

# Advisory Committee on the Auditing Profession

The Department of the Treasury  
Open Meeting  
March 13, 2008

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# Meeting of the Advisory Committee on the Auditing Profession

Thursday, March 13, 2008

The Department of the Treasury  
Cash Room  
1500 Pennsylvania Avenue NW  
Washington, DC

## AGENDA

- I. Introductory Remarks ..... 10:00 am – 10:15 am**  
Donald T. Nicolaisen, Committee Co-Chair
- II. Presentation of Preliminary Recommendations..... 10:15 am – 1:15 pm**  
Subcommittee on Human Capital  
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- III. Lunch Break ..... 1:15 pm – 2:00 pm**
- IV. Presentation of Preliminary Recommendations..... 2:00 pm – 4:50 pm**  
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- V. Closing Remarks ..... 4:50 pm – 5:00 pm**  
Arthur Levitt, Jr., Committee Co-Chair

**PREFACE OF THE CO-CHAIRS TO THE  
PRELIMINARY RECOMMENDATIONS OF THE SUBCOMMITTEES OF THE  
ADVISORY COMMITTEE ON THE AUDITING PROFESSION**

The Department of the Treasury chartered the Advisory Committee on the Auditing Profession to develop recommendations designed to increase investor protection and enhance the sustainability of a strong and vibrant public company auditing profession. The charge, important to maintaining the strength of our capital markets, is broad and daunting. Yet, as Co-Chairs, we have witnessed the members of this Committee embrace this task. Over the past several months, the three Subcommittees—Human Capital, Firm Structure and Finances, and Concentration and Competition—have been responsibly and conscientiously considering and developing recommendations. We commend the members for their efforts as the challenges the auditing profession faces are difficult and do not lend themselves to easy resolution.

The corporate accounting scandals of a few years ago convinced the capital markets, Congress, and regulators of the critical role of the auditing profession and the need for a new regulatory framework for the profession. The scandals also put the profession on notice of the need to alter its culture and redirect its focus to its most critical role: performing high quality audits. The failure of one of the largest auditing firms, the move from self-regulation to a more robust private regulatory regime under the Public Company Accounting Oversight Board, and enhanced independence requirements compelled some of these changes. We believe the profession has improved, undertaking more effective audits and ensuring more reliable financial reporting. The profession is stronger today than a decade ago.

But the profession continues to face challenges—an ever-accelerating pace of change in our capital markets, increased needs of investors, greater use of judgment and market values in financial statements, in addition to technological and informational innovations and globalization. Financial reporting and auditing are no longer local or even national concerns. They are global. Dealing with this global world is driving a need for heightened professionalism and an ability to understand an increasingly complex financial reporting and auditing environment.

With this growing globalization and complexity investors are entitled to expect more from the profession. Through audits and the audit process, the profession must ensure to investors that financial reporting is reliable, complete, and timely. This includes investors' receiving timely information regarding detection of material errors and omissions in financial statements.

The goal is to reach a point where investors and markets have confidence that the profession has the tools and talent in place to discharge its responsibilities effectively. To do so, it is important that the profession demonstrate its effectiveness and its sustainability, both to investors and regulators as well as to its employees. While considerable progress has been made, we believe that recommendations of this Committee and its members can also help. Our objective is to identify ways to strengthen the profession and to reinforce the profession's most important mandate: performing high quality audits so that investors have confidence in financial reporting and the capital markets. The journey requires a concerted effort by auditing firms, investors, regulators, policymakers, public companies, and academia.

With these objectives in mind, during this meeting we will review closely each of the Subcommittees' preliminary recommendations. We would like to emphasize that while the Subcommittees developed the recommendations, the intent is to develop a consensus of all the members so that in the end, all recommendations will be those of the full Committee. Thus, it will be important that the Subcommittees discuss not only the preliminary recommendations being advanced, but also other important matters that were considered in depth by the Subcommittees but did not lead to preliminary recommendations.

We would like to highlight a few of these preliminary recommendations. The profession sits on the front line of globalization, balancing complex rules and standards with a need for independent professional judgment. It is critical to make sure that those entering the profession have the technical skills, the ethical compass, and the experience that will lead to sound judgment necessary to an effective public company audit. The accounting student is where this starts. The Subcommittee on Human Capital has rightly focused much of its time and effort on ensuring the adequate preparation of this student. Today, the Subcommittee on Human Capital recommends increasing the pace of curricular changes in university and college accounting programs to match more effectively the increasing pace of market developments. New talent entering the profession faces a world of increasing complexity, international accounting standards, fair value reporting, principles and rules, technological innovations, all of which beg a high degree of professionalism and judgment. The Subcommittee has taken this to heart.

At the same time, the Subcommittee on Human Capital notes that it is "imperative" that the profession reflect the ethnic demographics of the global economy and has worked hard to ensure minority recruitment through a series of focused recommendations. We commend and support their focus.

Next, the Subcommittee on Firm Structure and Finances has worked diligently to come to consensus on difficult issues. The Subcommittee has asked us to consider enhancing disclosure around auditor changes. The belief of the Subcommittee is that increased transparency surrounding auditor changes will result in increased investor confidence in financial reporting and greater audit committee accountability.

The Subcommittee on Firm Structure and Finances also presents us today with a recommendation to better communicate auditors' fraud detection practices and limitations. The Subcommittee has correctly focused on an "expectations gap" between the objective of the design and execution of an audit in conformity with generally accepting auditing standards, which is reasonably designed to detect fraud (as well as error), and the perceived market and investor expectation that auditors will detect more fraud than those in the profession believe can be reasonably expected. We need, and the Subcommittee is proceeding to seek to address this, both to improve and better systemize the processes for fraud detection and clarify market and investor understanding of the auditor's role in detecting fraud. Our goal should be both better detection and better understanding.

Finally, the Subcommittee on Concentration and Competition offers what we believe to be one of the most significant recommendations. 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. The Concentration and Competition Subcommittee presents us today with a potential solution: a recommended 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. We believe this idea—which at its core is intended to protect our capital markets—merits careful deliberation. We anticipate a vigorous discussion today and at future Committee meetings.

