

December 31, 2002

Public Company Accounting
Oversight Board
c/o Mr. Charles Niemeier
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Members:

Institutions responsible for financial reporting in our capital markets are under intense scrutiny, reeling from the fall-out of financial reporting scandals that have raised serious questions about the integrity of our financial reporting system and the quality and usefulness of information that is so critical to the success of our capital markets. Clearly, these cataclysmic events have changed the world's view of a system that we have often proclaimed to be "the best in the world." Understandably, the damage to the reputation of our financial reporting system and its critical guardians has been so severe that the investing public has lost confidence and now demands real reforms.

The foundation upon which investor confidence is built is an audit of the financial statements by an independent third party, the independent auditor. However, the past several years have shown numerous cracks in this foundation. Investors have come to question the trust they formerly bestowed on auditors as they have seen restatements of financial statements aggregating billions of dollars¹, and even the criminal indictment and subsequent conviction of a major international auditing firm.

In the past, the auditing profession has responded to challenges to its performance with arguments that, on the whole, audits are effective and that public expectations of the independent audit are unrealistic. As a result, a wide and deep chasm has developed between the expectations of the investing public and the product the independent auditor is delivering. This chasm has devoured both investors as they have sustained losses totaling hundreds of billions of dollars and members of the auditing profession as they have been sued when investor expectations have not been met.

The road to a more lasting resolution begins with full acknowledgement by the auditing profession and all other gatekeepers in our capital markets of the reality that seems so clear today. Failures in our financial reporting system are more than aberrations. They seriously undermine the confidence of investors and the public in the institutions that are

¹ *Financial Statement Restatements – Trends, Market Impacts, Regulatory Responses, and Remaining Challenges*. United States General Accounting Office (GAO-03-138), October 2002. This report identifies 919 financial statement restatements announced by 845 companies from January 1, 1997 to June 30, 2002. It also states on page 4 that "From January 1997 through June 2002, about 10 percent of all listed companies announced at least one restatement." *A Study of Restatement Matters For the Five Years Ended December 31, 2001* published by the Huron Consulting Group states "...the number of restated financial statements filed by public companies has grown from approximately 120 in 1997 to 270 in the year 2001."

supposed to protect them. They “poison the well.” Pleas that the vast majority of financial reports are of high quality, that most audits are effective, and that financial reporting failures are few miss the point. In our capital markets, a single catastrophic reporting failure is a disaster in which losses to investors and the public can be, and often are, overwhelming, wiping out decades of hard work, planning, and saving. Debates about how many failures are acceptable are counter-productive.

Now is the time to design and implement major reforms in the governance and oversight of independent audits of the financial statements of public companies. Auditing firms need to adopt reforms that embrace a role that is fully consistent with high public expectations, tackle fraudulent financial reporting, and accept and support the necessary regulatory processes that give comfort to investors and the public that the auditing profession is doing all that it can do to prevent future episodes of failed financial reporting. It is critical to the integrity of the U.S. capital markets that the public trust in independent auditors be restored.

To restore investor confidence, we believe that it is critical for the Public Company Accounting Oversight Board (“PCAOB”) to exercise strong leadership in implementing the Sarbanes-Oxley legislation. In particular we believe that the PCAOB should:

- First, exercise its mandate to establish independence guidelines that will ensure that auditors embrace a role that is fully consistent with high public expectations. It is fundamental to restoring the trust in financial statements that the investing public once again comes to believe that an independent auditor is performing audits. If investors believe that a particular service conflicts with an auditor’s ability to be independent, than that service should be prohibited. Accordingly, it is important that the provisions of the Sarbanes-Oxley Legislation dealing with the independence of auditors be implemented rigorously and not weakened in any way.
- Second, insist that the profession tackle financial reporting failures as a distinct issue with a distinct goal – disaster prevention. We understand that, in life, “zero defects” are almost never realized. Nevertheless, the public expects that the profession will pursue that end – and with greater energy than in the past – and with more success. To this end, the PCAOB should establish auditing standards, rather than delegating that role to the auditing profession. For many decades, knowledgeable and well intentioned, full-time auditors have written the auditing standards. But the inherent conflicts between protecting the auditing firms’ interests and those of the investing public have resulted in standards tilted to favor the interests of auditors. Standards adopted by the PCAOB should (1) strengthen, and bring clarity and focus to the *public’s* expectation of, the auditor’s responsibility for detection of fraud, and (2) assure that auditors examine not only internal controls but also the numbers and disclosures that comprise the financial statements and (3) that they perform and adequately document their audit procedures, including the forensic auditing procedures that are applied.

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- Third, establish necessary regulatory processes that give comfort to investors and the public that the profession is doing all that it can do to prevent future episodes of failed financial reporting. Those processes should include independent inspections of the audits performed by auditors of the financial statements of public companies. Inspections should be performed by staff of the PCAOB and not “outsourced” to the auditing profession. The failure of peer reviews performed by one auditing firm for another to detect and remedy audit quality issues over the past twenty-five years have shown that this experiment in self-regulation does not work and should be ended. In addition, when an auditor has failed to fulfill the requisite professional standards, the PCAOB should undertake appropriate disciplinary actions and make its findings and actions known to the public at the earliest possible date.

Now is the time to begin in earnest the process of rebuilding public trust, and it is important that the PCAOB take the lead in doing so. We believe that by taking the steps outlined above, the PCAOB can rebuild public trust. But make no mistake, if the efforts of the PCAOB fall short, and if the investing public continues to receive and rely on financial statements that fail to present fair and accurate information, the result for our capital markets and investors will continue to be devastating.

Each of us has served as the Chief Accountant to the Securities and Exchange Commission. We have been members of the auditing profession, have been in or led the professional groups in national offices of international accounting firms, have served as business executives or as consultants to or members of corporate boards, and have taught college students seeking to join the profession.

Please do not hesitate to contact us if we can be of further assistance.

Yours truly,

/s/ Walter P. Schuetze

/s/ Michael H. Sutton

/s/ Lynn E. Turner

cc: Members of the Securities and Exchange Commission