

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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INVESTOR ADVISORY GROUP

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MEETING

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WEDNESDAY

MARCH 28, 2012

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The Investor Advisory Group met in the
Mount Vernon Room in the Madison Hotel, 1117
15th Street, N.W., Washington, D.C., at 9:00
a.m., Steve Harris, PCAOB Board Member,
presiding.

PCAOB BOARD OF DIRECTORS
JAMES R. DOTY, Chairman

LEWIS H. FERGUSON, Board Member

JEANETTE M. FRANZEL, Board Member

JAY D. HANSON, Board Member

STEVEN B. HARRIS, Board Member

SECURITIES AND EXCHANGE COMMISSION
ELISSE WALTERS, Commissioner
BRIAN CROTEAU, Deputy Chief Accountant

MIKE STARR, Deputy Chief Accountant

INVESTOR ADVISORY GROUP

BRANDON BECKER, Executive Vice President
and Chief Legal Officer, TIAA-CREF

KELVIN M. BLAKE, Investment
Advisor/Broker-Dealer Unit Chief and Assistant
Attorney General, Division of Securities of
the State of Maryland

JOSEPH V. CARCELLO, Ernst & Young
Professor, Department of Accounting and
Information Management, and Co-Founder and
Director of Research, Corporate Governance
Center, University of Tennessee

NORMAN J. HARRISON, Senior Managing Director,
FTI Consulting

MICHAEL J. HEAD, Managing Director of
Corporate Audit, TD Ameritrade Holding
Corporation

BONNIE HILL, President, B. Hill Enterprises
LLC, Co-Founder, Icon Blue, Inc.

BARBARA L. ROPER, Director of Investor
Protection, Consumer Federation of America
DAMON A. SILVERS, Director of Policy and
Special Counsel, AFL-CIO

ANNE SIMPSON, Senior Portfolio Manager, Global
Equity, California Public Employees'
Retirement System (CalPERS)

TONY SONDHI, President, A.C. Sondhi &
Associates, LLC

JUDGE STANLEY SPORKIN, Retired

ROBERT M. TAROLA, President, Right Advisory
LLC

LYNN E. TURNER, Managing Director, LitiNomics
and former SEC Chief Accountant

ANN YERGER, Executive Director, Council of
Institutional Investors

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1 P-R-O-C-E-E-D-I-N-G-S

2 (9:00 a.m.)

3 MR. HARRIS: I want to welcome
4 everyone to the third meeting of the Investor
5 Advisory Group of the Public Company
6 Accounting Oversight Board. I want to thank
7 all the members for participating and
8 contributing your time and expertise and
9 clearly there has been a staggering amount of
10 work that has been done by all the
11 participants and I very much want to express
12 my appreciation right up front for that work.

13 I especially thank SEC Commission
14 Elisse Walter for joining us, as well as Brian
15 Croteau, who is the SEC Deputy Chief
16 Accountant for Professional Practice, and Mike
17 Star, the Deputy Chief Accountant for Policy
18 Support and Market Monitoring.

19 PCAOB Chairman Doty is testifying
20 on the Hill this morning and will join us
21 later in the day.

22 Jim Kroeker, the SEC's Chief

1 Accountant, also is testifying and sends his
2 regrets.

3 Joe Carcello, I know that, you
4 too, will be doing the same later on, I think
5 it is this afternoon or later on this morning.
6 So I appreciate very much for joining us for
7 as long as you can and I hope you will return
8 afterwards.

9 Commissioner Walter, we all know
10 that the Commission's agenda is packed with
11 wide-ranging and important issues. The fact
12 that you have taken the time this morning to
13 attend today's meeting means a great deal to
14 all of us and it also demonstrates the
15 importance both of our organizations place on
16 hearing directly from investor representatives
17 on issues that affect the quality and utility
18 of reported financial information, and
19 ultimately the integrity of our nation's
20 securities markets.

21 Achieving the best results for
22 investors requires that the Board work closely

1 with the Commission, particularly with Jim
2 Kroeker and his office. And Commission
3 Walter, we appreciate the cooperative
4 relationship that has developed between our
5 two organizations.

6 It has been ten years ago that
7 Congress enacted the Sarbanes-Oxley Act of
8 2002, which is defined in its very first words
9 as an Act to protect investors by improving
10 the accuracy and reliability of corporate
11 disclosures made pursuant to the securities
12 laws. Title I of that Act created the PCAOB
13 and gave it a clear mandate to protect the
14 interest of investors in the participation and
15 the preparation of informative accurate and
16 independent audit reports.

17 It seems appropriate on the tenth
18 anniversary of Sarbanes-Oxley that investors,
19 the group the law was designed to protect,
20 take time to discuss what the PCAOB has
21 accomplished since the Act was passed and to
22 look ahead at what the Board still may need to

1 do to fulfill its mission.

2 We plan to have that discussion
3 today through presentations by four working
4 groups on the following topics: the role,
5 relevancy and value of the audit; Going
6 Concern and related global initiatives; audit
7 firm practice and transparency; and auditor
8 independence objectivity and professional
9 skepticism.

10 At the outset, I would be remiss
11 if I did not acknowledge former founding Board
12 Member Dan Goelzer's tremendous contributions
13 to the Board over the years.

14 As you know, Dan left the Board at
15 the beginning of then when his second term
16 expired and Jeanette Franzel assumed his
17 position. Dan was a highly valued colleague
18 and was, from the outset, a strong supporter
19 of this group in initiatives to protect
20 investors.

21 We will miss Dan but we welcome
22 Jeanette. Jeanette comes to the Board with a

1 legacy of public service, having had a
2 distinguished 23-year career at the Government
3 Accountability Office, where among other
4 things she conducted numerous financial and
5 program audits that significantly benefit
6 taxpayers and the public interest.

7 For example, in addition to
8 conducting the first financial audit of the
9 SEC, which resulted in significant SEC
10 internal control improvements, Jeanette was
11 heavily involved in financial audits relating
12 to major financial crises, going back to the
13 S&L crises, including auditing the Resolution
14 Trust Corporation, the Federal Deposit
15 Insurance Corporation, and more recently the
16 Troubled Asset Relief Program.

17 Jeanette headed up GAO's work
18 related to accounting profession issues and
19 she has already added valuable input to the
20 Board's deliberations. Again, welcome
21 Jeanette.

22 MS. FRANZEL: Thank you.

1 MR. HARRIS: Now to begin, I would
2 like to turn to Commissioner Walter for any
3 remarks you would like to make and then I will
4 recognize Board Members Lew Ferguson, Jay
5 Hanson, and Jeanette Franzel. And afterwards,
6 I would like to go around the table and have
7 all members briefly introduce themselves and
8 then we will get on with the day's program.

9 COMMISSIONER WALTER: Thank you,
10 Steve.

11 I'm very, very pleased to be here
12 today. I am probably, I joked a couple of
13 weeks ago with a lot of peers the commissioner
14 since Aulana who has spent more time with
15 accountants than I think anyone else who has
16 been appointed to the Commission and I do so
17 very, very happily.

18 Financial disclosure and financial
19 statements are at the heart of what the
20 securities laws are all about and auditors
21 stand as very, very important gatekeepers to
22 assure that investors have the information

1 they need to make informed decisions.

2 I think that the PCAOB is off to a
3 tremendous start as it enters its teens or
4 nearly, I guess it is a tween now. It is a
5 young organization that has made a tremendous
6 amount of progress in its infancy towards
7 becoming a mainstay under the federal
8 securities laws. I think the work that you do
9 is tremendously important and you have many
10 significant issues on your agenda and I look
11 forward to learning a lot today and to
12 bringing ideas back to the Commission, along
13 with my colleagues for us to undertake new
14 work or continue old.

15 So I am very pleased to be here
16 and pleased that I got to come back again,
17 which means I didn't blow it too badly the
18 first time. So thank you very much.

19 MR. FERGUSON: I just want to
20 welcome all of you and join Steve in doing
21 that and saying that how much we appreciate
22 the fact that you dedicate your time and make

1 efforts to come to Washington to do this for
2 us. You know, we meet with a lot of people as
3 part of the PCAOB but this is a group I always
4 particularly look forward to meeting with
5 because the worlds of auditing and accounting
6 can be rather hermetic and frequently we meet
7 with people who are dealing with the technical
8 details of that. I always get the sense that
9 from this group we get a perspective that is
10 kind of real-world perspective. How are the
11 things we are proposing or thinking about
12 affecting investors, affecting people out in
13 the business world and the various
14 constituencies we are trying to serve.

15 So we very much appreciate what
16 you do and look forward, I very much look
17 forward to hearing what you have to say today.

18 MR. HARRIS: Jay?

19 MR. HANSON: Thanks, Steve. I
20 would like to join my fellow Board Members in
21 welcoming all of you and everybody that is
22 here in the room with us, as well as

1 listening. I think this is the first time we
2 have had a meeting actually broadcast with
3 faces and talking heads on the internet. So
4 welcome to everybody and I think you all, the
5 IAG members for taking time out of your busy
6 schedule to come here and I really appreciate
7 the work that you put into the working groups
8 in preparing for the reports.

9 As we approach the ten year
10 anniversary, it is really gratifying last week
11 at our round table and hearing on auditory
12 independency, the strong interest in the
13 topic. It is, with over 620 comment letters,
14 and I especially appreciated that we had
15 strong support an input from all the
16 committees because they are such an important
17 constituent in effectively monitoring what
18 auditors are doing and being the owner of the
19 relationship. So I was really pleased to see
20 what they had to say.

21 And as Board Members, we are going
22 to be challenged with where do we go because

1 the input is so sharply divided. So I am
2 looking forward to hearing all of your
3 comments about that project today.

4 With all of our different groups
5 that we hear from, it is just outstanding to
6 me how much people come with thoughtful
7 meaningful input to us and gives us lots of
8 things to include in our data points for how
9 we are going to look at the issues. And
10 sometimes with the conflicting advice we get
11 I scratch my head and I think it would help me
12 to better understand who investors use both
13 the financial information and the audit
14 reports in making their investment decisions.
15 And I have rudimentary understandings of that
16 and I realize there is a lot of proprietary
17 information about how people make investment
18 decisions but I might probe a little bit more
19 on some of that with some of you about how do
20 you use the information that we are talking
21 about.

22 So I would like to also thank

1 Steve and his staff, Joanne, Jennifer, and
2 David for all the hard work that they put into
3 this. I have seen them scurrying around the
4 office for weeks in preparation. So thank you
5 for all the effort to pull off a good meeting.

6 MS. FRANZEL: Welcome and let me
7 add my thanks to all of you for taking the
8 time from your busy schedules to be here.

9 Over the course of my career, I
10 was on many different volunteer committees and
11 I know what a commitment it is. But it is
12 very important and so again we thank you for
13 taking time. The input and analysis from this
14 group is critical for some of the projects
15 that are facing the PCAOB and the need for
16 change. And so I really look forward to the
17 presentations from each of the workgroups
18 today and your input is going to directly
19 support our mission here to protect the
20 interest of investors in furthering the public
21 interest and really taking a hard look at the
22 status quo.

1 As you know, the Board held a two-
2 day public meeting last week to explore ways
3 to enhance auditor independence, objectivity
4 and professional skepticism, including a
5 consideration of audit firm term limits. As
6 expected, there were divergent views on the
7 issue of mandatory audit firm rotation. But
8 what was most striking about the two days last
9 week of input and dialogue from a very wide
10 variety of stakeholders, we had 47
11 participants that came and presented over two
12 days, was the common understanding and
13 agreement among all of the stakeholders that
14 improvements are needed to the current audit
15 model in order to make financial statements
16 more credible and relevant. And that was a
17 theme that just kept coming through very
18 strongly. So we have a responsibility to
19 really explore some of these. And it was
20 really, I would characterize this as a
21 consensus view that came out of the meetings
22 last week. And so I think it is really fair

1 to say that the status quo is not an option.

2 We heard from the participants on
3 a wide range of potential actions that could
4 help improve objectivity, credibility, and
5 reliability of financial audits. For
6 instance, strengthening audit committee
7 oversight and evaluation of audit firms and
8 audit processes, including disclosures about
9 audit committee activities, requiring
10 disclosures about audit firm tenure, changing
11 audit firm culture, this is really important,
12 and instilling a mindset among auditors that
13 the investor is the client. That theme came
14 up repeatedly last week as well.

15 Employing targeted audit firm
16 rotation and specific cases requiring periodic
17 rebidding or tendering of the financial audit
18 and conducting intensive PCAOB inspections in
19 certain cases.

20 So the list I just rattled off is
21 not comprehensive. The PCAOB staff now faces
22 the huge task of compiling and distilling

1 everything that we heard last week. But I
2 mention all of these things just to illustrate
3 really the task before us in looking at the
4 audit model and trying to come up with good
5 ways to improve the credibility and
6 reliability of audits.

7 And as you know, the Board is also
8 working on several other major areas of audit
9 practice and much of what we are going to hear
10 today will help feed into that process. And
11 so I look forward to today's presentations.

12 I will say as a new Board Member,
13 I am very troubled by the serious audit
14 deficiencies that are detected in PCAOB
15 inspections. We see far too many cases where
16 auditors issue clean opinions where work is
17 not complete or properly conducted, where
18 financial statement information is
19 contradicted by other available evidence,
20 and/or where audit conclusions on material
21 issues are based on management views without
22 independent verification.

1 And so I know that we are here
2 today to really get to addressing many of
3 these issues. And I thank you and I look
4 forward to hearing your input today.

5 MR. HARRIS: Thank you, Jeanette.
6 And now if we could just briefly go around the
7 room and everybody introduce themselves, why
8 don't we start with you, Norman?

9 MR. HARRISON: Thank you, Steve.
10 I'm Norman Harrison, Senior Managing Director
11 at FTI Consulting. And it is a pleasure to be
12 back and see the Commissioner and everyone.
13 Thank you for having us.

14 It is now my third meeting, I
15 think, of this group, and as always, a
16 pleasure to work with such a group of talented
17 people who bring a diversity of respect to
18 some of these issues. And I am sure we will
19 have a vigorous discussion again today and I
20 am very pleased to have a role in helping the
21 Board and the Commission in your goal of
22 protecting the integrity of our capital

1 markets. Thank you.

2 MS. HILL: Good morning. I'm
3 Bonnie Hill, B. Hill Enterprises, and
4 independent director for several corporate
5 Boards. And I am delighted to be here. Thank
6 you.

7 MS. YERGER: Good morning. I'm
8 Ann Yerger with the Council of Institutional
9 Investors. It is lovely to be here and I
10 wanted to express our working group's
11 particular thanks to Joanne, who was an
12 incredible help through this whole process.
13 I look forward to the discussions today.

14 MR. BECKER: Brandon Becker,
15 Executive Vice President and Chief Legal
16 Officer for TIAA-CREF. And I join with the
17 other members in thanking the Board for this
18 forum and the opportunity to discuss these
19 issues, as well as Ann's not even enough
20 praise for Joanne's help in getting us all
21 here.

22 MR. CROTEAU: Good morning. Brian

1 Croteau, Deputy Chief Accountant in the Chief
2 Accountant's Office at the SEC. I'm happy to
3 be here as well today.

4 Certainly I think Commissioner
5 Walter said it well relative to the importance
6 to the feedback that we receive from this
7 group as well as the Standing Advisory Group
8 and other outreach that the PCAOB does. I
9 would really like to commend the Board for the
10 extensive outreach, including the efforts of
11 again this group and the Standing Advisory
12 Group but also through other outreach that
13 they do and the multiple exposure drafts
14 concepts for concept leases and the like, as
15 they work through standard setting projects.
16 Certainly there is an active standard setting
17 agenda that the Board is working through and
18 we look forward to working closely with them
19 on many of the projects on their agenda and
20 considering the feedback that we hear from you
21 today as we do so. So, thank you.

22 MS. SIMPSON: I know Damon Silvers

1 will be joining us in a little while.

2 My name is Anne Simpson. I am the
3 Senior Portfolio Manager for Investments and
4 Director of Corporate Governance. CalPERS is
5 a very large pension fund. I think everybody
6 knows that. It is \$230-odd billion dollars,
7 depending on which day of the week you look at
8 the charts. But the most important thing to
9 say is that for every dollar that we pay out
10 to our members, 66 cents, roughly, come from
11 investments. We produced this now with one
12 and a half million members called the CalPERS
13 Buck to remind people 66 cents out of every
14 dollars comes from investments. That is why
15 governance matters. That is why effective
16 regulation matters. And I think as the
17 invested community, we need to be more vocal
18 and clear about the importance of effective
19 regulation. It is really our job not only to
20 say thank you for inviting us to be around
21 this table but we need to be aware that if we
22 do not have well-regulated markets, we as

1 active owners can't play our role and that 66
2 cents in every dollars is going to be under
3 threat.

4 So the work that the PCAOB does is
5 vitally important, as is the work of the SEC.
6 And it is very disappointing to see that that
7 role is not as well understood as it should be
8 in other quarters but certainly from the
9 invested community, we rely upon your good
10 work. And thank you very much for bringing us
11 to the table to talk to you about how we think
12 current matters can be improved. Thanks.

13 MR. TURNER: I am Lynn Turner. I
14 am an individual investor in the market as
15 well as I serve on the trustees of CoPERA,
16 which is a 40 to 45 billion dollar investment
17 fund that invests on behalf of about a half
18 million people, mostly in Colorado. And I
19 echo several times over what Ann just said.
20 If our members are going to have sufficient
21 money to retire on and live in a respectable
22 fashion, they too have to have that 60 to 70

1 cents on every dollar generated from returns
2 and that does require a well-regulated market
3 but it also requires a market that is very
4 open, very transparent, and provides us the
5 information upon which we can make some sound
6 investment decisions and allocations.

7 And so the role of the PCAOB, the
8 role of the SEC are all vitally important and
9 unfortunately I think getting the short shrift
10 these days very much so in Washington, D.C.,
11 which is of grave concern to us because
12 ultimately we are concerned that that is going
13 to impact our ability, not only our ability
14 anyone's ability, to generate the type of
15 returns that are necessary for our retirement
16 system work here in the United States.

17 So once again, I just echo
18 everything that Anne said about transparency,
19 governance, and the importance of regulation.

20 MR. HEAD: My name is Michael
21 Head. I am the Chief Audit Executive for TD
22 AMERITRADE. And obviously TD AMERITRADE is

1 very concerned about our individual investors
2 and their having good information and good
3 access and transparency. And thank you very
4 much for allowing me to participate and
5 contribute. I think this is a very, very
6 important group and your goals and
7 responsibilities are critical to the success
8 of the markets and therefore our customers and
9 individual investors and I look forward to the
10 activities today.

11 MR. SONDHI: Hi, I am Tony Sondhi.
12 I run a financial consulting and advisory firm
13 where I invest and manage funds for
14 individuals and certain companies. And I am
15 here representing the CFA Institute and,
16 therefore, a very large group of financial
17 analysts and money managers. And my interests
18 again, as many of you have said, are in
19 regulations, disclosure and transparency. And
20 I am keenly interested in furthering those
21 objectives. So I appreciate the opportunity
22 to be here.

1 MR. CARCELLO: I'm Joe Carcello.
2 I'm an accounting professor at the University
3 of Tennessee and Director of Research for our
4 Corporate Governance Center. I second or
5 third what Anne and Lynn said. I couldn't
6 agree more with that.

7 And I chair an audit committee for
8 a governmental entity and doing some research
9 on a number of the policy proposals that Board
10 is considering.

11 MR. TAROLA: Good morning. My
12 name is Robert Tarola, Bob Tarola. I'm an
13 independent director and audit committee
14 member for a public operating company and also
15 a group of public mutual funds.

16 My career was as an audit partner
17 for some 20 years and also as a practicing CFO
18 for three public entities now and managing
19 endowment funds and pension funds of those
20 entities as the CFO.

21 So I look forward to the
22 discussions today. We are getting into some

1 pretty interesting topics. Thank you.

2 MR. STARR: I'm Mike Starr, Deputy
3 Chief Accountant in the Office of the Chief
4 Accountant at the SEC. I appreciate the
5 opportunity to be here and be a part of this
6 discussion and meeting. I join with my
7 colleagues in commending the Board for
8 reaching out to investors. It is important to
9 understand the needs of investors so that we
10 can improve the audit process and help them
11 get the information that they need to make
12 good investment decisions.

13 So I look forward to the
14 discussion and thank you, Steve, for inviting
15 us.

16 MS. ROPER: Good morning. I'm
17 Barbara Roper with Consumer Federation of
18 America.

19 I have had the honor since PCAOB
20 was created to serve on both the Standing
21 Advisory Group and the Investor Advisory Group
22 now. And I really think one of the things

1 that this Board has done that should, we would
2 hope, set a model for other regulatory
3 agencies is create this active mechanism for
4 both investor input in this committee but also
5 in the Standing Advisory Group bringing all of
6 the stakeholders in a way that allows us to
7 test our ideas against each other and try to
8 reach consensus. So I think that has been a
9 very effective mechanism that the PCAOB has
10 created and I suppose, like everyone else, I
11 am pleased to be here.

12 MR. BLAKE: Good morning. I'm
13 Kelvin Blake. I am a lawyer and compliance
14 auditor for the State of Maryland Securities
15 Division, the Attorney General's Office and I
16 am glad to be here. Thank you.

17 MR. HARRIS: Well thank you all
18 for the remarks and those introductions.

19 Since the Investor Advisory Group
20 meeting in March of last year, the Board has
21 taken up a number of your recommendations,
22 which I think proves the importance of this

1 group. This also demonstrates that the
2 recommendations of the Investor Advisory Group
3 have made a difference in the Board's work and
4 helped the Board to establish its priorities.

5 At that meeting last year, a group
6 of IAG members led by Professor Carcello
7 presented the results of a survey of more than
8 300 leaders of investment banks, mutual funds,
9 pension funds, hedge funds, and private equity
10 funds who manage more than seven trillion
11 dollars of assets. Two points stood out in
12 those survey results.

13 First, investors want the
14 auditor's report to discuss the auditor's
15 assessment of the estimates and judgments used
16 by management to prepare the financial
17 statements and second investors want auditors
18 to discuss how they address the areas that
19 presented the most significant risk that the
20 financial statements might be materially
21 misstated.

22 In response to this and other

1 input, last year the Board published a concept
2 release and held a roundtable to solicit
3 comments on changes to the current auditor
4 reporting model. A proposed standard is
5 planned for release by the end of the third
6 quarter.

7 Another excellent presentation of
8 the last meeting focused on issues related to
9 auditor independence. With these issues in
10 mind, last year the Board issued a concept
11 release seeking public comment on possible
12 approaches to improve auditor independence,
13 objectivity and professional skepticism. And
14 last week we held a roundtable on the subject.

15 When we last met, the group also
16 discussed fraudulent financial reporting.
17 This has been a long-term project for the
18 Board and last month we issued a proposal that
19 would increase auditor scrutiny of related
20 party transactions, significant unusual
21 transactions, and executive compensation
22 practices that may create incentives or

1 opportunities for misstatements in financial
2 statements.

3 Members also discussed lessons to
4 be learned from the financial crisis. This
5 has been a priority issue for the Board and
6 since then the Board has issued two staff
7 audit practice alerts. One alert addresses
8 the audit risk in certain emerging markets.
9 Another is designed to assist auditors in
10 identifying events and relationships related
11 to the parties company's operating environment
12 that might affect the risk of material
13 misstatement in its financial statements.

14 The Board also proposed a new
15 standard that would require improved
16 communications between auditors and a public
17 company's audit committee, particularly with
18 respect to significant unusual transactions
19 and the auditor's views on the issuer's
20 ability to continue as Going Concern.

21 As in prior years, the specific
22 topics that will be discussed today have been

1 identified by Advisory Group members
2 themselves and the members have organized into
3 four working groups. To begin the
4 discussions, working group leaders will give
5 a very brief overview of their topics. And
6 following those introductions, each working
7 group will lead a full discussion of the topic
8 they have been studying by presenting their
9 findings to the group, leaving time for
10 further consideration by the full membership.

11 At the end of the day, there will
12 be an opportunity for everyone to bring up
13 additional topics or issues that were not
14 discussed during one of the day's panels.

15 I would like to note that today's
16 meeting is being video webcast. This meeting
17 is open to the public and information
18 connected with the presentations will be
19 posted on the PCAOB website.

20 Finally, the standard PCAOB
21 disclaimers apply that anything that anyone
22 from the Board may say today, including any

1 remarks I have made in this introduction will
2 be the views of the speaker and not
3 necessarily reflect the views of the Board or
4 its staff.

5 Now I would like to turn to Bob
6 Tarola, either Lynn Turner or Anne Simpson,
7 Brandon Becker, and Barbara Roper to give us
8 a brief overview of the topics they will be
9 discussing today.

10 And one of the reasons for doing
11 that, Commissioner Walter, is I know that you
12 probably have to leave around noon so we
13 thought we would give you a clear summary of
14 the issues that will be discussed right off
15 the bat.

16 And Bob, as I mentioned to you at
17 the outset, I know you flew in from London
18 last night. I've never been so happy to have
19 a plane land. So please go ahead.

20 MR. TAROLA: Yes, I like it when
21 it lands, too, Steve.

22 (Laughter.)

1 MR. TAROLA: Thank you. Our
2 topic, and I will introduce the group when we
3 stand up and give the whole theme, was role,
4 relevancy, and value of the audit, a very
5 broad topic but very interesting to try to
6 approach and dissect and try to get some
7 meaningful information.

8 We used the Investor Advisory
9 Group as our sort of our focus group and then
10 asked them to reach out to their professional
11 network and get information from them as well.

12 So we took a survey approach to
13 this topic asking questions that we believe
14 would give us some insight on the past
15 relevancy and value the present and the
16 future. And you will see a presentation
17 momentarily that focuses on those three time
18 frames to give us all a sense of how investors
19 feel, this body in particular and then their
20 extended group, about the role, and relevancy,
21 and value of the audit.

22 I will give you the punch line

1 now. Nothing dramatically earthshattering.
2 Nothing of major concern that you all have not
3 been already addressing but I think you may
4 find the data and the commentary from the
5 respondents of the data quite interesting. So
6 we look forward to that presentation.

7 MR. HARRIS: Either Anne or Lynn.
8 Anne?

9 MS. SIMPSON: Yes, thank you very
10 much.

11 Well this was a team effort.
12 Folks say that we had a real live accountant.
13 Lynn, thank you. And Damon Silvers and Pete
14 Nachtwey. Pete, of course is the CFO, and I
15 represent an investor point of view. So I
16 think we had a good mix of people who use
17 accounts and read them, that's me; people who
18 prepare accounts, that is obviously Pete's
19 role in life; and Lynn, who is obviously in
20 the weeds of the detail.

21 So we were asked to look at the
22 question of Going Concern. And we have got

1 quite a detailed set of slides and a
2 discussion memo where you can see the detail.
3 But let me tell you what the conclusions are.

4 First of all, we did a short
5 survey which was responded to by 40 investors.
6 They were almost unanimous in saying that the
7 concept of Going Concern is very important to
8 them. So we see this is the early warning
9 system that allows us as investors to actually
10 do something if there is a problem looming.

11 However, it is very rarely used.
12 Going Concern statements are rarer than hen's
13 teeth. You will see in the slides that we
14 have put there for you to look at, the top ten
15 recipients of TARP. There was no Going
16 Concern, no early warning bell there. And
17 then the top ten bankruptcies in the last ten
18 years, only twice. So it is important but it
19 is not used.

