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August 26, 2008

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

Re: Second Draft Report of the Advisory Committee on the Auditing Profession

Dear Members of the Committee:

Thank you for the opportunity to provide our views on the Second Draft Report of the Advisory Committee on the Auditing Profession dated July 22, 2008 (the "Second Draft Report").

BDO Seidman, LLP is a national accounting firm providing services to a wide range of publicly-traded and privately-held companies. Guided by our core values of competence, honesty, integrity, professionalism, dedication, responsibility, and accountability, we have provided quality service and leadership in the profession for almost 100 years through the active involvement of our experienced and committed professionals.

We serve clients through 37 offices and more than 150 independent alliance firms nationwide. As a Member Firm of BDO International, we serve multinational clients by leveraging a global network of resources comprising over 600 Member Firm offices in 107 countries. Each BDO International Member Firm is an independent legal entity in its own country.

Our firm currently audits well over 300 U.S. publicly-traded companies, including four in the Fortune 500. Many of these clients have foreign subsidiaries that are audited by other Member Firms of BDO International. We also review the SEC filings of approximately 70 foreign filers audited by other BDO International Member Firms. During the last three years, we gained a substantial number of large publicly-traded audit clients.

We appreciate the significant efforts undertaken by the Advisory Committee and the scope of its deliberations relating to its objective, as stated in its Charter, of providing advice and recommendations on the sustainability of a strong and vibrant public company accounting profession. In that regard, as we stated in our June comment letter with respect to the May 2008 Draft Report and related Addendum, we support many of the recommendations contained in the Second Draft Report. However, while we appreciate certain changes made from the May Draft Report, we continue to be disappointed that the totality of the recommendations (particularly in dealing with catastrophic risk) is insufficiently robust to

achieve the stated objective. Moreover, as described in that comment letter, we believe that certain of the recommendations may actually be detrimental to the profession and the public interest because of the interaction with other issues addressed by the Advisory Committee.

Because the Second Draft Report is substantially similar to the earlier Draft Report and related Addendum, this letter reiterates in summary fashion the fundamental concerns expressed in detail in our June letter, a copy of which is attached for ease of reference, that we believe should still be further addressed. After each of the subheadings below, there is a cross reference to the applicable item number in the Second Draft Report.

IV. HUMAN CAPITAL

Professionally Qualified Faculty (3a)—Accreditation standards should be revised to increase the percentage of faculty with significant practical experience.

V. FIRM STRUCTURE AND FINANCES

- ***Independent Board Members (3)***—In theory, we support the feasibility of appointing independent members to firm boards. However, because registered firms operate in a significantly different environment from that of a public company, we see little incremental benefit from the recommendation. In that regard, we are pleased that the Second Draft Report acknowledges the significant impediments to attracting independent board members.

- ***8-K Disclosure of Auditor Changes (4)***—We agree with the need for more transparent disclosure of auditor changes. However, in our view, a requirement to report the reasons for all changes is overly broad. Disclosures should address specific objective facts or events.

- ***Clarification of the Auditor's Role*** (5)—We support clarification of the auditor's role and limitations in detecting fraud, including considering the implications on auditor liability.

- ***Disclosure of Engagement Partner's Name (6)***—In our view, disclosure of the engagement partner's name in the proxy statement and/or mandating his or her signature on the auditor's report will not increase the partner's accountability or increase audit quality. We believe this would represent form over substance and could have unintended adverse consequences.

- ***Audit Quality Indicators and Disclosure of Audited Financial Statements (7)***—We would be pleased to work with the PCAOB and others in developing

appropriately disclosable key indicators of audit quality. Such indicators should be disclosed only if they clearly relate to audit quality and can be understood in the context of a particular audit. We suggest that the recently published framework of the Financial Reporting Council in the United Kingdom would be useful input to this initiative.

We are pleased that the Second Draft Report does not recommend dissemination of audited financial statements to the public. However, we believe that provision of audited financial statements to the PCAOB is not warranted since the PCAOB's current ability to obtain financial information is sufficient to provide insight into any firm sustainability issues. While this information is unaudited, we see little benefit in having firms incur the substantial cost of an audit. More importantly, we are unaware of any valid link that has been made whereby audited financial statements can provide meaningful indicators of audit quality.

VI. CONCENTRATION AND COMPETITION

- ***Provisions that Limit Auditor Choice (1a)***—We agree that provisions in agreements that limit auditor choice would impede the entry of smaller firms into the large company audit market. However, we question the effectiveness of the recommendation and are concerned that it could have unintended adverse consequences. We suggest that the SEC adopt a rule prohibiting such agreements, other than to specify that auditor selection be based on qualitative factors that demonstrate suitability to perform the audit.

