



The Bond Market Association
360 Madison Avenue
New York, NY 10017



Securities Industry Association

Securities Industry Association
120 Broadway
New York, NY 10271

October 6, 2005

Via E-mail – lceynowa@aicpa.org

Center for Public Company Audit Firms
American Institute of Certified Public Accountants
Harborside Financial Center
201 Plaza Three
Jersey City, N.J. 07311-3881
Attention: Lillian Ceynowa, Director

Re: Your Proposal to Withdraw Auditors from an Important
Gatekeeper Function and Jeopardize Investor Protection

Ladies and Gentlemen:

The Bond Market Association and the Securities Industry Association are writing to express our strong opposition to your proposal, which would:

- ***Jeopardize Investor Protection by Putting an End to Auditor Involvement in Due Diligence and in Crafting Disclosure.*** Your proposal would essentially eliminate all meaningful participation by audit firms in a key aspect of the due diligence process for securities offerings, thereby potentially weakening disclosure. This is directly contrary to a cornerstone goal of the federal securities laws for more than 70 years – protecting investors through improved disclosure tested by independent due diligence.
- ***Disenfranchise Investors and the Public from the Process.*** You have excluded from the decision-making process on your proposal the very group most importantly affected – retail and institutional investors – as well as other essential groups, such as issuers and their directors.

In addition to the above concerns, we urge you not to harm investors by permitting early implementation. Until open public due process is completed on your proposal, we emphatically request that you not change the historical cooperative working relationship between auditors and underwriters by early or *de facto* implementation. Because your proposal does not contain such a caution, and we presume has already been circulated to your audit firm members, we request that you immediately instruct your members not to begin implementing your proposal until industry, investor and public views have been heard, until the proposal has been substantially changed (or, if necessary, publicly withdrawn) and until your government regulators (the PCAOB and the SEC) have reviewed the revised proposal and confirmed that investors will not be harmed.

In this letter The Bond Market Association¹ and the Securities Industry Association² are together referred to as the “Associations.”

OVERALL PROBLEMS WITH THE PROPOSAL

The draft of this proposal, which you recently sent to the Associations (entitled “Auditors Attendance at Due Diligence Meetings with Underwriters, draft dated August 23, 2005” – White Paper II), essentially instructs auditors to stop the established practice of answering underwriters’ due diligence questions about the issuer’s financial statements, internal controls, conduct of the audit or any other matter falling within the scope of the auditor’s professional knowledge. Our primary concerns fall into three categories: (i) the effect of White Paper II is contrary to established public policy and practice; (ii) the procedure followed by the AICPA excludes investors and other important constituencies; and (iii) the substance of the document is flawed in many respects.

- ***Investors will be put at risk.*** If the auditors withdraw from the due diligence process as you propose, a valuable and unique source of independent information about the issuer would be lost, including the opportunity to discover significant information about the issuer’s financial statements and controls that may be useful in determining whether additional disclosure is necessary. A lack of meaningful participation by the auditors in the due diligence process could lead to weaker disclosure, and risks harming investors. This is directly contrary to long-standing practice. Furthermore, it undercuts the Sarbanes-Oxley Act reforms and related SEC and PCAOB rulemakings that have sought to improve financial disclosure and strengthen investor protection.
- ***The draft leaves nothing of substance that underwriters may discuss with auditors.*** Effectively, under White Paper II, there are no meaningful areas remaining that an auditor can discuss orally with the underwriters. This critical area of underwriter inquiry, with the third party “gatekeeper” who knows the issuer better than any other independent party, would be eliminated.

¹ The Bond Market Association is an international trade association representing approximately 200 securities firms and banks that underwrite, distribute and trade in fixed income securities in the U.S. and internationally. More information about the TBMA and its members and activities is available on its website www.bondmarkets.com.

² The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA members, including investment banks, broker-dealers and mutual fund companies, are active in U.S. and foreign markets and in all phases of corporate and public finance. More information about the SIA and its members and activities is available on its website www.sia.com.