20 So we have got several
21 recommendations. We think some of the
22 recommendations are rightly directed to the

1 PCAOB. We think the FASB has a role. And we
2 also see the SEC has a role.

3 And the recommendations fall into
4 three areas. The first is the definition.
5 The current definition of Going Concern means
6 you are pretty much over the edge of the
7 cliff. It is almost too late to do anything.
8 This is the substantial doubt. And we talked
9 a little bit in our group about whether we
10 need something which is a lower bar, you know,
11 nagging doubt. We didn't quite go to does
12 this keep you awake at night definition. But
13 I think in the survey it is clear that what we
14 need is some idea of likelihood. So a more
15 than 50 percent likelihood is a trigger that
16 we think is more sensible. So that is one
17 recommendation.

18 The second recommendation is
19 around timing. We think it is all very well,
20 fine and good, to be looking at the next 12
21 months. Is something dreadful going to happen
22 over the next 12 months to come? But what

1 about month 13 or 14, you know when maybe big
2 debt has to be rolled over? We think it is
3 important that the time period looks out
4 beyond just that one year. The 12 months is
5 really arbitrary to think about it. So we
6 think that is also going to be helpful.

7 And linked to that we also want to
8 see the disclosures and communication
9 freshened up. We think there is real room for
10 improvement here in terms of the disclosures
11 that investors get and we see the risk
12 management reporting is probably the format
13 for that. We think we know there is reform in
14 thinking about communication between auditors
15 and audit committees but we think there is a
16 channel there where things could be improved,
17 too.

18 So we have got those three areas.
19 I don't want to bog you down in detail because
20 this is just really meant to be the
21 highlights.

22 And obviously Damon is here now, a

1 member of our group. Damon is actually going
2 to be presenting the recommendations
3 themselves later in more detail.

4 But Lynn, do you want to add
5 anything to that?

6 MR. TURNER: No, that was great.

7 MS. SIMPSON: That will do. He's
8 given me a B plus. So we will pass muster.
9 Thank you.

10 MR. HARRIS: Well we will give you
11 an A for the introduction. Lynn's a tough
12 grader.

13 MS. SIMPSON: Oh, okay.

14 MR. HARRIS: And I think Brandon
15 -- Is Brandon going to do it, Ann?

16 MR. BECKER: Right.

17 MR. HARRIS: Okay, Brandon go
18 ahead.

19 MR. BECKER: Our group was looking
20 at firm practices and transparency which
21 increasingly focused on the question of
22 measurement and compensation. And while my

1 colleagues to my left will do a much better
2 job later in the afternoon providing a more
3 sophisticated and nuanced description,
4 briefly, we thought that it would be a
5 worthwhile idea for the Board to continue to
6 pursue a concept release on audit quality and
7 the measurement thereof that the dialogue
8 could be meaningfully advanced by the Board
9 taking that step.

10 We also came to the on balance
11 judgment that a fraud center or at least some
12 mechanism to better centralize and distribute
13 information regarding fraud would be a
14 worthwhile exercise and warns the Board to
15 continued attention.

16 We did not reach a consensus,
17 however, whether standards with respect to
18 audit partner compensation or special inquiry
19 with respect to audit partner compensation was
20 warranted at this time.

21 MR. HARRIS: Well thank you very
22 much. And as you know, I think what we want

1 to do is get as many ideas out on the table as
2 possible. And I don't think it is essential
3 that there be any consensus. We just want to
4 have a marketplace of ideas here and have a
5 general discussion throughout the process.

6 So thank you for all that.

7 MR. BECKER: We had a robust
8 marketplace.

9 MR. HARRIS: I understand and I
10 look forward to a robust discussion as well.
11 But thank you.

12 And Barbara, I know that Meredith
13 Williams could not be here and I know that you
14 picked up an awful part of the load. So thank
15 you for a terrific job. And if you could go
16 through summarizing your presentation, then we
17 will get to Bob.

18 MS. ROPER: Sure. So my working
19 group and two of my working group members are
20 here with me, our topic was on auditor
21 independence objectivity and professional
22 skepticism, which is obviously a hot topic

1 right now with the PCAOB concept release out
2 on how to improve performance in these areas.

3 For our presentation, we took, in
4 some ways we sort of took the ten years from
5 Sarbanes-Oxley Act as a perspective and did a
6 historical look at the issue, looking back not
7 just what has happened since SOX but what were
8 the conditions that existed prior to SOX that
9 led to its focus on auditor independence, how
10 did it address those, and then what is the
11 scene that we are looking at today.

12 And you know, there are some
13 things that jump out from that. It was sort
14 of an interesting trip down memory lane for
15 me. And I got to pull out some old files,
16 blow off the dust and remind myself what I had
17 been doing ten years ago.

18 But some of the things that jump
19 out at this is how long we have had a
20 seemingly sort of fundamental divide between
21 sort of an investor view of how the world is
22 working and the firm's view.

1 I mean, you can go back three
2 decades now easily and find evidence of pretty
3 severe concern in the investor community about
4 the lack of independence in audits, about the
5 quality of audits, and then sort of almost
6 total denial in the audit firm community that
7 there was a problem and it took the crash of
8 Enron and whatnot to move through what is
9 actually a fairly modest set of reforms that
10 didn't fundamentally change the nature of the
11 business.

12 And so now we are in the midst of
13 this debate and one of the things we tried to
14 do in our presentation is both, as I say,
15 provide the historical context for that debate
16 where we are now but also lay out the range of
17 options that have been put forward from all
18 the different parties about what is the
19 appropriate step to take so that we can have
20 a discussion within this group to sort of
21 tease out more about general investor
22 community views on these.

1 And then we also within the
2 committee, Meredith Williams took the lead on
3 developing a survey that we can then, we have
4 not yet administered but may look forward to
5 refining and then administering in the future
6 to get at some of these issues related to
7 independence and skepticism.

8 MR. HARRIS: Well great. Thank
9 you very much.

10 And Bob, why don't you introduce
11 your group and then start us off with the
12 role, relevancy, and value of the audit.

13 MR. TAROLA: Thanks, Steve.
14 Looking for the technician. It sounds like
15 it's on, even though I didn't do anything.
16 Okay. Thank you.

17 I'm going to be the conveyer of
18 data. And that is what we did. We
19 accumulated a fair amount of data around a
20 number of questions. And I want to walk you
21 through that. It may appear like I am reading
22 it to you. And I don't really want to do

1 exactly that but I want to make sure that I
2 convey the nature of the data and what we
3 thought it should mean to us as we looked at
4 this topic.

5 So the Task Group was Joe
6 Carcello, Mike Head, Gus Sauter, Tony Sondhi,
7 myself, and Joanne Hindman who really did most
8 of the work to help us pull all this together.
9 And we all appreciate the work Joanne did for
10 us.

11 It was a survey of the IAG. So I
12 want to make it clear here that it wasn't a
13 scientific survey. It was a survey of your
14 Investor Advisory Group and their main
15 contacts or professional contacts who were
16 kind enough to respond to what amounted about
17 a ten-minute exercise.

18 But we managed to get feedback
19 from those who invest, from those who oversee
20 investment funds, and those who support
21 investors and advisors to investors.

22 The survey was 21 questions

1 addressing as I said earlier the past,
2 present, and the future of public company
3 audits. And we obtained 62 responses,
4 representing \$8 trillion in invested funds.
5 We thought that was significant enough to
6 provide some pretty good feedback. About half
7 of the respondents were institutional
8 investors and about half were other
9 constituents of the investing community.

10 So not a scientific survey but we
11 thought a good cross-section of the investing
12 interests.

13 This is the first question and the
14 first chart and I want to use this to orient
15 you to how the data was configured. So this
16 first chart and actually the next seven
17 pertain to the past, really looking back at
18 the ten years that the PCAOB has now been in
19 operation. And it asks has the PCAOB been
20 effective in its oversight of auditors.

21 The bottom line here is 45 percent
22 net favorable. So let me give you a sense of

1 what that is. That is the two agree
2 categories minus the two disagree categories.
3 That is how that number comes about.

4 In this case, you will see a
5 fairly large bar for neutral. Neutral is
6 anything from don't have an opinion to not
7 sure to whatever the mindset might have been
8 to the respondent at the time.

9 So in looking at these data, the
10 fact that there is 45 percent net favorable
11 you also have to consider the fact that in
12 this case there was a fairly large percentage
13 of folks who didn't agree or disagree.

14 The other thing is every time we
15 asked a question we asked for commentary. So
16 am going to put up the commentary that folks
17 provide in their responses as well because it
18 will give the Board a sense of, more so than
19 just the question, but what people were
20 thinking in answering the question. And to my
21 surprise, we had very robust commentary for
22 almost every question that was asked.

1 So in this case about PCAOB's
2 oversight, recent enforcement actions have
3 been a step forward. Some thought it was
4 difficult to assess because Part II inspection
5 reports were private. Some lack of
6 transparency. And this one about the Board
7 does not have necessary authority to conduct
8 disciplinary process in a public manner
9 sufficient from this respondent's point of
10 view.

11 So that, if you don't mind, we are
12 going to through a series of charts with those
13 as the basically the ground rules in how we
14 pulled all this together.

15 The second chart, again about the
16 past. Audit quality has improved over the
17 past ten years. Also a high net favorable
18 result, meaning the agrees exceeded the
19 disagrees. A low or neutral impact on this
20 one with some commentary.

21 And generally, we found that the
22 commentary often came from those who probably

1 were the neutral or maybe the negative
2 viewpoint of a question because we thought it
3 was more natural for someone who agreed to
4 just move on.

5 So those who might have disagreed
6 provided some commentary more often, we think
7 that those that did. So the commentaries
8 ranged from Madoff to supportive of the
9 PCAOB's role to an indication of no marked
10 steps forward to an indication that 404 has
11 improved the integrated audits but quality
12 problems still persist.

13 Third question. The presence,
14 policies and practices of the PCAOB have
15 improved audit quality. This one is also net
16 favorable but again, a big neutral. So, we
17 think and I don't want to interpret the data
18 beyond what it says on its face, but a good
19 portion of the respondents just may not know
20 for sure and that is why we might be getting
21 the high neutral, I guess, rating.

22 In terms of comments, the

1 respondents feel strongly that PCAOB's
2 oversight role is having an influence on audit
3 quality, though overall auditors need to do a
4 better job.

5 The more robust and public stand
6 that the PCAOB has taken over the last 18
7 months or so is welcome and should help
8 reinforce the importance of quality.

9 And more transparency on a timely
10 basis would provide incentives to improve
11 audit quality.

12 So those were some of the
13 commentary relative to audit quality.

14 Again focusing on the past, the
15 PCAOB serves an important role in the
16 protection of investors. We tried to take our
17 commentary to the highest level of what would
18 be of interest to investors. And again a very
19 favorable result. The net favorable is 59
20 percent. A few disagrees and a relatively
21 small rating for neutral.

22 Respondents, that is the goal.

1 What about accomplishments? All the efforts
2 do not seem to be adequate.

3 Potentially yes it does serve a
4 vital role if it can carry forward that role
5 effectively.

6 So there was questions of
7 effectiveness in this particular area.

8 Question five, improvements in
9 audit quality over the past decade have
10 outweighed the increases in audit costs. Net
11 favorable, not to the degree of some of the
12 other questions. There was a fairly almost a
13 20 percent unfavorable and a 30 percent
14 neutral. But the commentary is interesting.

15 It is obvious that costs have
16 risen steadily. Improvements to audit quality
17 are more difficult to discern.

18 The current initiatives and
19 considerations at the PCAOB and the IAASB
20 should improve quality but these are
21 perspective and not historic changes.

22 Unclear whether quality has

1 improved. The real question is whether
2 auditors are testing and opining on things
3 investors care about.

4 So those were some of the color
5 commentary on that question.

6 Sixth question from the past. The
7 PCAOB has been an important factor in
8 improving corporate governance. Here a net
9 positive but a very high neutral response,
10 which should be factored into whatever
11 takeaway one might have on this.

12 But generally, it was viewed that
13 the PCAOB, at least from the commentary, have
14 improved overall governance because of the
15 audit-audit committee interaction and the
16 relationship between auditors and audit
17 committees.

18 And then there was a comment about
19 the failed attempt to reach agreement with
20 Chinese regulators. We thought we would throw
21 that up as it has been hitting the press
22 lately.

1 Seventh question about -- That was
2 it about the past. We are now moving into the
3 present.

4 This question was auditor's
5 opinion on the financial statements is
6 critical in making investing decisions. An
7 overwhelming agree on this question, which I
8 think we should all find, I guess favorable
9 and take comfort in it. A relatively low
10 neutral. A relatively low disagree.

11 But some of the commentaries, the
12 auditor report was sort of picked on by virtue
13 of this question. It is boilerplate. People
14 generally don't read. It is so boilerplate
15 the wording is useless.

16 It is importance in the case of
17 adverse or qualified opinions. The auditor's
18 report should provide additional information
19 to improve analyst's research.

20 It is critical but more critical
21 is the impact which the auditor, having given
22 an opinion, has on the reporting from

1 companies.

2 Only a value if it is negative, as
3 a positive opinion does not appear to mean
4 things are really okay.

5 So a lot of commentary around the
6 report of the auditor was brought out by
7 virtue of this question.

8 Question eight, again dealing with
9 the present. The auditor's opinion on the
10 effectiveness of internal controls over
11 financial reporting is critical in making
12 investing decisions. A net favorable in this
13 area; again, 47 percent. That is pretty high
14 in relative terms on our questions.

15 Some of the commentary though
16 again, the boilerplate commentary came up.

17 Understanding whether there are
18 internal control weaknesses is essential to
19 understanding governance.

20 The importance of this opinion is
21 grotesquely overrated. Strange word to use.

22 And other view, that it has been a

1 gravy-train for the auditing profession.

2 Question nine, the auditor's role
3 is critical to promoting the integrity of the
4 capital markets. And this one came across
5 highly favorable; 84 percent net favorable.
6 A relatively low neutral.

7 So reinforcing what we all
8 believe, I think is the need for auditors to -
9 - the auditor's role in sort of the public --
10 their public support role.

11 But then the commentary; but only
12 if investors know what issues are within the
13 companies. The role of the auditor needs to
14 be strengthened and should not be
15 underestimated.

16 Confidence of investors in
17 financial statements is critical.

18 If the auditor's role is carried
19 out well, this to the be the case. But too
20 often it is not.

21 It should be critical to the
22 integrity of markets but does not seem to add

1 much value as would be expected.

2 So the comment -- Despite the
3 ratings, the commentary again often from those
4 who may not be as strong on the question, came
5 back with some qualified comments.

6 Again staying with the present,
7 the auditor plays an effective role in
8 mitigating the risk of investing. Also quite
9 net favorable from the IAG and their extended
10 network, with the some commentary.

11 The auditor provides additional
12 information and confidence in the integrity of
13 reporting. The auditor helps minimize
14 confidence risk but does not mitigate the risk
15 of investing.

16 The auditor SHOULD, and this
17 responder in all caps, played an effective
18 role in mitigating the risk of investing but
19 they do not have a very good track record.

20 Only good auditors mixed
21 performance overall. The auditor can play
22 this role. Whether it is currently genuinely

1 effective, we would very much doubt.

2 So again, some more qualifying
3 commentary.

4 Staying with the present, the
5 auditor plays an effective role in lowering
6 the cost of capital. This was less net
7 favorable. I don't think the respondents show
8 clearly that that is the view.

9 And in the commentary, it is a
10 difficult question to measure. The auditor
11 can play this role as effective.

12 There are studies that show that
13 companies that have better governance,
14 transparency and provide quality disclosures
15 benefit from having a lower cost of capital,
16 the implication being that the auditor is part
17 of that system.

18 The auditors bring confidence to
19 the integrity of reporting, which also impacts
20 the cost of capital.

21 Also in the presence, the auditor
22 plays an effective role in the quality of

1 corporate governance. This was a fairly high
2 net favorable. A bit of a 30 percent neutral
3 respondents.

4 The commentary here was if
5 effective, the auditor can in fact do this.
6 It is probably the area of greatest doubt
7 about the current degree of effectiveness.

8 And then someone who has had
9 discussions with audit committees or is on an
10 audit committee noted frustration given the
11 complexity of audit issues and the complexity
12 of disclosures.

13 This page and the next one was an
14 attempt to get a sense from the IAG and
15 investors of how often various information
16 sources are used in making investment
17 decisions.

18 So we listed about a dozen
19 different information sources and asked the
20 respondents to give us their sense of how
21 often. So always, often, sometimes, rarely,
22 or never were the options for answers to these

1 questions. And I think it is interesting to
2 point out that audited financial statements
3 were used almost all the time. If you add up
4 always, often, and sometimes, you get pretty
5 much all the time. So the audited financial
6 statements seem to be the underpinning of many
7 investment decisions.

8 MD&A again, almost all of the
9 time. Report on controls over financial
10 reporting, less so but still a lot.

11 Business description and risk
12 factors that would be contained in an annual
13 report under 10-K or otherwise generally used
14 virtually all the time.

15 Proxy materials also used quite
16 often. Quarterly statements used. Self-side
17 analysts' reports also used quite frequently.

18 Let's go to the next. Rating
19 agency reports less so; are used often but
20 less so than audited information from issuers
21 or information from issuers.

22 Information contained in financial

1 distribution networks. I for one thought that
2 this would be an active source but it was
3 rated lower than audited information directly
4 from issuers.

5 Investor day or other
6 opportunities to meet with management ranked
7 relatively high. Again, we had a high
8 institutional investor response and they often
9 get access to management more so than the
10 average investor.

11 Self-developed investment models
12 that rely on audited financial statements,
13 another high ranking in terms of usability.
14 And then self-developed models that do not
15 rely on audited financial statements. Because
16 I think we see particularly in institutional
17 investing the analyst models that are used by
18 the buy side are often quite unique and
19 proprietary.

20 And then investor information
21 distributed via XBRL interestingly enough, it
22 hasn't caught on. So it may be an area to

1 look into.

2 But the takeaway here is that a
3 high percentage of the respondents used the
4 audited financial statements in their
5 decision-making.

6 Some commentary on that question.
7 Auditor reporting should include additional
8 information that will assist investors in
9 their capital allocation decisions.

10 Each investment decision has its
11 own unique characteristics and drivers and,
12 therefore, may use different material.

13 Brokers' advice was another source
14 of information.

15 Let's turn to the future. The
16 next six or seven questions are about what the
17 investors thought were important looking
18 forward. So the question was the auditor
19 should provide an opinion on the earnings
20 release. Only a six percent net favorable on
21 this question. Basically, the disagrees more
22 or less offset the agrees. There wasn't an

1 overwhelming interest in the auditor getting
2 involved at that stage in the reporting
3 process, which I thought was interesting.

4 The respondents in that question
5 was that the earnings release focuses on
6 short-term quarterly information only relevant
7 to progress and management's understanding of
8 the operating environment.

9 Since such an opinion would
10 unlikely involve an in-depth audit, the value
11 was questionable.

12 No opinion is necessary but
13 auditor sign-off before the release can be of
14 assistance.

15 So some interest in auditor
16 involvement at that early stage in the
17 reporting cycle but almost an equal amount of
18 not necessary.

19 The next question about the
20 future. The auditor should provide an opinion
21 on management's discussion and analysis.
22 Again, a net favorable but not an overwhelming

1 net favorable of ten percent, more or less the
2 disagrees offset the agrees.

3 So about a split in terms of the
4 view on that question. The comments as the
5 requirement to read and raise concern is of
6 much greater value and was thought to be less
7 expensive.

8 And this was an odd one. Auditors
9 do not really understand the business details
10 and issues and the financial numbers are
11 already reviewed and compared with the
12 financial statement.

13 So I think the commentary, again
14 probably from the negative side, was it wasn't
15 felt to be necessary.

16 Another one about the future. The
17 auditor should provide an opinion on quarterly
18 reports. This was much more favorably viewed
19 in terms of a 32 percent net favorable. And
20 the commentary was more on the negative side,
21 probably similar to earnings release and the
22 value would be questionable, but that is

1 interesting commentary, given the
2 pervasiveness of the interest in providing --
3 and I can't be sure if all the respondents
4 knew the difference between an opinion and a
5 review report and all that. So we will have
6 to take that one as an indicator, not
7 conclusive.

8 Another one about the future. The
9 auditor should specifically report on the
10 quality of estimates used. This was a fairly
11 strong net favorable.

12 And the commentary was this would
13 be ideal but tough to implement.

14 Agree if auditors report on
15 estimates which are most relevant to the
16 business.

17 We would suggest that the auditor
18 make a specific report on neutrality of
19 statements overall. I think that might mean
20 balance of information, rather than a general
21 view of estimates.

22 Another future question. Should

1 the auditor specifically report on the quality
2 of disclosures?

3 And again, this was another high
4 net favorable with the respondents indicating
5 hard to do.

6 The quality are of critical
7 importance, with a lot of commentary about
8 this person's view about actions of the
9 auditors seem to lead to increased disclosures
10 as a safety-first basis. I think this comment
11 is really getting to the pervasiveness of
12 disclosures, the length, and would it be
13 helpful or not so helpful?

14 Also the future, the auditor
15 should report on the fairness of the
16 presentation of the financial condition of the
17 issuer. And again, a very strong net
18 favorable on financial condition. I'm sure
19 this question will dovetail into a later
20 discussion around Going Concern, which is also
21 a financial condition kind of concept.

22 With some remarks from the

1 respondents again about neutrality or balance
2 and I think what the balance sheet may look
3 like or cash flow prospects may look like.
4 They are looking for more auditor involvement
5 in this assessment.

6 Should the auditor report on non-
7 GAAP financial information? And as many of
8 you know, it has become commonplace now for
9 non-GAAP information to be in earnings
10 releases and MD&A. A net favorable of 30
11 percent, not overwhelming.

12 The very few respondents thought
13 that the requirement to read and comment was
14 sufficient.

15 And this question was about other
16 information that issuers are either asked or
17 desired to present in their public reports.
18 Sustainability data, compensation data,
19 operational data. Should the auditor be
20 involved in that information? A 12 percent
21 net favorable, not overwhelming. A high
22 neutral rating. So it didn't seem like the

1 respondents were necessarily driven to ask the
2 audit profession to get involved in these
3 kinds of data.

4 Again, I think that commentary
5 says it would be hard to draw the line.

6 And to give you sense of how the
7 commentary came in, like I said, about half or
8 about 50 percent were institutional investors.
9 And then a lower percentage of analysts and
10 investment advisors and investment overseers
11 being trustees or folks involved in
12 governance.

13 This slide represents sort of the
14 summary observations of our Task Group, which
15 I will stop after this and open it up for
16 discussion with the IAG and Steve, as you
17 would like to handle it. But generally, and
18 everything here is generally, investors showed
19 strong support for the PCAOB and its role in
20 regulating the auditing profession.

21 Also, generally investors voiced a
22 strong support for the role of the auditor.

1 So the investors are saying the system is the
2 right kind of system. Where they departed or
3 where they had advice was investors are
4 encouraging actions to improve audit quality
5 and particularly, wanted more informative
6 audit report. At least that is what we got
7 from the data and what we were getting from
8 commentary.

9 And then in terms of looking
10 really at the future, investors are most
11 interested in expanded auditor involvement
12 into areas of financial condition, estimates,
13 and quality of disclosures.

14 I think the takeaway from all of
15 this is that you have been hearing this from
16 the IAG. You have been hearing it from other
17 constituencies of the Board. And this survey,
18 I think, reinforces what you have been
19 hearing. I don't think it has revealed
20 anything dramatically new but it is pretty
21 much a reinforcement.

22 With that, I will stop and ask my

1 Task Group if they have any further
2 commentary.

3 MR. CARCELLO: I think you covered
4 it pretty completely, Bob. So from my point
5 of view, let's see what the rest of the group
6 has to say.

7 MR. HEAD: I would agree with
8 that.

9 MR. HARRIS: Well then, why don't
10 we open it up for questions? I'm sorry, if
11 somebody else wants to kick it off, whoever's
12 got the first question.

13 Bob, let me ask one question.

14 MR. TAROLA: May I kick off a
15 question?

16 MR. HARRIS: Sure. No, no, please
17 do.

18 MR. TAROLA: One of the questions
19 I have for a group is whether they think the
20 PCAOB has leveled the playing field on quality
21 or is getting toward leveling the playing
22 field on quality.

1 There was a time when the size of
2 the auditing firm, the name of the auditing
3 firm often imparted some sense of quality to
4 either the investment bankers or the investing
5 public. I have a sense, anyway, that the
6 PCAOB's oversight and enforcement and
7 investigations has leveled that playing field
8 to some degree, to a meaningful degree and
9 would wonder what my colleagues think about
10 that.

11 MR. HEAD: Obviously, I have been
12 involved in a lot of the discussions of the
13 working group so we debated this topic and it
14 is intended to be provocative for the rest of
15 the group.

16 But I feel very strongly over the
17 last ten years, based on my interaction with
18 my company's audit committee, my involvement
19 with professional organizations, especially
20 from an internal audit point of view, and my
21 executive management and CEO, CFO, and our
22 corporate risk structure, that there is a

1 strong feeling, there has been significant
2 progress but that we are not across the finish
3 line yet. That there is still meaningful
4 things that can be done to encourage, incent,
5 and improve audit quality.

6 But my CFO, for example, in a
7 briefing before coming here really did feel it
8 was the 80-20 rule; that a lot of the hard
9 decisions that Sarbanes-Oxley Act of 2002 and
10 the reinforcement with AS 5 and all of the
11 additional efforts that the PCAOB and the SEC
12 have taken over the last several years have
13 moved the dial meaningfully. They just didn't
14 want to think we were done. He wanted to make
15 sure we didn't just say okay we will just pack
16 it in, we are done because he thinks there
17 still can be meaningful progress made. He is
18 just nervous about not going too far.

19 And so I just wanted to share
20 that.

21 MS. ROPER: I guess I would just
22 add maybe a slightly different perspective

1 with my usual sort of negative view of the
2 world.

3 I was thinking actually as I was
4 walking up from the Metro this morning about
5 the old Jack Nicholson movie, As Good as it
6 Gets where he walks through the therapist's
7 waiting room and says to the anxiety-ridden
8 people, "What if this is as good as it gets?"
9 You know, what if where we are now in terms of
10 our audit quality is as good as it gets?

11 Because my sense is most people
12 agree that yes, the PCAOB has made significant
13 progress. Yes, the things that we have done
14 since SOX have moved the dial. But we just
15 came through a financial crisis where the
16 audit provided no meaningful information about
17 the institutions that were about to go belly
18 up or were kept by going belly up just by
19 virtue of government intervention.

20 We have watched in the European
21 crisis auditors signing off on valuations for
22 Greek bonds. For example, for two different

1 clients they are dramatically different and
2 finding a way to get comfortable with both.
3 We see marketing materials that suggest that
4 auditors still see their roles as being
5 supportive of management and I ask myself you
6 know, yes, this is progress.

7 But really, in light of what we
8 have been through, is this really as good as
9 it gets? And I don't think it should be. And
10 I think we have not just a little more work to
11 go to get across the goal line but I was just
12 like okay, the goal line is still down there
13 and we need to be really making more dramatic
14 changes to get there, in my view.

15 MR. SILVERS: I think this is very
16 fine work on the part of this subgroup. I
17 have a question, though.

18 Did you get any data in the course
19 of doing this that gave you a sense of the
20 people you surveyed, the investors' view of
21 the relevance of the audited financial
22 statements over time? Meaning, what is the

1 directionality of change here?