Again, we commend the Committee members for their thoughtfulness and their diligence in developing these proposals. We look forward to deliberating these ideas over the next few months and we, as Co-Chairs, intend to push the Subcommittees farther in certain areas. The Subcommittees will continue to work to develop these proposals. We have the ultimate goal in mind: enhancing the quality of the audit process and audits for investors and ensuring the viability and resilience of the auditing profession. We seek your input and encourage the expression of your views. We've heard public testimony from many experts. Now it's our turn.

We note that members hold strong views on many of the matters under consideration. Our time today in this public meeting is limited, so we ask that members respect these limitations with succinct questions and summaries of their thoughts.

Arthur Levitt, Jr.  
Donald T. Nicolaisen

**Preliminary Recommendations**  
**Subcommittee on Human Capital**  
**Advisory Committee on the Auditing Profession**  
**The Department of the Treasury**

**Summary of Preliminary Recommendations**

The Subcommittee on Human Capital submits the following preliminary recommendations to the Advisory Committee on the Auditing Profession for its consideration:

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

(a) Regularly update the accounting certification exams to reflect changes in the accountancy profession, its relevant standards, and the skills and knowledge required to serve increasingly global capital markets.

(b) Reflect real world changes in the business environment more rapidly in teaching materials.

(c) Require that schools build into accounting curricula current market developments.

2. Ensure a sufficiently robust supply of qualified financial accounting, audit, and tax faculty to meet demand for the future and help prepare new entrants to the profession to perform high quality audits.

(a) Increase the supply of accounting faculty through public and private funding as well as through raising the number of professionally qualified faculty that teach on campuses.

(b) Emphasize the utility and effectiveness of cross-sabbaticals.

(c) Create tax incentives for private sector institutions to fund both accounting faculty and faculty research, to provide practice materials for academic research and for participation of professionals in behavioral and field study projects, and to encourage practicing accountants to pursue careers as academically and professionally qualified faculty.

3. Improve the representation and retention of minorities in the auditing profession so as to enrich the pool of human capital in the profession.

(a) Recruit minorities into the auditing profession from other disciplines and careers.

(b) Emphasize the role of community colleges in the recruitment of minorities into the auditing profession.

(c) Emphasize the utility and effectiveness of cross-sabbaticals with Historically Black Colleges and Universities.

(d) Increase the numbers of minority accounting doctorates through focused efforts.

4. Develop and maintain consistent demographic and higher education program profile data sets.

**Preliminary Recommendations**  
**Subcommittee on Human Capital**  
**Advisory Committee on the Auditing Profession**  
**The Department of the Treasury**

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

The accounting curricula in higher education are critical to ensuring individuals have the necessary knowledge, skills, and abilities to perform quality public company audits. In this regard, the Subcommittee makes the following recommendations:

**(a) Regularly update the accounting certification exams to reflect changes in the accountancy profession, its relevant standards, and the skills and knowledge required to serve increasingly global capital markets.**

Accounting and auditing professionals commonly complete the requirements of professional exams in order to comply with legal or professional association requirements. To become licensed at the state level as a certified public accountant, an individual must, among other things, pass the Uniform CPA Examination. In addition to the broad learning objectives of higher education, accounting curricula's technical and professional materials necessarily reflect the influence of these exams.

The Subcommittee believes that professional exam content should serve as an important catalyst for curricular changes to reflect the dynamism and complexity of auditing public companies in global capital markets. The American Institute of Certified Public Accountants (AICPA) already regularly analyzes and updates its exam content. The Subcommittee recommends such changes remain a focus to ensure important ongoing market developments, such as the increasing use of international financial reporting standards (IFRS), expanded fair value measurement and reporting, new Public Company Accounting Oversight Board (PCAOB) auditing and professional standards, risk-based business judgment, and technological innovations in financial reporting, are reflected in exam content in a timely manner. Specifically, the Subcommittee recommends that the market developments outlined above be made as soon as practicable, and not later than 2011. In addition, the Subcommittee recommends that new exam content continue to be widely communicated to college and university faculty and administrators so that corresponding curricular changes can begin, and continue to occur, in educational institutions.

**(b) Reflect real world changes in the business environment more rapidly in teaching materials.**

Students use a variety of sources, such as textbooks and online materials, to learn. Such materials are an important element of higher education. These commercial materials are often conservatively managed and follow rather than lead recent market developments.

The Subcommittee believes that accounting educational materials can serve as a catalyst for curricular changes to reflect the dynamism and complexity of the global capital markets and that commercial content providers should reflect this in their published materials. Specifically, the Subcommittee recommends that organizations, such as the AICPA and the American Accounting Association (AAA), meet with commercial content providers and encourage them to update their materials to reflect new developments such as the increasing use of IFRS, new PCAOB auditing and professional standards, risk-based business judgment, expanded fair value reporting as well as technological developments in financial reporting and auditing such as eXtensible Business Reporting Language (XBRL).

Further, in order to ensure access to such materials as a fundamental element of education, the Subcommittee recommends that authoritative bodies and agencies should be encouraged to provide low cost, affordable access to digitized searchable authoritative literature and materials, such as Financial Accounting Standards Board (FASB) codification and eIFRS, to students and faculty members. The Subcommittee believes that access to such primary materials would enhance student learning and technical research.

**(c) Require that schools build into accounting curricula current market developments.**

Accrediting agencies review institutions of higher education and their programs and establish that overall resources and strategies are conformed to the mission of the institutions. For example, the Association to Advance Collegiate Schools of Business and the Association of Collegiate Business Schools and Programs accredit undergraduate and graduate business administration and accounting programs. The accreditation standards relate to, among other things, curricula, program and faculty resources, and faculty development.

The Subcommittee believes that accreditation standards can serve as a catalyst for curricular changes to reflect the dynamism and complexity of the global capital markets. The Subcommittee recommends that accrediting agencies develop standards specifically emphasizing the need to continuously update accounting programs to reflect new developments.

