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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 2006-2803

Re: PCAOB Rulemaking Docket Matter No. 008 – Potentially Perjurious Testimony by Ernst & Young at HealthSouth Congressional Hearing.

Dear Board Members:

Having been closely associated with individuals working on the HealthSouth audit it may be interesting to ask – would the procedures outlined in your proposed rules have helped the external auditor, Ernst & Young, in identifying this fraud. The answer is a simple no. To understand why that is one needs to understand that what happened at HealthSouth (and Enron and the other infamous audit failures) was not only an elaborate fraud but a significant failure of a financial audit by the auditors.

Obviously the profession does not want to admit that and will work hard to defend themselves against such acquisitions. The reality is – the audit failed. Looking more closely at HealthSouth may help to shed some light on this issue.

The Audit Procedures that Ernst & Young used in executing their audit of HealthSouth were deficient. They did not adhere to Generally Accepted Auditing Standards in performing the audit.

For example, their procedures around investigating internal controls ("Tone at the Top") were defective. Mr. Lamphron and Mr. Dunn, the Ernst & Young professionals, testified to congress that they relied on a procedure known in the trade as "Inquiry" when auditing (assessing) HealthSouth's control environment. They failed to receive any "corroborative evidence" when they reportedly asked the chief compliance officer, Kelly Cullison, about the nature of any reports and investigations conducted.

The SEC staff has noted that generally accepted auditing standards provides guidelines for how to evaluate the sufficiency, persuasiveness, and verifiability of evidential matter. In Statement on Auditing Standards No. 31, Evidential Matter specific guidance is provided for the purposes of evaluating the sufficiency, persuasiveness, and verifiability of evidence.

In their testimony to congress the audit partners described a situation whereby they interviewed one or two key members of the compliance group on potential frauds in a meeting on December 3rd. They seemed to suggest that no matter what they did they were in effect duped because the fraud existed at the highest levels within the HealthSouth organization. Taken on the surface these are great sound bites. The reality is – Ernst & Young did not perform sufficient procedures to understand the true nature of compliance activity. The quality of the audit was deficient.

Every first year auditor knows that inquiry alone is not a sufficient audit procedure. Inquiry in fact is the least persuasive form of evidentiary matter. They did not seek to review any of the report logs or even fully understand how matters were brought forward to the compliance group. Ernst & Young's evaluation of these "entity level" controls was defective. They did not sufficiently probe to even ascertain if the dismissive statement they received was credible.

A close examination of the facts might cause one to question the truthfulness of Ernst & Young's testimony.

Mr. Lamphron testified that he met with Kelly Cullison and/or Tony Tanner more then 50-100 times. This is not only highly unlikely – it is likely to be an intentionally misleading, or at the very least a *Clintonese* type statement to somehow suggest that his procedures were in fact appropriate. Had he met with either of these parties as much as he claimed and performed any sort of evidentiary procedure beyond a very basic inquiry then he very possibly might have identified the concerns raised by Diane Henze in 1999.

The Auditors lacked sufficient knowledge of the client's business system to effectively perform the audits.

The client had implemented a fairly complex accounting system. Ernst & Young was very involved in evaluating the controls and accounting functionality of this system. They even helped develop business procedures and accounting rules on how this system should be utilized. This work was done by a Ernst & Young audit professionals at enormous expense to HealthSouth. The audit partners suggested to management that these services were necessary in order for them to effectively perform future audits. They generated substantial fees from these engagements.

The ironic thing is – that much of the fraud that was perpetrated was done so using these systems for which their auditor helped design "effective" controls. The interesting thing is that although Ernst & Young apparently helped them design effective controls the financial auditors lacked a sufficient understanding of this system to effectively audit it. They could not effectively conduct tests (beyond an inquiry) of this system because they lacked the technical knowledge of how this system operated. Perhaps they mistakenly assumed that since their own organization was involved in assessing, evaluating and documenting the controls of this system, no additional test of details was needed.

