Testimony

James S. Turley
Chairman and Chief Executive Officer, Ernst & Young LLP
United States Treasury Advisory Committee on the Auditing Profession
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Chairmen Levitt and Nicolaisen and members of the committee, I am Jim Turley, Chairman and CEO of Ernst & Young. While I also serve as Chair of the Center for Audit Quality Governing Board, to be clear, my testimony today is in my capacity as leader of Ernst & Young.

Along with my E&Y colleagues from around the world, I am encouraged by the formation of the Advisory Committee under your leadership and that of Secretary Paulson and Under Secretary Steel. We believe wholeheartedly in the Committee's stated desire to "promote and encourage prosperity and stability by both improving the quality of the audit process and audits and ensuring the viability and resilience of the public company auditing profession."

We understand and appreciate the critical role that our organization and the auditing profession play in the world's financial markets. Our earnest hope is that your committee's efforts will not only affirm the importance of what we do, but that your recommendations will help us to attract the best people to our profession, be even better at what we do, and promote the long-term sustainability of the private-sector auditing function, which is so essential to investor confidence and strong capital markets.

Given the scope of the Advisory Committee's considerations, it is indeed a difficult task that you have set for yourselves—or perhaps that was set for you. We share your objectives, however established, and pledge continued involvement and effort throughout your considerations.

Our Changing Environment

I have been the leader of Ernst & Young since 2001—assuming the post but a few months before Enron began making headlines.

At that time, our profession was the object of a great deal of criticism—much of it deserved. We have listened carefully, learned lessons, and emerged better for it.

We learned the dangers of arrogance. And we learned the importance of consistently engaging with a wide range of stakeholders—not just company management and boards of directors, but also investors, regulators, policymakers, and other opinion leaders—people such as yourselves. This has helped us to truly understand our public interest role.

We had the chance to step back and ask ourselves why we do what we do as accounting professionals, and why it matters.

At Ernst & Young, we have taken time to reflect on our purpose and how that purpose guides our decisions. We have asked ourselves, and continue to ask, fundamental questions that define the culture of our organization.

The public increasingly realizes the work of firms like ours has an enormous impact on their lives—on the companies where they work, on the investments they hold in their retirement accounts and on the quality of markets and the global economy.

The Ernst & Young global organization operates through its member firms in 140 countries. It comprises 130,000 professionals working on many of the most interesting and important issues in business today, for both audit and non-audit clients.

Our people help assess for investors whether companies are playing by a common set of rules and on a level playing field. They assist in transactions such as mergers and acquisitions, divestitures, and spin-offs. They help company management comply with tax laws around the world. They advise managers on best practices in running a business. And they help developing economies to put in place the controls that are needed to encourage entrepreneurship, investment, and job creation.

These issues matter to everyone, from the biggest investors in the U.S. to entrepreneurs in remote regions of the world. If you want to build a business, promote sustainable growth, and instill confidence in a community or a corporation, you need to call on the skills, talent, and experience of our profession. These are responsibilities we take seriously and we work hard every day to meet and exceed our stakeholders' expectations.

Globalization is fundamentally challenging the structure of businesses, investing, and the markets. Companies operate around the world, investors invest across borders, and what happens in one market can be felt in another on the opposite side of the world nearly instantaneously. As one of our people observed to me recently, many companies we work with don't even "think" in terms of countries any more.

Globalization is similarly impacting our profession. For us, Ernst & Young must be a truly global organization for it to fulfill its role and satisfy the demands of our stakeholders. As a global organization, our promise to the market, and the promise of our member firms, is "seamless, consistent, high-quality service, worldwide." We speak to it over and over again, and identify it to our people as such—our promise. It is what investors need and expect from us.

However, this drive towards seamless, consistent, high-quality service worldwide is mismatched against the fractured, inconsistent, and overlapping regulatory environment in which we and our clients operate around the world. We all contend with differing laws, legal environments, regulations, oversight regimes, financial accounting standards, and auditing standards. Such inconsistencies are inefficient, often confusing and increasingly outmoded in today's global market.

While regulatory and policy decisions clearly must continue to fit within particular national legal frameworks, when they affect global business, global investment, and global markets, policymakers must increasingly look to the prospect of international collaboration rather than stand-alone national approaches. We need to strengthen and embrace international standards and best practices, and seek common approaches to oversight of the accounting profession. As the Advisory Committee progresses with its work, we hope it will be mindful of the need for such international considerations and seek the input of parties from other jurisdictions.

The Changing World of Ernst & Young

As the world has changed, our organization has too. For years, I have been focused on driving changes within our organization to align with global market realities—making changes to our global structure, valuing the diversity of our people, and focusing on the fundamental of consistent and seamless quality service worldwide.

One of the most notable changes has been in our approach to our greatest asset—I often say our only asset—human capital. Globalization creates an absolute business imperative that we have a diverse work force, full of different perspectives, experiences and ways of thinking, collaborating in a way that is inclusive of ideas, regardless of culture, gender, sexual orientation or other differences.

In the profession and at Ernst & Young, we have recognized the need to be very attractive places to work, for all qualified personnel. Public accounting in general and our firm in particular, I am proud to say, are known as among the absolute best places to work. All of the four largest firms are on the *Fortune* 100 list of such companies—with EY the highest ranked at 25.

But more than that, we must be recognized for being great places to work for women, for working parents, for minorities, for members of the LGBT community, and for the disabled. And I am proud to say that my organization does win many, many awards for workplace inclusiveness and flexibility.

It is in our business self-interest to be a great place to work and to develop professional expertise. Smart people are the foundation of our business. Our business strategy is very simple. It is: Have the best people. Provide the best quality. Success follows.