- ***Preservation and Rehabilitation Mechanism (2b)***—In our view, the acknowledgment in the Second Draft Report that catastrophic risks faced by accounting firms are real, and similar concerns expressed in the 2008 GAO Report and in the May 2008 Recommendation of the Commission of the European Communities calling for liability limitations stand in stark contrast to the Advisory Committee's recommendations, which we believe fall far short of adequately addressing the risks.

  We do not believe the two step preservation and rehabilitation approach recommended by the Advisory Committee will accomplish its goal because it does not recognize the very real distinction between the fragile people-oriented nature of an accounting partnership and the typical corporate scenario.

  Our suggestions for dealing with catastrophic risks include:

  - Appeal bond limits

- Liability caps, structured so as not to be competitively disadvantageous to smaller firms
- Defendant's right to appeal denials of motions to dismiss
- Federal jurisdiction over lawsuits against accounting firms
- A single clear standard of care
- Ability to assert defenses in suits on behalf of bankrupt companies
- Supplemental government insurance
- Consulting by government authorities before they take action

- ***Independence Requirements*** **(4)**—While we agree with the recommendation to promote an understanding of independence rules, we believe more meaningful progress can be made by simplifying and harmonizing the rules.

PARTNER ROTATION

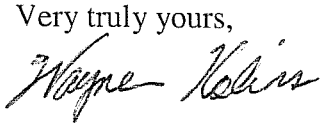
While the partner rotation roles of the Sarbanes-Oxley Act and related rules adopted by the SEC in 2003 continue to be excluded from the Second Draft Report, we believe they should be reconsidered in light of the significant issues they pose from human resource and audit quality perspectives. In that regard, we recommend that:

- The cooling off period for lead and reviewing partners should be reduced to two years from five.
- When the lead and reviewing partner begin their roles in the same year, the reviewing partner should be given an additional year of service beyond the five years.
- The rotation requirements for other partners should be eliminated or relaxed.

* * * *

We appreciate being able to provide our comments on the Second Draft Report and would welcome the opportunity to discuss our comments with you.

Very truly yours,



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June 27, 2008

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

Re: Draft Report of the Advisory Committee on the Auditing Profession and related Addendum to VI. Firm Structure and Finances

Dear Members of the Committee:

Thank you for the opportunity to provide our views on the Draft Report of the Advisory Committee on the Auditing Profession (the "Draft Report") and the Addendum issued May 30, 2008 (the "Addendum").

BDO Seidman, LLP is a national accounting firm providing services to a wide range of publicly-traded and privately-held companies. Guided by our core values of competence, honesty, integrity, professionalism, dedication, responsibility, and accountability, we have provided quality service and leadership in the profession for almost 100 years through the active involvement of our experienced and committed professionals.

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We appreciate the significant efforts undertaken by the Advisory Committee and the scope of its deliberations relating to its objective, as stated in its Charter, of providing advice and recommendations on the sustainability of a strong and vibrant public company accounting profession. In that regard, we support many of the recommendations contained in the Draft Report and Addendum. However, we do not believe the totality of the recommendations to date (particularly in dealing with catastrophic risk) is sufficiently robust to achieve the stated objective. Moreover, as described in our comments, we believe that certain of the

recommendations may actually be detrimental to the profession and the public interest because of the interaction with other issues addressed by the Advisory Committee.

Our comments on the draft recommendations with which we have fundamental concerns are set forth below.

V—HUMAN CAPITAL

3(a). Increase the supply of accounting faculty through public and private funding and raise the number of professionally qualified faculty that teach on campus.

We believe there needs to be greater emphasis on revising accreditation standards to allow the employment of a greater percentage of professionals with significant practical business experience. With the increasingly complex business environment and the myriad experiences encountered by professionals in the public accounting profession, private industry, and the government, it is critical that students benefit from this wealth of knowledge.

VI—FIRM STRUCTURE AND FINANCES

1(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.

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

The historical expectation gap is still very much a reality. Accordingly, we support the portion of the recommendation that would clarify, in the auditor's report, the auditor's role and limitations in detecting fraud under current auditing standards. In considering that recommendation, the PCAOB and SEC should also address management's role in detecting fraud and its primary responsibility for preventing fraud. Any changes to the auditor's report that go beyond this area (e.g., narrative descriptions of various judgments and other subjective analyses) should be approached with extreme caution, though, by considering the implications of such changes on the auditor's liability. Certain of the concepts underlying the broad Advisory Committee recommendation are applied in countries with far less onerous liability environments than in the U.S., so the effect of adopting them in the U.S. is far from certain.