This is a classic example of why the independent auditor should not be engaged to perform these types of services. There is a propensity to place undue reliance upon work performed by your own organization. After all how could the system be wrong when Ernst & Young collected over $288,500 (more then 25% of the total audit fees) in 2001 performing the "Oracle System Controls Assessment" for HealthSouth? After all weren't they engaged to make sure the system was right? The same holds true for the original accounting system which was placed into service in 1997.

Some might argue there is something more significant going on here, and that is that the auditors lack the technical competency to effectively conduct audits of their clients complex IT environments. Had the auditors had an appropriate understanding of the importance of these accounting systems to the overall activity that was being performed they would have (or should have) been able to design appropriate procedures to assess risk and perform an appropriate audit. This is something they clearly did not do at HealthSouth.

Individuals performing field level work did not have sufficient training and experience to conduct an effective audit.

According to existing regulations and professional standards that were in place prior to Sarbanes-Oxley, this fraud should have been detected. The Securities and Exchange Commission requires under the Securities Act, that audits of public companies must include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts." Accordingly, the provisions of SAS 53 and SAS 54 require auditors to have sufficient procedures and tests to effectively identify fraud that could be material to the financial statements.

The audit procedures used at HealthSouth were not sufficient in this regard. Clearly for a fraud of this magnitude to have occurred over a period of seven years one must assume that the audit itself was defective by design. Ernst & Young, and every other major accounting firm, should seriously scrutinize their existing methodologies, which, based on recent events, appear to be deficient. Not only was the approach deficient but many of the people performing the field work were not properly trained and supervised as they executed the tasks assigned to them.

There was pressure on the staff to perform activities within an aggressive budget dictated and controlled by the senior managers and partners on the engagement. This environment forced staff and senior auditors to ignore the sufficiency, adequacy, and completeness of their audit procedures and tests. Exceptions that occurred (which may have uncovered the fraud as early as 1997) were not pursued due to pressure from Managers and Senior Managers on the engagement to get work done on time and on budget. Staff and Seniors who went over budget or raised questions about the quality of the work were likely to receive lower performance ratings and/or were often transferred to other accounts or "counseled out" of The FIRM.

The pressure from Senior Partners to ignore potential issues was rampant and with good reason. Non-Audit Fees were more then 2X the audit fees. The Senior Partners spent time building deep personal relationships with the senior executives. The fact is they ignored their own team and spent very little of their actual time working on the engagement activities. Instead they spent (and charged time to the engagement) building personal relationships and entertaining the client executives. They wanted to affiliate themselves with some of Birmingham's most elite and admired power brokers. They did so at the expense of their own judgment, integrity, and team.

The congressional investigators should have interviewed former staff and seniors about the activities they performed relative to their superiors to get a real perspective of how inadequate and deficient the audit was. As much as they seemed to suggest that this account was very small and insignificant to the whole firm, anyone who worked in the Birmingham office knew this was a "flagship" account to work on. Again, the auditors demonstrate a pattern of misleading congress as they tried to suggest that this account was some how insignificant to the revenue of The Firm. They testified that this account was insignificant – yet much of their personal income was directly attributable to the success of this one account.

This Fraud was so massive the auditors should have discovered. Instead Ernst & Young, like their predecessor Andersen, made statements to Congress that are not entirely true.

Existing professional standards and existing regulations require auditors to develop procedures sufficient to uncover a fraud of this magnitude. The Ernst & Young Partner, Mr. Lamphron, testified at the Congressional hearings that they have taken corrective measure in response to the new "fraud standards" and regulations that have come out under Sarbanes-Oxley. They made a statement that they have conducted over "300,000" hours of fraud training for their employees. The implication being that these new standards are somehow going help prevent another audit failure.

There are two problems with these misleading, if not deliberately untruthful, statements. First of all, under existing professional standards there is and should be no reason that they missed this massive of a fraud except for one factor: the design and execution of their audit was deficient.

