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DEAR CENTER MEMBERS

Highlights of Treasury Advisory Committee on the Auditing Profession's Telephonic Meeting on April 1, 2008

The U.S. Department of Treasury Advisory Committee on the Auditing Profession (ACAP or the Committee) convened a public telephonic meeting on Tuesday, April 1, 2008 to discuss the revised preliminary recommendations of each of the following subcommittees of ACAP.

1. Human Capital
2. Firm Structure and Finances
3. Concentration and Competition

To view the agenda and meeting materials for this meeting, click on the respective link. This meeting has been archived and is available via audio webcast on ACAP's website.

ACAP was established to examine the sustainability of a strong and viable auditing profession. The Committee is considering, among other things, the auditing profession's ability to cultivate, attract, and retain the **human capital** necessary to meet developments in the business and financial reporting environment and ensure **audit quality** for investors; audit market **competition** and **concentration** and the impact of the **independence** and other professional standards on this market and investor confidence; and the organizational **structure**, **financial** resources, and **communication** of the **auditing profession**. Click on the respective links to view the ACAP Charter and By-Laws and Operating Procedures.

The ACAP includes 21 members and is co-chaired by Arthur Levitt, Jr. and Donald T. Nicolaisen. The Committee also includes representatives from the profession through the appointments of KPMG Chairman and Chief Executive Tim Flynn, Ehrhardt Keefe Steiner & Hoffman Audit Partner Gaylen Hansen, American Institute of Certified Public Accountants President and CEO Barry Melancon and Bailiwick Data Systems, Inc. President and CEO – and McGladrey & Pullen board member – Bill Travis. Flynn and Melancon are also members of the Center for Audit Quality (CAQ) Governing Board.

For prior CAQ alerts about the ACAP, please see CAQ Alert #2007-60 and CAQ Alert #2008-13.

The following represents highlights of changes to the preliminary recommendations and key discussion points from the April 1, 2008 telephonic meeting preceded by excerpts from the preliminary recommendations presented to the Committee. To view the revised changes submitted to ACAP for the call, click on meeting materials.

Subcommittee on Human Capital
Summary of Preliminary Recommendations
Subcommittee Chair: Gary J. Previts - Professor of Accountancy at Case Western Reserve University

Below is an excerpt of the Human Capital Subcommittee's preliminary recommendations that were submitted to the Committee for its consideration:

1. Implement market-driven, dynamic curricula and content for accounting students 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.

Key Discussion Points:

- There was a robust discussion by the full committee regarding the notion of a **professional school of accounting**. Committee members agreed that they were willing to consider including the proposal in their final recommendations.

- The **quality-of-life issue for auditors was raised specifically as it relates to the five and seven year partner rotation rules** as well as the impact of busy season particularly on retaining **young professionals**, especially **women.**

- One audit firm representative indicated that from the profession's standpoint, particularly on the audit side, the **workload tends to spread out throughout year**. But, he conceded that **smaller tax practitioners really feel the seasonal work burden**. He said he did not believe this to be a "burning issue" at this time.

- Another representative of the Committee indicated that the seasonal workload is a concern for **smaller practitioners especially those with significant tax practices and also indicated that he didn't see this as a gender issue given the multitude of factors contributing to work/life balance today**.

- Another member of the Committee reported that they interviewed younger partners who anecdotally indicated that **quality-of-life issues arose equally among males and females**.

- One smaller firm representative on the Committee indicated that smaller firms have a **heavy busy season**, while the larger firms have continuous audits year round, removing much of the seasonality burden. He continued to state that he also believes that **smaller firms have difficulty retaining people due to the quality-of-life issues**.

- Subcommittee Chair Previts indicated that the issue of quality-of-life may not warrant a formal recommendation, but he said the subcommittee would take it under advisement and seek more data.

Subcommittee on Firm Structure and Finances
Summary of Preliminary Recommendations
Subcommittee Chair: Robert R. Glauber - Lecturer at Harvard's Kennedy School of Government

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Below is an excerpt of the Firm Structure and Finances Subcommittee's preliminary recommendations that were submitted to the Committee 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.

Key Discussion Points:

- Recommendation 1 - In urging the creation of a center for auditing firms to share fraud prevention and detection techniques, experiences, and best practices; it was specified that the center be ***transnational.***

- Recommendation 1 (a) – Language was added that included ***forensic accounting firms,*** and ***certified fraud examiners*** with auditing firms, investors, other financial statement users, public companies and academics in the development of best practices for fraud detection and prevention.