2 I raise this because my sense is,
3 as I said in the public event last week on
4 auditor rotation issues. I think a number of
5 developments have, over the period of the life
6 of this Board tended to erode the direct
7 relevance of audited financial statements.

8 Obviously, and I think this work
9 shows it, investors look at audited financial
10 statements almost all the time. But are they
11 becoming more or less relevant?

12 MR. CARCELLO: Damon, I will take
13 a first shot and my colleagues could jump in.
14 I don't think we asked about whether financial
15 statements themselves have become more
16 relevant or better over time. Probably the
17 closest we got on that was the second
18 question, where we asked them what they think
19 about changes in audit quality and whether
20 audit quality.

21 So assuming that the financial
22 statements as initially prepared by management

1 haven't deteriorated, that is an assumption,
2 but you know, certainly 302 and 906 should
3 theoretically help. And if audit qualities
4 have gotten better, you could at least
5 extrapolate to think that financial statements
6 have gotten somewhat more useful but we didn't
7 ask about that directly.

8 MR. TAROLA: Let me also say,
9 Damon, we had a few questions that were
10 designed to get at whether investors wanted
11 auditors to be involved earlier in the
12 information cycle. And interestingly enough,
13 there wasn't overwhelming interest in getting
14 involved earlier.

15 On the other hand, I thought there
16 would be and there wasn't.

17 JUDGE SPORKIN: I will give you an
18 experience from my clients. When I asked them
19 about all the reports filed with the SEC and
20 they say to me, well that is history. We want
21 to know what is going to go on in the markets
22 in the future. And they don't give it much

1 credence.

2 Look at all the insider trading
3 cases. They are not based upon the fact that
4 somebody looked at last year's financial
5 statement they traded on it. They are based
6 upon someone giving the information of what is
7 going to happen tomorrow.

8 This is not an auditor problem. I
9 understand that because it is all looking
10 historical but somewhere there is a bridge
11 there and it has got to be -- we don't want it
12 to go nowhere.

13 But that is one of the real
14 problems that I find with highly sophisticated
15 investors who really want to know what is the
16 next step. Where are we going? Maybe my
17 experience is different than others but that
18 is what I understand.

19 You folks, Brandon, would you
20 agree with that?

21 MR. BECKER: Absolutely.

22 JUDGE SPORKIN: They don't give

1 much credence to the --

2 MR. BECKER: Well, it's not that
3 we don't give much credence. As the survey
4 reveals, it is critical but it is critical in
5 sort of a negative sense. You know, it gives
6 you a framework that tells you that there is
7 not something in the past that you have to
8 worry about but you are always looking forward
9 in terms of your earnings analysis.

10 COMMISSIONER WALTER: Thank you.
11 I get the sense and tell me whether you read
12 your results the same way that the focal point
13 of your results is less on the audited
14 financial statements themselves but on the
15 disclosures that accompany it, either
16 literally within in the financial statements,
17 the footnotes or on other parts of the
18 disclosure. And therefore the focal point of
19 interest is really on the quality of
20 disclosure. And I wondered if you could
21 confirm that or not.

22 And, secondly, I have long term

1 been very interested in trying to find a way
2 to sort of crack the barrier with respect to
3 MD&A which I think ought to be the single most
4 important place that one looks because it is
5 an investor or a prospective investor's
6 opportunity to really learn what management is
7 concerned about, happy about, sees as the
8 prospects for the future. I think most MD&As
9 don't do that very well, not in a violate the
10 law kind of way but in a quality sort of way.
11 And I didn't know if you got any feedback on
12 that issue as well.

13 MR. TAROLA: Let me take a stab at
14 that. I don't think we got as deep as you
15 might have liked us to get on that question.
16 The commentary and the results indicate to me
17 anyway and I hate to interpret data without
18 talking to the people that provided it, but
19 the Respondents seem to put the auditor in a
20 box. And more or less they sort of like the
21 box that they're in right now. And that they
22 would just like them to be more forthcoming

1 about what they see and hear and feel. But
2 they're fine with them being in that box.

3 So when we asked them about MD&A
4 there wasn't an overwhelming interest in
5 getting into that one or the description of
6 the business or the risk factors or even real
7 data like KPIs for operating performance or
8 anything like that. I thought they would
9 frankly.

10 MR. HARRIS: And I think that the
11 working group and others ought to feel
12 absolutely free to give their personal views
13 on some of these as well. I mean we're
14 dealing with the data. We ought to question
15 the data. But if people have reactions to
16 what they think ought to be either the future
17 role or relevancy we ought to open it up to
18 that as well.

19 But go ahead, Tony.

20 MR. SONDHI: Thank you. I wanted
21 to go back and I'll actually begin with a
22 response to Commissioner Walter's question.

1 I think unfortunately the MD&A
2 also has become boilerplate. I've actually
3 found financial statements where the MD&A
4 repeats what it said the previous year. And
5 I've also come across occasions where I've
6 noticed that they've forgot to change the
7 numbers.

8 I'm not making that up. I've just
9 seen it far too many times. So that's one of
10 the most fundamental problems.

11 But now let me bring into it
12 something Barbara said and that is I think
13 what investors and certainly I am concerned
14 about is the quality that I expect to see
15 going forward. Because when I look at the
16 possibility that I'm going to find the
17 financial statements prepared under, say,
18 international accounting standards, then it
19 brings me to the issue that Barbara raised
20 about the great bonds.

21 Ultimately, Hans Hoogervorst, the
22 Chairman of the ISB, had to step in and say

1 that you can't possibly have seven French
2 banks coming up with seven different amounts
3 of losses on the same bonds. And you've got
4 to do something about this.

5 In that sense, I think this survey
6 of ours looks at the quality of audits today
7 and it's looking -- I think the weight is on
8 the auditors here in the U.S.

9 I think we all ought to be
10 seriously concerned about auditing elsewhere
11 in the world. And that is what's going to
12 affect the information that we see. So Judge
13 Sporkin's comment about whether this thing
14 tells us anything about the future, I think
15 that is something that's a very serious
16 concern.

17 I would view this survey as an
18 introductory approach at trying to understand
19 where we are. I think what it tells us is
20 more about the questions that we ought to be
21 asking. That's the real import of this
22 survey. We need to take these comments and

1 then develop something that allows us to
2 better understand what's going on.

3 MR. HARRIS: I think in terms of
4 the recognition what I'd like to do is
5 recognize Board members, then working group
6 members and then I know that, Lynn, you had
7 your card up and Norman and Damon. So why
8 don't we do that. Lew, why don't you go ahead
9 and ask a question.

10 MR. FERGUSON: I would like to get
11 your views something that Judge Sporkin said
12 as well and he mentioned that basically the
13 auditor's report and the auditor's work
14 doesn't tell us about the future. I'm not
15 even sure it really tells us about the present
16 very much.

17 If you view investment decisions
18 as being made in real time on the basis of
19 information that's occurring, immediately we
20 have instantaneous access to information. And
21 there are all kinds of information.

22 And this is a view that Mike Cook,

1 the former Chairman of Deloitte and the
2 Chairman of the audit committee of a number of
3 public companies, had said that describing the
4 audit process as the caboose of the financial
5 disclosure train. And his argument is that
6 there is all kinds of information that is
7 coming out from companies all the time
8 including things like earnings announcements,
9 speeches by senior executives. It could be a
10 corporate development like the granting or not
11 granting of a major patent, the failure or not
12 failure of a drug test for a drug company.
13 All kinds of things like that that are going
14 out all the time and that probably have
15 profound impacts on the way the market looks
16 at companies. And that's not anything the
17 auditor is involved in at all.

18 I guess my question to you is
19 should the auditor be involved in things like
20 that. Can he be involved? Is there a way
21 that that sort of information, the
22 contemporary information, that gets into the

1 market can be analyzed in a way that would
2 help investors?

3 MR. CARCELLO: Well, Lew, as Bob
4 said earlier and I think all of us felt the
5 same way. I think we expected that there
6 would be more desire on the part of investors
7 for more information on the front of the train
8 rather than the back of the train if you will,
9 to use the Cook analogy. And, at least, in
10 terms of the questions we asked and Bob has
11 indicated this is there doesn't seem to be any
12 traction on that.

13 Now whether that's a function --
14 and we explored this a little bit last year
15 and explored this a little bit in the
16 roundtable on the audit report. Because as
17 you know in the concept release, one of the
18 options -- I think the third option -- is
19 expanded auditor involvement in the MD&A and,
20 at least, anecdotally some of the feedback
21 that we've heard from investors.

22 I think, Dan, you might have

1 shared this if I remember right as well as
2 others is let's get the basic product right
3 first before we start expanding the mandate.
4 Because when you expand the mandate, no
5 significant cost involved with that and I
6 think as you see from these results as well as
7 results in previous iterations of this group
8 is nontrivial concern about basic performance
9 on the main product.

10 MS. YERGER: I know I'm not in
11 order, but I just have to emphasize that. I
12 think the sense that I have gotten from
13 council members is we don't need to be adding
14 more to the outside auditors' plate. They
15 need to be doing a better job with the job
16 they have right now. And let's work on that
17 first.

18 MR. HARRIS: When you say let's
19 get the basic product straight, what exactly
20 do you mean?

21 MR. HEAD: Again, our survey even
22 though it didn't go deep enough and why the

1 last point on the general statement is the
2 survey initially results, they would like to
3 see audit quality as a focus. But focus on
4 financial condition, the estimates, and
5 quality of disclosures and that that would be
6 the most meaningful three areas for audit
7 quality improvement to address in light of all
8 the things they could. And I think they think
9 that's much more important than getting too
10 deep involved on some of the front end things
11 or even MD&A. But again we didn't go real
12 deep. This is only opening questions, not
13 necessarily answering all those.

14 MR. HARRIS: Lynn Turner.

15 MR. TURNER: Thanks, Steve. And,
16 Lew, I think your question and what Mike talks
17 about ties into some degree to what
18 Commissioner Walter has teed up with the MD&A.
19 The Commissioner and I were both at the SEC
20 when she and the staff at Corp Fin put out
21 what I personally thought was a marvelous MD&A
22 release back in `89 to try to address it. And

1 I think at the time it made great strides and
2 made it very clear that people are supposed to
3 be forward looking and really in plain English
4 talk about where the company is going.

5 But over time people have lost
6 that crisp focus that was there at the time.
7 And one of the things that preceded that
8 release was a publication in '87 by all the
9 large audit firms at the time that recommended
10 that we combine all the risk disclosures into
11 one place in the filing and do have an audit
12 opinion on that which I personally think would
13 be a great idea if it wasn't just risk
14 disclosures, but it was how do you mitigate
15 those risk disclosures.

16 Right now, we've just got as you
17 know the lawyers drafting legalese risk
18 factors that is useful quite frankly if you
19 read them. Unfortunately, most people don't
20 read them. But they are useful. But they
21 don't tell us what the company is doing to
22 mitigate those risks which is a major

1 shortcoming in how the thing has turned out.

2 So it's probably time to revisit that.

3 But I think Mike is wrong or I
4 hope he's wrong with the fact that the
5 auditors aren't involved with any of these
6 things. If, in fact, the auditor isn't
7 involved and isn't aware of what's going on in
8 the company with respect to, for example,
9 pharmaceutical what's coming out in the
10 pipeline and new drug announcements, then I
11 would turn around and tell you you've got a
12 problem with the auditor and the audit.

13 And, quite frankly, Mike might be
14 right that the auditors aren't involved. But
15 in reality if they were following GAAS, they
16 would be involved which gets back to the point
17 other people are saying. If the auditor isn't
18 involved and on top of the operations and
19 doesn't really understand the business which
20 is what the survey highlighted at times, at
21 least the belief they aren't, then how can
22 they really get the numbers right? And if

1 they can't get the numbers right, why would we
2 give them a bigger assignment when they don't
3 seem to be able to get the current assignment
4 done right?

5 I think those are all valid
6 points. I would actually like to see them get
7 more involved with MD&A. I think it would be
8 great. But if they're going to do that, then
9 somehow you've got to make sure that they do
10 it right. Because if they just do what
11 they're doing with the financial statements,
12 I don't think it gets the job done. In fact,
13 I would tell you that if they continue on the
14 track that they're on two decades from now
15 they'll no longer be relevant at all because
16 there is so much information in the public
17 domain today.

18 We didn't find the auditors
19 finding the problems at an Olympus or at any
20 of the Chinese companies. We didn't even find
21 the auditors finding the problem at Diamond
22 here in the U.S. It was analysts and other

1 people and information coming into the public
2 domain that's available.

3 And I believe with all the
4 information that is getting there and the
5 increase due to the very social media and the
6 Wikileaks and everything else that two decades
7 out if there aren't substantial improvements
8 made there won't be value to paying for the
9 cost of the audit because you'll find the
10 problems elsewhere.

11 And we'll supplant the need for an
12 audit with the digital and internet age. And
13 they'll just basically ride off into the
14 sunset.

15 So I think the work of the PCAOB
16 is important. I think the exams are very
17 important. But unless we can get better
18 audits and better transparency, the
19 marketplace will deem them no longer relevant.
20 And I think that will certainly happen within
21 the next two decades if substantial changes
22 aren't made and if people don't see value to

1 what they're spending money on.

2 On the other hand, if you get
3 toward that value, at least perceived at the
4 value that's really there, then I think
5 there's a good opportunity to put that fresh
6 set of eyes on the MD&A and on risk factors.
7 I think that would be marvelous.

8 The other thing is when you talk
9 about investors we talk about it way too
10 generic because if you're to ask people who
11 are doing indexing and today indexing is like
12 half of the market and growing. And, in fact,
13 all the data shows you shouldn't be for the
14 most part. You know, most Americans shouldn't
15 even be in picking stocks. They should be in
16 indexing.

17 And indexing, the audit has much
18 less relevance. I have yet to talk to a
19 portfolio manager who is actually indexing
20 that's really do much reading of the financial
21 statements. They're just indexing to the
22 index. For a good part, it's not relevant.

1 It's certainly not relevant for those who are
2 doing the computerized quant trading because
3 there the computer models are doing it all.

4 So it is the relevance of the
5 audit which is slowly narrowing given how the
6 markets are working today. And then it slowly
7 is marginalized by the market. Then the
8 question becomes will it be further
9 marginalized by the fact that we find you can
10 get better information in the public than you
11 can from an audit and an audit report.

12 MR. HEAD: And I apologize for
13 jumping out of line but just because I want to
14 clarify when he referred to disagreeing.
15 That's okay. My intent wasn't to say
16 involvement doesn't need to be more and more
17 robust.

18 There's a difference in
19 involvement, robust and being involved in it
20 and opining on something. And I think one of
21 the very good pieces of work that's came out
22 of this group earlier that a lot of us worked

1 on was the consideration of an auditor's
2 disclosure and analysis.

3 And I think that's a much more
4 meaningful way to address it than trying to
5 opine on management's MD&A or opine on
6 earnings release or opine on other pieces of
7 information and try to do that real time. I
8 think they have to be involved. They have to
9 understand the business. But I think it would
10 be of much more value to the investors in the
11 users community for us to really understand
12 what they're thinking, why they're thinking
13 it, what their basis for their assessments are
14 and that be in a more robust disclosure that
15 they would complement management's than just
16 opining on management's is more of where I'm
17 at.

18 MR. HARRIS: Let me recognize
19 Brian and then we'll go back and return to the
20 auditor.

21 Brian.

22 MR. CROUTEAU: Thanks, Steve.

1 Just in terms of getting the basic product
2 straight, a very important comment I think,
3 I'd like us to just turn back to slide 10
4 which I think was question three which relates
5 to the presence, policies and practices of the
6 PCAOB and whether they've improved audit
7 quality.

8 And I guess I was struck there by
9 the high percentage of neutral responses and
10 interested on slide 11 on the last bullet on
11 more transparency in a timely basis providing
12 more incentive for firms to provide audit
13 quality. I wondered if there's anything
14 anyone can say or any suggestions that people
15 have relative to the additional transparency
16 on a timely basis that again could provide
17 these incentives. I think that's an
18 interesting observation and would be
19 interested in additional thoughts there.

20 MR. CARCELLO: Obviously, it would
21 be conjecture, Brian, on any of us as to what
22 that means. But one possibility in terms of

1 more transparency on a timely basis would
2 provide more incentive for firms to improve
3 audit quality, taking both that comment and
4 some of the other free response comments that
5 you saw throughout the presentation, there
6 seems to be at least among who knows how many,
7 one or two or three -- you've got to take that
8 with a grain of salt -- statements about
9 concern about the lags and the lack of
10 disclosure associated with part two of the
11 inspection reports. And more transparency
12 would improve audit quality and again given
13 some of the comments earlier in the slide
14 deck, if you go back and look at it, I think
15 that might be where people are coming from.

16 The problem as you know as well as
17 anyone, as I understand it at least, that's
18 part of the law. That's not something that
19 the PCAOB could unilaterally change. I'm not
20 even sure the SEC could change that. I think
21 that's a Congress issue as to whether you're
22 going to make part two public. And the way

1 the law is written that's not, at least, my
2 understanding that's not an option.

3 MR. CROUTEAU: Certainly. And
4 maybe it's a good time to remind the views are
5 my own and not of the Commission,
6 Commissioners or other staff. But on that
7 point certainly the PCAOB has alternatives
8 relative to on a broader basis making quality
9 control findings public across firms to the
10 extent that that's useful and does so on an
11 occasional basis.

12 MR. CARCELLO: Yes.

13 MR. CROUTEAU: So I think there
14 are other alternatives to that. But certainly
15 the idea of a remediation period over the year
16 is built into the law. But if there are other
17 ideas along these lines certainly very
18 interested in hearing them to improve the
19 transparency and timeliness and really getting
20 focus on this.

21 MR. HARRIS: Tony, Lew and Ann, a
22 couple people had their cards up here for

1 awhile. Go ahead.

2 MR. CARCELLO: Steve, could I make
3 a statement? I'm going to have to leave here
4 in a second.

5 MR. HARRIS: Please do.

6 MR. SONDHI: Some people will use
7 any excuse.

8 (Laughter.)

9 MR. HARRIS: He's actually
10 testifying on the Hill.

11 MR. SONDHI: I know that, but I --

12 MR. HARRIS: That's a pretty good
13 one.

14 MR. CARCELLO: I would just point
15 to this last slide for the benefit of the
16 Board and the SEC people here today. I think
17 there is a couple of things that at least I
18 heard come out of this presentation. And I
19 thought Bob made a very -- did a really nice
20 job presenting. And that is although we might
21 have thought there would be real strong demand
22 for more, as we said earlier, there seems to

1 be strong demand for making what we have
2 better particularly in that third bullet,
3 "want a more informative audit report." I
4 think that definitely came through as well as
5 more information about financial condition and
6 estimates in the fourth bullet.

7 The reason I want to emphasize
8 this is I don't think you should take any one
9 piece of information in a vacuum. So today
10 you have before you the results of a survey of
11 62 investors or supporters of investors, many
12 of them institutions, with \$8 trillion of
13 assets under the management. A year ago
14 around this time, a little bit about a year
15 ago, you had a survey of 77 investors
16 representing around \$7 trillion.

17 Now there is some overlap. I'm
18 not saying there is a 140 unique respondents.
19 But there's probably at least 100 unique
20 respondents. That's a pretty big sample of
21 investors. If you go into the literature and
22 you look short of a CFA survey, but in terms

1 of a broad based survey that's pretty big.

2 The feedback you've gotten I would
3 say is very consistent from last year to this
4 year. And I would also remind the Board that
5 since the last time we met, a subset of this
6 group sent in a comment letter, Steve, that
7 was signed by two-thirds of this group.

8 And the reason I emphasize this is
9 there are other parties in the public domain,
10 some of whom I'll meet very shortly, who are
11 making statements like the Board is involved
12 in mission creep because they want to expand
13 what's communicated in the audit report. And
14 that's the province of state law and corporate
15 governance.

16 I would point out to the Board and
17 the members of the SEC for those who don't
18 know this the first standard on the audit
19 report written by the profession since there
20 was no PCAOB was written in 1939. So maybe 75
21 years is not a long enough history for some.
22 But it's a long enough history for me.

1 MR. HARRIS: Lew.

2 MR. FERGUSON: I was just going to
3 comment on something that Brian had said about
4 the capacity of this PCAOB to comment
5 generally on things. And while we can't
6 communicate specifically part two which are in
7 many ways the heart of the inspection work we
8 do, one of the things that a number of the
9 Board members had been thinking about is
10 putting a much more detailed report and do
11 this on an annual basis, a report that would
12 be kind of a state of the profession report
13 and that could include things like historical
14 comparisons of things we're finding. Are
15 things getting worse? Could include
16 statistical analysis of stuff like that.
17 Could include our views of what the root
18 causes of some of these problems are. And
19 also say things that we think people are doing
20 right. Maybe even discuss what we have viewed
21 as being best practices.

22 And do this over a period of time

1 so that as you look at this over a number of
2 years you actually get a sense of, at least,
3 the regulators' view of changes in the
4 profession. And use this as a document that
5 may guide and help guide auditors to make
6 changes again.

7 What are your thoughts about that?
8 Would that be a useful thing for us to do? It
9 kind of is a way around the limitations of not
10 giving part two of these reports.

11 COMMISSIONER WALTER: May I just
12 interject to say again speaking for myself?
13 Thank you, Brian, for reminding me to
14 disclaim. I think that's a fabulous idea.
15 And I think that we underestimate the value at
16 times of not even best practices but of good
17 practices.

18 It is important to include both
19 the upside, not just the downside, but the
20 upside because people do respond and
21 particularly those people which is most people
22 who really do want to do a good job will pick

1 up on that because they're not going to be
2 left behind the pack. So you get rid of some
3 of your outliers. I would very much encourage
4 you to think about that.

5 MR. TURNER: And make sure it is
6 written in plain English so people understand
7 it.

8 MR. HARRIS: I have seen the
9 number of cards have gone up and down. So in
10 order to encourage the people to keep their
11 cards up. Anne, why don't we go with you.
12 Bonnie and then, Norman, you put your card up
13 and down. But I want to make sure the people
14 who have not spoken have the opportunity to
15 speak. And afterwards since, Judge Sporkin,
16 you have spoken at length in the past about
17 the issue of complexity, I want to recognize
18 you as well.

19 MS. SIMPSON: Thank you. I think
20 I'm in the ordinary investor category. So I
21 like this idea of a report. Lew, I think this
22 is really helpful.

1 But my question for the working
2 group is about the barriers to improving audit
3 quality and where are these. And it may be
4 that we have poverty of ambition as investors.
5 We've got the auditor in a box because we see
6 constraints around the auditor role.

7 It may be that until we tackle
8 issues around liability, audit concentration,
9 non-audit fees, rotation. I mean look at the
10 agenda that the European Commission has put
11 forward. And they are really addressing these
12 structural issues in the way that the audit
13 market works.

14 So the other point I want to make
15 with respectful disagreement to my companion,
16 Lynn Turner, is that because we are indexed
17 and CalPERS is largely indexed we're so big.
18 We cannot be an active stock picker. We rely
19 on markets functioning. That's where the
20 beta, the main returns, to our fund come from.

21 And if we've got four global
22 networks responsible for auditing the bulk of

1 our investments we need to be paying attention
2 to the structure of the audit model. And
3 unless we expand our thinking and consider
4 what constraints are put on the quality of the
5 audit by this bigger structure, we're not
6 going to get a lot more out of it.

7 So where did that feature? Are
8 people sitting and thinking, "Well, we've got
9 what we've got?" I think this is Barbara's
10 point at the beginning, you know, Candide,
11 Voltaire, Dr. Pangloss. Are we in Dr.
12 Pangloss mode? It's the best of all possible
13 worlds.

14 Whereas, I think and this is where
15 I think Lew's suggestion about the state of
16 the audit market report could be so valuable
17 because it would allow us to actually expand
18 our thinking and not say, "Within the box
19 we've got, how could we make it a little bit
20 better" but actually "Have we got the right
21 box?"

22 MR. TAROLA: Let me take a shot at

1 that. I'm, I think, in the court of
2 Commissioner Walter in that I did audits and
3 now I prepare financial statements. And I
4 have to describe what's going on. And you
5 cannot do an audit without understanding
6 what's going on.

7 But it's excluded from the report.
8 It's about the score card as opposed to the
9 commentary and the view of the prospects.

10 I often thought that it would be
11 good for the capital markets if the auditor
12 played the role as kind of looking over the
13 shoulder of the CFO in every aspect, whether
14 it's the drafting of the press release or the
15 MD&A or the proxy disclosures or whatever it
16 might be and be that public overseer literally
17 of all aspects of business reporting, not just
18 financial statements because it's hard to
19 conclude on financial statements without fully
20 understanding all the other aspects of
21 business reporting.

22 MR. HEAD: And the reason I was

1 nodding is I agree with what's been said. But
2 I think what that all, if not directly saying,
3 implying is we need more quality direct
4 feedback from the auditor, not them concurring
5 with management on something that management
6 is saying. And the report that Commissioner is
7 talking about and the auditor disclosure and
8 analysis and overlooking the CFO is intended
9 for them to give direct input to the investor
10 community in an objective way, not just say
11 they agree with management and give some
12 boilerplate form where they say that on.

13 I agree with everything that's
14 been said. It's how do they provide that
15 input and demonstrate that they've increased
16 the audit quality and estimates and condition
17 and disclosures and how their experience has
18 been with the PCA examination and having more
19 transparency. It's giving people that
20 information and allowing them to have some
21 direct input.

22 At my audit committee, they didn't

1 want to hear from me as the head of Internal
2 Audit or from the CFO or from someone else in
3 the company about what was in the PCAOB's
4 examination of our audit firm. They wanted to
5 hear the partners' direct response to that and
6 if any of these things were applicable to our
7 engagement, our audit, and how could we have
8 comfort and ensure that these things were
9 being addressed or covered in the quality of
10 our audit. Not that I go and tell them that
11 or the CFO goes and tells them that. They
12 want to hear it directly.

13 MR. HARRIS: Ann Yerger and then
14 Bonnie Hill.

15 MS. YERGER: First to your
16 question about whether a report from the
17 regulator would be of value, I think it would
18 be of tremendous value to investors and audit
19 committees actually to help us understand
20 where there might be issues and what we should
21 be thinking about from policy response
22 perspectives.

1 I want to thank the working group.
2 I thought the survey was great. Getting the
3 data is terrific. And in a way I'm going to
4 repeating some of the things Joe said.

5 I think what was great about the
6 survey was I thought it reinforced what we
7 discussed a year ago in terms of the fact that
8 we see an important role for auditors in our
9 capital markets. We think there could be
10 better value from the audits.

11 We think that the reports could be
12 more relevant. And I guess for me this gets
13 back to the issues of how we can enhance
14 disclosures from the outside auditor to audit
15 committees and to investors.

16 So I guess in a way I would just
17 like to urge the Board to continue to go
18 boldly forth on some of its initiatives or its
19 considerations of issues about whether there
20 are ways to enhance the auditor's report to
21 investors and whether there are ways and how
22 there are ways to enhance its reporting to

1 audit committees.

2 MR. HARRIS: Bonnie.

3 MS. HILL: Thank you, the working
4 group, on the job that you've done. And I
5 think, Mike, you began to touch on one of the
6 questions that I have and that is we broadly
7 have not been able to determine exactly what
8 quality is. I think we all define it in a
9 different way.

10 One of the things that seems to be
11 missing from the discussions and maybe it's
12 assumed, but that's the role of the audit
13 committee and the Board as it relates to the
14 auditor and the report. I mean clearly
15 shareholders and stakeholders hold directors
16 and audit committees responsible. And so the
17 work that takes place between the auditor and
18 the audit committee as well as the Board is
19 very important.

