

II: CO-CHAIRS' STATEMENT

The Advisory Committee on the Auditing Profession, appointed by the U.S. Treasury Secretary Henry M. Paulson, Jr., was asked to examine comprehensively the condition and future of the auditing profession, with emphasis on the sustainability of a strong and vibrant profession. In conducting its work, the Committee recognized that the prospects for the auditing profession are directly related to the quality and effectiveness, as well as the perceived value, of independent audits. Ultimately, it is a combination of transparency and trust that enables our financial markets to function efficiently. A strong and vibrant auditing profession is a critical element of that regime and especially important to the U.S. capital markets where more than 100 million people invest their savings and retirement assets.

While the focus was on the auditing profession in the United States and in particular on the audits of U.S. public companies, the Committee approached its work with the awareness that audits, especially of large capitalization companies, are global in nature and that auditing firms, both here and abroad, rely upon the quality and consistency of their global network firms. For that reason, we reached beyond our borders in seeking input from observers, witnesses, and others and in considering the future of the profession.

The four largest firms audit approximately 98% of the market capitalization of U.S. public companies, a concentration generally comparable to their participation in other major capital markets. The auditing firms also examine and issue audit reports on privately owned entities, joint ventures, investment vehicles, employee benefit plans, and governmental and other entities. The requirements for such audits vary, but the objective is generally consistent, to provide an independent and objective test of the accounting policies, procedures, and judgment used by management in preparing the financial statements. In addition to audit and audit-related services, the largest auditing firms also provide a range of tax, advisory, and other professional services. In 2007, the four largest global network firms reported, in the aggregate, approximately \$90 billion in total revenues. Total revenue reported by the U.S. affiliates of the four largest firms was \$31.2 billion, of which approximately \$11.8 billion (37.8%) was for audits of U.S. public companies.

This is the first major study of the U.S. auditing profession since enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and the Committee heard of many positive developments within the auditing profession in recent years and of a generally positive impact the Public Company Accounting Oversight Board (PCAOB) has had on audits. The Committee was also informed that actions have also been taken by foreign regulators and others to strengthen audits in other countries. The auditing profession has been studied extensively in the past, but was previously self-regulated and implementation of recommendations was not consistent. Under the oversight of the PCAOB, we are optimistic that recommendations of this Committee will receive appropriate attention.

We believe the U.S. standard setters and regulators, including the PCAOB should be involved on international matters, working to ensure a positive interchange and consideration of experience and expertise from within and outside the United States to help inform global de-

velopments, with the objective of strengthening financial reporting and auditing worldwide. Because a substantial portion of the audits of U.S. public companies occur outside the United States, our capital markets benefit when standard setters work with regulators in other countries and with international agencies. We believe that the United States should take a leadership role in ensuring the highest quality accounting and auditing standards.

An important requirement of Sarbanes-Oxley is that audits of U.S. public companies are to include evaluation by the independent auditor of the effectiveness of a company's system of internal control. While there were initial complications in implementing this requirement, it now seems to be working generally as intended and is a watershed event that has improved and will continue to improve financial reporting. An effective system of internal control is critical to the timely and accurate recording of transactions, to the safeguarding of assets, and ultimately to reliable financial reporting.

Due to Sarbanes-Oxley, independent audit committees in the United States now engage the independent auditor and manage the relationship. Audit scope under Sarbanes-Oxley has been expanded to include reporting on internal controls, and audit fees for U.S. public companies have increased significantly. At the same time, fees billed to audit clients for non-audit services have declined, a result generally appreciated by investors as strengthening auditor independence. Pre-Sarbanes-Oxley, audit fees were on average approximately only 50% of total fees charged to audit clients. That percentage increased dramatically to approximately 80% by 2006. We believe it important that audit fees continue to provide a fair return to auditors and we would not wish to see a return to the situation pre-Sarbanes-Oxley when audits were sometimes viewed as a commodity and priced accordingly. Now that evaluation of internal controls has been integrated into the audit, it appears that the scope of work and the resulting audit fees have generally stabilized and auditing firms are looking to areas beyond audit to profitably grow their practices. The rate of growth for non-audit services, especially advisory services offered to non-audit clients, now exceeds the rate of growth for audit services. We realize that the allocation of investment dollars and professional talent is in many cases interchangeable, and that some auditing firms are working a delicate balance in allocating resources amongst their various practices. As Co-Chairs of this Committee, we strongly believe that the audit practice should always be the highest priority.