**Recommendation 2. Ensure a sufficiently robust supply of qualified financial accounting, audit, and tax faculty to meet demand for the future and help prepare new entrants to the profession to perform high quality audits.**

Accounting faculty play a critical role in developing qualified professionals for the increasingly complex and global auditing profession. In this regard, the Subcommittee makes the following recommendations:

**(a) Increase the supply of accounting faculty through public and private funding as well as through raising the number of professionally qualified faculty that teach on campuses.**

Research shows that there is a high level of concern about the adequacy of the near-term and long-term supply of doctoral faculty given the pace of expected faculty retirements.<sup>1</sup> The

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<sup>1</sup> It is estimated that one-third of the 4,000 accounting doctoral faculty in the United States are 60 years old or older, and one-half are 55 years old or older. The average retirement age of accounting faculty in the last decade is 62.4

Subcommittee recognizes that ensuring an adequate supply of doctoral accounting faculty in higher education is crucial to both retaining the academic standing of the discipline on campus and developing well-prepared and educated entry-level professionals. The Subcommittee recommends expanding federal and state government funding for accounting doctoral candidates. The Subcommittee also recommends that private sources continue to be encouraged to fund accounting doctoral candidates.

Additionally, minimum accreditation requirements for accountancy faculty typically require that approximately 50% of full-time faculty be academically qualified. Commonly, business school deans and academic vice presidents (those making the budgetary decisions regarding faculty allotments on campuses) interpret this accreditation requirement to require that a minimum of 50% of a department's faculty hold an earned doctorate and are actively engaged in research and publication activity. Although a high percentage of faculty are expected to be professionally qualified (i.e., having direct business experience), at times gatekeepers for budget allocations are less enthusiastic about maximizing the number of professionally qualified teaching slots in a given program. The Subcommittee supports the increased participation of professionally qualified faculty, thereby bringing additional practical business experience to the classrooms. The Subcommittee recommends that accrediting agencies support a more balanced faculty mix of academically and professionally qualified faculty.

**(b) Emphasize the utility and effectiveness of cross-sabbaticals.**

Cross-sabbaticals are interactive relationships where faculty and seasoned professionals are regularly represented in the practice and academic environments through exchanges (for example, currently, the Securities and Exchange Commission (SEC) and the FASB offer fellowship programs for professional accountants and accounting academics). Firms and institutions should ensure that accounting academics and professionals are awarded such sabbaticals in order to gain knowledge and share experiences in each other's environments. Academics must often forgo their full salaries for engaging in such sabbaticals which is a disincentive, and colleges and universities may not in fact encourage professional practice sabbaticals, preferring focus to be directed instead towards the number and placement of scholarly articles. The Subcommittee believes that changing both the academic and practice culture will require a plan and commitment of support at the highest institutional levels.

Specifically, the Subcommittee recommends that educational institutions, auditing firms, corporations, federal and state regulators, and others encourage cross-sabbaticals and eliminate financial or career disincentives for participating in such experiences. Further, the Subcommittee recommends that university administrators place as high a value on professional sabbaticals for purposes of promotion and tenure as they do today for scholarly publications.

The Subcommittee also recommends that accrediting agencies establish an expectation that at least one full-time accounting faculty per year participate in a sabbatical with a private sector

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years (Hasselback, November 2006). Further, the number of full time accounting faculty positions in higher education declined 13.3% over the period 1993 – 2004, while the undergraduate enrollment increased 12.3% over the same period, suggesting that productive capacity has been extended and that future capacity issues will need to be addressed primarily through the resupply of qualified doctoral faculty.

institution or a governmental entity. Auditing firms, corporations, government agencies, and universities should be expected to provide these opportunities with the elimination of any financial disincentives. Further, the Subcommittee recommends expanding faculty fellowship programs in agencies, such as those at the SEC and FASB, and making them available at the PCAOB.

**(c) Create tax incentives for private sector institutions to fund both accounting faculty and faculty research, to provide practice materials for academic research and for participation of professionals in behavioral and field study projects, and to encourage practicing accountants to pursue careers as academically and professionally qualified faculty.**

Currently, there are no specific tax incentives encouraging private sector funding of accounting doctoral faculty or sponsoring of professional accountants to teach at educational institutions. The Subcommittee recommends that Congress pass legislation creating tax incentives for private sector institutions to help fund accounting faculty and faculty research, to facilitate access to research data and individuals, and to sponsor transition of professional accountants from practice to teaching positions.

**Recommendation 3. Improve the representation and retention of minorities in the auditing profession so as to enrich the pool of human capital in the profession.**

The Subcommittee believes that the lack of representation of minorities in the accounting profession is unacceptable from both a societal and business perspective. As the demographics of the global economy continue to expand ethnic diversity, it is imperative that the profession reflect these changes. The Subcommittee makes the following recommendations:

**(a) Recruit minorities into the auditing profession from other disciplines and careers.**

The Subcommittee recognizes that minorities are significantly under-represented in the accounting and auditing profession and that the representation of minorities in the profession is unacceptable from both a societal and business perspective.<sup>2</sup> Accordingly, the Subcommittee recommends that auditing firms actively market to and recruit from minority non-accounting graduate populations, both at the entry and experienced hire level, utilizing cooperative efforts by academics and firm-based training programs to assist in this process. Further, the Subcommittee recommends that auditing firms expand their recruitment initiatives at Historically Black Colleges and Universities (HBCUs), and explore the use of proprietary schools as another way to recruit minorities into the profession.

**(b) Emphasize the role of community colleges in the recruitment of minorities into the auditing profession.**

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<sup>2</sup> In 2004, African American CPAs represented 1% of all CPAs, Hispanic/Latino CPAs, 3%, and Asian/Pacific Islander, 4%. Of new hires by the six largest accounting firms in 2007, Caucasians accounted for 67.4%, African Americans, 5.4%, Hispanics, 4.6 %, and Asians, 21.3%. In 2007, 93.7% of the partners in the six largest accounting firms were Caucasian, 1.0% were African American, 1.6% were Hispanic/Latino, 3.4% were Asian, and less than 1.0% were Native Hawaiian/Pacific Islander or American Indian/Alaska Native.

As of January 2007, approximately 11.6 million students were enrolled in the 1,200 community colleges in the United States: African Americans accounted for 13% of these students, Hispanics, 14%, and Asian/Pacific Islander, 6%. One-quarter of those entering the accounting profession take their initial accounting coursework at community colleges.