20 Sometimes the question is are
21 there things that the Board and the audit
22 committee know that they really do not

1 necessarily want to be for public disclosure
2 because of competitive reasons or other
3 reasons. How much forward thinking can you in
4 fact do and still maintain a certain edge?

5 Quality of audits is very
6 important. And I agree and you couldn't be
7 more supportive of that. But I think it's
8 very important for us to not take a large
9 brush that says one size fits all and
10 therefore everyone does the same thing no
11 matter what. But somehow or another there is
12 a balance that we must reach in order to
13 maintain the integrity of our capital markets.
14 So I would hope that in its discourse that the
15 PCAOB would consider that.

16 I would tell you that the auditors
17 today are really dotting Is and crossing Ts
18 and very concerned. In fact, I've heard terms
19 like scared to death of PCAOB. And I for one
20 do not want them to be so involved in dotting
21 Is and crossing Ts that they take their eyes
22 off the business.

1 We saw some of that initially with
2 SOX when directors were sitting in board
3 meetings making sure that they had done all
4 the things that were necessary to cross the
5 line to make certain that they had dotted Is
6 and crossed the Ts. And then, all of a
7 sudden, somebody said, "Who is looking out for
8 the business?" We're following the regulatory
9 process. We're making sure we do everything
10 that we're told to do, but let's not forget we
11 still have a business to run and that
12 shareholders expect us to make certain that
13 those businesses to run smoothly. So I would
14 just encourage us to continue to look for that
15 balance.

16 MR. HARRIS: As an audit committee
17 member, one thing we had heard about at the
18 roundtable last week in the two days was that
19 the PCAOB ought to be doing more to outreach
20 to audit committees. How do you think the
21 PCAOB could be helpful to audit committees and
22 audit committee members? I mean, what do you

1 want?

2 MS. HILL: I think it would be
3 helpful to hear from them and to really
4 understand. I think one of the things I'd
5 recommend is maybe sort of an open discussion
6 on what takes place in the audit committee.
7 I mean there's a requirement that the chair of
8 the audit committee be an expert, a financial
9 expert. Boards have done that. And we look
10 to those chairs to really help direct us
11 through these various reports.

12 I just think spending a little
13 more time with audit committee chairs would be
14 very helpful to understand the depth and the
15 breadth of what goes on inside those long
16 committee meetings.

17 MR. HARRIS: Kelvin.

18 MR. BLAKE: Thanks, Steve. You
19 actually have raised my question and the
20 question is how is the PCAOB reaching out to
21 the accounting profession in terms of
22 publicizing the most common deficiencies found

1 during the audits, the inspections or the
2 enforcement actions taken by the PCAOB that
3 think it's a good learning tool if these
4 accounting professionals, not the high level
5 but even down to the staff assistants are
6 aware of the common deficiencies and what they
7 should not be doing and the serious sanctions
8 taken by the PCAOB if they engage in such
9 activities.

10 MR. HARRIS: I think you heard one
11 suggestion by Lewis in terms of reporting.
12 And I think that what we'd like to hear from
13 you is obviously our part two has to be
14 confidential under the statute. But if there
15 are communications that you would like as the
16 investor community from the PCAOB in addition
17 to the report that Lew just mentioned, what
18 are some of the other things that you would
19 like us either annually or periodically
20 reporting on?

21 And we've got a problem with
22 respect to the enforcement, the transparency

1 of our enforcement proceedings. Once again,
2 under the law, we are unable to communicate
3 that publicly. But what are some of the
4 things that you would like us to get out there
5 that you may not be receiving?

6 MR. BLAKE: I know when I do -- I
7 do seminars where I have people from different
8 states. And I talk to them. Many of them are
9 not aware of the PCAOB or what it actually
10 does. I think there needs to be more outreach
11 by the PCAOB to make the general public aware
12 of what their role is.

13 But in terms of -- have you
14 considered and maybe you have a top ten common
15 deficiencies on an annual basis? That's
16 something we do at the state level where we do
17 compliance audits and our national
18 organization does a top ten list that they
19 publicize. So maybe that could be distributed
20 to the press.

21 MR. HANSON: Let me make a couple
22 comments. Excellent points. We do have a

1 series of forums we call Auditing in the
2 Smaller Business Environment where we take
3 this on the road to I think it's around seven
4 cities around the country. And it's geared
5 towards to the non big four and non national
6 firms. And we get over 700 auditors come to
7 those. And we do focus on what are the most
8 common findings and actually do little case
9 studies of here's what the standard requires.
10 Here are some facts. Let's have a little
11 discussion about them. So those have been
12 very well received and a lot of repeat
13 attendees at them. I'm not sure that the
14 press ever shows up at those events. But we
15 are trying to do that.

16 And with respect to the larger
17 firms one of the gauges that we use in
18 effectively the question do the firms get it
19 is they all have their own internal inspection
20 routes. So one of our gauges is how
21 consistent are the results that they have
22 internally with the results that we have. And

1 for the firms that are pretty close, and they
2 understand their issues and are communicating
3 dealing with them. Feel pretty good about
4 that. The firms that are a little further
5 apart we kind of push them pretty hard about
6 "Well, gee. Are you looking at the right
7 things if your results are different than
8 ours" and pushing them along in that.

9 So we have some very direct and
10 blunt discussions with the leaders of the
11 firms about what are they doing and encouraged
12 by some of the progress that we're seeing from
13 those blunt discussions that we're having.

14 MR. HARRIS: Kelvin, I think
15 separately we'd welcome your recommendations.
16 I think we have a terrific inspection staff.
17 We've got a terrific Office of Research and
18 Analysis. And I think it would be very
19 helpful if you gave us kind of a bill of
20 particulars in terms of what you would like
21 that we could get you, not get you personally,
22 but what we ought to get out in the public

1 domain.

2 We do an annual 4010 report.
3 We're very focused on that in terms of
4 figuring out what the priority issues are that
5 ought to be brought to the attention of the
6 public. But let's discuss that more
7 afterwards because as I say with respect to
8 our Inspections division and the Office of
9 Research and Analysis if you could give us a
10 direction in terms of what you think would be
11 helpful to you and your constituency that
12 would be very helpful.

13 Bob.

14 MR. TAROLA: Thanks, Steve. You
15 opened up the question. So I'm going to take
16 an opportunity.

17 This question of audit quality, I
18 think it's probably in your purview to define
19 what that means and who is measuring up and
20 who may not be measuring up. And I don't know
21 exactly how you might communicate that.

22 But right now the presumption is I

1 think that you're okay with audit quality.
2 But the investors are saying perhaps we need
3 to improve audit quality. Also this question
4 of leveling the playing field I think comes
5 into that question.

6 I'm sure it's not scientific. But
7 there will be indicators perhaps that you
8 could see that are characteristics that you
9 see that lead one to believe higher quality
10 than lower quality. And you might be in the
11 best position to make those judgments.

12 MR. HARRIS: We'll get back to
13 Lynn and Damon. But, Norman, your card went
14 up and it went down. So I want to recognize
15 you.

16 MR. HARRISON: Thanks. I'll be
17 very brief. It went down because I think my
18 comment was made in bits and pieces as the
19 discussion progressed. But I wanted to just
20 tie back very briefly because it relates to
21 the point that Judge Sporkin originally raised
22 about value of backward looking audit process

1 and statements to investors who by nature are
2 forward looking.

3 And I think Lynn has raised a very
4 interesting point about the relevance and
5 purposes of an audit in a market environment
6 where large volumes of trading decisions are
7 made by machines operating at warp speed, not
8 by individuals. I think that may be a
9 worthwhile topic for a future meeting of this
10 group.

11 But I did want to point out from
12 the standpoint of the fundamental or value
13 investors who are still out there in the
14 market in large numbers. The work of this
15 group is designed to discuss the role and
16 relevance of the audit process to the
17 investment community.

18 There are still a lot of funds out
19 there who do pick stocks. And I think the way
20 that they do their business can be simply
21 distilled to a process of collecting relevant
22 information including historical financial

1 statements and the results of audits and
2 commentary around it and projecting the
3 expected future performance of a company, its
4 capacity to generate earnings and cash flows
5 and discounting those back to a present value
6 at a discount rate that reflects the level of
7 risk that the investor attaches to those
8 projections.

9 And I think that what we're
10 hearing from investors and I agree with Anne,
11 I think we heard a lot today that is
12 consistent with what our working group heard
13 last year about the relevance or potential
14 expansion and the scope of the auditor's
15 report. I think we're hearing from investors
16 that there are qualitative assessments or
17 commentary, whether it's in an EDA or whether
18 it's conveyed in some other manner relating
19 particularly to issues such as estimates. Or
20 I think one topic we discussed last year were
21 situations in which more than one accounting
22 treatment would be permissible for a

1 particular category of expense or other
2 financial statement item and where the company
3 has chosen perhaps the more aggressive
4 position should there be some commentary by
5 the auditor about that fact, all of which
6 helps investors to assign a level of
7 variability or risk to their projections.

8 I think there are ways in which
9 the information conveyed in the financial
10 statements, in the footnotes which the
11 auditors will be first to tell you they don't
12 audit, in the commentary that auditors could
13 provide as part of an expanded scope of
14 discussion in some manner really do have
15 potentially very direct relevance to the work
16 that investors and analysts do every day
17 trying to identify opportunities to create
18 value by investing in individual companies.

19 I think there is again a lot of
20 overlap between, some overlap to what we've
21 heard and talked about last year, what this
22 working group's very fine work has shown. And

1 I think it's a clear affirmation of the
2 importance of the work the Board is doing on
3 the issue of the audit report which, of
4 course, ties in as well to audit scope. I
5 would encourage you to proceed full speed
6 ahead.

7 MR. HARRIS: We've got 15 minutes
8 more for this panel before the break. And I
9 recognize Lynn, Damon and others. What I'm
10 hearing are two things, one, let's get the
11 basic product straight which I think came out
12 of your report and then certain of you have
13 indicated substantial improvements must be
14 made. As we go through the process to round
15 up this segment, I'm wondering how we get the
16 basic product straight, what's meant by that
17 exactly from your perspective, and then what
18 are the substantial improvements that must be
19 made.

20 But actually Jeanette just put her
21 card up. So, Lynn, let me defer to her and
22 then we'll go to you and Damon and others.

1 MS. FRANZEL: And I'm actually
2 just tacking onto Steve's question here about
3 asking for feedback on getting the basics
4 right. I think last week we heard from a lot
5 of people that there have been a lot of
6 improvements since Sarbanes-Oxley and
7 everybody can point to those improvements.
8 But I think that in some respects that
9 actually masks some of the gaps that are out
10 there. And we really need to get at those
11 gaps.

12 There was a comment made that
13 presumption is that PCAOB is okay with audit
14 quality. But I don't think from my
15 perspective that audit quality is where it
16 needs to be. So we really need to get at
17 those gaps. And how can we do that going
18 forward help auditors get it right?

19 MR. HARRIS: Lynn and then Damon.

20 MR. TURNER: I think bringing more
21 transparency and accountability to the process
22 will help respond to the question that

1 Jeanette just raised. I think a 4010 type
2 report on the part twos if you will that you
3 talked about, Lew, I think would be very
4 helpful. It's certainly helpful amongst the
5 firms so they can see what people are seeing
6 the shortcomings are.

7 But I think you've got to go
8 beyond that. I'd certainly encourage it and
9 be a strong supporter of that. But I think
10 you've got to go back and revisit the initial
11 decision of the Board to not name the
12 companies in the part ones. I think you
13 absolutely -- and I think this Board's going
14 to continue to be extremely heavily criticized
15 until it starts naming the company.

16 Because as I'm investing in those
17 companies, I want to know the companies where
18 the auditors are getting the audit done right
19 and those that aren't. And if an auditor
20 isn't getting a job done right I don't want to
21 know what companies those are. I'm entitled
22 to know that. That auditor is supposed to be

1 working for me.

2 And if you find they aren't
3 getting the job done right, why are you
4 withholding that data from me. I can't
5 understand that at all.

6 So I think that data needs to be
7 made public so that we then have that
8 information when we go to vote on the auditor.
9 And I think that's one thing that should be
10 required in the listing requirements.
11 Probably have to come through listing
12 requirements.

13 But I think every year and I think
14 this was part of the recommendation at the
15 Treasury Committee as well. And it was maybe
16 to the SEC, but every year investors who rely
17 on these people should be entitled to have a
18 vote on the reappointment of the auditor. And
19 I think that's very important to come into
20 this place.

21 And not only should we have the
22 information with respect to where there's been

1 shortcomings, but to build upon the point that
2 Robert made, I think we need to have some
3 disclosures about audit quality. And I know
4 when we went through this discussion with the
5 firms during the Treasury Committee hearings
6 and meetings that they often told us, in fact
7 almost universally told us, you can't measure
8 out of qualities. There is no definition, no
9 central definitions, or common definitions,
10 etc. which made me think if the firms don't
11 know what audit quality than I sure as heck
12 know they aren't measuring. And if they
13 aren't measuring audit quality, I sure as heck
14 know they aren't managing to it.

15 And I think we ought to have the
16 firms report to you and to us on some key
17 drivers of audit quality. And if they can't
18 figure that out then we should all be
19 concerned. It shouldn't be that hard to come
20 up with them. They should already have them
21 quite frankly. And if they don't have them,
22 then they sure as heck should come up with

1 them very quick and should be required to make
2 that as part of an annual public report.

3 And then I think you've got to
4 start holding people accountable. Because as
5 you look through the part ones and you see
6 numerous citations of shortcomings and if you
7 read the ones in the last year or so, it seems
8 like the number of shortcomings is growing.
9 And that may not just be the firm's. I
10 suspect it's partially because the PCAOB is
11 getting much better with the examination staff
12 and finding things now that they wouldn't have
13 noted before. And I commend the whole Board
14 and the examination staff for that and getting
15 much better.

16 But I think when you see some of
17 those shortcomings we never see any
18 accountability being established in terms of
19 fines or penalties. I won't say never because
20 obviously there has been some enforcement
21 actions.

22 But you just don't see the

1 correlation between the fact that people miss
2 some very basic blocking and tackling on the
3 audits. And then how did you hold them
4 accountable? It's almost like you put out a
5 report. You don't name anyone. You don't
6 tell anyone enough information to figure out
7 who it is, where they had a lousy audit.

8 And then no one is held
9 accountable from a public perspective. And I
10 think that is a system that is ripe for
11 improvement. Obviously, part of that goes
12 back to legislation. And as Steve knows,
13 former Commissioner Goldsmith and myself were
14 very vehement that these things should have
15 stayed public which is where the Board is now.
16 But that's water over the dam, and I encourage
17 the Board to keep pressing to have the
18 enforcement cases made public on the same
19 basis as the 102(e)s.

20 But I think all of those things,
21 the part two being in a 4010, disclosure of
22 the companies, disclosure of audit quality

1 drivers and some accountability would all be
2 useful to improving the system.

3 MR. HARRIS: Damon.

4 MR. SILVERS: I said some time ago
5 that I thought there was an issue of
6 deteriorating maybe financial statement
7 relevance. And I think mindful, Steve, of
8 your question where Judge Sporkin talked about
9 complexity it occurred to me as the
10 conversation progressed that really what I was
11 talking about was rather more complex than
12 what I had said. And I wanted to explain a
13 little bit more. And I think much of what is
14 said here is relevant to this.

15 I think the survey data we have
16 here is consistent with I think much of what
17 the PCAOB has heard from a number of parties
18 in various public events over the last few
19 weeks which is that the work of the PCAOB and
20 the effect of Sarbanes-Oxley has been to
21 improve all of the things being equal to
22 improve the effectiveness of public company

1 audits and thus to in certain respects improve
2 the reliability of the financial statements.

3 But all of the things are not
4 equal, meaning other events have occurred at
5 the same time over the same period of time,
6 that have had the opposite effect. And I
7 think there are two big events here. One is
8 that I think some of us I think warned the
9 Board and FASB and the Commission were likely
10 to be the consequences of the move to fair
11 value and the effort to do something that
12 really can't be done which is to address what
13 Judge Sporkin said which was investors want to
14 know the future. And that is actually beyond
15 anyone's ability to do in any meaningful way.
16 And it can't be squeezed out of the audits.
17 It can't be squeezed out of the financial
18 statements.

19 The second problem is the
20 consequence of globalization and the fact that
21 more and more of the operations of our public
22 companies and in some cases the entirety of

1 their operations is located in countries that
2 are simply not prepared at this time to
3 enforce minimum standards of audit
4 independence and audit quality.

5 The Board has been very good on
6 this in relationship to China. China is not
7 the only country where these issues present
8 themselves. And I'm not saying that the Board
9 isn't good in those other places, but that's
10 a profound challenge of the relevance of the
11 financial statement and the quality of audits.

12 I want to say a further word about
13 the fair value issue. What a number of us
14 warned about fair value was that it was likely
15 to lead because the number of assets and
16 liabilities that actually are traded in
17 undisputably liquid markets is rather limited.
18 The fair value regime was likely to lead to a
19 lot of expanded judgment on the part of the
20 preparers and auditors, thus leading to
21 further challenges to audit quality and to
22 regulators.

1 I think all this has turned out to
2 have been true in very destructive ways in
3 relation to the financial crisis and has
4 produced a phenomenon where our major
5 financial institutions' book values and
6 trading values are wildly at variance and have
7 been wildly at variance and in some cases
8 still are in ways that are unprecedented and
9 really tell us concretely about the
10 diminishing relevance of audited financial
11 statements.

12 Now this is not something that can
13 be wholly addressed by the PCAOB. It really
14 has much more to do with FASB fundamentally.
15 But it increases the challenge to the PCAOB in
16 precisely the way that a number of my fellow
17 panelists has spoken to today which is that in
18 order for audited financial statements and the
19 audit itself to be relevant to investors in
20 this environment there's an increasing
21 investor demand for auditors to make more and
22 more qualitative judgments about the nature of

1 the preparer's financial statements and the
2 narratives associated with those financial
3 statements because increasingly it's simply
4 not enough against the background I just
5 described. It is not enough to be able to say
6 "Well, the basic numbers on the page haven't
7 been -- aren't fraudulent. They're not. We
8 don't have a WorldCom problem here." That
9 simply doesn't -- Saying that is not enough to
10 make the financial statements relevant in the
11 increasingly complex world we operate in.

12 And our experience, the labor
13 movement's experience, in talking to audit
14 committees of major financial firms in the
15 2008 and 2009 period bore this out quite
16 dramatically that in many instances it
17 appeared that whether or not this was true I
18 could never satisfy myself. But those audit
19 committees essentially were prepared to
20 represent to us that they simply didn't
21 understand the companies that they were
22 monitoring and that they were sort of unable

1 to properly oversee the discretion that
2 appeared to have been undertaken by management
3 in those circumstances.

4 That type of problem requires a
5 whole sort of additional level of oversight by
6 the Board, both oversight in terms of looking
7 at what investors were asking for in the
8 survey which is more auditor judgment about
9 the quality of narratives but also more
10 oversight in terms of measures like auditor
11 rotation that are designed to try to further
12 up the game and the autonomy of the outside
13 auditor.

14 MR. FERGUSON: Following up on
15 something that Damon mentioned about
16 globalization because when we've talked about
17 audit quality here. We've tended to think
18 about it in the domestic context. And in some
19 ways that's not really even relevant to big
20 audits today because great global companies,
21 in fact, their audits are conducted all over
22 the world by groups of firms, not by a single

1 firm which are not the same juridical
2 entities. They're separate entities subject
3 to separate regulatory regimes and separate
4 legal incorporations and things like that.

5 So one of the things we've
6 undertaken to do and this is with the
7 cooperation of the CEO of one of the largest
8 global firms is for the first time we are
9 going to do a global inspection. We can only
10 do it in certain jurisdictions because we
11 don't have agreements with certain
12 jurisdictions like China. But what we want to
13 do is simultaneously take a large multi-
14 national firm and inspect that audit in a
15 whole group of different jurisdictions which
16 will require a cooperative effort with other
17 jurisdictions.

18 But I think that will be the first
19 time we will actually have been able to look
20 at the kind of audit quality on at least an
21 extra U.S. basis. I wouldn't say totally
22 global because there will be certain

1 jurisdictions we can't get in and there will
2 be difficulties in coordinating. But at least
3 we'll do it in a number of jurisdictions which
4 I think will give us a much better view of
5 what's really going on around the world.

6 MS. ROPER: I wanted to just offer
7 one other thought on this issue of investors
8 wanting information about the future and the
9 role of auditors in that concept. I mean we
10 all want a lot of things we can't have.

11 But one of the things that
12 auditors are supposed to provide is some
13 assurance that we're not going to get a really
14 nasty surprise in the future that the
15 financial information we've been receiving
16 about this company in the past is a fiction.

17 So I do think that the role of the
18 auditor while it may be not directly relevant
19 to auditing statements about the future is
20 absolutely fundamental to this notion of how
21 investors think about the information they
22 have relevant to the future.

1 MR. HARRIS: That leads us right
2 into the break and I think that that's a topic
3 that probably Anne and Lynn are going to
4 address very shortly.

5 Bob, I wanted to thank you very
6 much for really this outstanding survey, the
7 time and effort that you and your entire group
8 put into it. It's really deeply appreciated
9 and thank you very much.

10 We'll take a 15 minute break and
11 then start up again at 11:30 a.m.

12 (Whereupon, the above-entitled
13 matter went off the record at 11:15 a.m. and
14 resumed at 11:29 a.m.)

15 MR. HARRIS: Jennifer, can you see
16 if you can find Lynn and some of the others
17 and we can get this started?

18 (Pause.)

19 Commissioner Walter has a hard,
20 fast noon deadline. She's going to be leaving
21 at noon, so wherever Lynn Turner is.

22 Anne, I know you're starting us

1 off.

2 Lynn, if you would take your seat
3 because I know you're an active participant
4 and co-lead on this one.

5 Anne, why don't you kick it off
6 and thank you very much.

7 MS. SIMPSON: I am very glad to be
8 here.

9 MR. HARRIS: Anne, hold on. We
10 are about to give you a microphone.

11 MS. SIMPSON: The working group as
12 I said at the beginning, I think is a good
13 mix. You've got me, not an accountant, but
14 representing an investor. What should we be
15 expecting from an auditor when we're reading
16 the financial statements? We've got Damon who
17 has absolutely got his finger on the pulse in
18 more than one department. Pete Nachtwey,
19 representing a CFO, so an issuer's
20 perspective, and of course, Lynn, a real live
21 accountant. So I think we have a really good
22 mix.

1 Before we go into the presentation
2 on Going Concern which is the issue that we're
3 really dug into, Steve had asked to also just
4 give a few remarks about what's happening
5 internationally. Now we don't have time to
6 really do a world tour, but Damon mentioned
7 earlier that the impact of globalization on
8 this agenda is profound. Maybe it's actually
9 a subject for a working group for a future
10 meeting. Certainly, we'd give it more time.

11 But we thought it would be
12 relevant to just give you the highlights of
13 what's being proposed by the European
14 Commission. Now this is highly relevant for
15 CalPERS because we're invested in 47 markets
16 and we have more money outside the United
17 States than inside the United States. We have
18 40 percent of our portfolio. So that means we
19 need to be thinking globally about this as
20 with everything else that concerns us from an
21 investor point of view.

22 So in the interest of time, here

1 are the headlines. The European Commission,
2 I think, has been grappling with the question
3 of audit quality with as much rigor and vigor
4 as the PCAOB and others, but I think it's
5 useful to look at what they consider needs to
6 be done. And these are the proposals.

7 The first is they're proposing
8 mandatory rotation of auditors. They're
9 saying this should happen at the six-year
10 point and there should be a grace period, if
11 it's a joint auditor arrangement, for three
12 years. So in other words, there is a little
13 flexibility, but that's proposal one out of
14 the box.

15 And then there should be four
16 years before you can come back in again. So
17 that's important.

18 The second thing is they are going
19 to prohibit audit tenders which confine the
20 option to bid to the Big Four. In other
21 words, they're trying to find a way to open up
22 choice and I think give more opportunity for

1 non-Big Four audit firms to get experience,
2 either through joint audits, but certainly
3 getting an opportunity to pitch.

4 The third element is a complete
5 ban on non-audit consultancy. So we can talk
6 a little bit more about what is consulting
7 work that's related properly and appropriately
8 to the audit. That's just an out and out ban
9 which I think is also interesting.

10 And they have a number of other
11 provisions to improve disclosure around the
12 internal workings of audit firms and audit
13 firm governance which I don't think we have
14 time to go into, but I think it's interesting
15 that that's another area that they'll be
16 addressing.

17 Now given the global nature of the
18 audit networks, the Big Four which are
19 responsible for auditing most of our portfolio
20 will, of course, be influenced by what's
21 happening in Europe and will be needing to
22 respond. So I think I would only echo the

1 point that was made earlier that we welcome
2 the PCAOB's attention to cross border
3 regulation. This is a very good example where
4 I think there's a lot to be learned and
5 certainly a lot to be coordinated and a lot
6 that's of real interest.

7 I'll finish with a final point
8 because I think this is relevant to the PCAOB.
9 The European Commission has its own version of
10 a cost-benefit analysis. It's called better
11 regulation or principles of better regulation.
12 And if you look at the Frequently Asked
13 Questions on the website, they have some
14 numbers about why they think these provisions
15 are actually going to be a net positive.

16 Their first point is that the
17 balance sheet for Europe after the financial
18 crisis is a -4.6 trillion euros. That's the
19 cost, almost 40 percent of European GDP. So
20 that's their first thought is actually that
21 having an adequate financial reporting and
22 auditing that didn't signal the alarm when

1 necessary to the taxpayer is a 4.6 trillion
2 euro cost.

3 But they've also done some
4 calculations which I think are interesting
5 about what they consider these reforms will do
6 to improve the cost of capital. They consider
7 this will give a net positive of 2 billion
8 euros a year which they consider will roll up.
9 It will be a recurring improvement in cost of
10 capital.

11 For individual companies with \$100
12 million balance sheet, which is the trigger
13 for these different provisions, they've also
14 come up with a number for the costs of
15 compliance. But I think given this issue of
16 cost benefit and how important that is the
17 work of the SEC, as well as the PCAOB, it
18 would be worth taking a little bit more of a
19 look how Europe is calculating this balance.

20 But certainly for CalPERS, given
21 how widely exposed we are in these markets, we
22 are certainly affected by systemic losses. I

1 think our fund was down \$70 billion through
2 the impact of the crisis, but we do all need
3 to be thinking about systemic benefits as well
4 as individual costs to particular companies.

5 So let me turn to our
6 presentation. The way that we're going to
7 work is I'm going to hand it over to Lynn to
8 talk about the history on Going Concern in the
9 spirit of understanding where you need to go,
10 you might first of all think about where you
11 are and where you've been.

12 We also conducted a survey and we
13 went with questions on Going Concern to a
14 network of investors, not just the Investor
15 Advisory Group, but groups like the
16 International Corporate Governance Network,
17 Council of Institutional Investors, and we
18 hope we've got some useful results. And I'll
19 explain what those are.

20 And then the final section is
21 recommendations. And Damon is going to
22 present those. And as I mentioned earlier,

1 we've got some quite specific things we think
2 can be done to improve the definition of Going
3 Concern that will be helpful. The timing,
4 triggers for Going Concern and also some
5 thoughts about the issue of enforcement.