This Report represents nearly one year's efforts of a philosophically diverse, talented, and committed group of investor, business, academic, and institutional leaders. Balance was a motivating force in creating a Committee that would be sensitive to the views of auditors (both large and small), public companies, investors, professionals, and the teaching profession. The Committee benefited from the input of observers who labored with the Committee in identifying and sorting through the issues. The level of commitment was high and the views received were often intense and passionate. The resulting Report of the Committee contains substantial information on the auditing profession and makes numerous recommendations that this remarkably collegial group of diverse interests embrace and support. All but one of the Committee members voted to issue the Committee Report.

We thank the Committee members and observers for their efforts, energy, intellectual input, and willingness to engage each other in exploring the broad range of issues. The Committee heard testimony from a large number of presenters and dealt with a tremendous volume of information, while identifying and debating the issues in a collegial and thoughtful manner.

We also wish to acknowledge the support and encouragement provided by our vice-chairman, Paul Volcker, and our Counselor, Alan Beller. Paul supported us with his deep experience, intellect, and pragmatic thinking. Alan was involved in all our discussions and took the lead in assuring that the Report of the Committee was accurately communicated. The unwavering support and encouragement of both Paul and Alan were invaluable and we are deeply indebted to them. Finally, we wish to express our appreciation to Treasury staff, led by former Under Secretary Robert K. Steel and Assistant Secretary David G. Nason. This Report also would not have been possible without the tireless support of the other members of the staff, particularly Kristen E. Jaconi, Senior Policy Advisor to the Under Secretary, Kelly A. Ayers, Financial Economist, Gerry Hughes, Financial Analyst, and Timothy M. Hunt, Financial Analyst, who accumulated volumes of background information, arranged meetings, and provided support and assistance to the outstanding panels of experts that provided testimony to the Committee.

The Report of the Committee offers thirty-one recommendations derived from the deliberations of three Subcommittees each focused on one of three key areas—human capital, firm structure and finances, and concentration and competition.

The auditing firms are major employers, recruiting talent in competitive markets and offering exceptional training and diversity of experience. The largest firms are often included in leading publications of the “best places to work.” Recruiting, training, and retaining talent are critical to a strong and vibrant profession. The Subcommittee on Human Capital, chaired by Gary J. Previts, focused its efforts on accounting education, minority representation, and the supply and experience of accounting faculty. The Subcommittee focused time and effort on the adequate preparation of the accounting student and noted the need to increase the pace of curricular changes in college and university accounting programs to match more effectively the increasing pace of market developments. In order to accomplish this, the Subcommittee recommended that the accounting certification examinations, accounting curricula, and teaching materials should be continually updated to reflect changes in market developments.

At the same time, the Subcommittee on Human Capital noted the need for the profession to reflect the ethnic demographics of the global economy. Concerned about minority representation and retention in the profession, the Subcommittee recommended that the profession recruit minorities from other disciplines and careers as well as implement programs to increase minority retention. The Subcommittee also highlighted the role of community colleges in the recruitment process, stressing cross-sabbaticals and internships with faculty and students at Historically Black Colleges and Universities, and recommending increased funding for minority doctoral candidates. Finally, the Subcommittee noted the progress and the need for continued attention to the development of opportunities for women in the auditing profession.

Concerned about the shortage of accounting doctoral faculty, the Subcommittee on Human Capital recommended the following potential solutions: increasing public and private funding, increasing the number of professionally qualified faculty, stressing cross-sabbaticals, and creating incentives for the private sector to fund both accounting faculty and faculty research. In order to better assess the supply and demand of accounting personnel, the Subcommittee on Human Capital recommended the establishment of a committee to encourage the collection of demographic profile data of professional accountants and auditors.

Having noted the increasing complexity of financial reporting and auditing in a dynamic and global environment and the need to adequately prepare future professionals for such an environment, the Subcommittee on Human Capital recognized that changes in the accounting education structure might be warranted. Thus the Subcommittee developed a long-term recommendation to form a commission to study the future higher accounting education structure. Finally, some concern was expressed that the accounting profession needs to do more to strengthen its image as one of a handful of prominent professions.

How auditing firms are structured, their governance, their finances, and their reporting to the public and to investors affect not only how they function but also the market's perception and acceptance of the profession. The Subcommittee on Firm Structure and Finances, chaired by Robert R. Glauber, directed its efforts to a number of complicated issues. Realizing the importance of the reliability of financial statements to investor confidence, the Subcommittee focused on enhancing auditors' fraud detection capabilities. To further enhance those capabilities, the Subcommittee recommended the creation of a national center for market participants to share experiences and develop best practices relating to fraud prevention and detection.