The Subcommittee believes that more attention to community colleges' accounting instruction may provide another avenue for minorities to become familiar with the auditing profession. The Subcommittee recommends that accreditation of two-year college accounting programs at community colleges be explored and proposed when viable. Further, the Subcommittee recommends that auditing firms and academic institutions at all levels support and cooperate in building strong fundamental academic accounting programs at community colleges, including providing internships or financial support for students who begin their studies in two-year programs and may be seeking careers in the auditing profession.

**(c) Emphasize the utility and effectiveness of cross-sabbaticals with Historically Black Colleges and Universities.**

Currently over 100 educational institutions established before 1964 to serve the African-American community are designated as HBCUs. At least one of the six largest accounting firms recruits professional audit staff at each of 27 HBCUs. As discussed above, African-Americans are significantly underrepresented in the auditing profession.

The Subcommittee recommends encouraging a concerted effort to increase the focus upon HBCUs in order to raise the number of African-Americans in the auditing profession and urging the HBCUs, auditing firms, corporations, federal and state governments, and other entities to emphasize the use of cross-sabbaticals. In addition, the Subcommittee recommends that HBCUs with accounting programs require one accounting faculty sabbatical annually with a private or public sector institution. The Subcommittee recommends that, at the same time, the private and public sector entities focus on arrangements to provide professional liaisons to build relationships at these institutions.

**(d) Increase the numbers of minority accounting doctorates through focused efforts.**

Some dedicated programs have succeeded in attracting minorities to enter and complete accounting doctoral studies. In particular, the PhD Project, an effort of the KPMG Foundation, has worked to increase the diversity of business school faculty. Since the PhD Project's establishment in 1994, the number of minority professors at U.S. business schools has increased from 294 to 812.

The Subcommittee believes programs such as these can successfully recruit minorities to accounting doctoral studies. The Subcommittee recommends that auditing firms, corporations, and other interested parties advertise existing and successful efforts to increase the numbers of minority Ph.D.s, by developing further dedicated programs. Additionally, the Subcommittee recommends that auditing firms, corporations, and other interested parties continue to fund these programs.

**Recommendation 4. Develop and maintain consistent demographic and higher education program profile data sets.**

The need for comparable, consistent, periodic information about the demographic profile of professional accountants and auditors, related higher education program capacity, particulars of entry-level supply and demand of personnel, accounting firm retention and compensation practices, and similar particulars are fundamental to a meaningful understanding of the human capital circumstances which affect the sustainability of the public company auditing profession.

Materials such as those supplied by the Center for Audit Quality, previous AICPA Supply and Demand studies, and recent demographic research as commissioned by the AAA provide examples of the information needed. In addition, AICPA membership data trends, augmented by data available from state boards of accountancy regarding numbers of licensees, may be useful data.

The Subcommittee believes that a national cooperative committee should be established, comprised of organizations such as the AICPA and the AAA, to develop and maintain periodic consistent demographic and higher education program profile data sets.

The Subcommittee believes that possessing such data will enhance the ability to more fully understand, monitor, and react to the sustainability of adequate human capital for the profession.

**Preliminary Recommendations**  
**Subcommittee on Firm Structure and Finances**  
**Advisory Committee on the Auditing Profession**  
**The Department of the Treasury**

**Summary of Preliminary Recommendations**

The Subcommittee on Firm Structure and Finances submits the following preliminary recommendations to the Advisory Committee on the Auditing Profession for its consideration:

1. Urge the creation of a center (preferably under the sponsorship of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and/or the Center for Audit Quality (CAQ)) for auditing firms and other market participants to share fraud prevention and detection experiences, and further, encourage the auditing firms and other market participants to develop best practices regarding fraud prevention and detection and clarify communications with the public regarding auditor responsibility relating to fraud detection, all in order to strengthen the audit process and improve the likelihood of preventing and detecting fraud.

(a) Urge the creation of a center (preferably under the sponsorship of COSO and/or CAQ) to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies, commission research and other fact-finding regarding fraud prevention and detection, and further, have the auditing firms, investors, other financial statement users, public companies, and academics develop, in consultation with the PCAOB, the Securities and Exchange Commission (SEC), international regulators, and the National Association of State Boards of Accountancy (NASBA), best practices regarding fraud prevention and detection.

(b) Urge that the PCAOB and the SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards and further that the PCAOB review these standards.

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

(a) Institute the following incentive mechanism to encourage the states to substantially adopt the mobility provisions of the Uniform Accountancy Act, Fifth Edition (UAA): Congress should pass a federal provision requiring the adoption of the mobility provisions of the UAA for those states failing to adopt these provisions of the UAA by December 31, 2010.

(b) Require regular and formal roundtable meetings of the PCAOB, the SEC, the Department of Justice, state boards of accountancy, and state attorneys general, in a cooperative effort to improve regulatory effectiveness and reduce the incidence of duplicative and potentially inconsistent enforcement regimes.

(c) Urge the states to create greater financial and operational independence of their state boards of accountancy.

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

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

Observation: Further Subcommittee consideration of transparency and liability issues.

**Preliminary Recommendations**  
**Subcommittee on Firm Structure and Finances**  
**Advisory Committee on the Auditing Profession**  
**The Department of the Treasury**

**Recommendation 1. Urge the creation of a center (preferably under the sponsorship of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and/or the Center for Audit Quality (CAQ)) for auditing firms and other market participants to share fraud prevention and detection experiences, and further, encourage the auditing firms and other market participants to develop best practices regarding fraud prevention and detection and clarify communications with the public regarding auditor responsibility relating to fraud detection, all in order to strengthen the audit process and improve the likelihood of preventing and detecting fraud.**

Public Company Accounting Oversight Board (PCAOB) standards require auditors to plan and perform audits to obtain reasonable assurance whether financial statements are free of material misstatement, including those caused by fraud. The auditing profession recognizes the need to develop and enhance its fraud prevention and detection skills.