6 I think earlier people talked
7 about this being the ten-year anniversary of
8 Sarbanes-Oxley, and in the interest of time I
9 think we'll just leave this graph here for a
10 moment before I hand over to Lynn. This tells
11 us how important it is that regulation is
12 directed towards ensuring the safety and
13 soundness of markets. Certainly for us as an
14 investor, doesn't stop picking that's going to
15 pay pensions. It's going to be the safety and
16 soundness of markets. And this volatility
17 from '96 up to 2012 and of course, the
18 introduction of Sarbanes-Oxley and Dodd-Frank
19 still coming through, shows us how critical
20 the role of regulation is.

21 We know it's not a substitute for
22 being active owners. It's certainly not a

1 substitute for the role that boards of
2 directors play. Those points have been made.
3 But let's try to understand that this is a
4 three-way responsibility between boards and
5 owners and regulators, and we have a mutual
6 interest in the system working smoothly.

7 So there's much to be done, and
8 let me hand over to Lynn to talk a little more
9 about the detail.

10 MR. TURNER: I think this was
11 actually also Anne's slide, but I'll take it.
12 Obviously, under SOX, we've got the PCAOB, in
13 fact, over half the actual pages in the
14 legislation go to create the PCAOB and give it
15 authority and accountability, to set up the
16 evaluation of internal controls, CEO/CFO
17 certifications, with the notion that we'd come
18 out of that with some improved financial
19 reporting.

20 On to the Going Concern issue and
21 we'll cover the history a little bit here
22 because I think it's good to understand where

1 we've been and learn from some of the lessons
2 of the past. If you go back to the '72-'73
3 bear market, and those who lived through there
4 at that point in time, we came out with large
5 bankruptcies, companies collapsing just as we
6 did a decade ago, and the corporate scandals,
7 and again as we went through the subprime
8 crisis. We had national student market, likes
9 of Penn Central, which is still one of the
10 largest bankruptcies in the history of the
11 country. Equity Funding, large financial
12 institution that went down at the time and out
13 of that they established a Cohen Commission
14 which was chaired by the former Kennedy
15 appointee as chairman of the SEC, Manny Cohen.

16 And when that Cohen Commission
17 came out with their report in '78, they urged
18 the accounting profession then to reexamine
19 the issue of Going Concern. And in fact,
20 their recommendation was to get rid of the
21 Going Concern report, just eliminate it. That
22 it was better for management to take on the

1 issue and discuss it and provide the
2 disclosures than the auditors.

3 And in fact, at that point in
4 time, people talked about a new standard. And
5 in fact, the SEC chief accountant at the time,
6 Clarence Sampson, came out in support of
7 eliminating the Going Concern, but lo and
8 behold, the charter financial analysts came
9 out like a hive of mad bees and went ballistic
10 on it and said no, this is very, very
11 important information to us. Clarence changed
12 his position and it was decided that there
13 would be a new standard.

14 And so in 1989, finally, we get
15 around to issuing a new standard, that
16 actually ups the hurdle, if you will, in terms
17 of the threshold or benchmark at what point in
18 time you'd issue the standard and we came up
19 with this notion of substantial doubt about
20 Going Concern. That substantial doubt
21 language hadn't been there before. It had
22 been more of you got a reasonable basis for

1 doubt that the thing isn't going to make it.

2 So at the same time, one of the
3 other recommendations about the Cohen
4 Commission was we need some better
5 disclosures, better warning flags here, red
6 flags. And so starting back in the mid-'80s,
7 the AICPA put together a group to start work
8 on that. MD&A had been upgraded by the
9 Commission in May of '89. The AICPA put out
10 a proposal in the early '90s that said let's
11 require companies to disclose information
12 about their financial stability. Let's have
13 the companies actually tell us whether they're
14 financially stable or not and if not, here's
15 the type of disclosures one would like.

16 Interestingly, those were the same
17 things people were asking for yet today. But
18 under an extreme heavy lobby from the business
19 interest, the AICPA took their original
20 proposal which had all these disclosures in it
21 and gutted it and came back with a much
22 watered-down final standard and ultimately it

1 had an impact in the financial crisis, because
2 we didn't get any of the disclosures. We'll
3 talk about that.

4 And so there was still concern
5 about the audits. Arthur Levitt did the
6 Numbers Game speech in September of '98,
7 formed the O'Malley Panel, chaired by former
8 CEO of PricewaterhouseCoopers, Sean O'Malley,
9 and in August they came out and they said hey,
10 we've looked at -- in fact, they had inspected
11 almost 100 audits and out of those audits that
12 they got in and inspected, they found there
13 was an issue with Going Concern. So they put
14 out a recommendation in 2000 to the FASB to go
15 do a new standard, define what Going Concern
16 is and make these companies put forward some
17 meaningful disclosures around it.

18 But let's put an onus where the
19 onus belongs, on management. They should be
20 the first ones coming forward. And the SEC,
21 at the time, urged the FASB to act on it.
22 Unfortunately, that didn't happen until a few

1 years ago. Finally, the FASB in 2008 comes
2 out with an exposure draft that probably moves
3 them in the direction of the international
4 standard where there is in the accounting
5 literature a somewhat ambiguous definition.
6 It's not really even a definition. It's some
7 ambiguous language we'll look at with respect
8 to Going Concern, but at least they moved in
9 that direction. But they couldn't get
10 agreement at the Board. Unfortunately, the
11 Board punted.

12 The Board said we don't think
13 management will ever tell you or make these
14 disclosures, notwithstanding the fact quite
15 frankly they're already required by SEC
16 financial reporting releases and MD&A. But
17 they said we can't trust management. We'll
18 never get it. So let's leave the onus on the
19 PCAOB and let them deal with it. We'll try to
20 do some disclosures. But their disclosures
21 are looking already to be weak, weak, weak.

22 That leads us up to where we are

1 and what did that get us? If you look at the
2 top ten bankruptcies, you'll see that for the
3 most part we never did get Going Concern
4 opinions. We picked up one on Consec, the
5 insurance company that had great trouble and
6 went down under. Pacific Gas & Electric, it
7 wasn't just the auditors. PG&E, the credit
8 rating agency never downgraded them until the
9 week they actually filed for bankruptcy, so it
10 wasn't just auditors as a gatekeeper that
11 missed it.

12 But clearly, for the most part, we
13 just aren't seeing Going Concern reports,
14 especially on the TARP companies. Again,
15 General Motors, and if you read the Going
16 Concern report on General Motors, it is so
17 vague, so simple, it conveys no information.
18 It basically says, based on these cash flows
19 and their operations, we don't think they're
20 any longer a Going Concern entity. It doesn't
21 tell you why. It doesn't give you any basis.
22 Quite frankly, it doesn't give you any useful

1 information other --

2 MS. SIMPSON: Sorry to interrupt.

3 MR. TURNER: Go ahead.

4 MS. SIMPSON: Time is short. We
5 need to speed along.

6 MR. TURNER: So anyway, on the
7 Going Concern reports, here's -- we've got a
8 lot of Going Concern reports issued over the
9 last ten years, but they're almost all small
10 over-the-counter companies. When you get to
11 the big companies that really mean something
12 to investors, you just again, you just never
13 get them. So we talked about the
14 international standard. It's pretty whooshie.
15 We've got some disclosures. The problem with
16 94-6, which is the disclosure requirement
17 here. You never had to disclose until there
18 was severe impact. You look at AIG, we just
19 never see those disclosures show up until all
20 of a sudden the government is having to bail
21 them out.

22 Everyone is working on it. What

1 we're seeing from the auditors quite frankly
2 is make the audit committee go first and then
3 we'll report on the audit committee. We don't
4 want to go first, but as you'll see in the
5 survey that Anne's going to take up next, you
6 will see that investors think it needs to be
7 the auditor out there.

8 And so the other thing is we've
9 seen no enforcement. While we didn't see any
10 of those, we haven't seen any enforcement
11 actions coming out of it either, so it raises
12 the question of if you've got a standard, was
13 it enforced or not? You really can't tell and
14 enforcement seems to be lacking here, too.

15 So with that, Anne will pick up
16 the survey.

17 MS. SIMPSON: In the interest of
18 being able to present the recommendations for
19 Commissioner Walter, we're actually going to
20 skip me talking through the pie charts and the
21 graphs. We can talk about that afterwards.

22 And Damon is going to go straight

1 to the recommendations, Commissioner, because
2 I know you have a hard stop.

3 COMMISSIONER WALTER: Thank you
4 and I appreciate that.

5 MR. FERGUSON: I appreciate that,
6 too. I think we ought to get right to the
7 recommendations and your concerns with respect
8 to the SEC, FASB, and the PCAOB and what you
9 think we ought to be doing in the next six
10 months to a year.

11 MR. SILVERS: So let me first
12 begin
13 -- before I come to the recommendations slide,
14 you should turn to the summary recommendations
15 slide. There are lengthy slides going through
16 these in detail, but I'm going to work off the
17 summary.

18 Before I do that, I just want to -
19 - we sort of neglected in this presentation to
20 begin with just a basic point about the
21 importance of the Going Concern issue. The
22 entire nature of the financial statements, as

1 prepared by the issuer, presumes that the firm
2 is a Going Concern. And therefore, if it is
3 not, and the question of what constitutes not
4 is going to be the subject of what I'm about
5 to say, but if it is not, then the financial
6 statements as a whole are simply not a fair
7 representation of the financial condition of
8 the firm.

9 And so for that reason, even
10 though there is actually a relative sort of --
11 there's relatively thin literature in this
12 area as Lynn -- and the reasons for that Lynn
13 went through in some detail. It's always been
14 understood as a central feature of the audit
15 to there being a background determination that
16 the firm is a Going Concern.

17 Now the key -- there were three
18 basic recommendations that our subgroup came
19 up with. The first relates to the question of
20 what is the standard for determining when a
21 financial statement and the auditor must
22 disclose a Going Concern concern. To

1 understand that, it's actually worth looking
2 for a moment at one of the pie charts. We
3 surveyed investors on the question and this is
4 pie chart that's on page nine. It says "When
5 should a company be identified as a Going
6 Concern?" And we surveyed investors on this
7 question. And we gave them three possible
8 analytic frames for this.

9 The first is the currently
10 existing framework which is substantial doubt.
11 Now as an attorney, I find it somewhat
12 surprising that substantial doubt in this
13 setting means 80 percent or more certainty
14 that there will, in fact, be a failure of the
15 firm.

16 The second option we gave people
17 was more likely than not, 51 percent. And
18 then the third is reasonably possible which is
19 less than 51 percent, but more than trivial
20 possibility. And as you see, there is a
21 strong view on the part of those surveyed that
22 the appropriate standard is a more likely than

1 not standard which we see 50 percent support.
2 And that is the recommendation of the panel of
3 our subgroup that the standard be moved from
4 the current 80 percent plus to more likely
5 than not.

6 Now I should note that this does
7 raise a series of issues about how to
8 determine exactly what do these percentages
9 mean. What are we assessing? And it goes to
10 the fact that the thinness of the guidance
11 here is a real problem because what typically
12 tends to be the case when a Going Concern
13 issue is present is that there is a set of
14 circumstances under which a firm will fail.
15 And then there are other possibilities in this
16 world. And it can be hard to assign the
17 probability of each of those other
18 possibilities happening or not happening.

19 And this goes to the second issue,
20 the second point of our recommendations which
21 is a recommendation about timing. Currently,
22 that guidance which exists views -- I'm just

1 paging back to my summary sheet, that guidance
2 which exists views the relevant time frame for
3 Going Concern assessment as being the 12
4 months following the date of the financial
5 statement. And the problem with this is that
6 it creates a cliff and it presents a
7 problematic situation where companies and
8 auditors are aware that, for example, on the
9 day after the 365th day, an event is going to
10 occur which raises a serious issue of the firm
11 continuing as a Going Concern, a specific
12 event on a specific date.

13 Now, of course, firms are always
14 faced with the possibility that something may
15 happen at any time that could create -- that
16 could destabilize the firm, but this really
17 refers to issues such as debts coming due
18 where there is a serious issue about being
19 able to refinance those debts and those debts
20 come due on a specific date and that date
21 happens to be in the 13th month.

22 And so it is the view of our

1 committee that the Going Concern inquiry needs
2 to extend to that type of circumstance. But
3 again, it needs to be quite precisely defined,
4 that we're not talking about general anxieties
5 of the kind that plague all firms at all
6 times. But rather very specific known events,
7 foreseeable events.

8 COMMISSIONER WALTER: Damon,
9 question.

10 MR. SILVERS: Sure.

11 COMMISSIONER WALTER: No outside
12 time frame? I mean the complaint, I assume,
13 that we collectively would get is you're
14 asking me to look out forever. And I know
15 you're talking about foreseeability. Did you
16 think about substituting two years, three
17 years, five years for 12 months?

18 MR. SILVERS: I think in reality
19 what we're recommending has that feature. The
20 reason why is because I think it's not just
21 that an event may be forthcoming that in some
22 circumstance could create an impression of

1 Going Concern. For example, a AAA-rated firm
2 that has a large rollover of debt, but which
3 has every reason to believe they can do it,
4 right, that they'll be able to roll over the
5 debt, the fact that that if they couldn't, the
6 firm would fail and that date for the rollover
7 is 13 months from now, that's not a Going
8 Concern issue.

9 So the notion that a firm that is
10 actually functioning today would be pretty
11 certain that they were going to have a problem
12 refinancing five years from now seems highly
13 unlikely to me. That does not seem the
14 circumstance where an audit firm would be
15 certain enough about the risk to bring this
16 into play. It's really the combination of the
17 foreseeability of the event and the
18 understanding of a high level of risk
19 associated with that event that comes
20 together.

21 The approach we're suggesting
22 gives a certain amount of leeway, right, to --

1 it doesn't create a cliff. It creates a
2 certain amount of leeway to understand how
3 those two factors interact with each other.
4 I don't think it's alien to what we're
5 suggesting that you put a hard stop at some
6 point out there. It's not the way we
7 approached it, but I hope you sensed that
8 there was actually a merging of these two
9 ideas.

10 COMMISSIONER WALTER: I do.

11 MR. TURNER: In response to your
12 question, there was also some additional
13 information that was given to us yesterday by
14 CFA Institute. They did their own independent
15 survey and on your point only 19 percent
16 favored limiting it to 12 months. Thirty-two
17 percent said the foreseeable future which they
18 defined as one to three years. And then 44
19 percent said limited to the next 12 months
20 from the date of the financials, but also
21 consider foreseeable events occurring shortly
22 after the next 12 months such as the need for

1 debt financing, loss of major contract,
2 etcetera, which is I think where the
3 international standard is. So they had 44
4 percent there; 32 percent foreseeable, in 1 to
5 3 years. Only 19 percent was a solid hard
6 stop at 12 months.

7 COMMISSIONER WALTER: Since I
8 unfortunately, because I'd much rather stay
9 here have to go, can I ask one other question
10 before I run out the door and reserve the
11 right to call you guys or call Steve to get
12 the rest because this is fascinating.

13 You have recommendations that go
14 to the FASB, the PCAOB, and the SEC. Do they
15 all need to move together? The SEC part seems
16 to me to be somewhat separable although to me
17 the FASB and the PCAOB part seemed to go
18 together. And that may be wrong, that's just
19 an initial impression.

20 MS. SIMPSON: That is absolutely
21 right. Our thinking about this is that you
22 want something on the definition and

1 obviously, that's FASB. You want something
2 about the time period which Damon has spoken
3 about.

4 And the issue is how do we, the
5 investors, get better information about what's
6 going on and that's the disclosure piece. And
7 what we want to do is think about Going
8 Concern being embedded in risk management
9 reporting because we think that's the place.

10 But Lynn or Damon, do you want to
11 add to that?

12 MR. TURNER: Elisse, I think they
13 can be done separately. I don't think they
14 have to be done as a group, but the package
15 does need to be done. So the notion, much to
16 what Anne was talking about, is create a
17 system where you have early warning
18 disclosures, so you have the FASB on financial
19 stability and risk and mitigation of the risk
20 coming from the SEC, including give us the
21 KPIs, require companies to give us KPIs,
22 because those are typically some of the best

1 red flag warnings you can ever see. So give
2 us that. Give us mitigation of risk, okay.
3 And that comes from the SEC. Then the FASB
4 can give us the disclosures on financial
5 stability before you ever get to a Going
6 Concern.

7 And then once you get to that 51-
8 49 cut though, then the auditor requirement
9 kicks in and the auditor needs to give us
10 Going Concern and that's the PCAOB piece of
11 it.

12 So it shouldn't be that we have
13 all these all of a sudden boom, drop off the
14 cliff and have Going Concern. It's we should
15 have disclosures leading and building up to
16 the point that you actually then end up in a
17 Going Concern.

18 COMMISSIONER WALTER: Is that less
19 true, Lynn, if you're lowering the threshold
20 from 80 to 51 percent?

21 MR. TURNER: No, I think,
22 certainly from my experience in running

1 companies and all, and working with companies,
2 you're still going to have that ramp up in
3 disclosures, even if you bring the threshold
4 down to 51 percent.

5 GM -- in fact, one of the
6 respondents to the CFA Institute, made the
7 point that GM and auto makers were insolvent
8 for a long time, for years. So you should
9 have this ramp up in disclosure as the company
10 gets in trouble financially. Typically, they
11 don't go just out overnight. Even companies
12 like Lehman and Bear Stearns, where even I may
13 not have given them a Going Concern, you
14 probably would have had better disclosures
15 about how leveraged they were and how they
16 were going to mitigate that level of leverage
17 if, in fact, the market turned on them.

18 COMMISSIONER WALTER: Yes.

19 MR. HARRIS: Since the
20 Commissioner has to go in two minutes,
21 actually, she's going to give us two minutes
22 more time, I think, if you could quickly go

1 through the recommendations. We're begging
2 five minutes of additional time -- and I know
3 you've got to get out of here.

4 COMMISSIONER WALTER: I really
5 can't because the people I'm meeting with at
6 12:30 have to meet with someone else at 1:00.

7 MR. HARRIS: Then we've got Mike
8 and Brian which is terrific.

9 COMMISSIONER WALTER: I will be
10 available to discuss later if you would like,
11 any group or subset or one of you. Thank you
12 very much. All of this has been marvelous.
13 And the next time I come I promise to stay for
14 the whole thing.

15 MR. SILVERS: As the Commissioner
16 stands up, I can finish the recommendations in
17 two sentences, which are, one, that auditors
18 need to take into account public information
19 that is not necessarily submitted by the
20 issuer. This seems to us to be incredibly
21 relevant to what happened in 2008 and 2009.

22 And the last piece is the

1 centrality of enforcement. And this is both
2 a PCAOB and a Commission matter. And that
3 seems to have been really lacking, frankly, at
4 least during the financial crisis, although
5 there may be things that we as a panel don't
6 know about.

7 And so that -- I know you have to
8 go. That's my two sentences.

9 COMMISSIONER WALTER: Let's talk
10 soon.

11 MR. SILVERS: Now with a little
12 more elaboration and a little less time
13 pressure.

14 I want to turn really to fleshing
15 out what I just said with a little more detail
16 because I think in the view of our group, this
17 is really -- these things were tested in the
18 real world very recently on a very large scale
19 and with very great consequences. And the
20 results, I think, were deeply troubling.

21 And I want to spell out a little
22 bit about that around the question of

1 enforcement, but also to give a little more
2 insight into the recommendations I just went
3 through in terms of the way in which both the
4 accounting rules and the auditing standards
5 ought to apply here.

6 If you go and look at the
7 companies that are on our list of TARP
8 recipients, you'll see that only one issued,
9 and has been noted, General Motors, only one
10 ever issued a Going Concern statement, a
11 statement of doubt as to the continuance as a
12 Going Concern.

13 There is a key element of that
14 chart that's sort of missing, which is that --
15 which we weren't able to put in at the last
16 minute -- which is that in addition to the
17 funds that those firms received, two of them,
18 Bank of America and Citigroup received large
19 guarantees from the Federal Government.
20 Guarantees of hundreds of millions of dollars
21 -- hundreds of billions of dollars of assets.

22 Now, these firms issued financial

1 statements, audited financial statements,
2 during the period when these matters were very
3 much in flux, meaning for year-end 2008. And
4 those statements were -- that was the
5 statement date and they were released to the
6 public, I believe, in March of 2009.

7 During that time there was an
8 active public debate as to whether or not, in
9 the aftermath of the initial TARP rescue of
10 those firms, the Federal Government would
11 require as a condition of continued support
12 the restructuring of the capital structure of
13 those firms. It was clear that those firms
14 had very limited access to the public capital
15 markets during that period. And it was clear
16 that without -- it was clear from a reading of
17 the press at the time that without government
18 support those firms, while they might not be
19 liquidated, those firms would likely be forced
20 into bankruptcy, into a Chapter 11-type
21 process.

22 And there was no legal requirement

1 that the Federal Government should continue
2 the support on the terms that it had had to
3 that date. And there was considerable
4 uncertainty. Again, it's very hard to know
5 exactly where it lies in the percentage range.
6 There was considerable uncertainty as to
7 whether more funds would be needed.

8 And there was also a lot that was
9 not visible to the public and to people such
10 as myself who was in -- I was in an oversight
11 capacity at that time. There was much that
12 was not visible about the amount of assistance
13 those firms were receiving in terms of
14 liquidity from the Federal Reserve.

15 And it was absolutely true that
16 Federal Reserve support was completely
17 discretionary and could be withdrawn at any
18 time.

19 Now in that respect, in March of
20 2009, the situation of the major banks that
21 were receiving TARP funds was not all that
22 dissimilar from the situation of General

1 Motors. General Motors issued their Going
2 Concern statement at a time when they had TARP
3 money, but where the question of how and on
4 what terms that TARP money was going to be
5 provided in the future was extremely unclear.

6 It has troubled, I think, the
7 members of the panel profoundly that only one
8 of these companies expressed a Going Concern
9 opinion. And that gives rise, I think -- it
10 supports two of our conclusions. One is the
11 need for enforcement in this area. The second
12 is the fact that it may be that the 80 percent
13 rule created a circumstance in which the
14 entire world knew that there -- the entire
15 world knew that there was a serious doubt as
16 to whether the capital structure of Citigroup
17 and Bank of America was going to survive the
18 months to come. It was being expressed
19 everywhere in the financial press, in academic
20 debate, in public policy debate.

21 There were numerous meetings that
22 we now know about at the White House and the

1 Treasury Department about this very question.
2 The country's leading economists were being
3 summoned to the White House to discuss whether
4 or not to allow this to happen. And the only
5 place in which you would not find a discussion
6 of this matter was in the company's financial
7 statements.

8 And that, really, I think -- it's
9 important to understand that to understand the
10 backdrop to our panel's recommendations, both
11 in respect to changing the substantive
12 standard, but also the absolute centrality of
13 enforcement of this matter. And with that, I
14 think I'm going to stop.

15 MS. SIMPSON: Comments and
16 questions?

17 MR. HANSON: Before we jump into
18 the questions, I just want to make one
19 comment. Damon's referred several times to an
20 80 percent rule. And just to clarify, the
21 original SAS 59 that our current interim
22 standards are based on, there's no specific

1 rule in there and in practice there's a lot of
2 variability. We heard it at the SAG meeting
3 in May that there's uncertainty about what the
4 percentage actually means and so it's not a
5 rule --

6 MR. SILVERS: Yes, I didn't mean
7 to suggest that there was some place where the
8 number 80 percent is printed in a standard.
9 What I meant to suggest was that it was the
10 group's view that within the level of
11 uncertainty you were just describing, right,
12 that the sort of median point of that
13 uncertainty appears to be an 80 percent view.

14 MR. TURNER: And I would add, Jay,
15 that in light of what we actually saw and what
16 history has told us, the actual opinions that
17 did get issued on the big companies where the
18 fees are big, that 80 percent may actually not
19 even be high enough in light of what actual
20 practice was and in terms of the actual number
21 of Going Concerns we got. It seems to vary
22 dramatically based upon the size of the audit

1 fee.

2 MR. HARRIS: Why don't we go to
3 Tony, Mike, and Brandon.

4 MR. SONDHI: Thank you. Listening
5 to some of the recommendations and some of the
6 comments that you made, Lynn, I was thinking
7 that maybe one of our failures has been the
8 attempts that were made, but unsuccessfully,
9 to come up with something on financial
10 flexibility because those disclosures would
11 have given some of the information that you
12 were talking about.

13 But even more critical, I was
14 looking at some of the Dodd-Frank, there's a
15 liquidity requirement in there that I've heard
16 people are already gearing up to fight and
17 there's a lot of discussion, but that
18 liquidity argument and the disclosures that
19 would go with it, those measures themselves
20 would give us a fair amount of early warning.

21 And then you can take into account
22 the fact that despite all the work that we may

1 have done, good or bad, nobody has ever
2 attempted to solve or tackle the problem of
3 coming up with a good cash-flow statement for
4 financial institutions. Those are the kinds
5 of things that Equity Funding, Lehman
6 Brothers, these are the -- that flexibility,
7 the financial flexibility, and the cash flow,
8 that's what would tell you about this. But
9 there's nothing on those issues at all.

10 MR. TURNER: Just responding,
11 Tony, the financial flexibility disclosures
12 that were proposed back around '92, '93, '94,
13 I think certainly got to some of the liquidity
14 issues. In fact, part of the proposal was
15 companies would have to disclose if they were
16 going to end up needed government bailout
17 funds and government support. That was
18 specifically black and white in the rule
19 itself. And that came out as well.

20 So it seems like the things that
21 were going -- or were proposed were the things
22 that would have actually given everyone a much

1 greater heads up, much earlier in the crisis.
2 But, obviously, those are embarrassing things
3 for anyone managing a company to have to say
4 because it in essence says, hey, you haven't
5 done a very good job of managing the company.
6 Or it says something has dramatically changed
7 in your industry that maybe is outside of your
8 control.

9 But either way, people just do not
10 want to disclose those. You've seen the fight
11 over Dodd-Frank, how much we actually end up
12 with out of Dodd-Frank is highly questionable
13 at this point in time and whether or not what
14 we do end up with has much value is even a
15 greater question.

16 So I do think if the FASB gave us
17 better disclosures about liquidity, including
18 a revised cash flow statement, that would be
19 much more helpful and move us, but I think it
20 has to go beyond the cash flow statement. I
21 think it has to talk about the liquidity and
22 how that liquidity impacts you, because you

1 look at a Lehman.

2 I mean, Lehman's financial show
3 that company was extremely highly leveraged.
4 What it doesn't talk about -- and it tees up
5 some of that even in the risk factors -- what
6 it doesn't say though is what happens if this
7 thing -- if we aren't able to refinance the
8 debt? So it talks about the short-term nature
9 of the debt. That's laid out. It even talks
10 about in the footnotes how in the first
11 quarter after the year you've got to roll the
12 debt. What it doesn't get into at all is if
13 we aren't able to roll that debt, and if some
14 reason we aren't able roll our overnight repos
15 financing that we're using to finance long-
16 term assets, what are we going to do?

17 And the reality was, as we all
18 know now, they didn't know what they were
19 going to do. And in fact there was no plan in
20 place that would have done it, which brought
21 around the demise of the company. That
22 disclosure was not there. The financial

1 stability disclosure was not there and I find
2 it very troubling that to this day the FASB is
3 still refusing to act on that and punts.

4 MR. SONDHI: The off balance sheet
5 financing is really the other critical -- I
6 mean, the question that I've asked at the ITF
7 is since management is using the money that's
8 provided by investors, under what basis are
9 they allowed to keep something off outside the
10 financial statements? That's something that
11 just doesn't make any sense. And we just
12 don't do anything about that.