Let me speak for a minute about the second part of that strategy—providing the best quality.

We recognize that there are many stakeholders in the quality and integrity of our work, and we take our responsibility to them all very seriously. Ernst & Young has adopted a set of values that stresses integrity and "doing the right thing" at all times.

Our commitment to quality and integrity starts at the top—with me. My message is the same to our people wherever I go—for us, it is about abiding by the simple axiom of doing the right thing, for the right reason.

I consider my most important responsibility to be doing everything I can to ensure that the people of Ernst & Young wake up every day with a personal sense of knowing what is right and what is wrong, and knowing that no matter what, nothing is more important than their own personal leadership and integrity. If anything or anyone makes them uncomfortable—at a client or internally at Ernst & Young—I want them to know that it is not just OK for them to object or raise their hand and ask for assistance, it is their personal and professional duty to do so.

While quality flows from our values and from the personal commitment of each professional to integrity, it must be supported by systems and processes that assure our regulators and other stakeholders that we have taken every appropriate measure to provide for quality.

Organizationally, we have a global network and governance structures that help us bridge national differences and deliver consistent, high quality audits worldwide. We use the same audit methodology the world over. We have consistent approaches to service delivery within our tax and transaction advisory lines. We have the same rigorous quality requirements and internal quality review processes worldwide for all of our service lines. We test and monitor a broad array of independence compliance issues across our organization. And our partners and principals are judged against a global performance management standard.

There is discipline within our structure. Membership in our global organization means that member practices agree to grant oversight authority to global management on various matters; to comply with global quality, independence, and risk management policies; to coordinate local practices in accordance with the global strategy in certain areas; and to utilize global training programs. Violating these regulations can subject a member firm to various disciplinary actions, including expulsion from the global organization.

Challenges to the Profession

In the balance of my written testimony, I would like to address challenges facing the profession in the U.S.: the need for extremely talented human capital to want to be a part of the profession, the need for globally consistent regulatory approaches, standards, and oversight to enhance the reliability of what we do, and the need to address the unlimited and uninsured nature of liability risk that threatens the future of the private sector public company auditing function.

Human Capital

As outlined above, we are committed to attracting, retaining and mobilizing talented professionals who have the highest standards of integrity, professionalism, and sense of public purpose. Yet we have significant challenges to pursuing that goal.

Recruiting Issues

While the number of U.S. college students studying accounting has increased in recent years, it has not proven sufficient to match demand. Today's accounting students face increased educational requirements and there are increasing opportunities for accounting majors in other areas of business.

Currently, candidates for CPA certification must have 150 hours of accounting education. We believe consideration should be given to alternative means of achieving the requirements of the 150-hour rule that supplement, not replace, traditional undergraduate and graduate classroom learning. Possibilities could include experiential learning, required (and perhaps accredited) firm training, or some combination of the two. Far from being a backing away from the need for educated accountants, this approach would be very much in line with our philosophy that sound accountants want a balanced approach of experience, classroom education, and mentoring—and need that balanced approach to be successful.

College accreditation standards demand that most accounting faculty must have Ph.D.s to teach students, but there is a shortage of Ph.D. candidates. We suggest that there should be an examination of the desired balance in the classroom between teachers who are Ph.D.-qualified and those that are qualified practitioners; the possibility of setting guidelines for the body of knowledge that would constitute an "undergraduate accounting education" and a "graduate accounting degree"; and tie this to the learning required for professional certification.

Global Mobility

Another issue is the clients' increasing demands for audit, tax and transaction professionals who have international experience. Companies need auditors, tax advisors and other professionals who can understand the complexities of reporting and recording financial transactions across countries and continents.

While many U.S. colleges and universities offer international internships, these don't provide the same experience as spending time in a foreign country serving a mix of local companies and U.S. subsidiaries of multinational corporations. We need professionals with experience from other countries. Many H1-B visa candidates possess the experience we need, but the accounting profession sees almost 35-40% of these applicants denied each year because of the visa cap. Increasing the number of H1-B visas allotted each year will allow many of the accounting firms to tap into additional international talent from all parts of the globe.

This barrier to global mobility has a clear impact on the quality of audits: addressing it would help the profession to get the right professionals to the right jobs at the right time and enable the firms to develop the support, training, and career development infrastructure to make this successful and sustainable.

U.S. Mobility

Just as important as global mobility is the ability of our professionals to work seamlessly across state borders within the U.S. All 50 states and the five territories license certified public accountants through state licensing boards, each with its own licensing requirements, practice standards, and disciplinary regime.

A bold plan for eliminating cross-border inefficiencies is included in provisions of the Uniform Accountancy Act (UAA), developed by the National Association of State Boards of Accountancy and the American Institute of Certified Public Accountants. Provisions of the UAA make state licensing more efficient and address many of the hurdles to cross-border mobility. The Treasury Committee should recommend those states that have not yet adopted the mobility provisions of the UAA do so as quickly as possible.

Recommendations

1. *Recruiting*—The Treasury Committee should examine the Ph.D. shortage and certification requirements, and propose uniform guidelines for the academic accounting and auditing curriculum, including training in IFRS, and alternatives for meeting the 150-hour rule requirement.
2. *Global Mobility*—The Treasury Committee should suggest that Congress increase the number of H1-B visas for accounting firms as part of an effort to streamline the ability of firms to deploy human capital resources in the international marketplace to provide high-quality audit services globally.
3. *U.S. Mobility*—The Treasury Committee should suggest that the states eliminate barriers to interstate practice by universal adoption of the mobility provisions of the Uniform Accountancy Act.