- The auditors play a special role in protecting investors, as has been acknowledged repeatedly by the SEC: “The audit profession is unique – serving the public interest first and foremost. That is a significant responsibility, and it’s important that the auditor understand the needs of investors.” Speech by Donald T. Nicolaisen, SEC Chief Accountant, on September 14, 2004.
- There is no real way to replicate the input into the process provided by the auditors. They have an independent knowledge of the issuer’s financial affairs and controls that cannot be obtained in the course of a securities offering from any other outside party, even another accountant that might be retained for the purpose of assisting the underwriters.
- ***The proposal would disenfranchise investors and the public from the process.*** Emblematic of White Paper II’s apparent disregard for the interests of investors, there is no indication that the draft has been or will be circulated among investor groups, outside directors, issuers and others. There is no description of any intended open due process system for seeking comment from other interested parties and the public, yet they could be significantly impacted by the proposed withdrawal by the auditors from the due diligence process. Standard-setting organizations have formal mechanisms for investor input. The PCAOB, which regulates auditing standards, has a standing advisory group that includes investor representatives. The FASB, which sets accounting standards, just announced the creation of a standing investor task force to provide input as proposals are drafted. These organizations also formally seek public comment on proposed versions of their standards before issuance. Investor, director, issuer and other interested groups should be given a meaningful opportunity to review and comment on White Paper II, and on a reasonable timetable. They should also have been (and should in the future be) invited to attend any meeting to discuss White Paper II.
- ***Directors will also be harmed.*** Directors and issuers benefit from the traditional interaction between auditors and underwriters in the due diligence process because of the different perspectives each can bring. In the absence of auditor involvement in due diligence, directors, who have legal responsibilities with respect to the prospectus, will lose the benefit of the auditors’ contribution to improving disclosure through this due diligence process with underwriters. This creates a further risk of exposing directors to unnecessary liability. Also, audit committee members, who already bear increased burdens, may have to spend more time explaining second-hand to the underwriters the matters the auditors have previously discussed with the directors and which the auditors are now unwilling to address directly with the underwriters.

- ***Issuers will be harmed as well.*** Issuers that are already public may find their access to the capital markets slowed and made more cumbersome by the new hurdles to interaction between auditors and underwriters in the due diligence process described in the previous paragraph, as well as by the additional issuer consent letters and other procedural requirements contemplated in White Paper II. Some public issuers, as well as many seeking to go public, may even find their market access entirely blocked.
- ***Existing standards permit current practice.*** The draft proposal is, in our view, based on a fundamental misconception of the auditing standards that it recites. Contrary to your assertions, the existing standards already fully permit the customary due diligence procedures at issue here. The auditors' informal due diligence discussions with underwriters and issuers are not regulated by the auditing standards cited by White Paper II, which instead govern formal functions of auditors. Yet the AICPA seeks to curtail due diligence discussions by characterizing them as subject to these formal standards. To the extent the AICPA perceives some new risk that the auditors' involvement in informal due diligence discussions could be misunderstood as representing more formal assertions governed by existing auditing standards, clarifying disclosure would be a simple solution.
- ***The draft is mandatory on auditors, but the AICPA does not have legal authority.*** By using a mandatory tone and "interpreting" existing standards for formal auditor reports as applying to informal due diligence discussions, the draft is really a disguised new standard of auditor conduct. Yet only the Public Company Accounting Oversight Board is legally authorized to issue new standards or interpretations of existing ones. Furthermore, the AICPA's promulgation of White Paper II suggests the concerted action of a few audit firms dominating public company audit work. It is this kind of concerted action that concerned Congress enough to require the General Accountability Office, as part of the Sarbanes-Oxley Act, to study the adverse effect on capital formation and audit firm competition of consolidation among public accounting firms.
- ***Numerous specific provisions in the draft raise concerns.*** We have many specific concerns about the various provisions of White Paper II. Some of our more significant concerns are listed in Annex A. We note a few points below as illustrative of White Paper II's flawed principles:
 - ***Auditors must not disclose their audit committee communications.*** The draft prohibits auditors from disclosing to underwriters their mandated SAS 61 communications with audit committees, even if the issuer consents. These encompass an issuer's most sensitive accounting issues, including methods to

account for unusual or controversial transactions, significant financial statement changes resulting from the audit, the auditor's judgments about the quality of the company's accounting principles, disagreements with management or serious difficulties encountered during the audit. The draft states that even the company is not authorized to reveal to underwriters these communications.