The Subcommittee believes that enhancing auditors' fraud prevention and detection skills will improve financial reporting and audit quality and enhance investor confidence in financial reporting and the auditing function. The Subcommittee recommends the following:

**(a) Urge the creation of a center (preferably under the sponsorship of COSO and/or CAQ) to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies, commission research and other fact-finding regarding fraud prevention and detection, and further, have the auditing firms, investors, other financial statement users, public companies, and academics develop, in consultation with the PCAOB, the Securities and Exchange Commission (SEC), international regulators, and the National Association of State Boards of Accountancy (NASBA), best practices regarding fraud prevention and detection.**

No formal forum currently exists where auditors and other market participants regularly share their views and experiences relating to fraud prevention and detection in the context of fraudulent financial reporting.

The Subcommittee believes that a collective sharing of fraud prevention and detection experiences among auditors and other market participants will provide a broad view of auditor practices and ultimately improve fraud prevention and detection capabilities and enable the development of best practices. The Subcommittee also believes that research into industry trends and statistics will help auditors focus and develop procedures to identify areas and situations at greater risk for fraud. The Subcommittee believes that best practices regarding fraud prevention and detection will enhance the internal processes and procedures of auditing firms. The Subcommittee recommends that entities, such as COSO and/or CAQ, create a center both to facilitate auditing firms' sharing of fraud prevention and detection experiences, practices, and

data and innovation in fraud prevention and detection methodologies and technologies and to commission research and other fact-finding regarding fraud prevention and detection. The Subcommittee recommends that the auditing firms, investors, other financial statement users, public companies, and academics develop, in consultation with the PCAOB, the SEC, international regulators, and NASBA, best practices regarding fraud prevention and detection.

**(b) Urge that the PCAOB and the SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards and further that the PCAOB review these standards.**

A long-standing "expectations gap" exists between the public's expectations regarding auditor responsibility for fraud detection and the auditor's required and capable performance of fraud detection. The public may believe that auditors will detect all fraud, or detect more fraud than can be reasonably expected. This belief may be unreasonable in some circumstances given the difficulties of detecting fraud. The auditing standard governing fraud detection, AU Section 316, *Consideration of Fraud in a Financial Statement Audit*, notes that fraud may involve deliberate concealment and collusion with third parties. AU Section 316 states that the "auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." This gap between public expectation and the auditor's performance causes confusion and ultimately undermines investor confidence in financial reporting and the capital markets.

The Subcommittee believes that the auditor's report should articulate clearly to investors the auditor's role and limitations in detecting fraud. The Subcommittee believes that expressly communicating to investors, other financial statement users, and the public the role of auditors in fraud detection would help narrow the "expectations gap." The Subcommittee recommends that the PCAOB and the SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards. In addition, the Subcommittee recommends, in light of this continuing "expectations gap," that the PCAOB review the auditing standards governing fraud detection and fraud reporting.

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

The SEC, the PCAOB, and individual state boards of accountancy regulate the auditing profession. The SEC and the PCAOB enforce the securities laws and regulations addressing public company audits. Individual state accountancy laws in 55 jurisdictions in the United States govern the licensing and regulation of both individuals and firms who practice as certified public accountants. State boards of accountancy enforce these laws and also administer the CPA examination. NASBA serves as a forum for these boards to enhance their regulatory effectiveness and communication.

The Subcommittee believes that enhancing regulatory cooperation and reducing duplicative oversight of the auditing profession by federal and state authorities and enhancing licensee

practice mobility among the states is in the best interest of the public and the effective operation of the capital markets. The Subcommittee recommends the following:

**(a) Institute the following incentive mechanism to encourage the states to substantially adopt the mobility provisions of the Uniform Accountancy Act, Fifth Edition (UAA): Congress should pass a federal provision requiring the adoption of the mobility provisions of the UAA for those states failing to adopt these provisions of the UAA by December 31, 2010.**

The American Institute of Certified Public Accountants (AICPA) and NASBA jointly author the UAA, a model bill which focuses on the education, examination, and experience requirements for certified public accountants. As the name of the bill suggests, the UAA advances the goal of uniformity, in addition to protecting the public interest and promoting high professional standards. In 2006 and 2007, recognizing the changing global economy and the impact of electronic commerce, the AICPA and NASBA proposed amendments to the UAA to allow for a streamlined framework for CPA “mobility” of practice among the states; that is, a CPA’s practice privileges would be valid and portable across all state jurisdictions beyond that of the CPA’s resident state. According to NASBA, to date 14 states have passed mobility legislation. Sixteen other states currently have mobility legislation introduced and other bills are anticipated in the 2008 legislative session. Almost every state is now discussing or considering mobility, and 11 other state boards of accountancy voted to support and move forward with mobility.

The Subcommittee believes that, given the multi-state operations of many public companies and the multi-state practices of many auditing firms, practice mobility will foster a more efficient operation of the capital markets. The Subcommittee recommends the following incentive mechanism to encourage the states to adopt the UAA’s mobility provisions: Congress should pass a federal provision requiring the adoption of the UAA’s mobility provisions for those states failing to adopt substantially these provisions by December 31, 2010. The Subcommittee also recommends that the states participate in NASBA’s Accounting Licensee Database (ALD) as a mechanism to assist in maintaining appropriate oversight of CPAs throughout the country regardless of where they practice and that appropriate authorities interpret federal and state privacy regulations to facilitate implementation of the ALD.

**(b) Require regular and formal roundtable meetings of the PCAOB, the SEC, the Department of Justice, state boards of accountancy, and state attorneys general, in a cooperative effort to improve regulatory effectiveness and reduce the incidence of duplicative and potentially inconsistent enforcement regimes.**

Under the federal securities laws, the SEC has enforcement authority over public company auditing firms and oversight authority over the PCAOB under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Sarbanes-Oxley established the PCAOB to register, inspect, and bring enforcement actions against and set standards for public company auditing firms. In addition, the 55 boards of accountancy license, regulate, and enforce state accountancy laws pertaining to certified public accountants and their firms.

The Subcommittee believes that there is duplicative and sometimes inconsistent federal and state oversight of the profession today. The Subcommittee recommends required regular and formal roundtables of the PCAOB, the SEC, the Department of Justice, the state boards of accountancy, and the state attorneys general, to periodically review the overall enforcement regimes applicable to the public company auditing profession. These roundtables also should focus on regulatory coordination, improvement, and consistent approaches to enforcement to minimize duplicative efforts. Because of the difficulty and cost of bringing together many different state agencies on a regular basis, the Subcommittee recommends that NASBA assist states by taking a leadership role in coordinating their responsibilities and interests.