Concentration, Choice and Competition

Ernst & Young agrees with the Advisory Committee's over-arching principles stating that "[t]he audit market benefits from a competitive and innovative population of auditing firms." We support sensible efforts to encourage greater participation by more accounting firms in the public company audit market.

In the context of the public company audit market, we see the three words—concentration, choice and competition—as being quite distinct. There clearly is concentration in the audit market, particularly when one considers the percentage of market capitalization audited by the largest accounting firms. The degree of choice available in the selection of an audit firm can be an issue only for the very largest of companies where the global reach and capacity of the largest firms is important (independence rules also have an impact on choice as discussed later).

Yet even within this segment of the market—serving large multi-national corporations—and certainly across all market segments, it is important to recognize the level of intense competition that exists between accounting firms. Competition is based on accounting expertise, industry expertise, client service models, firm culture, geographic reach, price and other factors. In its 2003 report on audit firm concentration, the U.S. Government

Accountability Office (GAO) "found no empirical evidence that competition in the audit services market has been impaired to date." We understand GAO is in the process of updating their report.

Mid-tier or medium sized firms have the depth and reach to handle all but the largest multinational companies. With this recognition, many public companies have migrated to audit firms other than the four largest. In the long term, well-conceived, market-based measures such as challenging market biases would have the best chance to continue this trend and allow the larger mid-tier firms to increase their penetration into the large company market.

In the U.S., a significant barrier to entry in the audit market is enormous liability exposure and the inability to obtain adequate insurance coverage. Addressing liability risk is essential not just for increasing competition, but indeed to ensuring that the private sector audit function is sustainable (a matter I discuss further below).

Regulatory complexity and the lack of convergence among national regulators can also impact competition. The significant investment in the compliance-oriented infrastructure required to operate in a global environment can act as a barrier to entry for firms.

Overly restrictive independence rules contribute to limited auditor choice, especially for the largest companies. In our view, there are relatively modest changes that could be made to the U.S. independence rules which would enhance auditor choice in the immediate and longer term, while not adversely affecting audit quality and auditor independence.

For independence purposes, the SEC defines an audit client and its affiliates in a broad manner. This can significantly impact auditor choice for public companies since any prospective auditor has to be independent of the many entities that fall within the definition. For example, when a company is an investee of a private equity fund or in the case of an investment company complex, the impact of the "audit client and affiliate" definition can be quite expansive. We suggest the Committee consider whether there are ways to reduce this impact through a definitional change that does not capture as many entities but which preserves the auditor's ability to conduct its audit with objectivity and integrity.

There is no *de minimis* or materiality rule related to prohibited services provided to an audit client during the audit engagement period. Thus, even where a prohibited service is provided to the client that is insignificant to the overall audit, such as payroll or bookkeeping in a small foreign location, it is inconsistent with the SEC's independence rules. This limits companies' choices of auditors unless they have planned far ahead of the time in which they seek to make a change in auditors. Certain other independence standards such as those promulgated by the International Federation of Accountants (IFAC) employ a materiality consideration to determine whether the provision of a particular service has a bearing on the auditor's independence.

Under the SEC's independence rules, audit firms generally cannot become the auditor for a company if the audit firm provided the company any prohibited services or had prohibited relationships (e.g., business relationships) during certain periods of time prior to the potential audit engagement. Under those rules, there generally is not an opportunity to mitigate the potential impact of such relationships or to apply safeguards so that auditor independence is protected. This prevents the firm from competing to serve as auditor, which obviously can impact the degree of auditor choice available to companies.

Under IFAC standards, in contrast, the effect of the prohibited services and relationships on independence can be assessed and appropriate safeguards, where possible, can be applied so that the firm could undertake the audit. If available safeguards are insufficient, then the firm may not become the auditor. Again, applying safeguards to the independence threat created in the period of time preceding being appointed the auditor is a principles-based approach to assessing independence available under IFAC standards but not under SEC rules.

There are multiple independence rules applicable to an auditor in the U.S. (e.g., those of the SEC, PCAOB, Department of Labor, AICPA, and individual states). The large number of these, the complexity of the differences, and nuances of each make it costly and impractical to manage multiple systems and sets of rules, so firms often default to applying the most restrictive of the applicable rules. We suggest there be harmonization or convergence to one accepted, robust standard of independence rules rather than many different rules. Harmonization of independence standards on a global level, perhaps evaluating the suitability of the IFAC Code of Ethics, would yield greater opportunity for auditor choice for companies.

We believe a shared commitment across the profession to pooling audit firm resources to develop certain audit tools, techniques, and methodologies—such as anti-fraud initiatives—would help all firms in the performance of audits and could strengthen smaller firms in the profession without requiring a commensurate level of investment on their part. However, there is some uncertainty as to anti-trust implications of such efforts. Therefore, the Treasury Committee could recommend that regulators explore with the profession and aid in resolution of any anti-trust issues that may impede such efforts.

Overall, we do not believe there is a “silver bullet” that will rapidly increase auditor choice, especially at the top end of the market. Any proposal for increasing competition must be considered for its impact not just on choice, but on audit quality and independence. Also, a careful assessment should be made of costs versus benefits and of unintended detrimental consequences that could result from intervention in the marketplace. For example, we do not believe there is a persuasive case that can be made in support of proposals such as mandatory firm rotation or a break-up of the largest firms as a means to foster increased choice. In our view, these proposals would have a significant negative effect on audit quality, domestically and globally.