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

In theory, we support having the PCAOB and SEC explore the feasibility of this recommendation. The best practices and the regulatory, legislative, and listing requirements established in recent years have led to enhanced oversight of public companies by boards that include independent directors and, as a result, have strengthened investor confidence in financial reporting.

However, in considering this recommendation, the Advisory Committee should keep in mind that an accounting firm operates in a significantly different oversight environment from that of a public company. While independent directors provide the only layer of oversight to the business activities of public companies, such oversight in the case of an accounting firm's activities would be incremental to that currently provided by the PCAOB during its rigorous inspection process. Such inspection process includes a focus on areas that would likely also be the key concerns of independent board oversight—tone at the top, the partner compensation process, independence, risk monitoring, technical competence, professional resources, and compliance with rules and regulations. Therefore, we see little incremental benefit of having independent directors or advisory boards for accounting firms registered with the PCAOB.

The Advisory Committee's recommendation does not appear to reflect how the fiduciary duty of an independent director of an accounting firm would differ from that of an independent director of a public company. The independent director of a public company has a fiduciary duty to the shareholders, who generally are passive owners of the company. In contrast, as stated in the Draft Report, the fiduciary duties of an independent director of an accounting firm "run to the auditing firm and its partners/owners…," who are actively involved in the business. We assume that the recommendation would, therefore, not extend these duties beyond this scope; otherwise, it would be a significant and unwarranted extension of directors' current duties and a possible conflict of interest. This would likely be a substantial disincentive to serving as a director (for either an active partner in the firm or an independent director). It would also appear to discourage accounting firm partners from consenting to participation by outsiders on their firms' boards.

Consideration of the recommendation should also recognize that there are a variety of structures in which accounting firms operate, so each firm should be given flexibility in how to implement any final recommendation.

We are pleased that the Draft Report acknowledges certain significant impediments to attracting independent board members—diverse state partnership laws that prohibit non-CPAs from involvement with firm governance, the need for board members to comply with SEC and PCAOB independence rules, and the difficulty that independent board members may have in obtaining insurance in view of the present inability some audit firms have in obtaining management liability insurance.

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 change on public company audit clients.**

We agree with the need for more transparent disclosure of auditor changes if that disclosure provides insight into an issuer's governance process relating to financial reporting. However, we believe that a requirement to "characterize appropriately and report every public company auditor change" is overly broad. Further, a requirement for auditors to respond as to the accuracy of disclosures relating to subjective reasons is not feasible, since auditors have no basis for agreeing or disagreeing with management regarding *why* they dismissed the auditors. Instead, we suggest that Item 304 of Regulation S-K be expanded to cover specific objective facts or events relating to the auditor change, such as:

- Whether the predecessor auditor is no longer independent of the issuer.
- Whether the issuer restated its financial statements for correction of an error during the last two fiscal years and subsequent interim period.
- Any conditions imposed on the issuer by a successor auditor as part of their acceptance of the engagement (e.g., changes in personnel in a financial oversight role).

We do not see an appreciable benefit in a requirement to notify the PCAOB as to premature changes in engagement partner, because such changes could occur for a myriad of reasons unrelated to audit quality or the relationship between the firm and the issuer. If there is to be such notification, we suggest that the conditions triggering it should be specifically defined and exclude routine matters.

VII—CONCENTRATION AND COMPETITION

1(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.

We agree with the concern that provisions in agreements with third parties that limit auditor choice would impede the entry of smaller firms into the large company audit market. However, we question whether the Advisory Committee's recommendation will achieve its stated objective. In that regard, it is not clear how such disclosure will reduce the incidence of these agreements. It seems unlikely that issuers and third parties would be reluctant to enter into these agreements out of the fear that they might be perceived in a negative light by investors and regulators, and we are, therefore, skeptical that this indirect means of addressing this issue is likely to be effective. Public disclosure of the agreements may actually have the unintended consequence of making other third parties aware of their use, motivating them to insert those provisions in their own agreements with issuers, thereby increasing, rather than decreasing, their use.

We suggest a different approach to address this issue. The Advisory Committee could recommend that the SEC adopt a rule prohibiting agreements with third parties that limit auditor selection to specific firms, other than to specify that the firm selected must be suitably qualified to perform the audit. Factors to consider in determining whether the firm is suitably qualified would be described in the rule and could include: accounting expertise and experience, experience in auditing public companies, PCAOB inspection results, adequate resources, domestic and international reach, quality of the firm's audit methodology and the consistency with which it is applied globally throughout the firm's network, the nature and extent of partner involvement in the audit, firm technology, technical support provided to audit professionals, firm culture, and tone at the top.