- ***Auditors are silenced on many other critical subjects.*** The draft also prohibits auditors from discussing with underwriters internal control matters, awareness of fraud or illegal acts, specific items in the financial statements or any financial matter that has a subjective element or involves a qualitative assessment.
- ***Auditors are authorized to remain silent even in the face of management misstatements.*** According to the draft, auditors have no duty to correct any management misstatement made to the underwriters in the auditors' presence.
- ***The draft subverts long-standing due diligence practices.*** The securities laws reflect a basic belief that due diligence is a key element in ensuring good disclosure.
 - The due diligence process involves a detailed review of financial statements and other company information, probing questions of management and, where appropriate, the seeking of independent information and verification from third parties such as auditors. For years, the typical due diligence process has included a full, frank, unrestricted and meaningful discussion with auditors, undertaken with the support and consent of the issuer.
 - Courts, including in the 2004 WorldCom case, have indicated that where "red flags" or other concerns exist regarding a company's financial disclosure, even in its audited financial statements, underwriters may need to engage in a further due diligence effort, including through additional discussions with the auditors. White Paper II would virtually prohibit auditors from participating constructively in that effort, even when requested to do so by their issuer clients.

RECOMMENDED ALTERNATIVE APPROACH

We believe that your draft should be set aside and an entirely different approach should be taken regarding the question of auditor participation in the due diligence process:

1. ***Withdraw the proposal.*** The current draft should be withdrawn by the AICPA. In order to avoid misunderstandings and risks of *de facto* implementation of the

proposal by auditors, the AICPA should accomplish the withdrawal by issuing a public statement. The goal of withdrawal should be to return involvement of auditors in informal due diligence discussions to the *status quo* of several years ago, in which auditors are responsive to questions as financial disclosure is being developed. We believe withdrawal of the proposal and return to the *status quo* of true auditor involvement would be a fully satisfactory resolution of the matter.

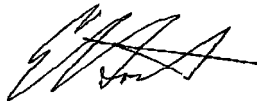
2. ***Define the policy objective in terms of pro-disclosure investor protection.*** If, however, you wish to pursue issuance of guidance regarding auditor involvement in due diligence, the goal of the effort should be defined at the outset as enhancing disclosure and protecting investors. Any proposed changes to current practice should be tested against that objective. We believe, in fact, that auditor involvement in the disclosure and due diligence process has eroded in recent years. There is a need for regulatory guidance to *increase* auditor involvement in that process.
3. ***Involve the PCAOB and SEC.*** The process should only be undertaken at the direction and under the guidance of the Public Company Accounting Oversight Board with significant participation by the Securities and Exchange Commission. Congress decided, in enacting the Sarbanes-Oxley Act in 2002, that the PCAOB – not the accounting industry through its industry organization the AICPA – should regulate auditing standards and their application and should establish all other rules governing auditor conduct involving public companies. PCAOB standards must be approved by the SEC before taking effect.
 - The PCAOB may wish to appoint an advisory group that includes representatives of all interested parties, not merely auditors and underwriters, but also institutional and retail investors, issuers, and directors.
4. ***Start with an open public request to frame the issues that should be addressed, with the stated objective of promoting rather than ending the involvement of auditors in the due diligence process.*** For a subject as historically central to the federal securities laws as due diligence and full disclosure to investors, the next step should be the issuance of a concept release inviting input on issues developed by the PCAOB or its advisory group. We believe that existing auditing standards, when correctly interpreted, do not impede the free flow of information between auditors and underwriters in the due diligence process. The PCAOB should confirm this view and, if necessary to correct auditor misunderstanding, should revise or interpret existing standards to promote auditor involvement in due diligence.