13 If you don't know it's there,
14 there's no way to do anything about it.

15 MR. SILVERS: When you look at our
16 time required that we look -- go right to the
17 summary sheet, look at our detailed
18 recommendations. They're not just literally
19 recommendations about a Going Concern, when a
20 Going Concern concern needs to be stated.
21 There are recommendations about these issues.

22 MR. HARRIS: And Damon, first of

1 all, I appreciate the total flexibility in
2 terms of altering the presentations, so you
3 were flying quick in terms of juggling there.
4 I think it is extremely important, if you
5 would, to spend five minutes to get it on the
6 record with respect to what your specific
7 recommendations are. You did it in two
8 seconds, but I think if you could spend five
9 minutes and then we will go to the questions.
10 But your recommendations took a lot of
11 thought. I want to make sure they're out
12 there, they're discussed and that they're on
13 more of a record than just a slide show.

14 MS. SIMPSON: Why don't you go
15 back to the first slide with -- it's page 11.
16 You've got 74. Perfect. Thank you.

17 MR. SILVERS: We'll begin then --
18 per your request, we'll begin in detail now
19 with recommendations for FASB, for financial
20 accounting standards. And I've already gone
21 through the Going Concern definition. This is
22 the substantial versus more likely than not

1 matter.

2 Then we go to the question of
3 management disclosure, which I think in some
4 respects gets to what Tony and Lynn were just
5 describing, which is that if there are events
6 that are reasonably foreseeable that would
7 lead to an entity not being able to meet its
8 obligations, most obviously these sorts of
9 liquidity problems, then there has to be a
10 discussion in the financial statement, if
11 reasonably estimable, of what those events
12 are, the possible effects of those events or
13 conditions, a clear statement that if they
14 were to occur, there would be a real risk of
15 discontinuance of operations; a management
16 evaluation of those conditions and events; any
17 mitigating factors, plans for actually being
18 able to refinance debt, for example; whether
19 those plans can be effectively implemented,
20 the likelihood of doing so; and the
21 recoverability or classification of recorded
22 assets amounts and liabilities that would bear

1 on these circumstances.

2 Now, again, this is a set of
3 disclosures that would be potentially required
4 even where you would not have a determination
5 under, for example, either the substantial
6 likelihood or reasonable likelihood decision.
7 And here it goes in fact to the circumstances
8 I was just describing in the financial
9 industry. I'm not sure that we as a group
10 certainly don't have -- have not expressed an
11 opinion about this, and I'm not certain myself
12 as to what percentage should have been
13 assigned to -- what percentage likelihood
14 should have been assigned to the possibility
15 that major financial institutions would have
16 failed to meet their obligations during the
17 period of 2008-2009.

18 There was certainly a set of
19 issues of the kind that are described in these
20 recommendations that should have been
21 disclosed in a rigorous way to investors.

22 Now, I'm not going to go through

1 what our concerns are with auditing standards.

2 I'm just going to go through what the
3 recommendations are.

4 The first recommendation is our
5 belief that there needs to be a refining of
6 auditing standards. The PCAOB needs to be
7 clear as to what objectives it expects
8 auditors to achieve in relation to questions
9 about the preparer's viability as Going
10 Concern. This requires that there ought to be
11 audit design aimed at obtaining evidence with
12 respect to Going Concern. Auditors should be
13 -- and as I said earlier, in order to catch
14 Commissioner Walters, auditors should be
15 required to consider evidence available to
16 them and the public. There should not be a
17 process of blinders here around this most
18 fundamental issue in the financial statement.

19 And, as the case with audits in
20 general, the auditors should be required to
21 understand the company's plan for dealing with
22 contingencies of the type that I described a

1 moment ago in the FASB section: checking key
2 assumptions, consistency of assumptions and
3 data, challenging key omissions, understanding
4 industry-specified factors, and we've had a
5 fair amount of conversation about that in the
6 financial sector, and look at what, if
7 anything, past trends would tell us about the
8 likelihood and seriousness of the issues in
9 play.

10 Now, from there we move to the
11 question of how auditors' findings in these
12 areas should be communicated. And, again, I
13 think this is an area where it's pretty clear
14 that during the financial crisis there was
15 significant failure. Auditors need to be
16 required to communicate to the audit committee
17 what their conclusions were as a result of the
18 process I described earlier. And to
19 communicate to the audit committee whether or
20 not they have concerns as to whether it is
21 reasonable to expect a company may not
22 continue as a Going Concern and the basis for

1 their conclusion.

2 Now here I want to emphasize that
3 this recommendation is not the recommendation
4 that the auditor communicate to the audit
5 committee when they have found that there is
6 a need for a Going Concern statement in the
7 audit, but rather when they're engaged in an
8 active process of inquiry and thought about
9 whether or not this is necessary, that that's
10 the standard at which to communicate to the
11 audit committee.

12 And this is an extremely important
13 point because it's really not possible for an
14 audit committee to do its function of
15 performing independent oversight of the audit
16 process and of the financials -- the
17 preparation of the financial statements, if
18 the audit committee is unaware that a very
19 serious conversation about Going Concern is
20 occurring in another room with the management.

21 Part of this involves requiring
22 the board and the audit committee to play its

1 role of defining objectives from the auditors
2 and the process that the audit committee must
3 use when there is a Going Concern issue. So
4 having been told that this conversation was
5 going on in another room, the audit committee
6 needs to have clearly stated procedures for
7 how to address its own responsibility in that
8 circumstance.

9 Now finally we come to the SEC,
10 and I think Lynn has already described this,
11 but I will go through it again for the record,
12 which is that this -- that where these types
13 of Going Concern issues are in play, there
14 needs to be a disclosure not just of the
15 risks, but also what the mitigation plans are,
16 both in place and being developed for
17 addressing those risks. And we expressed the
18 fond hope that such a disclosure be in plain
19 English.

20 And in addition to that, a more
21 detailed disclosure of key performance
22 indicators. Some companies provide

1 information in the public domain of this type
2 in their 10-K statements and others do not.
3 This is an overall -- we're making
4 recommendations around an overall disclosure
5 regime that takes a little bit of the edge off
6 of some of the questions of Going Concern
7 issues.

8 So to the -- I would observe that
9 to the extent the SEC were to adopt this more
10 detailed and more -- and less sort of on/off
11 disclosure regime, it has some impact on the
12 urgency of adopting some of the more
13 aggressive standards around Going Concern. If
14 the disclosure regime brings out this more
15 continuous disclosure process, then maybe we
16 have more flexibility on the other end.

17 And so what this would involve is
18 disclosure of factors critical to the success
19 of the company, its operations, and in
20 particular, its cash flows, to Tony's point.
21 And, obviously, these types of disclosures
22 vary greatly by industry and require a great

1 deal of monitoring by corp fin if this type of
2 approach were to be adopted.

3 And again, I'll conclude. Since
4 I'm sort of doing this in sort of a formal
5 way, I'll conclude by emphasizing the absolute
6 centrality of vigorous enforcement here, both
7 by the Commission and by the PCAOB in
8 relationship to both companies' and auditors'
9 conduct where there is a Going Concern issue.

10 And I think the profound sense of
11 our group that currently our financial
12 accounting system and our system of auditor
13 oversight and of securities regulation is
14 operating at a deficit of public and investor
15 trust because of the events that occurred over
16 the last several years and the silence around
17 these issues in so many institutions that were
18 clearly on the brink.

19 And by on the brink, I mean
20 literally on the brink. There were at least
21 two major firms which I discussed before,
22 Citigroup and Bank of America, where chief

1 executives called the United States Government
2 and said we are going to be insolvent within
3 days if you don't act. This is a matter of
4 public record and yet, as I said before, where
5 is the financial accounting and auditing
6 regime in relationship to the reality of
7 imminent insolvency in these firms?

8 Finally, I'll say -- and I think
9 our group's recommendation that there needs to
10 be much more detailed guidance in this issue.
11 I want to restate an experience that some of
12 us have had in a different body, the Standing
13 Advisory Group, around these issues, which is
14 that it has been impossible since the fall of
15 2008 to have a conversation in which anyone
16 can explain what is the standard in
17 relationship to what -- how is it that an
18 auditor should think in relationship to the
19 issue of Going Concern when a company's
20 financial viability is dependent on the good
21 will of public authorities on a day-to-day
22 basis? What is the appropriate way to think

1 about that?

2 It has been impossible to get
3 anyone to answer that question at the meeting
4 of the Standing Advisory Group now for close
5 to four years, despite the fact that we have
6 the finest minds in the auditing profession
7 gathered around that table and preparers and
8 academics and members of the board, that
9 question cannot be answered. And we ought to
10 get an answer to that question before the next
11 time a large cap firm is dependent from day to
12 day on the good will of the government for its
13 survival. Thank you.

14 MR. HARRIS: Mike, you had a
15 question.

16 MR. HEAD: And I'm not sure if
17 it's a question or a comment or just a
18 butterfly that's in my stomach. One, I want
19 to applaud all the detailed recommendations.
20 And as a CPA and as a former external auditor
21 of financial statements and as a head of an
22 internal audit function that has a fiduciary

1 obligation to shareholders, audit committees,
2 and ultimately management, but I said them in
3 that order intentionally, the Going Concern
4 opinion to me, for whatever reason, my gut
5 tells me I go all the way back to your history
6 that you presented, and it seems to have no
7 place in today's current environment to me.

8 What makes so much sense to me is
9 the disclosures, and it's not the same as risk
10 factors, but it can't be separated from risk
11 factors at all. It seems robust, ongoing,
12 enhanced disclosures relative to the financial
13 condition and economic situation that
14 companies are encountering is what's really,
15 really important and ever since I encountered
16 the first time where I had, as an auditor in
17 the public, for the public accounting firm,
18 had to have a discussion about assessing is
19 Going Concern relevant or not, distracted from
20 the entire needed point which was how do we
21 get the right information and disclosures so
22 the investors and users of the financial

1 statements understand the circumstances and
2 can make educated, informed decisions versus
3 getting hung up on again a boilerplate piece
4 of paper that relates to a lot of fights and
5 going to national and trying to determine what
6 is the true criteria, and you spend all your
7 energy on trying to conclude if that opinion
8 should be in there or not, and justifications
9 for yes or no versus all the things that are
10 giving you concern are they adequately
11 disclosed either in MD&A or in the risk
12 factors or in the financial statements.

13 And so I don't have an opinion one
14 way or another on Going Concern other than I
15 agree wholeheartedly it's under understood.
16 It needs a lot of guidance and the end result,
17 I would hope, would be substantially better
18 disclosures on a continual basis to provide
19 the users the information and then I'm not
20 sure if the piece of paper matters or not with
21 an opinion or not. But that's just -- I'm
22 reacting out of my gut, not studying it like

1 you guys have as a working committee for a
2 long period of time.

3 MR. SILVERS: Mike, if you don't
4 mind, I'd like to respond to your point by
5 showing -- by going back to one of these
6 slides, because I think the question is not is
7 the current Going Concern approach the only
8 way to do this? As I suggested earlier, part
9 of our recommendations is for a much more
10 enhanced sort of continuous system.

11 The question is this. The
12 question we have to face up to in relation to
13 that is this, that we do have a robust system
14 of auditors expressing concerns about the
15 viability of firms under the Going Concern
16 system. You can see that somewhere between 15
17 and 20 percent of audit opinions reflect this
18 type of analysis and this kind of a drawing of
19 a bright line.

20 The problem is, is that these are
21 small firms. We have a major double standard
22 here. And it's not the only double standard

1 that we've seen in the last few years, but
2 these types of double standards fundamentally
3 erode the public's confidence in the financial
4 regulatory system.

5 So there's nothing about -- I
6 mean, look, we make distinctions between small
7 and large firms in financial regulation all
8 the time and many of those distinctions are
9 narrative, but there's nothing about failure
10 that is unique to small firms.

11 MR. TURNER: Let me respond back
12 to Mike for just a second.

13 MS. SIMPSON: I think Jeanette --

14 MR. TURNER: Oh.

15 MS. FRANZEL: Well, let me
16 compliment the Working Group on this very
17 difficult piece of work. I just have a couple
18 of comments and then I want to just pose a
19 question because I think there's going to be
20 additional thinking and analysis that we need,
21 because to do this and to do it right, we're
22 going to need very good alignment between

1 FASB, SEC, and PCAOB. Because if there is a
2 misalignment in how some of these
3 recommendations are either implemented or not
4 implemented, I think we've got a big problem.
5 And so I have a technical question in that
6 regard between the alignment of the FASB
7 recommendation and the PCAOB recommendation.

8 On the FASB recommendation,
9 there's a recommendation to require management
10 disclosure of conditions and events where it's
11 reasonably foreseeable that an entity may not
12 meet its obligations. So I guess my question
13 is, does it -- how do you really enforce that?
14 How do you ensure that management is really
15 looking at that or do they just say oh, we
16 have a trigger and now we're going to
17 disclose?

18 And in the audit piece, auditors
19 are required to design the audit to obtain
20 evidence with respect to Going Concern. So
21 that implies in all cases -- so can you
22 explain the alignment between those two? Is

1 it your intention that management would be
2 evaluating Going Concern in all cases and then
3 the auditors would be evaluating that
4 consideration in all cases?

5 MR. TURNER: Under current
6 standards, supposedly, people are supposed to
7 already be doing this, Jeanette. I mean, to
8 answer your question, under the SEC guidelines
9 and under GAAP, you're already required to
10 determine whether or not you're Going Concern
11 and had to look at liquidating basis. So
12 that's nothing new. The piece of that that is
13 new is that the auditor then when they get
14 into auditing those assessments has to
15 actually have a look at evidence.

16 Right now, the auditing standard
17 if you go back and look at SAS 59, it says the
18 auditor only has to use the evidence that they
19 pick up in the other parts of the audit. They
20 don't have to specifically look to anything
21 with respect to Going Concern or go out and
22 try to obtain any evidence beyond what they're

1 doing elsewhere. That seems somewhat
2 ridiculous, especially as we look at some of
3 these entities in the public data that was
4 available. That's like saying I'll audit to
5 management's numbers rather than audit the
6 numbers. So therein that lies the problem.

7 MS. FRANZEL: I think there is a
8 substantial gap in practice and I guess my
9 point is we have to also bridge that gap. So
10 that will be an important piece of whatever
11 new standards or guidance is written.

12 MS. SIMPSON: And also, speaking
13 as the non-accountant here, this to me is
14 entirely what professional skepticism is meant
15 to be. Is it not? Is to go beyond the pitch
16 from management and the sampling. And it used
17 to be thought of as common sense.

18 I suppose that's what we're trying
19 to recover in these recommendations, is the
20 sort of stepped disclosure of basic notions of
21 relevant and timely. These are two notions in
22 reporting that we take for granted. But that

1 system simply did not work. The warning bells
2 did not go off. The dogs didn't bark in the
3 night. I suppose that's what we're doing is
4 going back and saying, good grief, how could
5 that be? How could the system get to the
6 brink? How could the taxpayer be on the hook
7 to that level? How could there be calls in
8 the night to government and reliance on
9 bailout as a strategy for dealing with a
10 situation? And it wasn't properly addressed
11 through the financial statement.

12 So if we want financial statements
13 to have utility, they must be able to address
14 this particular circumstance and that for us
15 is a lesson learned from the crisis, or maybe
16 lesson we haven't learned yet, I think is the
17 point.

18 Damon, do you want to say anything
19 before you --

20 MR. SILVERS: No. The president
21 of the AFL-CIO is awaiting me.

22 MR. HARRIS: Thank you very much

1 for your participation, but why don't you hold
2 on for one second because Lou probably has a
3 profound comment that he would want you to
4 hear.

5 MR. FERGUSON: It's not profound
6 nor a comment. It's a question. It's
7 probably a stupid one, but, you know, I guess
8 this partly goes back to my experience as a
9 lawyer, but when I would represent smaller
10 companies and it was quite interesting in
11 dealing with auditors. I was really struck by
12 the statistic there, that 20 percent of audit
13 opinions have Going Concern values, but
14 apparently almost no large ones do, because
15 the presumption in a small company,
16 particularly if there's any financial risk at
17 all from the part of the auditor, at least the
18 board oftentimes feels this, there's almost a
19 presumption that there will be a Going Concern
20 value that has to be overcome.

21 So aside from fears of losing a
22 large client, what's going on here? Are the

1 auditors applying separate standards for
2 little companies? What are they doing?
3 What's happening?

4 MR. SILVERS: I just want to --
5 actually, in a way, having said something
6 about sort of double standards, I also want to
7 say there is, of course, reason to expect to
8 see some difference between small and large
9 companies in this regard because of issues of
10 access to credit markets, right? And so I'm
11 not sure you would say, looking at that data,
12 that you wouldn't expect to see in a fairly
13 administered system some difference.

14 I think the problem is is that our
15 historic experience suggests that it doesn't
16 explain -- that story doesn't explain what
17 we've seen happening.

18 MR. TURNER: Having signed a number
19 of these opinions, including both private and
20 public companies and consulted on them, I do
21 think Damon was right. I think there is a
22 double standard here in practice. I think

1 Jeanette's right. There's a big difference
2 between what's in the standard and what's in
3 practice, which behooves that you get involved
4 in the enforcement side or you'll never fix
5 that by just righting another standard.

6 But the small companies don't have
7 access to capital, don't have the economies of
8 scale, so that would tell you there's going to
9 be more. But just when you look at the
10 percentage, the percentage is what's key
11 there. And it does tell you that that big
12 company, the auditor, I will tell you, does
13 have in the back of their mind, are they going
14 to lose that? And the bigger that audit
15 client is, that may get -- once you get into
16 the S&P 500 that may be 80, 90 percent of what
17 that partner does for a year. So it goes --
18 that's going to weigh on someone's mind. It
19 just can't help but weigh on. It's just the
20 way people think and act. It's not that
21 they're bad or anything. It's just the way
22 people behave.

1 And I think you have to understand
2 that, in fact, they are much less going to be
3 -- going to be much less reluctant -- or much
4 more reluctant to pull that trigger. I think
5 this is why you're seeing auditors push for
6 disclosure, push for the audit committee to do
7 more, all of which I think is good. But
8 ultimately, that ain't going to get you there
9 because ultimately at the end of the day it's
10 going to have to be the auditor that pulls the
11 trigger because management isn't going to.

12 I would like to -- let me come
13 back to one point that Mike made about these
14 Going Concern reports and whether they're
15 relevant or not today because that was an
16 issue back with the Cohen. At the end of the
17 day, we're writing a product for investors.
18 In the CFA Institute survey, which should be
19 part of the record, is very good on this
20 point. They note that 81 percent of them said
21 that on a scale of one to five, having that
22 Going Concern opinion was a four or five to

1 them. Eighty-one percent. This is very
2 important to them. So to remove it is
3 degrading the product. And 92 percent of them
4 said that they believed the auditors --
5 ninety-two percent, that's unbelievable,
6 almost unanimous said the auditor's report
7 should identify the basis and reasons for
8 their conclusions.

9 So while I understand the notion
10 of perhaps from an auditor's perspective they
11 shouldn't have to do this, from an investor's
12 perspective, over the decades, the investors
13 have always said we want it and we want it as
14 part of the product. So it's how do we get
15 them that information, get it from the auditor
16 which they're all asking for and get it early
17 enough that it serves the purpose.

18 MR. HARRIS: Tony, hold on for one
19 second because I want to recognize Jay, and
20 then Jeanette and then we'll wrap up and go
21 around the table.

22 Jeanette?

1 MS. FRANZEL: Just a quick
2 comment. I think it's very important to note
3 what's coming out of this discussion. If
4 there is a double standard or a different
5 practice that's being used for the very large
6 companies, certainly those very large
7 companies have very large impact on investors
8 and on the markets. So I think the interplay
9 of these two factors is something very
10 important to consider going forward.

11 MR. SONDHI: Just listening to the
12 discussions and Damon's emphasis on that
13 statistic, I'd like to point something else
14 out. I think you're actually understating it
15 and I'll tell you why, because as I think Lynn
16 said, people have recognized that General
17 Motors was probably in financial distress long
18 before anybody recognized it. And that's the
19 real problem is that a Going Concern
20 assessment or the acknowledgment of that is a
21 negotiated thing.

22 From an investor's perspective,

1 it's financial distress and the destruction of
2 the stock -- of the value of the company that
3 matters much more and that very often happens
4 way before any of this comes to light. There
5 are people who have studied -- it's like can
6 you predict bankruptcy? Well, that's the
7 wrong question to ask. Because bankruptcy is
8 something that's negotiated.

9 The question should be can you
10 predict an economic concept such as financial
11 distress and the reduction in the market value
12 of the company. And that part is -- it's an
13 enormously different number, both for small
14 and large firms.

15 MR. HARRIS: Brian.

16 MR. CROTEAU: Thanks, Steve. Just
17 two things. One, I just wanted to make an
18 observation that I don't think I've seen any
19 or certainly not very many, if any, inspection
20 findings for annually-inspected firms related
21 to Going Concern. I think none might be the
22 answer. So as we think about whether there is

1 a different standard, it may be that they're
2 partly a scope point relative to inspections,
3 but perhaps there's more to do there relative
4 to evaluation of that. And so I just draw
5 that observation.

6 Secondly, in the recommendation to
7 change or remove substantial doubt and replace
8 it with more likely than not, I guess I just
9 pose the question of did you give
10 consideration to whether you would actually
11 lose something relative to the substantial
12 doubt being a very important, perhaps today,
13 threshold where it is fairly far along a
14 continuum and whether you're actually looking
15 for something incremental to that versus
16 replacing it and removing it entirely.

17 MS. SIMPSON: Again, this is an
18 investor comment and Lynn can make an
19 accounting comment. My view is that
20 substantial doubt is too late and too close to
21 disaster. And when we were in the Working
22 Group we said we want some steps along the

1 way. We don't want a cliff. We want a slope.
2 Maybe it's a downward slope, but do we invent
3 terms like nagging doubt or a bit worried or
4 I'm biting my nails? But we need something
5 that gives us an indication of anxiety in
6 advance of a panic attack.

7 So it's a good question about
8 whether we're actually thinking about
9 replacing this from the investor side. I
10 think it's actually going to disclosure which
11 is allowing you to understand task and
12 question the credibility of the assumptions
13 upon which financial security is resting.

14 MR. TURNER: A couple points,
15 Brian, to both the points you make. I, like
16 you, have read the inspection reports and
17 haven't seen the comments about Going Concern,
18 at least in what's been made public. So I
19 think that's a valid point. I know you're out
20 there on the stomping trail saying, hey, we
21 should be learning more from these
22 examinations and all.

1 I will also tell you though I
2 haven't seen a whole lot in the way of SEC
3 comment letters on these same companies
4 either. And so I think that comment probably
5 runs to both of you which is why we're raising
6 the enforcement issue.

7 On the flip side, about would you
8 lose something? Well, as you've seen from the
9 slides, we aren't going to lose anything,
10 especially on the big companies because they
11 were never there. So there's nothing to be
12 lost. So if you bring it back down to a lower
13 level, do I think you'll lose something?
14 Absolutely not. I think you'll probably start
15 getting more at an earlier date and if you put
16 the whole regime in -- KPI is not new. The
17 Jenkins Commission recommended it back in '92.

18 The Commission itself in an MD&A
19 release about a decade ago also recommended
20 companies on their own on a voluntary basis do
21 KPI. There's been very little reaction to
22 that.

1 So the market has had a chance to
2 do it on a voluntary basis at the urging of
3 the Commission and people didn't act. And now
4 having gone through the financial crisis, it
5 would seem it's now time to build this early
6 warning system in that runs to Tony's point
7 and learn from the lessons. I mean, none of
8 this stuff is new. Putting an objective in
9 the standard, the International Standard
10 Center is already doing that. The KPI has
11 been out there for over two decades.

12 The notion of, hey, you actually
13 audit -- for the auditor to consider something
14 other than just what management gives them?
15 That's not enough.

16 MS. SIMPSON: It's fundamental.

17 MR. TURNER: And the role of an
18 audit committee in an oversight function, not
19 perform but an oversight function, none of
20 these things are new. It's just like with the
21 financial stability disclosures. We all had
22 a chance to do it and never did it. Now

1 people have lost trillions in value and
2 watched their retirement disappear almost
3 overnight. So it would seem to me we've got
4 a great lesson. Now it's just are people here
5 in Washington going to do something about it?

6 MR. HARRIS: Let's move on so we
7 can get to lunch. Bonnie Hill and then Judge
8 Sporkin and Barbara Roper and then Anne, if
9 you want to make any closing comments with
10 respect to anything on the global initiatives,
11 but Bonnie, why don't you go ahead.

12 MS. HILL: Thank you. Mine is more
13 of a question, Anne. I was wondering, given
14 the extensive risk analysis that companies are
15 required to make, when you look into -- I just
16 read tons of them -- so when you look into the
17 disclosures and all the things that they have
18 as concerns, I'm wondering if you looked at
19 whether or not the lawyers and the
20 accountants, and you know the auditors talk to
21 one another, because it seems like a no-
22 brainer to take a look at the deep discussion

1 on risk which have a lot to do with Going
2 Concerns, that somehow or another being able
3 to bring those together gives you a pretty
4 good picture of where the concerns are. I was
5 just curious if anyone had looked at that.

6 MS. SIMPSON: The point is very
7 well made, Bonnie. And that's why we on the
8 disclosure piece think this ought to be part
9 of the risk management reporting. That's
10 absolutely the natural place and that's where
11 the systems are being built, the assumptions
12 are being tested. Scenarios are being thought
13 about. Mitigation is set out. We don't
14 envisage some parallel process and disclosure
15 being -- this is absolutely the natural place.
16 Fully agree.

17 JUDGE SPORKIN: It seems to me
18 everybody in this country has a credit score.
19 Why doesn't every company and it need not --
20 I'm sorry, I don't have it on, I'm sorry. It
21 need not be only the accountant. It could be
22 an outside group. There are many, many

1 metrics out there in which you can determine.

2 I'll give you one right now. When
3 you see a company's stock go from \$32 to \$3 a
4 share, you don't need to be a rocket scientist
5 to figure out there's a Going Concern issue
6 there. So, I mean, there are many metrics,
7 but again, I don't know how they figured out
8 my credit score, but it seems to me, Lynn, why
9 not have a Going Concern score and let the
10 accountants then figure out, explain what it
11 is using objective standards as you say,
12 rather than just do it on a case by -- just do
13 it on a situation where there might be some
14 risk or something else that are disclosed.

15 Can't you do it in every case?

16 MR. TURNER: There is what's known
17 as a Z factor risk score out there with
18 respect to Going Concern. There is what's
19 known as a Z risk. Most of the firms, I
20 suspect all the Big Four, certainly my firm,
21 started to use that data, so that Z risk is
22 out there. It's publicly available. Auditors

1 should be considering that. That's one of
2 those pieces of public information that is
3 very good that should be considered that
4 management probably isn't going to give them.

5 So that data is already out there.

6 JUDGE SPORKIN: Do you get a score
7 in each case or do you think that's going too
8 far? Get a score, say, all right, somebody is
9 at the 900 --

10 MR. TURNER: They already have got
11 the score. All you do --

12 JUDGE SPORKIN: Then what are we
13 talking about then? If you already have the
14 score --

15 MR. TURNER: Because that's not
16 available --

17 JUDGE SPORKIN: To who?

18 MR. TURNER: Judge, to all
19 investors. That would be available to whoever
20 --

21 JUDGE SPORKIN: No, but as long as
22 it's available to accountant, that's the

1 important person. Then he -- whether it's
2 disclosed to the public or not, I haven't
3 gotten to that issue yet. But the issue right
4 now is whether the accountant get the
5 information.