- Recommendation 3 – In a discussion about the exploration of the feasibility of firms appointing independent members with full voting power to firm and/or advisory boards to improve transparency and governance at firms, a sentence was added noting ***the PCAOB and the SEC should consider the size of auditing firms in analyzing and developing governance proposals.***

- Subcommittee Chair Glauber indicated that the subcommittee did not address two sets of issues in its recommendations: **transparency and metrics for audit quality**. However, he indicated the subcommittee's recommendations on transparency would include comments on the disclosure of metrics of audit quality. In keeping with a decision by the co-chairs, he said the metrics issues would be more **directly addressed by the Concentration and Competition Subcommittee.**

- The subcommittee was asked by one of the Committee members to reconsider the **2010 deadline in recommendation 2(a), suggesting that moving it to 2011 would avoid the risk of setting a deadline that may be impossible to achieve.**

Subcommittee on Concentration and Competition
Summary of Preliminary Recommendations
Subcommittee Chair: Damon Silvers - Associate General Counsel for the AFL-CIO

Below is an excerpt of the Concentration and Competition Subcommittee's preliminary recommendations that were submitted to the Committee 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.

Key Discussion Points:

- Recommendation 1 (a) – In a discussion on the recommendation that the SEC require public companies to disclose provisions in material agreements that limit auditor choice, language was added to specify the disclosure be made in **annual proxy reports.** In addition a sentence was added detailing the nature of the disclosure in the annual proxy report as being **the existence of the material agreement, the names of the parties to the agreement, and the actual provisions limiting auditor choice.**

- Recommendation 1 (b) – Language was added to address the inclusion **of representatives of smaller auditing firms in committees, public forums, fellowships, and other engagements.** In addition, paragraphs were added stating **the lack of smaller firms' name recognition and reputation have hindered smaller auditing firms' ability to compete in the larger public company audit space,** and the belief **that increasing the name recognition and reputation could promote audit market competition and market choice.**

- Recommendation 3 – Recommendation 3 was added to **determine the feasibility of developing key indicators of audit quality and requiring audit firms to publicly disclose these indicators.**

- Recommendation 5 – In a discussion of annual shareholder ratification of public company auditors by all public companies, they added language stating, ratification of auditor selection **through the annual proxy report** can enhance the audit committee's oversight in regards to ensuring an auditor is suitable. Additionally, **to further enhance audit committee's oversight…the Subcommittee recommends that disclosure in the proxy report regarding shareholder ratification include the name(s) of the senior auditing partner(s).**

- The Committee discussed audit quality metrics for firms. Chair Silvers indicated that the received a comment letter from the public stating that there isn't much information available to audit committees or shareholders on audit firms to enable them to compare the quality of each provider. **The subcommittee added a recommendation that the PCAOB develop a battery of key indicators of audit quality that could be the subject of disclosure by audit firms**.

- One committee member strongly objected to the recommendation of establishing key performance indicators for audit quality, citing that **it would be "an enormous mistake"** and would "ratchet up the potential for liability." He reminded committee members that their goal was to improve audit quality while maintaining a healthy profession. He further indicated that requiring firms to indicate in their reviews, their quality and their deficiencies was "not very valuable," not doable and an incentive for lawsuits. "I strongly object to this recommendation," he said.

- **In contrast, another committee member indicated that he strongly supported the recommendation.** He indicated that the comment letter submitted was "superb" and spelled out the type of quality indicators that are appropriate. He expressed confidence that smaller firms could compete with the Big Four on quality indicators. He also said he did not think litigation would be a problem, and added that it's "always good to have transparency" around audit quality.

- Another committee member **acknowledged the difficulty of developing quality indicators. He also questioned how much of the data would be publicly disclosed, suggesting that it might be kept internal at the PCAOB.** He further stated that "if we can do this right," the goal of metrics on quality should have widespread support.

- The Chairman of the PCAOB, Mark Olson, stated that **the intent of the recommendation was to look at the feasibility of establishing metrics, as well as the implications of it.** He said there is always the possibility there could be some confusion between what is a regulatory requirement and what is a best practice.

- **Subcommittee Chair Silvers stated that the impact of quality metrics on smaller firms is an important consideration.** He said part of the reason to give the PCAOB latitude is to ensure that the indicators are fair for all firms, regardless of size. He also suggested that audit services are different from other professional services, and noted that there have been many advances in performance metrics for professional services. The performance of a public company audit seems a much more defined service than the breadth of a law firm or a management consultant.

- An investor representative on the Committee **expressed support for the recommendation. He further indicated that UK Big Four provide a number of key performance indicators in their reports, including indicators for audit quality. He urged the subcommittee members to take a look at those reports as they develop their recommendation.**

- **Co-chair Don Nicolaisen said the discussion had been helpful, but suggested that the Committee might consider finding another way to describe the metrics other than "key performance indicators." He said that having firms compete on cost has been "disastrous" for investors** and the firms. "It's in the best interest for everyone to provide audit committees and investors an opportunity to better understand how firms compare…," he said.

- **Co-chair Arthur Levitt agreed, but said he was mindful of the objections being voiced**.