CONCLUSION

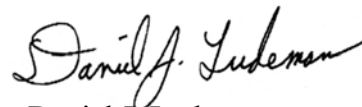
We would be pleased to meet with representatives of the AICPA at the meeting you have proposed on October 11, 2005 to discuss further our views expressed in this letter and our recommended alternative approach. We have taken the liberty of sending copies of this letter and draft White Paper II to members of the PCAOB and the SEC, as well as to several investor and issuer organizations who we believe should be interested in this important topic.

If you wish to contact the Associations about White Paper II, please do so through Sarah Starkweather, Regulatory Counsel, at The Bond Market Association (tel: 646-637-9292; e-mail: sstarkweather@bondmarkets.com) or Eileen Ryan, Associate General Counsel, at the Securities Industry Association (tel: 212-618-0508; e-mail: eryan@sia.com), who will coordinate with the appropriate members and staff of both Associations.

Very truly yours,



Edward Forst,
Chair
The Bond Market Association



Daniel J. Ludeman,
Chairman
Securities Industry Association

cc w/draft White Paper II:
Hon. William J. McDonough, Chairman
Hon. Kayla J. Gillan, Member
Hon. Daniel L. Goelzer, Member
Hon. Bill Gradison, Member
Hon. Charles D. Niemeier, Member
Dr. Douglas R. Carmichael, Chief Auditor and Director of Professional Standards
Members of Standing Advisory Group
(Public Company Accounting Oversight Board)
Hon. Christopher Cox, Chairman
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Hon. Cynthia A. Glassman, Commissioner
Hon. Annette L. Nazareth, Commissioner
Mr. Donald T. Nicolaisen, Chief Accountant
Mr. Alan L. Beller, Director, Division of Corporation Finance
Ms. Carol Stacey, Chief Accountant, Division of Corporation Finance
(Securities and Exchange Commission)

The Bond Market Association's and Securities Industry Association's Specific Concerns with White Paper II

We have many specific concerns about White Paper II. Some of these concerns are summarized below.

- ***The AICPA is exceeding its legal authority by seeking to set professional conduct standards.*** White Paper II claims not to set standards for auditor conduct – which only the Public Company Accounting Oversight Board is legally authorized to do – yet in effect it does just that by creating new limitations on the conduct of auditors that go well beyond existing standards. In 2002 the Sarbanes-Oxley Act removed from the AICPA all authority for setting standards that govern the professional conduct of auditors and placed that responsibility with the PCAOB under government oversight – but the AICPA is effectively amending existing auditing standards through White Paper II.³ For example,
 - It prohibits auditors from engaging in any discussion with underwriters with respect to internal controls (Question 12), or fraud or illegal acts (Question 13).
 - It says auditors should limit remarks about financial statements to matters a SAS 72 comfort letter could cover, but SAS 72 does not extend to informal underwriter due diligence discussions and has never previously been so interpreted.⁴
- ***The draft ignores that limitations on auditor communications may be waived by the issuer.*** White Paper II fails to take into account that auditors' participation in the due diligence process is undertaken at the request and with the consent of the issuer and agreement by the auditor. The document misapplies statements in existing standards about limiting auditor communications with third parties, which cover situations in which the issuer or auditors have not agreed to the communication.

³ In March 2003, the SEC Chief Accountant sent the AICPA a public letter emphasizing that only the PCAOB, and not the AICPA, has authority to set auditing standards applicable to auditors for public companies. That letter was issued in response to a draft of an internal control auditing standard proposed by the AICPA on the eve of commencement of the PCAOB's operations. The AICPA draft was not adopted by the PCAOB, which instead issued its own standard (Auditing Standard No. 2).