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

We appreciate the Advisory Committee's acknowledgment that catastrophic "risks are real" and that the loss of one of the larger accounting firms would likely have a significant negative impact on the capital markets. As stated in the Draft Report, such risks include "general financial risks and risks relating to failure in the provision of audit services and non-audit services, including civil litigation, regulatory actions, and loss of customers, employees, or auditing network partners due to a loss of reputation."

This view is supported by the 2008 GAO Report (referred to in the Draft Report) that noted the possibility of the loss of one of the largest firms due to matters such as civil litigation, regulatory action, or criminal prosecution.

In addition, the global reach of this catastrophic risk problem is exemplified by the May 2008 Recommendation of the Commission of the European Communities. According to the Recommendation, "[s]mooth functioning of the capital markets requires sustainable audit capacity and a competitive market for audit services in which there is a sufficient choice of audit firms capable of conducting and willing to conduct statutory audits of companies the securities of which are admitted to trading on a regulated market of a Member State. However, increasing volatility in market capitalization has led to much higher liability risks, whilst access to insurance coverage... has become increasingly limited... Since unlimited joint and several liability may deter audit firms... from entering the international audit market for listed companies in the Community, there is little prospect of new audit networks emerging which are in a position to conduct statutory audits of such companies... As a consequence, the liability of auditors... carrying out statutory audits of listed companies should be limited." Accordingly, the Commission recommended that the Member States either establish liability caps or a system of proportionate liability for audits of listed companies in the European Union. In response to those who would ask whether a liability limitation would have a negative impact on audit quality, the Frequently Asked Questions ("FAQ") associated with the Recommendation states, "During the public consultation in early 2007, a majority of respondents (including investors) from countries where a liability cap already exists (e.g., Germany, Austria, and Belgium) supported a Commission initiative and did not believe that their domestic cap had had adverse effects on audit quality." In that regard, the FAQ recognized the "pivotal role [audit regulators will play] in maintaining the high audit quality which companies and investors deserve." In assessing the strength of the Commission's recommendation, it is particularly noteworthy that it was developed in a litigation environment that is significantly less hostile than that in the U.S.

The aforementioned views as to the severity of catastrophic risk expressed in the Draft Report, the GAO Report and the Recommendation of the Commission of the European Communities stand in stark contrast, however, to the Advisory Committee's recommendations, which we believe fall far short of adequately addressing catastrophic risk relating to civil litigation or regulatory/governmental enforcement action. Before offering our recommendations to sufficiently address such risk, we will comment on recommendation 2(b) of the Draft Report.

The two step preservation and rehabilitation approach recommended by the Advisory Committee seems better suited to address widespread quality control issues within a firm, rather than circumstances where the firm is facing demise resulting from catastrophic risk. It appears to be structured as an after-the-fact solution, instead of a mechanism to prevent the risk from becoming catastrophic. Moreover, while this approach might be effective in a corporate scenario, a corporation selling products is radically different from an accounting firm whose sole major assets are its licenses to practice, its people, and its reputation, which allow it to service and retain clients and, therefore, remain in business. Accordingly, we do not believe this approach will accomplish its goal.

We believe it is important to evaluate the recommendation in the context of an accounting partnership, which is wholly dependent on its people, licenses, and professional reputation in order to stay in business. Professionals are hired and retained by firms based on their individual skills. However, professionals possessing such skills are highly mobile. Companies retain accounting firms based on their reputation and ability to perform quality work, the skills of the particular engagement team performing the audit, and the technical support from the rest of the firm. The fragility of this environment becomes readily apparent when a firm is facing catastrophic risk from litigation or regulatory action. In those cases, a firm may find itself dealing with a deadly confluence of self-perpetuating events: departure of clients, departure of partners and other professionals and failure to attract recruits, drying up of bank financing, landlords' refusal to renew leases, and disintegration of the firm's international network.

We agree that firms should have a centralized governance mechanism designed to respond quickly and wisely to threatening circumstances. However, we believe that most audit firms currently have such a governance structure in place. If the first step of the draft recommendation is intended to replace a firm's existing governance team with a new one, this would likely erode the confidence in management at a time when such confidence is crucial. Ordinarily, a catastrophic risk stems from a specific matter involving a relatively small number of people, rather than from a systemic failure of management. Therefore, replacing a centralized management team picked by the

partners for their managerial ability with another, less well known and ostensibly less qualified or less experienced, team would be likely to weaken the firm's ability to successfully resolve the threats.