**(c) Urge the states to create greater financial and operational independence of their state boards of accountancy.**

Critics have long complained about the lack of independence of state boards of accountancy and its effect on the regulation and oversight of the accounting profession. A number of state boards are under-funded and lack the wherewithal to incur the cost of investigations leading to enforcement. In addition, some state boards fall under the administrative “umbrella” of other state agencies and lack control of financial resources and/or operational independence necessary to carry out their mandate of public protection. In some cases, board members are nominated by private associations whose constituencies are not necessarily focused on protection of the public.

The Subcommittee believes that greater independence of state boards of accountancy would enhance their regulatory effectiveness. The Subcommittee recommends that, working with NASBA, states need to evaluate and develop means to make their respective state boards of accountancy more operationally and financially independent of outside influences.

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

State laws and partnership agreements determine the governance of auditing firms. Often a firm’s governing body is comprised of elected firm partners. Although not well-publicized, some firms are currently using advisory boards.

The Subcommittee believes that enhancing corporate governance of auditing firms through appointment of independent board members, whose duties run to the auditing firm and its partners/owner, to advisory boards with meaningful governance responsibilities (possible under the current business model) and/or to firm boards could be particularly beneficial to auditing firm management and governance. The Subcommittee also believes that such advisory boards and independent board members could improve investor protection through enhanced audit quality and firm transparency. The Subcommittee is particularly intrigued by the idea of independent board members with duties and responsibilities similar to those of public company non-executive board members. The Subcommittee recognizes the multiple challenges that

instituting a governance structure with independent board members might entail, including compliance with state partnership laws and independence requirements, insurance availability for such directors, and liability concerns. Accordingly, the Subcommittee recommends that the PCAOB and the SEC, in consultation with federal and state regulators, auditing firms, investors, other financial statement users, and public companies, analyze, explore, and enable, as appropriate, the possibility and feasibility, within the current context of independence requirements and the liability regime, of firms' appointing independent board members and advisory boards.

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

Under current SEC regulations, public companies must disclose auditor changes on Form 8-K. The company also requests that the auditor responds with a letter addressed to the SEC stating whether it agrees with the company's disclosure and, if it does not agree, stating why. While the SEC does attempt to uncover through its rules whether the auditor change relates to disagreements over accounting and reporting matters, the SEC rules do not require the public company to provide a reason for the auditor's departure in the vast majority of cases. There must be disclosure of any disagreements on financial disclosures during the preceding two years prior to the resignation and whether some issue, such as the auditor's inability to rely on management's representations, may put into question financial disclosure reliability. The limitations of the existing requirements has resulted in companies failing to disclose any reason for their auditor changes in approximately 70% of the more than 1,300 annual auditor changes occurring in 2006.

The Subcommittee believes that more transparency surrounding auditor changes would result in increased investor confidence in financial reporting, greater audit committee accountability, improved regulatory oversight through enhanced information, and may help to increase competition if negative perceptions regarding auditor changes are minimized. The Subcommittee recommends that the SEC amend its Form 8-K disclosure on auditor changes by providing for the following mechanism: The public company would file within four days of an auditor change a Form 8-K with a statement from the audit committee disclosing that an auditor had resigned, was terminated, or did not seek reappointment; the audit committee would appropriately characterize and state in all cases in plain English the reason or reasons for the change. The auditor would be required to respond, which response would be included as an exhibit to the company's Form 8-K filing. The auditor currently responds to the company's statements in the Form 8-K regarding disagreements over accounting and financial matters. This mechanism for auditor response should be retained.

In addition, the Subcommittee recommends that auditing firms notify the PCAOB of any engagement partner changes on public company audits if made before the normal rotation period and other than for retirement and the reasons for those changes.

**Observation: Further Subcommittee consideration of transparency and liability issues.**

The Subcommittee continues to consider transparency and liability issues concerning the auditing profession.

The Subcommittee has reviewed and considered a range of transparency reporting options. In May 2006, the PCAOB issued a proposal, not yet finalized, requiring annual and periodic reporting pursuant to the mandate under Sarbanes-Oxley's Section 102(d). This proposal would require annual reporting on such items as a public company audit client list and the percentage of fees attributable to audit clients for audit services, other accounting services, tax services, and non-audit services. The PCAOB proposal would also require firms to file a "special" report, triggered by such events as the initiation of certain criminal or civil governmental proceedings against the firm or its personnel; a new relationship with a previously disciplined person or entity; or the firm becoming subject to bankruptcy or similar proceedings.

Also, by June 2008, all public company auditors in the European Union Member states must comply with the European Union's Article 40 Transparency Report, which requires that public company auditors post on their websites annual reports including the following information: legal and network structure and ownership description; governance description; most recent quality assurance review; public company audit client list; independence practices and confirmation of independence compliance review; continuing education policy; financial information, including audit fees, tax advisory fees, consulting fees; and partner remuneration policies. The Article 40 Transparency Report also requires a description of the auditing firm's quality control system and a statement by firm management on its effectiveness. Furthermore, for several years auditing firms in the United Kingdom have published annual reports containing audited financial statements pursuant to limited liability partnership disclosure requirements as well as a discussion of those statements, a statement on corporate governance, performance metrics, and other useful information.

The Subcommittee also has considered the liability issues impacting the profession. The Advisory Committee has received statements that the auditing firms face the possibility of catastrophic losses from legal claims. The Advisory Committee has received recommendations for a variety of potential solutions to this liability issue, including liability caps, appeal bond caps, general securities litigation reform, damages recalculation, catastrophe bonds, tax enhancements to captive insurance funds, establishing a clear standard of care through regulation, federal jurisdiction for actions involving public company audits, and financial statement insurance. The Advisory Committee also has received statements of opposition to these recommendations to further limit auditor liability.

The Subcommittee will continue to work energetically to attempt to arrive at a consensus recommendation on these issues.