Recommendations

1. The Treasury Committee should identify market and regulatory factors that discourage competition or impede the number of auditor choices available to large public companies and recommend changes to address them.
    a. The Treasury Committee should identify perceived and real barriers—including market biases, liability risks, and regulatory complexity--for mid-sized and small firms that seek to perform more public company audits, and recommend ways to mitigate those barriers.
    b. The Treasury Committee should consider potential changes to aspects of independence rules that can have an undue adverse effect on auditor choice for public companies such as—
        i. Modifying the definitions of “audit client” and “affiliate” to avoid undue limitations on auditor choice without impacting auditor objectivity and integrity
        ii. Establishment of a *de minimis* or materiality rule, such as exists in IFAC standards, related to prohibited non-audit services
        iii. Allowing for relief from the independence rules through the application of appropriate safeguards where prohibited services or actions occur prior to becoming the auditor
2. The Treasury Committee should urge that the various independence rules established by regulatory and professional bodies (e.g., SEC, PCAOB, Department of Labor, AICPA, and state boards and agencies) be harmonized to a single accepted and credible standard for auditor independence. Harmonization of independence standards on a global level, perhaps evaluating the suitability of the IFAC Code of Ethics, would yield even greater opportunity for auditor choice for companies.

3. The Treasury Committee should recommend that regulators explore with the profession and aid in the resolution of any anti-trust issues that may impede the sharing and development of methodologies and techniques, including anti-fraud initiatives, in a manner that would be beneficial to all firms.
4. The Treasury Committee should express opposition to governmental or regulatory marketplace intervention—such as mandatory firm rotation or breaking up of firms—as a means to decrease concentration, due to the detrimental impact of such actions on audit quality.

Oversight of Financial Reporting

As a number of parties have observed, the U.S. is at risk of increasingly becoming isolated from a global capital market perspective due to unique features in its financial reporting, regulatory and legal environments. While we do not agree with every contention or recommendation that a variety of private-sector commissions and committees have put forth over the past year, we believe many legitimate concerns have been raised.

During the March 13, 2007 Capital Markets Competitiveness conference led by Treasury Secretary Paulson and SEC Chairman Cox, there was considerable focus on the need for what was described as "balance," specifically the need for regulatory balance.

As I interact with audit committee leaders in the U.S. and around the world, it is safe to say that their concern with the risk of regulatory second-guessing has never been higher. Last year, there were over 1,500 restatements of financial statements in the U.S. In preparation for my participation in the March conference, I looked into the number of restatements in the U.S. versus other jurisdictions, such as the U.K. Interestingly, I couldn't find the numbers from other jurisdictions because there were so few no one seemed to be keeping a tally.

I am not suggesting that other jurisdictions have it right and the U.S. has it all wrong, or that financial reporting in the U.K. is better than financial reporting in the U.S. But when one out of ten U.S. filers must restate earnings and the market doesn't always seem to care, we should challenge the approach. With the work of the Treasury Department examining what is behind such a vast number of restatements and the work of the SEC's Committee on Improvements in Financial Reporting, that appears to be happening, and I applaud the efforts.

A key consideration in this regard involves questions of when and how to appropriately respect judgments of management, audit committees, auditors, or others involved in the financial reporting process. This becomes even more critical with considerations of moving from a more rules-based mentality to a principles-based world. An auditor's exercise of independent professional judgment is a vital component of the important work that auditors perform for the capital markets and the investing public. Auditors must be willing to take a stand on behalf of investors when they believe that the client has not applied the relevant accounting standards in an appropriate manner. Regulators and the legal system must be able to respect good-faith professional judgments—judgments that are rational, well-considered, and documented.

As I said, I interact with audit committee leaders in the U.S. and around in the world. We periodically bring together audit committee chairs from Europe and the U.S., and the discussion has included these very issues. What I hear from these circles is that there exists a forward-looking mindset outside the U.S.—where regulators focus on what is the financial statement impact of a particular issue going forward—versus a backward-looking or historical mindset inside the U.S. Others refer to it as a risk-focused approach outside the U.S. versus a compliance and punishment focus within the U.S. These perspectives inform the interest in getting the right "balance," which was the view of many participants in the March conference.

U.S. Adoption of IFRS

A principles-based approach to financial accounting standards is becoming the norm worldwide, with IFRS becoming the dominant language for financial reporting. Today, more than 100 countries either require or permit IFRS as their accounting standard or base their own local standards on it. Canada shifts in 2011, while Brazil, Chile, India, Israel, and Korea are among the countries that have also set a date for a move to IFRS.

In a recent comment letter to the SEC, we stated our support for the SEC to set a date certain for a shift to IFRS from U.S. GAAP for U.S. companies and believe the Advisory Committee should advocate the same.

Establishing a date certain for a move to IFRS would enable U.S. companies to begin preparing now and would provide the impetus to confront needed legal and regulatory changes that would accompany the shift. The transition in the U.S. would have its share of hurdles—many U.S. companies are not ready to make the change, and they have legitimate concerns about the degree to which judgments about international standards will be respected by regulators and the courts.

Such a global standard would bring greater efficiency to companies that currently must pay internal and external legal and accounting experts—such as firms like mine—to help them sort through accounting differences across multiple jurisdictions. For investors, it would bring a new level of comparability and reliability for global investments.

For emerging markets and the poorest countries of the world, a globally embraced set of standards would provide a readily available foundation for capital market activity. This could promote investment, strengthen the economy, and improve people’s lives in local economies.

If the U.S. were to establish a date certain for a shift to IFRS, it would motivate universities to train tomorrow’s accountants in IFRS and promote similar moves by other jurisdictions to embrace these international standards instead of modifying them for local use. It would also help countries establish and work toward the improvement of a single standard, rather than devoting their energy to tweaking national standards to make them look more like IFRS.