The second step (an external preservation mechanism) also raises doubts as to its workability. This step apparently presumes that an SEC-appointed trustee would be able to provide sufficient assurance to the firm's clients, partners, employees, international network, banks, and landlords to prevent a mass exodus, while holding at bay the causes of the catastrophic threat—plaintiffs and/or regulators/government agencies. For the same reasons discussed above, we believe that appointment of a trustee may actually accelerate the departure of clients, personnel, and others. In this quasi-bankruptcy type of solution proposed by the second step, the testimony of James Doty is particularly relevant: "[i]t is an anecdotal but firmly held perception of the profession that no accounting firm has entered bankruptcy and emerged to continue its practice. The hard assets of the firm are not significant: the professionals and the clients are the lifeblood of the registered firm. With any anticipation of bankruptcy, these mobile assets are gone."

Suggestions for Dealing with Catastrophic Risk

The major catastrophic risks faced by accounting firms are civil litigation and regulatory/governmental enforcement actions. While we believe that firms should be held responsible for their actions, any resultant liability should be fairly determined based on the totality of the circumstances and the ability of the firms to defend themselves throughout the entire judicial and regulatory processes. We believe that, in many cases, this does not occur. We offer the following suggestions in this regard:

- ***Appeal bond limits***—An accounting firm generally must post a bond in order to stay execution of a judgment resulting from an adverse verdict. Unless there is a statutory limit placed on the bond, the amount required to be paid is generally at least equal to the judgment. As a result, a firm that is financially unable to post the full bond may also be unable to appeal the trial court verdict even if it is replete with errors. This potential outcome may force firms to settle cases at exorbitantly high levels, rather than risk the uncertainties of a jury trial. Currently, only 22 states have appeal bond caps and there are no caps at the federal level. Accordingly, we suggest that the Advisory Committee recommend that suitable limits be adopted by all states and in federal courts to protect a defendant's right to appeal.

- ***Liability caps***— Given the sheer magnitude of the claims against accounting firms, as demonstrated by the data provided to the Advisory Committee in April

2008 by the six largest accounting firms, we believe it is logical to consider whether liability caps should be part of a cohesive plan to address catastrophic risk. Such caps could take a variety of forms, but should be structured so as not to be competitively disadvantageous to firms of different sizes.

- ***Defendant's right to appeal denials of motions to dismiss***—A plaintiff is allowed to appeal decisions granting defendants the right to dismiss, but defendants have no comparable right. Therefore, an accounting firm that is a defendant confronted with such denial is placed under extreme pressure to settle even in a case lacking merit, because of the risk of losing a trial. Accordingly, we suggest that the Advisory Committee recommend that defendants be granted the right to file appeals of denials of motions to dismiss.

- ***Federal jurisdiction over lawsuits against accounting firms***— In response to the request in the Addendum, we suggest that the Advisory Committee recommend that all claims arising from audits of issuers be heard in federal court since the SEC and PCAOB regulate the conduct of those audits. It would also be more efficient if all suits for a specific audit were consolidated before one judge.

- ***A single clear auditor standard of care***—Auditors have been subjected to differing legal standards under varying interpretations of federal and state laws. This creates a confusing environment for all participants in the litigation process. Accordingly, in response to the request in the Addendum, we suggest that the Advisory Committee recommend that the SEC establish rules for one clear standard of care that would require liability to be based on actual knowledge that a statement was false and misleading. This approach would clearly and appropriately place accounting firms at risk when they participate in or otherwise are aware of a fraud.

- ***Defenses in suits on behalf of bankrupt companies***—Audit firms are often looked to as the only remaining deep pockets when companies become bankrupt. Disproportionately large claims may be brought against an accounting firm by a receiver, trustee, or litigation trust standing in the shoes of the company. In some such instances, courts have denied the accounting firms the right to assert defenses that would have been available to them if the claim had been made directly by the bankrupt company, subjecting the firm to huge damages and threatening its existence. Accordingly, we suggest that the Advisory Committee recommend that an accounting firm should be able to assert all of the defenses available to it had the claim been brought directly by the company.

- *Supplemental Government Insurance*—The Advisory Committee has been provided testimony about the inability of many accounting firms to obtain adequate levels of insurance. Therefore, we suggest that the Committee recommend consideration of the feasibility of a government sponsored program to supplement the firms' existing programs.

- *Consulting by government authorities before they take action*—As demonstrated in the case of Arthur Andersen, severe action (e.g., an indictment) by government authorities can precipitate a series of self-perpetuating events that ultimately result in a firm's demise. In taking action, a government authority may not fully understand the ramifications to the accounting firm and to the capital markets. According, we suggest that the Advisory Committee recommend that government authorities be required to consult with and seriously consider the advice of the SEC and PCAOB before making a decision that could jeopardize the sustainability of an accounting firm.

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 disclosures of indicators of audit quality are feasible, require the PCAOB to monitor these indicators.**

We would be pleased to work with the PCAOB and the other recommended parties in this initiative. However, while we believe the identification and disclosure of audit quality indicators are worthwhile goals, we caution the Advisory Committee as to the difficulty involved in ascribing any degree of precision or other range of acceptability to such additional indicators.

