalizations, the potential liability exposure over an alleged audit failure is so massive that no auditing firm can in good conscience roll the dice on a trial on the merits—even when the merits are strongly in favor of exonerating the auditors.³⁸

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

As Mr. Nally stated in his testimony, “public disclosure about key elements that drive audit quality would be a useful benefit to the capital markets.”³⁹ Beyond PCAOB monitoring, we believe that disclosure of objective measurements of quality, perhaps coupled with equally important qualitative data which can more effectively describe such quality components as tone-at-the-top and firm culture, will be of use to public-company audit committees in choosing between audit firms. Indeed, such transparency should help drive competition on the basis of audit quality. As Mr. Gerdts noted, “objective criteria bearing upon firm quality could create a more level playing field for less well-established entrants into all subsectors of the market.”⁴⁰ In other words, small and mid-sized firms may be able to leverage disclosure of metrics of audit quality to mitigate the reputational advantages of better-known “brand names” in the audit-services market. Moreover, investors can use such information to make judgments about the accuracy of registrant financial disclosures. Finally, we believe that the European Union’s Eighth Directive provides a useful model for a transparency regime that the PCAOB could adapt to the U.S. context.

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

- a) **Compile the SEC and PCAOB independence requirements into a single document and make this document website accessible. The AICPA and states should clarify and prominently note that differences exist between the SEC and PCAOB standards (applicable to public companies) and the AICPA and state standards**

³⁸ Gerdts Testimony, June 3, 2008 Transcript at 323-25; Young Testimony, June 3, 2008 Transcript at 158-59.

³⁹ Nally Written Testimony at 6.

⁴⁰ Gerdts Written Testimony at 11.

(applicable in all circumstances, but subject to SEC and PCAOB standards, in the case of public companies) and indicate, at each place in their standards where differences exist, that stricter SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements. This compilation should not require rulemaking by either the SEC or the PCAOB because it only calls for assembly and compilation of existing rules.

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

We agree that a greater understanding by all capital-market participants of auditor independence requirements would enhance competition and audit quality, in part by making those participants aware of the restrictions the requirements place on audit choice. To that end, we support the Draft Report’s recommendation that “the SEC and PCAOB independence requirements [be compiled] into a single document” that is website accessible and that “the AICPA and states should clarify and prominently note that differences exist between the SEC and PCAOB standards (applicable to public companies) and the AICPA and state standards.”

We also agree with the Draft Report’s recommendation that training materials be developed to “help foster and maintain a healthy professional skepticism with respect to issues of independence that is objectively focused and extends beyond a ‘check the box’ mentality.” Indeed, PricewaterhouseCoopers maintains a comprehensive training program on independence requirements and related issues for its personnel (partners and staff from all lines of services). This includes annual, computer-based training for all partners and professional staff, comprehensive training for new hires, targeted training for professional staff at career milestones (*e.g.*, new managers and new partners), as well as numerous other communications and messages regarding the independence rules and their application to different situations.

Overall, PwC believes that independence forms the bedrock of credibility in the auditing profession, and is essential to the firm’s primary function in the capital markets. At the same time, independence rules are most beneficial to investors and other stakeholders in the capital markets when they are robust, conceptually sound, well understood, and risk-based in order to keep pace with an increasingly complex, global marketplace. To that end, we hope the Committee in its final report will encourage the regulators to make improvements in the independence regime, addressing especially those areas that are most complex and least well-understood.

Committee recommendation 5: Adopt annual shareholder ratification of public company auditors by all public companies.

While we are supportive of the concept of shareholder ratification of audit committees' selection of audit firms, it is our experience that the reinvigorated leadership undertaken by independent audit committees pursuant to the Sarbanes-Oxley Act is a key driver of the improvement in audit quality. Therefore, we have concerns regarding proposals that could diminish or have the appearance of diminishing this critical audit committee function, in an effort to place shareholders in a position to drive auditor choice—a role we believe shareholders, in the aggregate, are less equipped to perform. However, we imagine the Committee is cognizant of, and agrees with, this distinction and we assume it is not the Committee's intention to undermine oversight and control by audit committees over the audit process.

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

As noted above, we believe we are quickly moving toward a world of greater harmonization of audit systems across national jurisdictions. We view this as a welcome development, both for audit quality and for enhanced mobility of capital across capital markets. Therefore, we strongly support cooperation and collaboration between the PCAOB and its foreign counterparts to facilitate this trend.

In conclusion, we appreciate the Committee members' time and service, and we thank the Committee for its consideration of our comments on the Draft Report.

Sincerely,

PricewaterhouseCoopers, LLP

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