6 MR. TURNER: The accountants have
7 access to that information.

8 JUDGE SPORKIN: But do they score
9 it though? That's the question.

10 MR. TURNER: My firm --

11 JUDGE SPORKIN: Do the accountants
12 score it?

13 MR. TURNER: That data, you could
14 either run the score yourself or you could get
15 it from a subscription service. My experience
16 was, our firm, and maybe Bob can talk to his,
17 but our firm did consider that when assessing
18 the Going Concern. That assessment wasn't
19 made available to the public. And as the CFA
20 Institute survey indicates, 92 percent of them
21 want to know how the auditor reached their
22 conclusion that it either was or was not a

1 Going Concern, and certainly that would be one
2 of the things that would enter into that.

3 JUDGE SPORKIN: Let's ask the
4 PCAOB, when you look at the reports, do they
5 do score Going Concern in every -- do you
6 require them to score Going Concern?

7 MR. TURNER: The standard doesn't
8 require that right now.

9 MR. HANSON: There's nothing in
10 the standard that requires it.

11 MR. HARRIS: Barbara.

12 MS. ROPER: So first of all, I
13 think you guys did a terrific job and I'm very
14 supportive of your recommendations and I think
15 they're very thoughtful. The one thing that
16 did occur to me as I was just listening to
17 some of this, it will obviously be important
18 on how you move forward on those
19 recommendations, because I think when you're
20 talking about gradations of information and
21 risk we want to avoid -- we should learn
22 something from the terror risk alerts. We

1 don't want to create a system in which every
2 company is amber, you know, always. There
3 needs -- if we're going to go that route,
4 there needs to be meaningful differentiation
5 and not just have management and then the
6 auditors sort of migrate to some sort of
7 comfortable median ground where they express
8 a certain amount of concern. So that would be
9 my only comment.

10 MR. TURNER: Barbara, there's a
11 memo that we provided to the Board as well
12 that should go in as part of the record that
13 puts a lot of meat around the bones that we
14 circulated, as you know, not only to within
15 our subgroup but to other people as well and
16 got feedback back from.

17 And I think it gets into some of
18 that. It gets into some of the issues. So if
19 you haven't seen that, I'd certainly want to
20 make sure that gets into the record and people
21 consider that.

22 MR. HARRIS: We'll put all that on

1 our website. Brandon, and then Anne, you can
2 wrap up.

3 MR. BECKER: I think that this
4 raises a lot of important issues. We all have
5 our own views about what happened in the last
6 seven years. Andrew has a very good paper
7 about the Rashomon aspects of that.

8 I would think it would be
9 important to take this, however, and back test
10 it. I mean what do we think would have been
11 done different in say 2005, in 2006, in 2007,
12 when Chairman Bernanke said this was a limited
13 decline, probably going to stay in the
14 subprime real estate market. In August of
15 2007, when there was a quant decline that
16 seemed limited to the hedge funds.

17 Apparently, it means that between
18 March of 2008 and September of 2008, while the
19 greatest financial crisis of our generation
20 was occurring, we would have had standards
21 that generated a wide range of Going Concern
22 opinions from accounting firms. It's hard to

1 replay what happened between March and
2 September of 2008 and what would have been the
3 contribution of those Going Concern opinions
4 to that process between March of 2008 when the
5 financial markets almost seized up.

6 Looking forward, when the FSOC
7 designates significant financial firms, it is
8 hard to imagine how this gets applied when the
9 Federal Reserve Board does a series of stress
10 tests and four major firms failed those stress
11 tests. Is the Board going to expect that the
12 accounting profession come in and
13 independently assess the Federal Reserve
14 Board's assessment of systemically important
15 financial institutions and expect that the
16 accounting profession make its own judgment
17 and put that into the public domain under a
18 51-49 percent standard with any attendant
19 legal liabilities attached thereto?

20 This strikes me as potentially
21 raising really interesting issues of the
22 interaction of the Board's requirements and

1 the oversight of our financial system and what
2 we expect accounting firms to do in the
3 interplay of that oversight. So I think that
4 your challenge in terms of just what you're
5 going to ask accountants to do as opposed to
6 financial analysts and portfolio managers is
7 enormous if what you're asking them to do is
8 to opine upon systematically important
9 financial institutions based on publicly-
10 available information including Federal
11 Reserve Board stress tests.

12 MR. HARRIS: I guess Brandon, we're
13 really backing up on the lunch hour, but I
14 guess what we're asking is what does this
15 TIAA-CREF and CalPERS, for example, want in
16 this area? And do they think that they've got
17 enough during the entire past decade in the
18 context of the financial services and in this
19 case, is the status quo acceptable or do you
20 want more and if you want more, what would you
21 want?

22 MR. BECKER: I would go back to

1 what Mike Head alluded to in terms of a robust
2 risk assessment and at the risk of disagreeing
3 with Damon or at least agreeing with a partial
4 comment he made, and the earlier panel's
5 discussion, I'd like to get the basics right
6 and I'd like to know that fraud isn't being
7 committed.

8 So broadly stated that means that
9 my portfolio managers can figure out whether
10 or not the change in leadership in Apple is
11 significant. They can figure out or at least
12 they should figure out whether or not they're
13 doing the right thing with their cash. But
14 I'd like to know that the sales numbers are
15 right.

16 MR. HARRIS: Anne, do you want to
17 wrap up for us?

18 MS. SIMPSON: It's a one-line wrap
19 up because everybody is hungry. And the
20 critical thing is that we understand that
21 these parties to ensuring that we have true
22 and fair reporting, these parties need to work

1 together. So our recommendations are looking
2 at the standards. We actually think the
3 recommendations we're making will make it --
4 Bonnie, back to your point -- easier for
5 directors of companies to understand what's
6 going on. Because we know that in the
7 failures, all right, we've pointed the finger
8 at the regulators. We've pointed the finger
9 at shareholders. We know that directors admit
10 they didn't know what was going on. And we're
11 here today to think about what auditors could
12 and should have been doing.

13 So let's think about this in the
14 need for independent audit, for skepticism,
15 and for other measures that are going to
16 support my independence. It's not just going
17 to be through standards improvement that we're
18 going to get this. So the other wider
19 discussion about rotation, about non-audit
20 work and potential conflicts of interest,
21 professional skepticism, this is all highly
22 relevant. So it's important we develop a view

1 about improving audit quality. It's going to
2 take account of all these component parts.

3 We've zoomed in on one piece, but
4 I don't want not to distract from the fact
5 that we won't get what we need unless the
6 audit is independent and that requires other
7 measures to be addressed as well.

8 MR. HARRIS: I want to thank this
9 panel very much for all the work and the
10 effort that you put into it and I think you
11 have created a highly meaningful record for
12 not only the PCAOB, but FASB and the SEC to
13 take your recommendations under advisement.
14 And I appreciate your making the time to be
15 here. I know that different people had
16 different travel schedules and came from quite
17 significant distances to be here, so I want to
18 express my appreciation and we'll reconvene at
19 2 o'clock after lunch. Thank you.

20 (Whereupon, the above-entitled
21 matter went off the record at 1:00 p.m., and
22 resumed at 2:00 p.m.)

1 A-F-T-E-R-N-O-O-N S-E-S-S-I-O-N

2 (2:01 p.m.)

3 MR. HARRIS: Let's get started.

4 Our next presentation and discussion addresses
5 topics related to how audit firm practices and
6 transparency in the areas such as key audit
7 quality indicators and partner compensation
8 can affect audit quality.

9 The group examining these issues
10 is led by Brandon Becker and Ann Yerger, and
11 members of the group include Bonnie Hill and
12 Norman Harrison. And Brandon I think is
13 kicking it off, is that correct?

14 MR. BECKER: Right.

15 MR. HARRIS: So appreciate very
16 much your starting.

17 MR. BECKER: Sure. We focused
18 when we tried to unbundle firm practice and
19 transparency into what that might mean in
20 particular. And our focus was on the
21 measurement of audit quality and performance
22 as well as audit partner compensation.

1 I will take the first topic, and
2 Ann will pick up on the second topic. I will
3 add an editorial comment that it appears from
4 the first two panels this morning that
5 measurement is a topic of some attention, and
6 it looks like we are consistent with the
7 Committee of the Whole. But you all will
8 judge that as we go through.

9 Just to give you a quick summary,
10 as I did earlier this morning, of where we
11 come out, we fundamentally support the
12 issuance of a concept release on the
13 disclosure of key indications of audit
14 quality, the creation of an audit fraud
15 center.

16 We didn't reach a consensus about
17 revisions to some of the compensation or a
18 focus on compensation going forward, but Ann
19 will highlight why we sort of went back and
20 forth on that issue to some extent, not to
21 underestimate its significance.

22 With respect to measurement, I

1 think most of you are familiar with the
2 background of the issue of the Treasury
3 Advisory Committee recommendation to determine
4 the feasibility of developing key indicators,
5 as well as the various steps that the Board
6 has taken to try and address these issues over
7 time. I would note some of the inspection
8 reports also contribute to this dialogue in an
9 important way.

10 Where we thought additional study
11 would be appropriate would be to issue a
12 release for the public to comment on this
13 approach, especially to disclose key
14 indicators of audit quality.

15 I think it is fair to say that in
16 our discussion the conversation went round and
17 round about whether one could identify key
18 indicators and how you would measure those key
19 indicators, as well as the potential for the
20 law of unintended consequences to lead to only
21 getting what you measure, so that if you
22 identify a key indicator, will that become the

1 driving force?

2 Nevertheless, I think our judgment
3 on balance was that this would be a helpful
4 step, as I will describe in the next slide, as
5 well as the creation of the fraud center.

6 So just to go back to where our
7 debate was, the definition of what would be
8 the key indicators we think could enhance the
9 quality of the audits and try and move
10 forward. We have heard this morning a variety
11 of other techniques, whether or not it is an
12 annual disclosure by the Board of some of its
13 findings or an annual report about the state
14 of the industry.

15 But we think that disclosure of
16 the key indicators would help the quality of
17 audits, the ability of smaller audit firms to
18 compete with the larger audit firms -- we
19 discussed earlier the leveling effect -- the
20 audit committee's ability to have a robust
21 selection process, irrespective of where you
22 come out on mandatory rotation an informed

1 assessment of your auditor could be enhanced,
2 shareholder ratification, as well as Board
3 oversight, by having those standards.

4 I think simply put, on balance, we
5 thought that in terms of measuring quality you
6 have to have a measuring stick. That while
7 there may be a variety of debates about how to
8 define the measuring stick, how long it should
9 be, what the increment should be, you
10 ultimately needed a measuring stick when you
11 were going forward.

12 Now, in terms of the other side,
13 it is the flip side of the measuring stick
14 debate. It is tough to define it. There may
15 be differing indicators. The nature and scope
16 may create its own problems. One size may not
17 fit all.

18 I think that our judgment, on
19 balance, was that definitional complexity did
20 not mean we shouldn't pursue this as an
21 initiative, because of our view that to try
22 and get enhanced quality you needed some

1 measure of what quality was.

2 Let me just pause here to see
3 whether any of my colleagues want to add
4 anything to my summary before I move on to the
5 fraud center.

6 MS. YERGER: Well, if I could jump
7 in, I think the issue of the audit quality
8 indicators is one where I think we should be
9 looking also outside of the U.S., because in
10 some countries their disclosure standards are
11 much more advanced than ours. So I think
12 there are lessons to be learned outside of the
13 U.S. in this space.

14 MR. BECKER: Anything else?

15 MR. CARCELLO: Brandon, do you
16 want to hold questions until the very end?

17 MR. BECKER: Yes. Let us get
18 through our presentation, Joe, and then -- so
19 we will get everything on the table and we can
20 take it from there, because we did see an
21 interconnection between quality and
22 compensation incentives. We came out in one

1 place, others may come out others, and I think
2 they do merge in some sense.

3 With respect to the fraud center,
4 I think we haven't really changed from where
5 I think this -- I don't want to speak for the
6 whole committee on its memory, but the general
7 view that the fraud center, on balance, would
8 be helpful going forward as a center of
9 excellence.

10 We do recognize that it is a
11 resource issue, so it is not for us to judge
12 how the Board allocates its resources. But on
13 balance, centralizing and propagating those
14 issues we thought was critical for the Board
15 because of the key role they play.

16 I would, without trying to gild
17 the lily, suggest that the conversation this
18 morning about the importance of getting the
19 basics right is consistent with this
20 recommendation, that there is much work to be
21 done as in the going-concern conversation, but
22 getting this right struck us as sufficiently

1 fundamental, that it would be worth the
2 allocation of resources by the Board, while we
3 recognize that we don't want to get too micro
4 into the Board's organization.

5 Anything folks want to add to
6 that?

7 MS. YERGER: Maybe this is a
8 question for the Board to discuss later. I
9 know that the recent strategic plan now has
10 sort of a center -- I don't know if it's for
11 audit excellence -- and whether that is
12 encompassing this issue. But we would like to
13 get the Board's input maybe on where it is
14 headed.

15 I know there were plans a few
16 years ago to hire someone for the fraud
17 center, and this seems to have morphed. I
18 just don't know how that fits relative to what
19 our recommendation is.

20 MS. HILL: And I might add one of
21 our concerns here was just duplication of
22 effort. We just wanted to be sure that if

1 something was already being done, or there was
2 a place where you could handle it, that we
3 weren't establishing something above and
4 beyond what is already there. So just the
5 efficiency of the use of resources.

6 MR. BECKER: And this was just a
7 summary of our opening recommendations. And
8 on that I think rather than repeat them I will
9 turn it over to Ann, so we can keep the
10 conversation going, if that's okay.

11 MS. YERGER: Well, Brandon just
12 eloquently covered the first M of our
13 presentation, which was measurement. I am
14 going to try to do him justice and also
15 describe our second M, which was money.

16 It goes without saying that the
17 area of compensation is of increasing
18 interest, not just to investors but also to
19 regulators. And we have learned over the
20 years that compensation structures do indeed
21 matter.

22 The good news is that they

1 actually work, and not surprisingly
2 individuals are motivated to perform as they
3 are incentivized. The bad news is that that
4 behavior can be less than ideal.

5 Certainly, there has been a lot of
6 soul searching I think about compensation
7 structures in the wake of the financial crisis
8 and whether financial structures motivated
9 behavior that was harmful. And now
10 regulators, such as the Fed, are paying
11 attention to the issue of compensation as it
12 relates to its regulated entities.

13 In some respects, this attention
14 has been mandated by the Dodd-Frank Act, which
15 included some provisions addressing the
16 financial regulators and incentive
17 compensation at regulated entities.

18 The audit profession is sort of
19 exempt from Dodd-Frank-related issues in this
20 space, possibly because Sarbanes-Oxley covered
21 this area. As we all know, Sarbanes-Oxley
22 included two provisions that sort of directly

1 and indirectly at least addressed audit firm
2 compensation.

3 One provision of that Act
4 prohibited firms from providing certain non-
5 audit-related services to the clients, and the
6 second provision requires audit committee
7 approval of other non-prohibited, non-audit-
8 related services.

9 A couple of trends are worth
10 noting and something we really discuss, which
11 is today, I mean, things have changed quite
12 greatly in the realm of audit firm
13 compensation and arrangements. And that is
14 that increasingly they are not providing a lot
15 of non-audit services, and in many cases
16 audit committees are providing a much more
17 robust oversight and analysis of what types of
18 non-audit-related services the firms are
19 providing.

20 However, you can see from the
21 chart that the number of companies providing
22 -- number of S&P companies that are getting

1 non-audit-related services from the audit
2 firms is increasing slightly, and the value of
3 those services has gone up. But as Norman
4 astutely observed, that if you look at that on
5 an average basis that is not a very high
6 number, if you divide it by the number of
7 companies. But, still, it is a trend that
8 these services are increasing.

9 In 2003, the SEC adopted a rule --
10 and I'm not a lawyer, so I will cite it here
11 as Rule 2-01(c)(8) -- that prohibited
12 accounting firms from establishing an audit
13 partner's compensation or allocation of
14 partnership units based on the sale of non-
15 audit services to audit clients.

16 However, that release includes two
17 footnotes that suggest that audit partner
18 compensation could be indirectly influenced by
19 the sale of non-audit services, because the
20 language expressly allows the partners to be
21 evaluated on the overall relationship with a
22 client, including the provision of non-audit

1 services.

2 So the question is: is that
3 footnote somehow shaping compensation for
4 audit partners that may be impacting
5 professional skepticism and ultimately the
6 quality of audits? And is this an issue we
7 should be concerned about?

8 We have been told that perhaps in
9 response to those footnotes that audit partner
10 pay and promotions at some firms may be being
11 influenced by the provision of non-audit-
12 related services. We don't have empirical
13 data on this.

14 And while we did not have an
15 opportunity to evaluate the standard relative
16 to what is in place outside of the U.S., we
17 have a general sense that ethical and
18 regulatory standards in some countries are
19 stricter than what our standard is here. So,
20 and that might be an area worth further
21 exploration by the Board.

22 So the overarching question for

1 the working group was, what, if anything,
2 should the PCAOB do when it comes to audit
3 partner compensation, particularly as it may
4 impact audit quality?

5 We centered our analysis on three
6 areas, which was, first, should the PCAOB
7 recommend that the SEC kind of close that
8 footnote loophole? Second, should the PCAOB
9 be doing more in the inspection realm when it
10 comes to audit partner compensation?

11 We appreciate that the Board
12 currently does look at audit partner
13 compensation, but at a high level. The
14 question is whether there should be more
15 specialized, more robust audits of audit
16 partner compensation, particularly as it
17 regards and relates to audit quality.

18 And the third question was, should
19 there be some sort of public disclosure of
20 audit partner compensation trends and
21 practices? And, Lew, this sort of I think
22 gets in a way at your point about whether

1 there should be some overarching report from
2 the regulator in those areas.

3 As Brandon highlighted earlier,
4 our group was mixed on this. I'm having
5 trouble advancing. Why is it me and Power
6 Points -

7 (Laughter.)

8 -- do not get along? Thank you.
9 There it is, there it is.

10 MR. BECKER: One of the skills I
11 have.

12 MS. YERGER: I like being
13 consistent with past performance.

14 So our group was actually really
15 split in this space, and I think it's fair to
16 say that two of us were really in favor of all
17 three of those questions. We felt like there
18 was room for the Board to look and do more.

19 We felt that changes were
20 consistent with the intent of Sections 201 and
21 202 of the Sarbanes-Oxley Act, and we also
22 believe that compensation can be one reason

1 why audit partner and audit -- the auditor's
2 skepticism may be impaired.

3 On the con side, we had two
4 members who believe that the current analysis
5 of Sections 201 and 202 are appropriate, and
6 that it was -- it's inappropriate to further
7 band audit partner compensation, because that
8 was not the intent of Congress in the
9 Sarbanes-Oxley Act, and also it was
10 unnecessary because audit committees are doing
11 so much more in this space.

12 So we are presenting you a sort of
13 mixed bag of recommendations and look forward
14 to input from the full group. If anyone from
15 the working group has comments.

16 MR. HARRISON: I will -- just to
17 follow up, I will weigh in briefly first. On
18 the issue of compensation, I think another way
19 possibly to look at the sequence -- or the
20 possible courses of action we have considered
21 is to think first perhaps in terms of the
22 Board enhancing or implementing some formal

1 inspection procedures around compensation
2 formulas and results as a pre-cursor to
3 considering whether a recommendation to revise
4 the SEC rule -- the statute might be
5 advisable.

6 I think it is -- you know, as Ann
7 mentioned, we didn't dig too deeply into data,
8 but it is noteworthy I think on the occasion
9 of a 10-year retrospective on Sarbanes-Oxley to
10 remember what happened in the immediate
11 aftermath of the Big Four.

12 And most public accounting firms
13 sort of got out of the consulting business, in
14 some cases by divesting entire units of their
15 business, but they are certainly back in it.
16 And to a significant degree -- I just did a
17 little quick research over the past couple of
18 days -- but as of results reported for last
19 year, in terms of total revenues for each of
20 the Big Four, their consulting or advisory
21 revenues were anywhere between about 25 and
22 almost 38 percent of total revenues for the

1 business. And what is even more interesting
2 I think are the growth rates.

3 I think we all know from those of
4 us who are in the profession, or those of you
5 who are in the profession, or those of us who
6 work with boards who deal with auditors, that
7 audit firm fees, audit fees have been under
8 some significant pressure in recent years, and
9 in fact most of the Big Four reported declines
10 in their audit revenues in 2009 and 2010, or
11 flat growth.

12 Whereas, on the other hand, you
13 know, advisory or consulting revenues grew in
14 2011 between 15 and 18 percent for each of the
15 Big Four. If you go back five years, those
16 growth rates are still in the eight to 12
17 percent range. So, you know, accounting firms
18 are like other businesses. They are in
19 business to generate profits and to share
20 those profits with their owners.

21 And I think that there is, you
22 know, every indication that at least at

1 present revenue growth is being largely driven
2 by the consulting and advisory practice. And
3 I would think perhaps for that reason alone it
4 is worth some level of examination as to
5 whether or to what extent perhaps there are --
6 I wouldn't expect that you would go in and
7 conduct a review and find that there is a
8 point system awarded to audit partners for
9 referring business to other parts of the firm,
10 or anything quite as transparent.

11 But I think there is a fair
12 question here around an examination of culture
13 or of qualitative factors brought to bear on
14 compensation in the firms.

15 And as I mentioned, in particular,
16 in an environment in which audit fees have
17 been under such pressure -- and I don't
18 believe in regulating by anecdote, but I think
19 probably any number of us could recount
20 experiences we have had either with clients or
21 in talking with people in the profession, you
22 know, one of the ways in which I think firms

1 have tried to mitigate the impact of the
2 pushback they received on audit fees is by
3 exploring or encouraging clients to consider
4 using the firm for other aspects of their work
5 -- for tax return preparation or tax provision
6 work or perhaps in some cases for some type of
7 consulting service.

8 So I think that, you know, all of
9 those trends -- and, again, given the fact
10 that the scale of revenue from those -- the
11 consulting practice has become such a
12 significant component again of audit firm
13 revenues and is clearly the growth area, that
14 it would be prudent to undertake some level of
15 appropriate examination to ensure that
16 compensation processes and formulas are still
17 being conducted, with a view toward the
18 regulatory requirements.

19 MS. HILL: I might weigh in at
20 this point and say that, first of all, I think
21 if one is going to take a look at the growth
22 of revenue from non-audit work versus audit

1 work, one has to go back to pre-Sarbanes-
2 Oxley, because during the Sarbanes-Oxley
3 period audit fees went up tremendously.

4 I mean, you have only to look back
5 and recognize that the burden was so heavy on
6 many companies, and particularly smaller
7 companies, that there had to be some
8 rethinking about all that had to be done.

9 So audit fees of course went up
10 quite significantly. And the fact that they
11 are ratcheting back I would think is a
12 testament to the fact that the work that was
13 done during Sarbanes-Oxley has probably paid
14 off in some ways.

15 I think the other thing is that we
16 recognize that the world has changed
17 significantly, and that in terms of our -- of
18 the globalization of our economy, and all of
19 the other things that we have to look at on a
20 regular basis, there are a lot of other things
21 that have to be audited.

22 My experience, 20 years of

1 experience, on over 11 different boards, I
2 have not found that audit companies came in
3 and sold us services for non-audit fees. What
4 I found was that on those audit committees
5 that I served on, when we had a need for
6 something beyond our regular audit services,
7 we looked at it.

8 We then looked at the number of
9 firms that could do that service for us, and
10 we looked at the cost and the time, and we
11 made the decision as to who we wanted to have
12 do that.

13 I would tell you that my
14 experience today is not that we are sold
15 services, but that we in fact review the
16 needed services, and then we look at the best
17 resources of the shareholder's funds, because
18 that is what we are using, the timeframe, and
19 who can best do the job in the most
20 expeditious time period and the most efficient
21 way.

22 So it is for that reason that I am

1 certainly -- as Ann talked about, you know,
2 the split, I am on the side of saying, you
3 know, there is some obligation on the part of
4 board members and audit committees, and the
5 SEC has already put forward a ruling as to how
6 it is to be dealt with.

7 And unless we are just looking for
8 something additional to do, I think, you know,
9 it doesn't mean that you can't review it, but
10 we review it in the board room, audit
11 committees review it. We have to approve any
12 additional non-audit fees, and they are
13 reviewed not only by the committee but also
14 advanced to the board as well.

15 So it is not done in a cavalier
16 way. It is done with a great deal of thought
17 and consideration for more than one factor.

18 MR. HANSON: I'm glad you brought
19 that up, Bonnie, because that is one of the
20 questions I was going to ask of you. And I
21 can't remember if others of you are currently
22 serving on audit committees, but from either

1 side of the table, either as a preparer or the
2 audit committee member, any more color that
3 you want to provide around the substance of
4 the audit committee preapproval of the
5 services that came in after Sarbanes-Oxley,
6 and how that factors into the views, I would
7 be -- so I am very glad that you said that.
8 If anybody else wants to comment on that, I
9 would appreciate it.

10 But then, a second question I
11 wanted to ask, on that table on the -- the
12 four-year table on page 5 of the S&P 500 and
13 the value of the non-audit services, if you
14 have also looked at the trend of the
15 percentages of the non-audit services compared
16 to the total audit fees, if there is any
17 information there that would be useful to talk
18 about, so --

19 MS. YERGER: Regarding the trend,
20 let me just quickly -- no, we can certainly
21 try to get that data and follow up.

22 MR. BECKER: And our experience is

1 very much the same as Bonnie's, that it's a
2 highly formal process by which we consider
3 using our auditor for any consulting or
4 independent services. It is reviewed by our
5 audit committee, by our chairs, and done I
6 think fairly infrequently because of our
7 concerns not only about formal independence,
8 but what I would call optical independence,
9 how well it will stand public scrutiny.

10 MR. TAROLA: And I will just
11 confirm what Bonnie and Brandon said. From my
12 experience, it's presumed that you would not
13 use the auditor unless it is a unique
14 situation.

15 MR. FERGUSON: On the compensation
16 question, we are very aware of the issue of
17 the relationship of compensation to audit
18 quality. And it is, to some extent, difficult
19 to measure because -- and I will tell you how
20 we do do it, though, which we think is a
21 reasonable surrogate for it.

22 But you can clearly look at a

1 firm's compensation policies, but we don't sit
2 in the rooms where the compensation committees
3 are making those decisions and allocating the
4 resources.

5 What we do do, though, and what
6 you can look at is you can see what happens to
7 particular partners, for example, who have had
8 less than perfect results, as a result of the
9 internal inspections or as a result of our
10 inspections. What does that do to their
11 compensation? Does it affect it negatively?
12 Does it affect their promotions? Does it
13 affect the kinds of jobs they get?

14 And those kinds of things we look
15 at very carefully, and in fact I think are
16 paying increasing attention to that issue,
17 because, you know, clearly to the extent you
18 want to promote audit quality I think you want
19 to relate that to compensation somehow. You
20 want people to be rewarded for doing a good
21 job.

22 MS. YERGER: Well, and I think to

1 speak for the working group, maybe
2 incorrectly, I think there was real consensus
3 that we wanted the auditors to be paid for
4 high quality audits. I mean, that was -- but
5 the question is, are there tweaks here that we
6 could ensure that is what is happening? And
7 that is really where I think ultimately this
8 really was.