The Draft Report mentions a variety of indicators used or otherwise suggested by some parties to measure audit quality. Some of these, such as "proposal win rate" and "revenue and profit per partner" do not appear to have any logical connection to audit quality. Others, such as average ratio of firm personnel to firm partners and average experience level of firm staff on individual engagements, can be too simplistic if they do not consider the multiplicity of factors differentiating one audit engagement from another, including: the issuer's size, its industry, its locations, the complexity of its operations and accounting, and the assessment of audit risk. These factors, which are unlikely to fit neatly into any set of indicators, determine how the accounting firm reacts in terms of staffing the engagement with suitably qualified professionals.

Disclosure of indicators would only be meaningful if they have a clear and demonstrable relationship to audit quality and, even if they do, only if they can be understood in the context of a particular audit. Because of the inherent difficulty in developing specific indicators, we recommend that the Advisory Committee first consider developing overall objectives of audit quality indicators (e.g., that the ratio of staff to partners on specific audits should reflect the size and complexity of the audit and the requisite skills of the professionals on the team).

The Draft Report refers to the recently published paper of the Financial Reporting Council in the United Kingdom. The FRC framework focuses on the following drivers of audit quality:

- Firm culture
- Skills and qualities of partners and staff
- The effectiveness of the audit process
- The reliability and usefulness of audit reporting
- Outside factors

We suggest that the Advisory Committee recommend that the PCAOB and others use the input of the FRC and other bodies in connection with this initiative.

Addendum-Article 40 Transparency Report of the European Union Eighth Directive

The Addendum recommends that, beginning in 2010, the PCAOB require larger accounting firms to issue public information required by the Article 40 Transparency Report of the European Union Eighth Directive as deemed appropriate by the PCAOB, after appropriate consultation. While certain elements covered by the Article 40 Transparency Report appear to be relevant to audit quality, this does not necessarily apply to all the elements. In that regard, we suggest that the Advisory Committee evaluate each element of this Directive and do so in the context of the different regulatory and liability regimes in the U.S. and Europe.

Addendum—Transparency-Disclosure of audited financial statements

In considering the merits of the Advisory Committee's recommendation regarding disclosure of audited financial statements, the threshold question to be answered is

whether these financial statements are useful in evaluating the audit quality of the firm or for any other purpose relevant to the public interest. We are unaware of any valid link that has been made whereby audited financial statements can provide meaningful indicators of audit quality.

While a firm's profitability (before partner compensation), revenues by service lines, and capitalization may be indicators of financial strength and sustainability, none of these metrics provides insight into the quality of the audit. Moreover, such data are not even particularly good measures of sustainability without considering the magnitude of legal claims against a firm, which is generally publicly available information for major cases, and can far exceed a firm's ability to pay, as demonstrated by the aforementioned data provided to the Advisory Committee by the six largest accounting firms that reflect potential claims whose magnitude was 24 times the firms' aggregate capital.

It should also be recognized that public disclosure of audited financial statements would enable plaintiffs' lawyers to obtain this information, which they have heretofore been unable to do, except in rare cases, and use it to sway juries and negotiate higher settlements based on this information, rather than the merits of the cases. It has been argued that since some countries (e.g., the U.K.) require published audited financial statements of accounting firms, this should also be required in the U.S. However, the legal environment in the U.S. is dramatically different and more litigious than in those other countries. Therefore, any consideration of public disclosure in the U.S. needs to recognize the potential adverse legal consequences to a U.S. accounting firm.

We are also concerned with the unintended consequences that public disclosure of audited financial statements could have on the firm concentration issue. If certain financial metrics based on sheer magnitude are used as important reasons for selecting an accounting firm, then firms other than the very largest would be placed in a competitive disadvantage. The mindset of "bigger is better" might overwhelm the more relevant indicators previously mentioned in our comments on recommendation 1(a) of Section VII. In addition, smaller accounting firms that do not have significant SEC practices might decide to relinquish those practices completely. Also, smaller firms without an SEC practice that would not be required to disclose audited financial statements might find themselves at a competitive disadvantage when bidding against firms with an SEC practice on an audit engagement of a privately-held company. Even if there were a cutoff point in firm size triggering the requirement for audited financial statements, firms below that threshold might feel pressured by the marketplace to provide such information.

A requirement to undergo an audit would also raise the question of who would be the auditors. Presumably, they would be the primary competitors of the audited firms. While peer reviews are still performed on the non-SEC audit practice of substantially all firms and were performed on the entire audit practice before the advent of the PCAOB, the information peer reviewers are privy to does not and did not extend to the firms' financial statements, including pricing and partner/employee compensation data that would be available in a financial statement audit. This information might then be used in competing against the audited firm for clients and personnel. This certainly seems out of place with the normal environment in the marketplace that respects the confidentiality of such information with respect to one's competitors and does not share pricing information.