⁴ We also note that this would exacerbate the effects of White Paper I ("Comfort Letter Procedures Relating to Capsule Financial Information Presented in a Registration Statement Prior to the Issuance of the Year-End Financial Statements"). That document, issued by the AICPA in late 2004, advises auditors to refrain from covering various financial statements and other financial information in their SAS 72 comfort letters, even though SAS 72 permits such coverage and it had been routinely provided in the past.

- ***The draft incorrectly treats the informal problem-spotting nature of due diligence as the expression of a formal opinion.*** White Paper II misconstrues the nature of conversations with underwriters, which are not intended to serve as confirmations or attestations by the auditors, but rather serve the entirely different purpose of ascertaining whether the auditors are aware of matters that the underwriters may wish to pursue further with the issuer.
- ***The draft is not merely advisory, but in effect is an edict requiring auditor silence about a host of important subjects.*** While its introductory language describes the draft as a summary of issues to consider, the document is replete with mandates to auditors about what they must not do.⁵ A common misconception underlying many of these prohibitions is that the informal due diligence discussion with underwriters should be governed by auditing standards applicable to formal written reports by auditors in which auditors express affirmative conclusions about various matters. This has never been true. Instead, the purpose of the due diligence discussion with auditors is to share knowledge of matters about which the underwriters should be aware – and about which they may not otherwise become aware – so that those matters can be considered by the underwriters and, in appropriate cases, resolved with the issuer and reflected in improved disclosure. This is the process by which investors are ensured of receiving full and current disclosure about the issuer’s financial affairs. Examples of troublesome prohibitions in White Paper II are:
 - ***Auditors have no duty to correct management misstatements.*** The auditor is advised to tell the underwriter that the auditor’s silence in the presence of management misstatements is not to be taken as agreement, and further, the draft goes so far as to say that the auditor does not need to speak up in such a situation. (Question 2)
 - ***Auditors must not discuss specifics.*** The auditor should not address questions about specific items in the financial statements, even though in the course of conducting an audit or other review an auditor may come to know information on specific financial items, not reflected in the financial statements or audit report, that is highly germane to the discussion of the proposed disclosure. (Question 9)
 - ***Auditors must not discuss views on high risk aspects of the financial statements.*** The auditor should not address risk assessments that influenced the nature, scope and timing of audit procedures. (Question 10)

⁵ Even in areas where White Paper II merely advises auditor caution, the mere existence of such a warning from the AICPA has the very real effect of causing general auditor conduct to “toe the line.” This was proved abundantly clear by the issuance in late 2004 by the AICPA of “White Paper I,” discussed in footnote 4, which warned auditors to “exercise caution” about issuing comfort letters to underwriters between the annual earnings announcement and completion of the audit. The result was an immediate across-the-board blackout on comfort letters during that period by each of the Big Four audit firms, resulting in a blackout of many securities offerings in January and February 2005. That result is expected to repeat in 2006 and future years.

- ***Auditors must not discuss numerous other critical subjects.*** The auditor may not address questions regarding
 - communications with the issuer's audit committee, even those mandated by the Sarbanes-Oxley Act and SAS 61 and even with the consent of the issuer or audit committee (Question 11)
 - internal control matters, including for example material weaknesses, reportable conditions or significant deficiencies (Question 12)
 - awareness of fraud or illegal acts (Question 13)
 - matters that are subjective or require a qualitative or judgmental assessment, even if they clearly fall within the auditor's professional knowledge (Question 14)
 - whether the issuer's disclosures in its Management's Discussion and Analysis are complete (Question 16)
- ***Auditors must not discuss auditor independence.*** Beyond the assertion that the auditor is independent, the auditor should refrain from answering questions about its independence (Question 4), including discussing any implications for its independence of specific services provided to the issuer (Question 7).
- ***Auditors must not discuss what the prior auditor revealed.*** The auditor should not discuss with the underwriters the specific matters discussed with a predecessor auditor. (Question 6). The current auditors are required by auditing standards to discuss various matters with the predecessor auditor, which is generally required to respond. There is no requirement that the predecessor speak to the issuer or the underwriters. The underwriters' only practical means to understand issues relevant to the predecessor auditor's work is through the current auditors.