Furthermore, the willingness of the U.S. and other nations to embrace International Financial Reporting Standards provides a glimpse of the prospect for more international collaboration—rather than stand-alone national approaches—in other areas of capital market regulation. As SEC Chairman Cox has said, “Having a set of globally accepted accounting standards is critical to the rapidly accelerating global integration of the world’s capital markets.”

Recommendations

1. The Treasury Committee should support establishment of a framework to provide clarity as to when exercise of good-faith accounting and auditing judgments will be respected by regulators and in legal proceedings (see professional judgment rule under litigation section). If good-faith preparer and auditor judgments would be respected, that would increase the potential for success of principles-based standards rather than a body of guidance consisting of a plethora of rules, bright lines, exceptions, and interpretations.

2. The Treasury Committee should recommend that the SEC establish a date certain for the adoption of IFRS for all public companies filing in the U.S. Setting a date will create the incentive to expedite the

introduction of the many changes in the U.S. that would need to accompany such a shift to a single set of high-quality accounting standards for use by all companies across the globe.

Oversight of Our Profession

Since the adoption of the Sarbanes-Oxley Act in 2002, and similar legislation in many countries around the world, a key development in promoting audit quality, protecting the interests of investors and furthering the public interest is the emergence of independent oversight and regulation of the public accounting profession. Concomitant with that watershed transformation, we have made substantial changes in our internal organization and governance. We believe that further improvements in transparency and governance, along with enhanced U.S. oversight, could help increase public confidence in the profession, particularly if consistent with similar initiatives outside of the United States.

Enhancements to U.S. Oversight

In the U.S., the Public Company Accounting Oversight Board has a broad mandate to promote audit quality and protect the public interest through its authority to set standards, collect information, conduct inspections, initiate enforcement actions, and impose penalties. In addition, the SEC oversees the PCAOB and engages in its own substantial oversight of financial reporting, including enforcement actions against auditors.

While we are transparent to our regulators, we believe that more could be done to alert the public to the changes that have taken place in our firms and the regulatory scrutiny under which we operate, so as to promote confidence in the public company audit profession and the services we provide. We believe that greater insight into our commitment to audit quality and the way we govern ourselves would promote public confidence. Of course, the U.S. markets and U.S. firms do not operate in isolation, and other countries around the world are also looking at this issue of transparency. The EU Eighth Directive, due to be implemented into the different national laws of the European Union member states and of the European Economic Area member countries by June 2008, sets out minimum requirements for the contents of an annual transparency report that audit firms need to publish on their website within three months of the end of their financial year. The audit firm annual transparency report will include information such as a description of the firm's legal structure and ownership, a description of the network and the legal and structural arrangements in the network, a description of the governance structure of the audit firm, and a description of the internal quality control system of the audit firm. With this in mind, we believe the Treasury Committee should consider recommending that the PCAOB require each registered audit firm to publish a transparency report on its website, consistent with the transparency requirements of the EU Eighth Directive, in which they highlight to the public the policies, processes, methodologies and tools that are in place to help ensure audit quality. This transparency report also would include a description of audit firm governance processes.

Furthermore, we recognize there may be governance changes consistent with our public interest obligations which merit further consideration such as the inclusion of individuals from outside the firm in a director, advisory or related role. Currently, however, the independence rules can present uncertainties and challenges to the ability of firms to utilize individuals in such capacities. In particular, the definition of 'covered persons' and the associated financial interest restrictions, as well as the business relationship rules, have an impact on the pool of candidates that could assume such positions, and raise difficult independence issues. We would encourage the Committee to recommend that the SEC and the PCAOB explore the possibility of modifying or clarifying the independence rules so as to facilitate consideration by the audit firms of such governance changes.

As noted earlier, Ernst & Young operates in over 140 countries around the world, and we are regulated by what—at times—feels like at least that many regulators. Yet none of the jurisdictional regulators has a complete view across the entirety of our organization. We believe an increase in global regulatory cooperation would enhance the contribution of regulators to sustainable, high quality audits around the world and investor confidence in the audit process. For that purpose, the Committee may want to underscore the importance of consultations between U.S. regulators and their foreign counterparts, both on a regular basis and before any significant government action that could threaten the survival of a public company audit firm or the network to which that firm belongs.

Furthermore, the sustainability of independent audit services is critical to investor confidence and capital market stability, and we believe the PCAOB could have an important role to play here. As I will discuss in a moment, the audit profession's sustainability should be a significant public policy concern, and the PCAOB is in a position to assess the firms' financial strengths and risks. In order to inform public policy considerations and protect the public interest, we believe the Treasury Committee should recommend the PCAOB consider use of existing authority to obtain and evaluate information about the financial resilience and viability of the audit firms it regulates.

Three years ago, in testimony before the Senate Banking Committee, I made a variety of observations regarding the PCAOB that I still believe are true. I noted how a tough, but fair and independent regulator will make our profession and Ernst & Young better, how the PCAOB provides a credible voice to judge how well the accounting profession is living up to our commitment to quality and how effective we are in delivering on investors' expectations.

I observed that while nobody likes to be inspected by their regulator, Ernst & Young and the entire profession would be better for it. I embraced the process then and embrace it now because the whole profession has improved as a result of it and investors' confidence in us has justifiably improved markedly.

The PCAOB and SEC continue to challenge and improve on the original inspection process design. In my view, the current state of publicly reporting specific audit engagements with technical deficiencies doesn't add much insight into a firm's commitment to audit quality via its processes, systems, and controls to promote audit quality. We support a prudential regulatory approach and believe there would be greater value to the profession and users of inspection reports if the inspection process increasingly were focused on evaluating and highlighting the quality control system of the firm rather than individual audits containing technical deficiencies. Accordingly, we believe the Treasury Committee should consider recommending that the PCAOB focus its public reporting of inspection results on the PCAOB's procedures to evaluate the sufficiency of a firm's quality control system. Also, under our proposed approach, the PCAOB could later describe follow-up procedures to determine whether the firm has taken adequate corrective measures during the 12 months subsequent to the original inspection report and could state how the PCAOB is satisfied with those corrective measures. We believe the reporting model should continue to provide for public reporting of specific quality control deficiencies should a firm not address them to the PCAOB's satisfaction.