It is also useful to question why audited financial statements might be needed for accounting firms, but are not demanded for others that do business with a public company. The rationale that those who audit should also be audited does not seem to have a logical underpinning. If the need for audited financial statements is based on a concern about the sustainability of the accounting firm and whether they may need to be replaced because of a financial problem, wouldn't the same need apply to a company's privately-held major suppliers and customers, its outside counsel, and even to its management and board? This analogy also suffers from a fundamental difference regarding an investor's relationship with a company and with the company's auditor. An investor has a financial stake in the company, so the company's financial results are directly relevant to the value of that investment. The investor has no financial stake in the accounting firm.

Even if it is decided to restrict the provision of audited financial statements to the PCAOB (with no public disclosure), it is not clear why this would be necessary. The PCAOB already has access to extremely detailed financial information about registered firms sufficient to provide a clear picture of operating results and other performance indicators, prepared based on how management runs the practice. While this information is not audited, we see little benefit to incurring the substantial cost of an audit and this provision still does not address the concern mentioned above of having a competitor perform the audit.

In summary, we believe that disclosure of audited financial statements to the public or only to the PCAOB is not warranted and that the PCAOB's existing access to financial information is sufficient to provide oversight with respect to any sustainability issues that may be encountered by firms.

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 the audit processes and audits.

While we agree with the recommendation to promote an understanding of the multi-layered patchwork of independence rules, we believe that more meaningful progress can be made by simplifying and harmonizing these rules. In a number of cases, the independence rules are overly complicated (e.g., those involving an investment company complex) and contain no de minimis thresholds. We think these rules should be revisited in light of the experience gained in the post Sarbanes-Oxley era, with the goal of providing easy to understand rules reflecting clearly articulated principles that will still provide suitable protection to investors.

5. **(in part) Disclosure in the company proxy statement of the name of the senior auditing partner staffed on the engagement and the Addendum recommendation to mandate the engagement partner's signature on the auditor's report**

In our view, disclosure of the engagement partner's name in the proxy statement and/or mandating his or her signature on the auditor's report will not achieve the objectives expressed in the Draft Report and Addendum of increasing the partner's accountability, thereby increasing audit quality. On the contrary, we believe these recommendations represent form over substance and could have unintended negative consequences.

This issue was discussed at the February 16, 2005 meeting of the PCAOB Standing Advisory Group ("SAG") and, while there was some support expressed, there was no consensus for further consideration of the matter. As described in the Addendum and the issue paper discussed at the SAG meeting, proponents of the signature analogized it to the Section 302 certification under the Sarbanes-Oxley Act in that they believe the lead audit partners should also take responsibility for the reports they sign and that naming them might reinforce to them the importance of performing a diligent audit. The Addendum goes further by indicating that proponents believe that the partner's signature will put the partner on the same level as the CEO or CFO who signs the Section 302 certification.

We disagree with the views expressed by the proponents and believe the analogy to the Section 302 certification is not valid. In that regard, we agree with the opponents' view expressed in the SAG issue paper that Section 302 was adopted because some management was attempting to disavow responsibility for the financial statements. In contrast, the engagement partner's responsibility for the audit is clearly set forth in generally accepted auditing standards and the related quality control standards. Further, he or she is subject to disciplinary action by the applicable state board(s) of

accounting, the PCAOB, and the SEC, and is also subject to civil litigation. In addition, by putting the accounting firm at risk by signing the report, the partner is also placing at risk his or her capital in the firm and retirement benefits. Moreover, we do not believe it is appropriate to posit that the partner should be put "on the same level" as the CEO and CFO. The company has primary responsibility for its financial statements and, as officers, the CEO and CFO are directly responsible to ensure that the company's responsibility is carried out.

The proponents' position also fails to recognize that an audit is performed by a coordinated team of professionals, each of whom is responsible for his or her own actions and is subject to the sanctions previously mentioned. It is not the sole responsibility of one partner. Directing the spotlight onto only the lead partner may give others on the engagement team a diminished sense of responsibility. Since an effective team approach leads to higher quality audits, the signature requirement should reflect this approach. In addition, the PCAOB recognizes the importance of firm-wide quality control systems in its inspection process.

We are pleased to see that the Human Capital section of the Draft Report emphasizes the importance of attracting qualified people into the accounting profession. However, we are concerned that the potential for any additional media or other attention to be glaringly directed to an individual partner may actually be a disincentive to entering the profession or embarking on a career path towards becoming a partner, or remaining one.