As state boards of accountancy license public company auditors, the Subcommittee on Firm Structure and Finances developed several recommendations to make this regulation more effective and consistent across a national level: Congress should pass a federal provision requiring those states that do not voluntarily do so to adopt the Uniform Accountancy Act's mobility provisions. Federal and state regulators and enforcement bodies should meet in regular roundtables to reduce duplicative and potentially inconsistent enforcement regimes. States should ensure greater financial and operational independence of their state boards of accountancy.

Recognizing the recent improvements to public company corporate governance, the Subcommittee on Firm Structure and Finances recommended a series of initiatives to enhance transparency of the auditing profession. First, the Subcommittee recommended that the PCAOB and the Securities and Exchange Commission (SEC) consider the possibility of auditing firms' appointing independent members to firm boards or advisory boards. Second, the Subcommittee recommended that the SEC amend public company disclosure requirements to mandate disclosure of all public company auditor changes. Finally, the Subcommittee on Firm Structure and Finances recommended that the larger auditing firms produce a public annual report similar to the European Union's Eighth Directive, Article 40 Transparency Report and including audit quality indicators and also file on a confidential basis audited financial statements with the PCAOB.

The Subcommittee on Firm Structure and Finances also focused on improving the usefulness of the auditor's report, the auditor's primary means of communication with investors. The Subcommittee recommended that the PCAOB undertake standard-setting initiatives to consider improving the content of the auditor's report beyond its current pass/fail model and to require that the engagement partner sign the auditor's report.

As the result of mergers and the demise of Arthur Andersen, there are fewer large auditing firms with particular concentration amongst large global public companies. Audit committees and those who engage auditors desire choice and a competitive environment, which stimulates excellence and innovation. The Subcommittee on Concentration and Competition, chaired by Damon Silvers, directed its attention to the high degree of concentration in the public company audit market, particularly the larger public company audit market where four auditing firms dominate. The Subcommittee on Concentration and Competition did not consider any significant regulatory action to increase competition. However, in order to reduce the barriers to entry for smaller firms into the public company audit market, the Subcommittee recommended that public companies disclose in their SEC filings any agreements that limit audit choice. They also suggested that regulators and policy makers include smaller auditing firms on committees and public forums.

The Subcommittee on Concentration and Competition also examined the impact of catastrophic risk on this highly concentrated profession. The Subcommittee recognized that no auditing firm is too big to fail. However, it seems clear that the loss of one of the larger auditing firms would have systemic repercussions throughout the global capital markets. As a two-step solution to prevent and/or limit such repercussions, the Subcommittee recommended first that the PCAOB continuously monitor the sources of catastrophic risk to the profession. Second, the Subcommittee recommended a framework for a plan to rehabilitate and preserve a firm facing circumstances threatening its viability, thereby safeguarding its most critical assets: its partners and employees, its reputation, its client base.

At the same time, the Subcommittee on Concentration and Competition discussed enhancing audit quality as a key element in improving the viability and resilience of the auditing profession. The Subcommittee learned that auditing firms provide limited information on audit quality to the public, particularly to audit committees and investors. The Subcommittee recommended that the PCAOB consider the feasibility of developing and disclosing audit quality indicators so that more of such information can be developed and communicated.

The Subcommittee on Concentration and Competition focused considerable time and effort on auditor independence, critical to the credibility of the audit. The Subcommittee on Concentration and Competition recommended a greater understanding of independence by requiring that the public company auditor independence requirements be compiled into a single document and creating additional independence training materials for auditors.

To further enhance the accountability of audit committees, the Subcommittee on Concentration and Competition recommended that public companies adopt annual shareholder ratification of public company auditors, a practice common at over 70% of public companies today.

The Subcommittee on Concentration and Competition also noted the increasing globalization of the capital markets and the consequent increasing need for regulators and policy makers to collaborate at the global level to oversee auditing firms and monitor audit quality. The Subcommittee on Concentration and Competition recommended that the PCAOB continue to collaborate and cooperate with its foreign counterparts.

The work of the entire Committee was outstanding, but in spite of the earnest efforts of Subcommittee chairs working with extraordinarily well-informed and committed members we were unable to find common ground on one important issue the Committee faced from its inception- the question of the role of the civil litigation system in relation to public company audits. While consensus on this issue was not obtainable, the Committee nonetheless makes an important contribution by capturing the differing views that exist about private litigation involving auditing firms. As Co-Chairs we feel an obligation to express our own views.