Such changes to the audit quality inspection, independent oversight and transparency processes would enable the PCAOB to not only examine individual audit engagements and quality control systems, they would also allow the PCAOB to provide informed considerations regarding the resilience, or safety and soundness, of the private sector public company audit function.

Recommendations

1. We believe that the Treasury Committee should recommend that the transparency and oversight of audit firms be enhanced, while recognizing the need for global consistency and coordination in this regard. Specific proposals that we believe merit further consideration include the following:
   a. The PCAOB could require registered audit firms to publish a transparency report, consistent with the transparency requirements of the EU Eighth Directive, to provide increased public insight into a firm's commitment to audit quality and the way it is governed.
   b. The SEC and PCAOB could explore modifying or clarifying the independence rules in a manner that would facilitate audit firms engaging non-firm personnel as directors, advisors or in other related capacities should firms so desire.
   c. Coordination of regulatory oversight of the profession's global networks should be increased to enhance the contribution of regulators to sustainable, high-quality audits around the world and investor confidence in the audit process.
   d. In order to protect the public interest in the provision of public company auditing services, the PCAOB could utilize existing authority to obtain and evaluate information about the financial resilience and viability of the audit firms it regulates.
   e. To have a more positive impact on audit quality and foster greater confidence in the oversight provided by the PCAOB, the PCAOB inspection process could be increasingly focused on evaluating the quality control systems of audit firms and communicating its comfort with corrective measures taken by the firms in response to inspection findings.

Liability Risk and Insurability

The unlimited, uninsured, and potentially catastrophic top-side liability risk facing firms in the U.S. threatens the long-term sustainability of private sector auditing of public companies. Because of this, it should be a concern not just to the U.S. but to the global economy.

Audit firms face increased liability exposure to what have been termed "mega-claims"[1] and this increased risk is largely due to the increased size of today's public companies.[2] If a registrant's stock price is volatile and suffers a significant downturn associated with financial reporting, an investor class action can assert a very large claim against the auditor. If a client increases its outstanding debt and becomes insolvent, the auditor's liability exposure can encompass the entire amount of the registrant's indebtedness.

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[1] In a study of extremely large claims against audit firms entitled *Mega-Claims 2006*, the insurance broker Aon observed that "mega-claims remain a source of concern to audit firms for three reasons. One is that such claims are linked to economic cycles and may increase—once again—during the next economic downturn. The other is that various business, economic, and financial factors that have fueled mega-claims during economic downturns in the past are factors that remain strong today—and may be growing more potent. Finally, numerous plaintiff strategies—some old, some new, some still-evolving—make mega-claims potentially more costly to defendants." Aon Professional Risks, *Mega-Claims* 2006, at 19.

[2] The total market capitalization of companies listed on the three major U.S. exchanges grew by a factor of five between 1989 and 2004, from $3.5 trillion to $17.8 trillion.

Audit firms cannot fulfill their responsibilities in the financial reporting system if they themselves are not financially viable. We believe that it would be appropriate for the PCAOB to assess the extent to which the current liability rules, combined with the unavailability of sufficient insurance, expose audit firms to the threat of destruction through litigation.

Various private sector commissions and committees have considered the issue and agreed that action should be taken—as have governmental commissions in the European Union and UK.

Many countries have already recognized the need to reform unlimited auditor liability regimes. Germany has had statutory caps on auditor liability for many years. Countries such as Australia, Belgium, Canada, and Spain have enacted legislation to limit auditor liability in the past few years.

Potential for Failure

In 2005, the European Parliament directed the European Commission to "present a report on the impact of the current liability rules for carrying out statutory audits on the European capital markets and on the insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations of financial liability."[3] The Commission engaged the consulting firm London Economics to prepare a report on issues relating to auditor liability, released last year.[4] The European Commission concluded that "four key issues" were identified in the study:

> First, "[t]he level of auditor liability insurance available for higher limits has fallen sharply in recent years. The remaining source of funds to face claims may essentially be the income of partners belonging to the same international network. Constantly large claims might therefore put at risk an entire network."
>
> Second, "[t]he failure of a network could lead to difficult consequences for the wider economy like a significant reduction in large company statutory audit capacity possibly creating serious problems for companies whose financial statements need to be audited."
>
> Third, "[t]he international market for statutory audits of large and very large companies is highly concentrated and dominated by the Big-4 networks. The likelihood of new entrants into this market is very limited in the coming years. Additionally, under the current circumstances, middle-tier firms are unlikely to become a major alternative if a Big-4 network fails."
>
> And fourth, "[a] limitation on auditor liability would reduce this risk. While there exist a number of variants of statutory audit liability limitation, the diversity of circumstances in terms of both audits and company size is such that it is unlikely that a one-size-fits-all EU-wide approach is the most useful."[5]

Subsequently, EU Internal Markets Commissioner Charlie McCreevy endorsed limits on auditor liability in private lawsuits to prevent the destruction of the audit function.[6] Observers of the U.S. capital markets have expressed the same concerns about auditor liability under U.S. law.