We recognize that some jurisdictions require the signature of the lead partner, but even in these cases there are exceptions for personal security reasons. It should also be recognized that these jurisdictions do not operate in the same environment as the U.S., with its multiplicity of civil, regulatory, and professional incentives to perform a diligent audit.

Partner Rotation

While the partner rotation rules of the Sarbanes-Oxley Act and the related rules adopted by the SEC in 2003 are not discussed in the Draft Report, we believe they should be reconsidered in light of significant issues they pose from human resource and audit quality perspectives.

Section 203 of the Sarbanes-Oxley Act provides that neither the lead nor reviewing partner may provide audit services to an issuer for more than five consecutive years. The legislative history of the Act indicates that Congress focused significant attention on rotation and decided to limit it to those two partners. The final provision of Section

203 could also be interpreted to provide for only a one year cooling off period before becoming involved in the audit again.

In 2003, the SEC adopted rules that went considerably beyond Section 203 by providing for a five year cooling off period and extending the rotation provisions to certain other partners (e.g., a seven year service limit and a two year cooling off period). In arriving at the final rules, the SEC considered input from commentators reflecting the need to balance the benefit of bringing a fresh look to the audit with the benefit of providing for continuity of the engagement team and the resulting audit quality. The SEC's adoption of a five year cooling off period for the lead and reviewing partners is based on its belief that any shorter period would cause investors to be skeptical that these partners were not simply being held in abeyance on a temporary basis, after which they would return to the engagement.

While we support the "fresh look" objective through the rotation of the lead partner and, to a lesser extent, the reviewing partner, we believe the extra layer of rules adopted by the SEC may impair the ability of accounting firms to assign suitably qualified partners to audits. More specifically, adverse consequences of these incremental rules include:

- The expanded rotation rules seem to assume that each accounting firm has an unlimited and interchangeable supply of suitably qualified partners with the same level of skills and industry expertise in every office. However, this is simply not the case. It is critical to the reliability of financial statements that the audit engagement team comprises the most competent and experienced partners available and a rule that makes this objective too difficult to achieve is counterproductive.
- The Advisory Committee has heard testimony about changes in the workforce and issues impacting mobility that would only be exacerbated by increased rotation requirements that would force partners to move their families in order to handle audits more effectively. In that regard, in 2006-2007, female graduates in accounting outpaced male graduates 52% to 48% and accounting firms continue to hire more females than males. The human capital and work/life implications of these trends need to be considered in evaluating rotation rules that can disrupt the lives of many professionals and their families.

- Even if a partner does not move in his or her new role, audit quality can be diluted by having their workpaper reviews performed electronically from remote locations, rather than in a face-to-face setting.

- Replacement of a key partner on an audit reduces the value to the audit committee of the issuer by reducing the engagement team's institutional knowledge of the company.
- The learning curve required of the new partners can be costly to the issuer.
- A knowledge gap is created when the lead and reviewing partners rotate off the engagement in the same year.

The post-Sarbanes-Oxley Act era has seen development of effective safeguards to deal with the concerns that triggered Section 203 and the related SEC rules:

- The robust PCAOB inspection process has greatly sensitized audit partners to the real possibility that their work will be subjected to a fresh look by the PCAOB.
- Independent audit committees have provided meaningful oversight of the audit process, including involvement in resolving contentious accounting issues.
- There is a built-in safeguard with respect to the reviewing partner regarding any concern that he or she may be influenced inappropriately if his or her compensation is affected by the audit fee—these partners and the other (non-lead) partners who are subject to the rotation rules have no such economic incentive.

Based on the mix of factors discussed above, we suggest that the Advisory Committee recommend that:

- The cooling off period for lead and reviewing partners should be reduced to two years. The rotated partners would, in the normal course of business, be reassigned to other engagements during this period. This should provide sufficient time for a fresh look by other partners who take their place during that period.
- When the lead and reviewing partners begin their roles on an engagement in the same year, the reviewing partner should be permitted one additional year beyond the five year limit in order to avoid having both of them rotate off the engagement in the same year.
- The rotation requirements for other partners should be eliminated or the criteria for inclusion in this category relaxed since these partners do not have authority to sign reports or to otherwise approve issuance of the report.

The first and third changes above would only affect the SEC rules, so there would be no need for a legislative amendment to Section 203. The second change might be accomplished through an SEC rule dealing with the effective date of Section 203 as

applied to the reviewing partner during the transition year, similar to what was done when the SEC rules were issued in 2003.

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We appreciate being able to provide our comments on the Draft Report and would welcome the opportunity to discuss our comments with you.

Very truly yours,

Wayne Kolins
National Director of Assurance