**Preliminary Recommendations**  
**Subcommittee on Concentration and Competition**  
**Advisory Committee on the Auditing Profession**  
**The Department of the Treasury**

**Summary of Preliminary Recommendations**

The Subcommittee on Concentration and Competition submits the following preliminary recommendations to the Advisory Committee on the Auditing Profession for its consideration:

1. Promote the growth of smaller auditing firms consistent with the overall policy goal of promoting audit quality. Because smaller firms are likely to become significant competitors in the market for large company audits only in the long term, the Subcommittee recognizes that Recommendation 2 will be a higher priority in the near term.

(a) Require disclosure by public companies in their proxy reports of any provisions in material agreements with third parties limiting auditor choice.

2. Create a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms.

(a) Broadly monitor, through the Public Company Accounting Oversight Board (PCAOB) authority over registered firms, potential sources of catastrophic risk, which would threaten audit quality.

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

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

(a) Compile the SEC and PCAOB independence requirements into a single document and make this document website accessible. The American Institute of Certified Public Accountants (AICPA) and states should clarify and prominently note that differences exist between their standards and those of the SEC and the PCAOB and indicate, at each place in their standards where differences exist, that additional SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements. This compilation should not require rulemaking by either the SEC or the PCAOB because it assembles existing rules.

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

4. Adopt annual shareholder ratification of public company auditors by all public companies.

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

**Preliminary Recommendations**  
**Subcommittee on Concentration and Competition**  
**Advisory Committee on the Auditing Profession**  
**The Department of the Treasury**

**Recommendation 1. Promote the growth of smaller auditing firms consistent with the overall policy goal of promoting audit quality. Because smaller auditing firms are likely to become significant competitors in the market for larger company audits only in the long term, the Subcommittee recognizes that Recommendation 2 will be a higher priority in the near term.**

The large public company audit market remains highly concentrated, with the four largest auditing firms auditing 98% of the 1500 largest public companies (with annual revenues over \$1 billion). Since 2002, auditor concentration among smaller public companies (with annual revenues under \$100 million) has declined—mid-size and smaller firms now audit 80% of the smallest companies. Challenges facing the smaller auditing firms' entry into the large public company audit market space include lack of staffing and geographic limitations on both the physical span of their practices and experience and expertise with global auditing complexity, lack of potential partners abroad to create a global alliance, the need for technical capability and industry specialization, lack of name recognition and reputation, and limited access to capital. In addition, expanding into the large public company audit market space may be unattractive for smaller auditing firms for a variety of reasons, including the possibility that their business model is not scaleable.

To address these issues, the Subcommittee recommends that policy makers encourage, to the extent possible, the potential for smaller firms to compete with the larger auditing firms. This involves not only encouraging growth, but also encouraging and promoting the development of technical resources in such areas as international accounting principles and fair value accounting, the continuing breakdown of non-substantive resistance to using smaller firms, and the development of specialized or "niche" practices or industry "verticals" where they are in the best interests of investors and can lead to more effective competition.

**(a) Require disclosure by public companies in their proxy reports of any provisions in material agreements with third parties limiting auditor choice.**

Certain contractual arrangements limit public companies' choice of auditor. This practice is particularly prevalent in the initial public offering arena, where an underwriter may include in the underwriting agreement a provision limiting the company's choice of auditor to a specified group of auditing firms.

The Subcommittee believes this practice impairs competition by limiting the issuer's choice of auditor and the ability of smaller auditors to serve a greater share of the public company market. Accordingly, the Subcommittee recommends that the SEC require public companies to disclose any provisions in material agreements limiting auditor choice.

**Recommendation 2. Create a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms.**

The loss of one of the larger auditing firms in the United States would likely cause significant and global market disruptions and limit auditor choice. It would certainly occur in an environment where investor confidence had been damaged and the resulting decrease in competition could lead to a decrease in audit quality. One means of preventing such adverse effects would be to develop a mechanism to assist in preserving and rehabilitating a larger auditing firm that becomes unstable. In addition, the PCAOB should be encouraged to monitor broadly potential sources of risk within a firm that could impact audit quality.

**(a) Broadly monitor, through the PCAOB authority over registered firms, potential sources of catastrophic risk which would threaten audit quality.**

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) provides the PCAOB with registration, reporting, inspection, and enforcement authority over public company auditing firms. Under its inspection authority, the PCAOB inspects audit engagements, evaluates quality control systems, and tests as necessary audit, supervisory, and quality control procedures. For example, in its inspection of an auditing firm's quality control systems, the PCAOB reviews the firm's policies and procedures related to partner evaluation, partner compensation, new partner nominations and admissions, assignment of responsibilities, disciplinary actions, and partner terminations; compliance with independence requirements; client acceptance and retention policies and procedures; compliance with professional requirements regarding consultations on accounting, auditing, and SEC matters; internal inspection program; processes for establishing and communicating audit policies, procedures, and methodologies; process related to review of a firm's foreign affiliate's audit performance; and tone at the top.

The PCAOB also has authority to require registered auditing firms to provide annual and periodic reports. In May 2006, the PCAOB issued *Proposed Rules on Periodic Reporting by Registered Public Accounting Firms* requiring annual and periodic reporting. The PCAOB has not yet finalized this proposal.

The Subcommittee believes that sources of catastrophic risk are inextricably intertwined with audit quality. The Subcommittee believes that the PCAOB should exercise its authority to monitor potential sources of catastrophic risk that would impact audit quality through its programs, including inspections, registration and reporting, or other programs, as appropriate. The objective of PCAOB monitoring would be to alert the PCAOB to situations in which risks to the firm's stability might be impairing audit quality.

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

In the event of threatening circumstances at a larger auditing firm, lack of effective governance may delay crucial decision making, block difficult decisions that could sustain the firm and its human assets, and impede the firm's communication with private, regulatory and judicial bodies. To address these concerns, the Subcommittee recommends the following two-step mechanism described below.