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[3] 17 May 2006 Directive (Directive 2006/43/EC) of the European Parliament and the European Council on the statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EC and 83/349/EEC (8th Company Law Directive)**.**

[4] Study on the Economic Impact of Auditors' Liability Regimes, MARKT/2005/24/F (September 2006), *available at* http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf.

[5] European Commission Press Release, *Auditors' Liability: Commission Publishes Independent Study on Economic Impact of Current Rules* (4 October 2006), *available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/06/1307&-format=HTML&aged=0&language=EN&guiLanguage=en.

The American Assembly, a nonpartisan think tank that operates under the auspices of Columbia University, assembled more than 50 knowledgeable participants in May 2005 to discuss auditor liability. Its report states that "[t]he current pattern of litigation involves huge claims—one Big 4 firm faced claims for damages of $12.5 billion—the extent of which prevents firms from even bringing their cases to trial, forcing them to settle to avoid potentially debilitating damages."[7] "At present, the U.S. liability system hampers the flow of valuable information to the market, negatively affects the quality of auditing and threatens the viability of auditing as an effective check on corporate financial reporting."[8]

The Chamber of Commerce Capital Markets Commission determined that "there is substantial evidence that audit firms face litigation threats so large and so uninsurable that they could lead to the demise of one or more audit firms."[9] It concluded that "that this problem should be addressed promptly by policy-makers."[10]

The Interim Report of the Committee on Capital Markets Regulation, commonly known as the Scott/Hubbard Committee, similarly concluded that Congress should consider protecting audit firms against the risk of catastrophic loss through litigation.[11]

Similarly, Professor John Coffee has stated that "the risk of catastrophic [litigation] loss…is the factor most likely to cause the market [for audit services] to unravel."[12] He suggested in October 2006 that regulators adopt a ceiling on audit firm liability under U.S. law: "Sooner or later there will be a financial disaster that will impair the solvency of one of these firms without some change."[13]

Availability of Insurance

Aon, a leading insurance broker with substantial expertise in this area, told the Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century that "[t]he auditing profession is one of the very few where insurance protection for catastrophic losses simply is not available."[14] "The loss experience of the international accounting networks has been such that significant commercial risk transfer insurance limits are generally unavailable to these firms. Such limits as are available are, in the views of actuaries and other experts we have consulted, insufficient to pay the possible maximum losses to which accounting firms are subject."[15]

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6 *Commissioner Urges Liability Cap for Big Four Accountancy Firms*, Financial Times at 7 (Oct. 27, 2006) ("a large claim may put an entire[audit] network at risk. Personally, I think we should have a cap [on auditors' liability] or a variation thereof").

7 American Assembly, *The Future of the Accounting Profession: Auditor Concentration* 19 (May 2005).

8 *Id*. at 10-12.

9 Commission on the Regulation of the U.S. Capital Markets in the 21st Century, Independent Bipartisan Commission Established By The U.S. Chamber of Commerce, *Report and Recommendations* 107 (Mar. 2007), *available at* http://www.capitalmarketscommission.com/NR/rdonlyres/eozwwssfrqzdm3hd5siogqhp6h2ngxwdpr77qw2bogptzvi5weu6mmi4plfq6xic7kjonfpg4q2bpks6ryog5wwh5sc/0703capmarkets_full.pdf.

10 *Id*.

11 Committee on Capital Markets Regulation, *Interim Report* 88-89 (Nov. 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

12 John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U.L. Rev. 301, xxx (2004).

13 *Coffee Advises Paulson Panel of Ways to Mitigate Securities Litigation Threat*, BNA Daily Report for Executives (Oct. 16, 2006).

14 Letter from Aon to U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century (October 19, 2006).

15 *Id.*

In other sectors of the economy in which the private insurance markets are unable to supply sufficient coverage, the federal government has stepped in to address the issue,[16] but there has not, of course, been any government action with respect to insurance for audit firms.

Potential Consequences of a Larger Auditing Firm Failure

The study sponsored by the European Commission concluded that there would be very significant adverse consequences for investors and markets if a large audit firm failed:

> "A failure of one of the Big-4 networks may result in a significant reduction in large company statutory audit capacity if partners and other senior staff at the failed firm, the remaining Big-4 firms, and possibly even some middle-tier firms, were to decide that auditing is a too risky activity and therefore shift to other business lines. This would obviously create very serious problems for companies whose financial statements need to be audited."[17]
>
> "In such circumstances, a major increase in the price of statutory audits would be required to restore the equilibrium between demand for and supply of statutory audit services."[18]
>
> "Financial institutions in particular could face serious transition problem as the special skills their audits require and the independence rules may severely restrict their range of choice for a new auditor."[19]
>
> "The cost of capital is unlikely to be impacted much directly even if audit fees increase sharply as the share of audit fees in total operating costs is typically very small. Even a doubling or a trebling of audit fees is unlikely to affect much profitability of companies, except those whose profitability was borderline. But, the cost of capital could be affected indirectly if the loss of one of the Big-4 was to make investors lose confidence more generally in capital markets."[20]
>
> "While such an impact could be potentially very substantial, it is difficult, if not impossible to quantify it precisely as the magnitude of the impact will ultimately depend on the perceptions and mood of the investors at the time the failure occurs. If such a shock were to occur in already unsettled markets the impact could be much larger than in normal market conditions."[21]

The EU study also examined the possibility that a second audit network would fail: "[g]iven the limited availability of insurance and the large actual and potential claims faced by a number of Big-4 firms," it "cannot be ruled out that a second network would fail too."[22]

"Such a situation would obviously be dire and any market adjustment would be rendered much more difficult. In all likelihood, investor confidence would fall significantly and capital markets will most probably react much more negatively than in the case discussed above. The audit market adjustment to such a shock will also in all

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16 Price-Anderson Act (nuclear power industry); Terrorism Risk Insurance Act (insurance related to acts of terrorism).