While not all Committee members will share our views we wish to express our gratitude for the extensive efforts made by all members to carefully and openly examine every point of view. The effect of private litigation on auditing firms has been contentious for decades and it is not surprising that it continued to defy a consensus solution, but the Committee's dialogue nonetheless has laid the groundwork for continued and constructive effort in the future. It is in that spirit that we wish to define our perspectives on this issue. Similarly, we as Co-Chairs feel we need to amplify the conclusions of the Committee as a whole in the area of auditing firm transparency. The major auditing firms are key actors in the public securities markets. They must comply with the same principles of transparency that we ask of other major market actors, both for the sake of the credibility of the market system as a whole, and for the credibility and long-term health of the firms themselves. Below we outline specifically how we believe the Committee's recommendations should be implemented so as to accomplish this goal.

We accepted the challenge of chairing this Committee because we believed in the vital importance of auditing as a profession for the health of our markets and our economy, and, in a certain respect, the well-being of our society. The role of the auditor is noble. Yet, the prestige of the profession is understated. It is our sincere desire that the reputation of the profession will grow as recommendations made by this Committee are implemented and as the profession competes vigorously for a greater share of the best talent. Confidence in the content of information of all kinds is necessary for a complex society to function and many play a role. The rule of law, and a free and independent press are key structures in developing that confidence. So too is a strong and transparent auditing profession insofar as confidence in our economic enterprises and markets is concerned.

A desired outcome is an environment in which savings can be invested with confidence, but the more important outcome is that we can live our economic lives relatively free of suspicion and mistrust about the bedrock of our infrastructure of investor safeguards. Investment risk will always exist, and that is as it should be. The pursuit of higher returns involves greater risk and our markets consistently produce winners and losers. But, investors should have confidence that our infrastructure, including audits of public companies, is fundamentally fair and functioning effectively.

Considering the importance of the profession and its current concentration, during our work with the Committee we also closely examined the health of the auditing profession with particular emphasis on the largest firms. On many occasions we heard about the auditing firms' beliefs that their very survival is jeopardized as a result of their exposure to civil litigation brought by investors and the companies which they audit. As Co-Chairs, in reviewing the evidence, we came to the following conclusions.

- Litigation-related expenses are a significant component of auditing firms' cost structures. However, while significant and a concern, we do not believe the Committee was presented with evidence showing that ongoing litigation costs are at a level that significantly affects their ability to recruit talent or grow their practices.
- Audits of large public companies are concentrated amongst a limited number of auditing firms and the largest such firms are not able to use third party insurance in a cost-effective manner to manage the full range of their litigation costs. Some firms do use captive self-insurance in managing the costs of routine litigation but are unable to do so for damage claims in amounts that threaten survival of the firm. It is of course the case that a number of professions and industries are similarly unable to insure against catastrophic risks.
- The largest U.S. public companies have enormous market capitalization and, if a large cap company becomes insolvent or suffers a significant diminution in market value, such market loss often greatly exceeds the total capital of the auditing firm which audited that company. A suit for damages in the amount of that loss may be brought against the firm, which audited the public company. Similarly, while our focus was on audits of public companies, there are also significant claims against auditors arising out of audits of non-public entities. Such actions were generally referred to as "mega" or "catastrophic" claims in the Committee's deliberations. The auditing firms informed the Committee that they often feel pressured to settle such cases, even when they believe they have meritorious defenses, because taking such cases to judgment carries an unpredictable risk of loss in an amount that could threaten survival of the auditing firm.
- In addition to catastrophic threats to survival from private litigation, the firms are also at risk that a serious breach of professional audit duty, a criminal indictment, or other conduct that causes a mass loss of client, investor, employee and/or network firm confidence could threaten survival. These risks are inextricably intertwined with the use

of private firms to audit public companies and while they can be managed, they cannot be made to disappear completely, nor may they be fully insured against.

- Private litigation is an important supplement to regulatory activity in ensuring accountability and confidence in our financial markets.
- The range of issues identified by and the proposed solutions suggested to the Committee regarding private litigation were varied, some were exceedingly complex, and most could potentially affect many market participants both in the United States and abroad, not just the auditing firms who were the subject of the Committee's study.
- The U.S. auditing firms are private partnerships national in scope, but significantly dependent on the strength of their global networks. The largest such firms provide only limited information to the investing public about the sources of their revenue, their governance practices, the amount of their earnings, and their financial condition. The largest U.S. auditing firms informed us that they do not prepare financial statements using GAAP (Generally Accepted Accounting Principles) although in other regions of the world, some of their networked firms do provide such information.

Notwithstanding the Committee's inability to reach a recommendation as to private litigation, we believe that our responsibility as Co-Chairs is to lay out as clearly as feasible the considerations that should be considered in the future. There are strongly held views on both sides of the question as to whether adjustments in the system of private litigation are desirable, and as to the direction that those adjustments should take. It seems to us desirable to continue that debate, and it further seems to us unavoidable whatever our views.