### **First Step – Internal Governance Mechanism**

The Subcommittee recommends that larger auditing firms (those with 100 or more public company audit clients that the PCAOB inspects annually) would establish in their partnership agreements an internal governance mechanism, involving the creation of an Executive Committee (made up of partners or outsiders) with centralized firm management powers to address threatening circumstances. The centralized governance mechanism would have full authority to negotiate with regulators, creditors, and others, and it would seek to hold the firm's organization intact, including preserving the firm's reputation, until the mitigation of the threat, or, failing that, the implementation of the second step outlined below. The auditing firm voluntarily would trigger the operation of this mechanism upon the occurrence of events specified in the partnership agreement, such as a legal or regulatory action. If necessary, the SEC and the PCAOB could encourage the firm to trigger the mechanism through private communications, public statements, or other means. Regulators also could assist in maintaining the firm's organization intact by, for example, increasing the time period for registrants that are audit clients to have audits or reviews completed and providing accelerated consultative guidance to registrants that are audit clients.

### **Second Step – External Preservation Mechanism**

The larger auditing firms would establish in their partnership agreements a rehabilitation mechanism under SEC oversight. The failure of the internal governance mechanism to preserve the auditing firm outlined in the first step above would trigger this second step, which would require legislation. Upon triggering of the second step, either voluntarily by the firm or by the SEC, the SEC would appoint a trustee, subject to court approval, whose mandate would be to seek to address the circumstances that threaten survival, and failing that, to pursue a reorganization that preserves and rehabilitates (or transitions) the firm to the extent practicable. If this second mechanism is to include an element that addresses claims of creditors (which could include investors with claims, audit and other clients, partners, other employees, and others), legislation to integrate this mechanism with the judicial bankruptcy process may be necessary. It is extremely important that this mechanism not be used as insurance for partner capital. But, as in other bankruptcy proceedings, there must be powers to hold the firm together.

**Recommendation 3. Promote the understanding of and compliance with auditor independence requirements among auditors, investors, public companies, audit committees, and boards of directors, in order to maintain investor confidence in the quality of audit processes and audits.**

**(a) Compile the SEC and PCAOB independence requirements into a single document and make this document website accessible. The AICPA and states should clarify and**

**prominently note that differences exist between their standards and those of the SEC and the PCAOB and indicate, at each place in their standards where differences exist, that additional SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements. This compilation should not require rulemaking by either the SEC or the PCAOB because it assembles existing rules.**

The independence of the public company auditor—both in fact and appearance—is crucial to the credibility of financial reporting, investor protection, and the capital formation process. The auditor, free from conflicts of interest, is expected to offer critical and objective judgment on the financial matters under consideration. In the United States, various oversight bodies have authority to promulgate independence requirements, including the SEC and PCAOB for public company auditors, and the AICPA and states for public and private company auditors.

The Subcommittee believes that the multiplicity of sources of independence requirements may confuse auditing firms, investors, audit committees (required under exchange listing standards to evaluate auditor independence), boards of directors, and company management. The Subcommittee recommends that the SEC and PCAOB publish their independence requirements in a single document and make this document easily accessible on their websites. The Subcommittee recommends that the AICPA and states clarify and prominently state that differences exist between their standards and those of the SEC and the PCAOB and indicate, at each place in their standards where differences exist, that additional SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements.

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

Concerns have been raised that some auditing firms are taking a “check the box” approach to independence, rather than exercising independent judgment about whether the substance of a potential conflict of interest may compromise integrity or objectivity, or create an appearance of doing so. This problem may be particularly relevant for mid-career professionals who over time may fail to exercise healthy skepticism.

The Subcommittee recommends that auditing firms develop appropriate independence training materials for auditing firms, especially partners and mid-career professionals, that help to foster a healthy professional skepticism with respect to issues of independence rather than a simple “check the box” mentality. The training materials should focus on lessons learned and best practices observed by the PCAOB in its inspection process and the experience of other relevant regulators as appropriate. To ensure the implementation of this training on a nationwide basis, the PCAOB should review this training as part of its inspection program.

**Recommendation 4. Adopt annual shareholder ratification of public company auditors by all public companies.**

Although not statutorily required, the majority of public companies in the United States—nearly 95% of S&P 500 and 70%-80% of smaller companies—put auditor ratification to an annual shareholder vote. Even though ratification of a company’s auditor is non-binding, corporate governance experts consider this a best practice serving as a “check” on the audit committee. Sarbanes-Oxley mandated that the public company audit committee appoint, compensate, and oversee the auditor. Ratification allows investors to oversee the audit committee’s work, including the reasonableness of audit fees and apparent conflicts of interest. The SEC’s rules implementing Sarbanes-Oxley specifically permit shareholder ratification of auditor selection.

The Subcommittee believes shareholder ratification of auditor selection can enhance the audit committee’s oversight to ensure that the auditor is suitable for the company’s size and financial reporting needs. This may enhance competition in the audit industry. Accordingly, the Subcommittee encourages such an approach as a best practice for all public companies. The Subcommittee also urges the exchange self-regulatory organizations to adopt such a requirement as a listing standard.

**Recommendation 5. Enhance continuously regulatory collaboration and coordination between the PCAOB and its foreign counterparts, consistent with the PCAOB mission of promoting quality audits of public companies in the United States.**

The globalization of the capital markets has compelled regulatory coordination and collaboration across jurisdictions. Regulators of public company auditors are no exception, as companies increasingly seek investor capital outside their home jurisdictions and the larger auditing firms create global networks of affiliates in order to provide auditing and other services to companies operating in multiple jurisdictions. In the context of globalized capital markets, the PCAOB can benefit from cooperation with foreign auditing firm regulators (many created and modeled after the PCAOB) to accomplish its inspections of registered foreign auditing firms. In May 2007, the PCAOB hosted its first International Auditor Regulatory Institute where representatives from more than 40 jurisdictions gathered to learn more about PCAOB operations. In 2006, the PCAOB formally joined the International Forum of Independent Audit Regulators, created to encourage regulatory collaboration and sharing of regulatory knowledge and experience.

The Subcommittee believes that global regulatory coordination and cooperation are important elements in making sure public company auditing firms of all sizes are contributing effectively to audit quality. The Subcommittee strongly supports the efforts of the PCAOB to enhance the efficiency and effectiveness of its programs by communicating with foreign regulators and participating in global regulatory bodies. The Subcommittee urges the PCAOB and its foreign counterparts to continue to improve regulatory cooperation and coordination.