The second, and perhaps more incriminating problem with this statement, and their testimony, is that it is simply untrue. Again, they appear to be engaged in an Andersen like pattern of misleading congress. Ernst & Young has not conducted over 300,000 hours of fraud training for all of their auditors as Mr. Lamphron testified. Not only are they misrepresenting the facts they have plagiarized statements made by one of their competitors in this regard.

Earlier this year – executives from PriceWaterhouseCoopers (PWC) were quoted in the Wall Street Journal and print ads as saying that they were "undertaking an initiative" to train their auditors in fraud discovery techniques.

PWC claimed that they planned to provide fraud training in the neighborhood of 300,000 hours for some of their professional staff. Last I heard, EY and PWC have not formally merged. Yet, Mr. Lamphron testified to congress that they have actually performed that which their competitors intended to do. Perhaps these auditors are simply oblivious to the concept of truthfulness and accuracy whether that be in their testimony or in their client's financial statements.

The veracity of the Ernst & Young Partner's statements should be carefully examined. The Ernst & Young statements and testimony was not only highly deceptive – but it is simply untrue. Do the math. If they have 22,000 employees that would mean that every employee has gone through approximately 2 days (or 16 hours) of fraud training. This has not happened. This is a false and deliberately misleading statement. The fact that Ernst & Young is now defending itself by plagiarizing statements from their competition in a Congressional Hearing highlights just how corrupt the accounting profession has become.

In conclusion, it seems that although you have defined some rather broad and all encompassing rules. These rules are somewhat pointless if the auditors don't do their job and that is: audit the financial statements. The proposed standard is far too broad and far too reliant upon the work of inexperienced and unqualified audit professionals. Where is the boundary between sensible policymaking and unreasonable enforcement?

The proposed standard seems to suggest that a needless and senseless vaccine known as the documentation of internal controls can somehow cure all that ails our capital markets. This is absurd. The reality is quite clear – internal controls are far more complex and elusive. Documentation and testing of those controls by unqualified, inexperienced, and incompetent auditors is not and will not be an adequate prescription.

This will not help auditors identify and detect nefarious executives who are comfortable violating their own responsibilities for personal gain. Teresa Sanders, the former Chief Auditor of HealthSouth testified to Congress that when you have a collusive fraud at the senior levels of management it is very easy to defeat a financial statement audit. Why would an audit of internal controls as you have proposed be any different? It would not be and therein lays the problem with the proposed standard.

If the PCAOB is serious about implementing reform, then you should table these proposed rules until you can adequately address the reform that is truly needed. Rather then create a whole new opportunity for auditors to escape responsibility for performing an adequate audit you should instead focus on defining rules that would make financial audits more effective. Instead of burdening companies with bureaucratic requirements that provide little if any value or benefit – you should:

- Establish rules that require auditors to be completely independent of their audit clients. This might include placing restrictions on the firm's

ability to hire-back or hire-out their professionals to their clients. (A common practice that causes serious issues/conflicts).

- Bar auditors from performing other lucrative services such as internal audit and system audits for their clients. This would include requiring the firms to disband their tax, legal, and other consulting practices from their audit business

- Ban auditors from entertaining their clients and ban clients from entertaining their auditors. As seen in the HealthSouth situation these close personal relationships caused the auditors to shelve their judgment for social advantage.

- Restrict auditors from assisting their clients in assessing, designing, developing internal control systems that they later need to rely upon to execute their audit. This obvious conflict impairs independence and undermines the entire purpose of your intended rules. Companies should engage other independent firms to assist in providing these services and/or do the work themselves internally.

- Table the impending rules until you have sufficient time to examine the other more serious issues that have contributed to failed audits.

Thank you for considering these observations and comments as you move forward in the rulemaking process. It is important that accounting reform take place. Unfortunately the proposed prescription may not be the right cure for today's ailment.

Sincerely,

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