Focusing more precisely on our Committee's mandate to consider the public company auditing profession, concerns about the potential effect on our capital markets from loss of one of the largest firms prompted a recommendation by the Committee that the PCAOB monitor auditor conduct that might present a risk to sustainability on an ongoing basis and that Congress establish a mechanism under which a firm could be rehabilitated. We strongly support this recommendation. Moreover, we believe it would be even more effective if the PCAOB were to on annual basis report its findings regarding the sustainability of the auditing profession to the Secretary of the Treasury or the President's Working Group on Financial Markets.

Beyond this recommendation, with respect to private litigation against the auditing firms, we believe that the auditing of public companies is fundamentally a matter of national interest and concern. The steps taken under the Sarbanes-Oxley and the creation and operation of the PCAOB are two clear manifestations of that reality. Public company audits are conducted within the framework of a national securities market, and public company auditing standards are set nationally by the PCAOB. But the auditing of public companies can give rise to liability in state courts under differing substantive and procedural standards. This, in turn, creates a process that is costly, time consuming, and redundant. We therefore also believe that policy makers and the legal system should consider progressively moving towards a structure that at least for the most part embodies a common national set of standards. There are many complex issues that must be considered in moving further toward a national professional liability

regime for public company auditing firms, but clear national standards would seem consistent with the national perspective on public company auditing and the uniform national regulatory oversight system demonstrated by Sarbanes-Oxley and the PCAOB. We believe that while Congress and regulators and other policy makers all will have a role to play in the development of such a system, it must also be developed taking advantage of the best thinking of our most informed legal, economic, and other minds as to how such a system would be structured and implemented. We do believe that if done correctly, such a step has the potential to reduce cost and complexity, and can also be taken in a manner that does not lead to a reduction in accountability. If federal standards for professional conduct for public company auditors are eventually considered, they should reinforce the integrity of the auditing profession.

Fairness also dictates that auditing firms faced with litigation claims that threaten their survival, should have reasonable opportunity to litigate and appeal such matters. We believe the variations in state substantive and procedural law, when combined with the economics of actions arising out of matters involving major audit clients, can act to deny auditing firms a reasonable opportunity to litigate and appeal some cases.

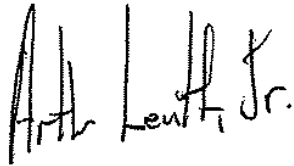
Given the significant role auditing plays in our capital markets, as part of federalization of liability standards for public company auditors, Congress may in fact wish to consider the creation of a federally chartered audit structure for firms which choose to operate as such. It would require that the exclusive mission of such a firm be auditing and auditing-related matters. Characteristics of such a structure might include incorporation (with tax and financing advantages), requirements for capitalization, federal licensing, further clarity of PCAOB oversight, new governance structures with independent directors, limits on liability for audits of public companies, mandatory public reporting, including audited financial statements, and improvements to the auditor's report to investors. Additionally, Congress may in connection with creation of a federal charter, wish to consider the establishment of a federal insurance agency to provide coverage to investors in certain instances, funded by a portion of the audit fees charged to public companies. A federally chartered structure for auditing firms would have the advantage of maintaining independence and the focus on the audit as the principal product.

Any change enacted by Congress has the potential to affect other capital market participants in unintended ways and as noted above, ultimately policy makers and regulators must approach controversial issues from a perspective of basic fairness, informed by balanced expertise and supported by public exposure and input.

As Co-Chairs, we also have additional views in the area of transparency. We endorse the recommendation made by the Committee which calls for the PCAOB to develop standards of disclosure applicable to the auditing firms including a requirement that by 2011 the largest firms prepare and submit audited GAAP financial statements to the PCAOB. While we believe implementation of this recommendation would be a significant improvement in providing insights into the auditing profession, we also continue to believe that at least the largest auditing firms should make audited financial statements available, including to audit committees and the investing public. Issuance of audited financial statements provides greater

transparency and increases discipline and helps sharpen focus, accountability, and trust. The largest auditing firms play a vital role in ensuring the integrity of our capital markets and fairness requires that if a handful of these firms dominate the public company audit market, they should be transparent and provide a level of financial reporting that is generally comparable to that of the public companies they audit. We would encourage the largest firms to do so voluntarily, but if that step does not occur, we would have the PCAOB determine the effective date and precise content of such public reports and disclosures.

We hope our observations, as Co-Chairs of the Committee, will provide the starting point for a future consensus built around the principles of fairness to all participants in our public markets. **Again, this statement reflects the views of the Co-Chairs and not necessarily those of the other Committee members.**



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