17 Study on the Economic Impact of Auditors' Liability Regimes at xxxvii; see also *id*. at 134-136.

18 *Id*.

19 *Id*.

20 *Id*. at xxxviii; see also *id*. at 135.

21 *Id*. at xxxviii-xxxvix; see also *id*. at 135.

22 *Id*. at xxxix.

likelihood be much more difficult and chaotic, especially if such an event causes experienced audit staff and audit partners to leave the industry in light of the heightened risk."[23]

It continued, "investors' confidence may be seriously shaken by such an event as they are likely to raise many questions about the value of audits and the audit profession, and capital markets will most probably react much more negatively than in the case discussed above. Investors' trust in audited accounts of companies likely will be severely undermined by such events and the costs of capital will likely rise as a result."[24]

Next Steps

We urge the Committee to consider these issues fully, recognize the threat posed by liability risks, and identify changes that could protect investors and the capital markets against the adverse consequences from the destruction of audit firms due to catastrophic liability.

We believe that there are a number of regulatory and statutory changes that could improve this situation. These include amending federal tax policy to facilitate greater use of captive insurers, adopting a federal standard precluding the imposition of liability for auditors' decisions that are based upon professional judgment[25], establishing top-side limitations on liability, and authorizing intervention by federal regulators to prevent destruction of an audit firm.

We also suggest considering a change to the Federal Rules to permit firms to make interlocutory appeals from denials of motions to dismiss in private actions. Also, we recommend a limit on the size of federal and state appeal bonds (as many states have). Currently, Federal Rules provide courts some discretion but generally require the posting of bond equal to the size of any award in order for the judgment to be appealed. In mega-cases, this can in effect eliminate the appellate option for audit firms.[26]

Moreover, bankruptcy law today does not provide audit firms—whose partners are both owners and key employees—with a realistic chance of reorganizing and emerging as a going concern able to provide services to public company clients. The Committee may want to suggest reforms that would make reorganization through bankruptcy a practical option for audit firms.

Recommendations

1. *Appeal Bonds*—The Federal Rules governing appeal bonds should be revised to ensure that defendant audit firms can always obtain appellate review of large judgments. The Treasury Committee should encourage states that have not enacted fair appeal bond limitations to do so.
2. *Permit Appeals of Denials of Motions to Dismiss*—Defendant audit firms should be able to file an interlocutory appeal to the federal appellate courts of a denial of a motion to dismiss a private action in federal district court.

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[23] *Id*. at xxxix; see also *id*. at 135-136.

[24] *Id*.

[25] The Canadian Public Accountability Board ("CPAB") supported providing auditors with a defense against post-hoc second-guessing of professional judgments in comments recently submitted to the SEC Advisory Committee on Improvements in Financial Reporting ("CIFiR"). See CPAB Comment Letter at 4-6. The issue is now under active consideration by the CIFiR.

[26] A recent case in which a state court jury returned a verdict in excess of $500 million against one of the six largest accounting firms shows the importance of these limits: that accounting firm could invoke its right to appellate review because the governing state law sets a maximum of $50 million for appeal bonds.

3. *Enhancing Audit Firms' Ability to Utilize Captive Insurers*—The tax rules should be changed so that a captive insurer owned by an audit firm registered with the PCAOB that writes insurance to cover damages claims is not required in addition to write insurance for unrelated risks in order to enable the audit firm to deduct its premium payments for tax purposes.
4. *Creating a Professional Judgment Rule*—Auditors and a registrant's internal accountants should be able to rely upon a regulatory professional judgment rule or framework that would function like the business judgment rule to protect against regulatory second-guessing and civil liability arising from rational, well-considered, documented judgments.
5. *Emergency Actions and Expedited Reorganization of Public Accounting Firms*—The SEC should have the authority to take emergency action it deems necessary in the public interest and for the protection of investors in the case of a development that threatens the ability of a registered public accounting firm to continue to provide audits to its issuer clients. Additionally, the bankruptcy code should be amended to facilitate the audit firm's reorganization.
6. *Addressing Catastrophic Risks*—The Treasury Committee should consider measures, such as a top-side limitation on liability, to eliminate or at least significantly reduce the threat of serious harm to investors and the capital markets from a verdict against an audit firm in private litigation so large as to destroy the audit firm.

Conclusion

We strongly support the work of the Advisory Committee to "promote and encourage prosperity and stability by both improving the quality of the audit process and audits and ensuring the viability and resilience of the public company auditing profession." The Committee's efforts are vitally important to the public company auditing profession, to investors, and to the growth and stability of our financial markets.

As outlined in this submission, Ernst & Young has embarked on significant changes in the last few years designed to help us deliver on our promise of seamless, consistent high-quality service worldwide. The world in which we compete, and the regulatory structure under which we operate, has undergone historic changes. We've made significant investments in our people, technologies, processes, and procedures to meet the challenges of the increasingly global marketplace. We have improved our governance structures, have become more transparent with our regulators, and continue to strive to exceed the expectations of the investors we ultimately serve.

Yet significant challenges remain. Audit quality can always be improved, the pipeline of human capital necessary to the continued viability of the public company auditing profession must be enhanced, the choice of auditors for issuers can be improved, oversight and standards must be harmonized across national boundaries, and the sustainability of the profession is not assured.

We welcome the focus of the Advisory Committee on such key topics and look forward to working with the Committee as it weighs recommendations to advance the public interest. A number of these issues I have addressed are complicated, and I have only briefly touched upon them. We would be pleased to provide the Committee with additional information and insights as it considers these and other matters in coming months.