9 MR. HANSON: And we have -- it is
10 mixed results in what we see in the firms.
11 And I think I would characterize it as they
12 are all in an evolution of how they are
13 factoring in the different quality elements
14 and the transparency to -- in terms of what
15 gets documented and what we see as lucid.

16 We can't sit in the room when
17 there is a substantive deliberation about how
18 is a particular finding going to affect a
19 particular partner's compensation. And we are
20 challenging the firms to better document what
21 went through their head in terms of what went
22 into the compensation.

1 So we can see that, and we have
2 their attention. And we are expecting them to
3 make meaningful progress on dealing with the
4 criticisms that we have had. And we have had
5 very blunt discussions with the firms about
6 the need to do that, and at least from my
7 chair I think they are kind of getting the
8 message that we are very serious about this
9 and we are putting it in the findings.

10 MR. HEAD: My initial thoughts --
11 and I come from this, again, with our audit
12 committee is responsible for hiring and making
13 these decisions, as everybody has explained,
14 and the process is much more robust post-
15 Sarbanes-Oxley and all of the rules.

16 And, again, it is another
17 demonstration of all the progress that has
18 been made through -- over the last 10 years.
19 I do think that this element, the compensation
20 of firms, and, therefore, partners can't be
21 looked at without considering the topic we are
22 going to talk about after this, which is audit

1 rotations, because this is another dial that
2 you continue to move dials to ensure
3 independence and objectivity.

4 And it is a whole different
5 discussion in the audit committee meeting and
6 room knowing that the audit committee has
7 said, "We don't hire you for non-audit
8 services," no matter if it's prohibited or not
9 prohibited.

10 Then, you don't have that as a
11 table. The discussion is: are you getting
12 compensated at an adequate level to perform
13 the audit quality that we are asking for? And
14 this is it, you are not getting anything else,
15 and that creates a whole different atmosphere
16 and discussion than if it is justifying quals
17 and if it is cost beneficial and is it really
18 a conflict or not a conflict. It takes all of
19 those discussions off the table.

20 And I actually feel this dial is
21 just as strong on ensuring objectivity and
22 independence, maybe even stronger than it is

1 -- than considering audit rotation, because
2 they -- if they know that what they have to be
3 focused on is providing the highest quality
4 service to the audit committee, and that they
5 need to be compensated for that, and there is
6 not a lost leader, there is not another
7 average return on investment, that it is --
8 you are here to do one job and one job only.
9 I think that is a much stronger message than
10 worrying about audit rotations, which you will
11 see as I get comments on the next one, but I
12 won't broach into that.

13 And so that is my thought. But,
14 again, this is one of those over the last 10
15 years it is significantly a different
16 environment today in the audit committee board
17 room than it was before Sarbanes-Oxley. This
18 was an issue prior to Sarbanes-Oxley, and I
19 don't think it is nearly the issue because of
20 the rigor that the audit committee oversight
21 goes through today.

22 MR. HARRIS: Let me recognize

1 Chairman Doty. Thank you very much, Jim, for
2 coming. I know you had a day testifying
3 before the House, and I imagine it was a ton
4 of fun, but we welcome you.

5 (Laughter.)

6 We are on the subject of audit
7 firm practice and transparency. But if you
8 want to make any brief comments, or otherwise
9 we will just move directly to Joe and Barbara.

10 MR. DOTY: No, I'm here to listen.
11 I'm here to listen and happy to be here.

12 MR. HARRIS: Then, Mike, why don't
13 you go ahead and --

14 MR. STARR: Norman, you laid out
15 the statistics on the growth in the non-audit
16 practices over the last two or three years.
17 And my question goes to, what consideration
18 did you give to the impact of that growth on
19 the culture, and, as a result, on audit
20 quality?

21 MR. HANSON: I think that that, at
22 least from my standpoint, may be the question

1 to be explored. I mean, the data were simply
2 public data taken from the firms' websites and
3 disclosures.

4 But my -- I think that it is -- I
5 must say also that I take with great respect,
6 and I appreciate the point particularly of my
7 colleague here, who I know any audit committee
8 Bonnie Hill is on is going to be the gold --
9 the platinum standard.

10 And it wasn't really even my
11 intention to suggest that there isn't great
12 reason for confidence in audit committees
13 today, and their awareness of their
14 obligations with respect to independence
15 issues.

16 It was more an observation that --
17 and I think as we all know, compensation,
18 particularly given that there isn't -- I think
19 each of the firms may take a slightly
20 different approach, and even with each firm
21 there may be variations by practice group, and
22 there are qualitative assessments that inform

1 evaluations, particularly at the more senior
2 partner levels, that in that environment it
3 would be -- and, again, given the trends in
4 terms of where revenues are coming from and
5 growth rates among the three principal
6 practice groups, that it would -- that there
7 could be no harm in some assessment of the
8 environment around compensation and the rigor
9 of the process to try to measure exactly what
10 you raise in your question, which I don't have
11 a real sense for or any objective basis for
12 assessing, you know, as I sit here today.

13 MS. YERGER: If I could just in
14 for one second, too, because I am
15 uncomfortable in a way that we have sort of
16 moved into this place where it is like the
17 audit committee versus -- and everything else
18 is exclusive. And I don't think that is
19 probably where Norman and I were on this
20 issue.

21 I think it has been so important
22 that the audit committees are doing so much

1 more in this space. I think the question I
2 was asking was whether we should be -- there
3 should be changes to ensure that the audit
4 firms, in terms of how they are making
5 decisions about audit partner compensation,
6 whether that should be tweaked, and whether
7 one of those tweaks is through that footnote
8 to the SEC rule.

9 So I guess I am -- I think I maybe
10 am splitting the baby a bit by saying we could
11 have both of these, and I think they would be
12 good things.

13 MR. STARR: And if I could ask
14 just one more question. Lynn earlier talked
15 about the need for quality indicators. And I
16 think you touched on it in your slide, right?
17 And my question is, what consideration did you
18 give to looking at those quality indicators
19 and pushing them down to the ground level, to
20 the audit partner and staff level, and having
21 that become the basis for compensation both at
22 the staff level and the audit partner level?

1 MS. YERGER: Well, I think our
2 initial slide -- and this is why we thought
3 measurement and money go hand in glove is that
4 first of all there need to be -- we need to at
5 least consider, how do we measure audit
6 quality? And obviously, then, that should be
7 sifting down to the compensation issues. But
8 right now I don't think there is a good sense
9 there is a nexus, nor can there be, because
10 there isn't -- we don't have any definitions
11 of what those key audit quality indicators
12 are.

13 MR. BECKER: Our thinking was --
14 and the group can correct me -- was if you
15 develop those key indicators, you set up a
16 framework, just as Lew and Jay described, that
17 you can then go in and examine and ask
18 yourself in the greater context of governance
19 and compensation within the firm, whether that
20 compensation -- whether those standards are
21 being reflected in the compensation of
22 particular audit partners.

1 MS. HILL: And I think if you
2 start doing that, there is another factor that
3 has to come in. As you know, audit partners
4 are rotated every five years. And so if you
5 are going to look at audit quality, I mean, I
6 think you have to say, "Okay. What was
7 happening during the first four years? Did
8 something change during the fifth year?"
9 There are so many factors that come into it
10 when you start looking at all of these things
11 that it gets to be I think more of a challenge
12 if you don't really have a clear set of
13 objectives.

14 I think the other thing is that
15 when you take a look at the growth of the non-
16 audit fees, it would be very important not to
17 use a broad brush and say they are all
18 growing, but to be able to do more of a deep
19 dive, just say, "Well, where are those growth
20 areas?"

21 I mean, I think you would look at
22 every company and you would find they would be

1 very different. It might be that they had to
2 use the same firm on an international, you
3 know, audit or something that -- you know, or
4 an issue there of fraud or something.

5 So there is no clear-cut one way
6 to do it, and I think we reached that
7 conclusion, but there are a number of factors
8 that we would hope people would bring into
9 play.

10 MR. HARRIS: Joe?

11 MR. CARCELLO: So wasn't that fun,
12 Jim?

13 (Laughter.)

14 I have a question for Norman and,
15 really, a comment as well, and then I guess
16 either Brandon or Ann.

17 Looking at this information,
18 Norman, on non-audit services, I think there
19 are two issues. And I think we have hit them
20 but maybe haven't tightly delineated them.
21 One is the growth of non-audit services for
22 audit clients, which is really all you can get

1 out of the proxy statement.

2 And, clearly, that is going up in
3 magnitude. And whether it is a problem or
4 not, you know, different people can be the
5 judge based on these numbers. But then there
6 is also another issue, which in my opinion is
7 more insidious, and I think this is the issue
8 that Mike got at, and that is the growth in
9 non-audit services for anybody, whether it's
10 an audit client or a non-audit client.

11 And I always like to take things
12 to an endpoint, although endpoints don't
13 usually happen. If non-audit services are
14 growing at six to eight to 10 to 12 percent a
15 year, and audit services are essentially flat,
16 and if that continues for an extended period
17 of time, at some point you have a situation
18 where non-audit fees or what I would call
19 essentially consulting fees are 60 or 70 or 80
20 percent of total firm revenue, and audit
21 revenue is the balance.

22 And at that point -- and maybe --

1 I think this is what I heard Mike saying; I
2 couldn't agree more -- at that point you have
3 a consulting firm that does a little audit,
4 not an audit firm that does a little
5 consulting. And those are fundamentally
6 different animals.

7 And I think the Board -- I don't
8 know if there is an action they need to take
9 now, but I think they need to be monitoring
10 that.

11 And let me get my other question,
12 and then if you want to comment, Norman. And
13 then my other question would be I guess either
14 for Brandon or Ann, and you are talking about
15 audit quality indicators.

16 And I couldn't agree more -- we
17 have had -- as the Board knows, we have had
18 previous conversations around this -- at least
19 one that I remember, maybe more than one -- at
20 the SAG. And it was an interesting
21 conversation, but we didn't get real far.

22 But one of the things that I think

1 it is important to think about with audit
2 quality indicators is to clearly define or
3 differentiate between inputs, process, and
4 outputs, because the firms will be very, very
5 happy to give you all kinds of inputs. And
6 they will tell you how wonderful all of the
7 people are that they hire, and how much they
8 spend on training, and on and on and on and
9 on.

10 And I'm not saying those things
11 aren't important, but those are already in
12 their transparency reports. You allude to
13 that on your last slide. A lot of this
14 already exists in the transparency reports in
15 Europe, and the major firms have started
16 producing that report voluntarily in the
17 United States, or at least they did it a year
18 or two ago. I don't know if they are still
19 doing it.

20 Process -- they will give you some
21 information on that, but not quite as much as
22 inputs. When you start talking about outputs,

1 which is what I think investors care about, at
2 least that is what I would care about if I was
3 managing money, they don't want to go there.
4 And it is a lot harder -- I'm not saying it's
5 easy -- it is a lot harder, but I think that
6 is what matters.

7 And so I think to say we are going
8 to do audit quality indicators, it is going to
9 be a bunch of input stuff. I don't know if
10 you have really accomplished a whole lot. So
11 I would be curious of Ann or Brandon's
12 perspective.

13 MS. YERGER: We wrestled with this
14 issue of, could we define what we were looking
15 for, and the answer was no. I mean, I think
16 our message to the Board is we think a concept
17 release -- nice job, Bob --

18 (Laughter.)

19 I think the issue for us was it is
20 time to issue a concept release and get these
21 ideas percolating, get input from the
22 marketplace. And I do agree with you that I

1 think the investors are mostly interested in
2 the output piece. But I suspect that the
3 feedback on any concept release is going to be
4 extremely mixed.

5 MR. BECKER: Let me just add that,
6 yes, I think outputs is the place that you
7 ultimately want to get to. But as an old
8 bureaucrat, I think that if you could start
9 with inputs and processes, even though you
10 might be codifying that which exists, Joe, I
11 think it would create a momentum that would
12 get you further down the road. And that
13 unless you start down that road, we will
14 endlessly debate whether we should take the
15 first step.

16 MR. CARCELLO: Let's start with
17 inputs and process, because you can probably
18 get agreement on that, and then eventually you
19 probably get output.

20 MR. BECKER: That's my guess.

21 MR. HARRISON: I just wanted to
22 first of all thank you, Joe, for in your

1 typical fashion, you know, tabling an issue in
2 an articulate way. I was probably -- in an
3 articulate way. I was probably trying to get
4 there earlier with some of the points I was
5 making and didn't quite get it.

6 But I think you raise an
7 interesting point about another reason for at
8 least some inquiry and monitoring, if not
9 concern, about the growth of the advisory
10 practices, and that is the potential impact on
11 the marketplace for audit services, because it
12 is sort of the reverse conflict, if you will.

13 If a company has an established
14 relationship with an auditor but is using two
15 of the other Big Four for millions of -- or
16 tens of millions of dollars of consulting and
17 advisory fees year-in, year-out, when it comes
18 time to revisit the process and perhaps select
19 a new auditor, you have the issue then about,
20 you know, the firms with which there is some
21 established relationship on other fronts.

22 So in an environment where issues

1 of mandatory rotation or other initiatives are
2 being discussed, that are designed to, you
3 know, preserve the marketplace for audits,
4 objective audit services, I think that is a
5 very relevant concern. I appreciate your
6 raising it.

7 And then, on your second point
8 about the outputs, I think you saw in one of
9 our slides that one of the areas that we think
10 would be -- it may, again, already be part of
11 what you do currently, and there may just not
12 be that much public visibility on it, but I
13 think it would be in the area of compensation
14 a question worth examining is whether failures
15 to deliver a good product and a good service
16 to a client, and whether they are documented
17 by a PCAOB inspection or by some form of
18 internal quality review, whether significant
19 failures in an audit have consequences in
20 terms of compensation or advancement or other
21 performance metrics.

22 So I think that is part of what,

1 you know, we intended to raise as an issue in
2 our presentation.

3 MR. HARRIS: Damon, you might
4 address the definitional issues involved with
5 audit quality.

6 MR. SILVERS: Well, I was going to
7 make an observation. I'll come to your
8 request in a second. I was going to make an
9 observation about the "been around a long
10 time" part of this.

11 (Laughter.)

12 I have been party to both -- more
13 than 10 years of conversation in this standing
14 -- no, it's not more than 10 years. It feels
15 like that. I guess it's eight years of
16 conversation in the Standing Advisory Group
17 here around these issues.

18 The presentation refers to the
19 Treasury Department Committee on the future of
20 auditing that a number of us were involved in.
21 You know, while there are obviously voices
22 from audit committees and from audit firms

1 that had concerns about the issues around
2 quality indicators and around the fraud
3 center, these have really been the consensus
4 position of investors and of I think a variety
5 of voices within the profession for some time
6 now.

7 And the question I think that
8 bring -- that having this discussion again
9 about them really raises is, I mean, at what
10 point is "yes" going to be taken for an
11 answer? I mean, I think that is really the
12 issue here.

13 On the other hand, I am sort of
14 profoundly disturbed by the findings in this
15 presentation about non-audit services and the
16 role of non-audit services in compensation.

17 When Sarbanes-Oxley was enacted,
18 as a number of people around this table well
19 know, there was I think an openness on the
20 part of the drafters of the statute, and of
21 the Commission at the time, which were made up
22 of people who were very serious about ending

1 conflicts of interest, significant conflicts
2 of interest in the auditing profession, there
3 was a kind of willingness to be reasonable
4 about, you know, allowing certain exceptions
5 and things around the margins.

6 This report really suggests that
7 as a result that has turned out to be an
8 excuse for really not making the cultural
9 change that Sarbanes-Oxley was designed to
10 make. And there is an alternative approach to
11 this, and I think that in addition to doing
12 what this proposal -- what this presentation
13 suggests, which is to look into the impact of
14 compensation arrangements around non-audit
15 services for audit partners, that's something
16 the Board absolutely needs to do.

17 There is another way of dealing
18 with this, and that way of dealing with this
19 is to insist on the audit-only firm. And it
20 seems to me that, you know, enough is enough.
21 If being reasonable is not -- if the major
22 firms don't understand the idea that

1 reasonableness on the details entails
2 seriousness and commitment to cultural change
3 on the other hand, if that is beyond people's
4 understanding, then I think it is time to talk
5 about less reasonable solutions.

6 Now, Steve, your question about
7 the metrics of audit quality. There is of
8 course a kind of view that thoughtful people
9 know a quality audit when they see one, and
10 that, thus, it is -- and that it goes to the
11 whole nature of the interaction of the audit
12 team with the preparers of the financial
13 statement, with the audit committee, and that
14 it is "hard to measure that."

15 And at one level that is -- at one
16 level that is true, as is true of almost
17 anything in life that's complicated. The best
18 type of assessment is a kind of qualitative
19 assessment by very experienced people of the
20 kind of the intangibles of a process.

21 But that being said, when we
22 looked at this matter at the Treasury

1 Committee, I well remember the many
2 conversations about a whole bunch of -- whole
3 list of quantitative metrics that could be
4 brought to bear on the quality of an audit,
5 ranging from measures of the seniority of the
6 individuals involved, the time involved in
7 comparison with the size of the firm, looking
8 at the -- when you have a longstanding audit
9 relationship, looking at issues of restatement
10 and the like over time, if one is looking --
11 rather than looking at particular issuers, if
12 you'd look at the question on an audit firm
13 basis, comparing a variety of sort of after-
14 the-fact problems against, you know, on a
15 firm-wide basis, obviously starting with
16 things like restatements.

17 There are a whole wide range of
18 quantitative measures that can be deployed
19 here. These are the sorts of basic kinds of
20 metrics that I think are generally used in
21 business to evaluate business processes. It
22 is a little unclear to me why we wouldn't --

1 so it's unclear to me why we wouldn't want to
2 have such basic metrics in auditing.

3 I think that does not mean -- that
4 should not relieve either investors or boards
5 of the requirement to engage in a much more
6 sophisticated qualitative type of assessment,
7 as is true in evaluating any other process.
8 But to not have any quantitative data
9 organized in a manner that tends to address
10 audit quality strikes me as sort of not having
11 the foundations in place.

12 MR. HARRIS: Bob?

13 MR. TAROLA: This is a tough
14 question, and I commend the task group for
15 putting it on the table the way they have.
16 And it is -- I think it is totally appropriate
17 that they were unable to come to some clear
18 conclusion.

19 In terms of audit quality, so much
20 of the audit is now done by some -- by
21 specialists in particular areas, whether it is
22 security valuation or actuarial measures or

1 operational assessments or technology control
2 assessments, and if we are going to have
3 quality audits, you really need people who are
4 experts in those fields doing those
5 assessments.

6 Does one stay an expert if they
7 are an adjunct to a process or a service? Or
8 do they stay an expert because they are
9 personally sought out by other customers to do
10 similar things in that field? And that is the
11 dilemma I see, because if the auditing firms
12 were forced, if you will, to be audit-only,
13 and, therefore, narrow the field of experts
14 they might have available to them, I'm not so
15 sure that would improve audit quality.

16 JUDGE SPORKIN: You preempted me.
17 I was going to say the same thing, that, for
18 example, I want the forensics to be used in
19 the audit. I mean, if the audit-only is going
20 to be looking strictly at financial, they are
21 going to miss a whole lot. I have now been
22 experimenting with a client of combining the

1 forensic with the financial audit.

2 And there might be other areas
3 like that, like where Bob just mentioned, but
4 -- and so I don't want them to be that
5 sterile. I really don't. I think they have
6 got to have these other -- you can't say we
7 are not going to be looking at whether there
8 is fraud or something else, if something like
9 that occurs.

10 MR. HARRIS: What is the reaction
11 of your client with respect to combining both
12 the financial and the forensic?

13 JUDGE SPORKIN: It has worked like
14 a -- we have done it now for four years, and
15 it has, as far as I'm concerned, worked like
16 a charm. The clients like it. They thought
17 the big problem was going to be that clients
18 wouldn't pay for it. But now with FCPA, and
19 all of these other problems, they love it.
20 They think it's terrific.

21 And as soon as I get released, I'd
22 like to write about it, because I do think it

1 is the thing to -- you can't separate the two
2 anymore. I mean, this concept that a
3 financial audit is going to look at
4 materiality, look at only the finances, and
5 the heck with corruption or fraud or anything
6 else like that. I mean, if you want to look at
7 what the public wants, what the investor
8 wants, he wants to know whether the company is
9 -- you know, if they are getting a good count,
10 is there dishonesty involved, or anything like
11 that?

12 They are not going to be -- it's
13 too long now since we have heard about, "we
14 are financial auditors; we don't care about
15 these other things." And it is coming back to
16 haunt both the clients and the accounting
17 profession, because when they say, "We are
18 only going to look at the financial, we are
19 going to look at materiality," well, what
20 happens in a big firm when the government
21 comes in and sues them for dishonesty, as
22 recently happened with the Federal Government

1 coming in and suing a company?

2 The financial auditor can't say,
3 "Well, that's too small. It is only going to
4 cost so much." That's not true anymore. And
5 that, you know, goes into 10A and everything
6 else. But it is -- you know, you've got to
7 have a robust, broad-based auditing firm that
8 can deal with the appraisal values, values of
9 inventories, and what not, that takes
10 expertise, and an accounting firm needs it.

11 MS. ROPER: Can I jump in just a
12 minute?

13 MR. HARRIS: Sure.

14 MS. ROPER: I want to actually take
15 the liberty of speaking up for Damon, since he
16 had to leave the room, and I have been in
17 enough of discussions with him on this
18 particular topic. Damon absolutely believes
19 that looking for fraud is part of the audit.

20 When he is talking about audit-
21 only, he is not talking about an audit that
22 doesn't look for fraud. So I think that is a

1 fundamentally different issue from one that
2 involves non-audit services, in the way that
3 at least Damon is framing the issue.

4 And then, just also -- and I will
5 just keep this brief, because I deal with this
6 -- for those of you who aren't sick of it yet,
7 I deal with it in the next session as well.
8 But when you look at non-audit services, one
9 of the things you have to recognize is after
10 -- when the rules were written after SOX, the
11 SEC went in at the behest at the accounting
12 firms and redefined a lot of non-audit
13 services as either audit services or audit-
14 related.

15 So the pool of services that is in
16 the audit services -- one reason those audit
17 fees went up is because a lot of other stuff
18 that they were doing that were previously not
19 counted as audit fees were now in the audit
20 fee category. So to the degree that there is
21 growth, the problem is more significant than
22 it would otherwise appear if you don't

1 recognize that change in definition that
2 occurred.

3 MR. FERGUSON: Well, you know,
4 when we talk about non-audit services,
5 oftentimes the discussion is in terms of what
6 is the growth rate and what is the proportion
7 of revenues. And I, frankly, don't think that
8 is terribly meaningful, because I'm not sure
9 that that is really how businesses govern
10 themselves.

11 One of the things that I have both
12 thought about and have urged the PCAOB to
13 think more about is to look at things like,
14 what are the relative profitabilities of these
15 various lines of business? What are the
16 changes in profitability? What is driving the
17 growth? Where is investment in the firm
18 going? What are we investing in? Is
19 investing in a new line of growth taking --
20 moving investment dollars that the firm has
21 away from other things?

22 But, you know, having the kind of

1 deepest understanding of what the economic
2 drivers of the profession are, and which in
3 the final analysis are profitability. They
4 are not absolute growth; they are
5 profitability. That's what these people are
6 in business for.

7 And part of the reason they are
8 driven by profitability is that they are very
9 concerned about the fact that if probability
10 starts to fall in the firm, they won't be able
11 to attract good people, because the people who
12 are the best people have options. They can go
13 to other professions where people make more
14 money.

15 So I think it requires -- if you
16 really want to talk about this stuff, it seems
17 to me you really need to have a very deep and
18 a pretty subtle understanding of what is going
19 on here. It is not just about growth and
20 percentages, it seems to me.

21 MR. HARRIS: Mike? Sorry, Norman,
22 did you want to respond?

1 MR. HARRISON: I actually did want
2 to respond, and thank you. I take your point
3 completely. And, obviously, under the current
4 regime, those of us who don't have inspection
5 rights don't have a lot of insight or
6 visibility into those topics.

7 There is another slide at the end
8 of our presentation which at least indirectly
9 raises this issue, and I just wanted to point
10 that out to everyone -- that another topic
11 that has been out there for some time is the
12 question of whether the Board should require
13 some more formal and detailed financial
14 disclosures by the auditing firms, which
15 perhaps would give us at least a little bit
16 more insight into some of the issues Lew
17 touched upon.

18 MR. HARRIS: Mike?

19 MR. HEAD: Thank you very much.
20 And, Barb, this is one where you and I are
21 passionately on the same page with, on what
22 should be in scope of audit because it's not

1 just forensic or fraud, it is not just
2 actuarial, it is not just -- it is technology,
3 it is whatever that industry -- if you go from
4 insurance to financial services to
5 manufacturing to defense, you know, you pick
6 an industry, you pick a group of potential
7 audit clients, that firm needs to have the
8 deep expertise to provide all of the related
9 business analysis and understanding, so they
10 understand the risk factors and understand all
11 of the risks that they are facing, so that
12 they know that they are looking at all of the
13 right things to come up with a judgment on the
14 financial statements.

15 And technology is probably just as
16 big as forensic, and we like to characterize
17 those as general computing controls and
18 applications. But, you know, it is all of
19 that has to be part of the scope.

20 So in my definition, when you talk
21 about an audit-only, it is not changing the
22 expertise that the firm needs to bring to the

1 table at all, it is a matter of them
2 understanding that they are providing all of
3 that expertise for audit and audit-related
4 services only, not on a consulting basis, and,
5 therefore, they are eliminating a potential
6 for conflict or revenue.

7 And the part that makes me a
8 little nervous here, and someone alluded to it
9 earlier, where if non-audit services grows
10 from, you know, 80 percent to -- or audit
11 services decline and non-audit grows to 80
12 percent, eventually the end state is they will
13 choose to get out of auditing, because that is
14 not the way you run businesses. How do you
15 make money?

16 And if eventually auditing isn't
17 making money, and one potential solution is
18 you eliminate that conflict, potentially,
19 while allowing them to have the expertise,
20 that is why firms will say, "Okay. We just
21 went through a merger. We are talking about
22 needing to eliminate independence and

1 remediate, because we have to decide what firm
2 is going to do the audit work on the new
3 merged firm."

4 And believe it or not -- you
5 probably do believe it -- post-Sarbanes-Oxley,
6 firms would say, "We choose not to bid on the
7 audit work because we don't want to remediate
8 the conflicts," because it is much more
9 profitable for us and we don't have the
10 litigation risk with those services.

11 Therefore, it is not, is the audit
12 committee going to consider the RFP? They
13 just walked away and said, "We're not even
14 going to give you an RFP. You asked us to
15 give you one. We are not going to because we
16 don't want to remediate or eliminate this
17 conflict." And the only choice the company
18 would have in that case is to say, "If you
19 don't RFP on the audit work, we are not going
20 to give you the non-audit work."

21 Well, you know, that makes no
22 logical sense at all. So I really -- you

1 know, Barb, we talk off and on a lot. This is
2 one where I'm not saying I'm definitely a
3 proponent of audit-only. But as soon as --
4 non-audit services really has nothing to do
5 with expertise and knowledge and understanding
6 of the business.

7 It is: what are they focusing on
8 for you on delivering services? And what do
9 they feel like the revenue sources for you
10 are? And it should not be distracted from the
11 audit services, because then it creates a
12 potential conflict on, are they focused on
13 audit quality? Are they focused on revenue
14 and profit maximization for their firm?

15 MR. HARRIS: I think we are going
16 to get into a lot of those issues in the next
17 session as well. Joe?

18 MR. CARCELLO: Steve, and others,
19 there may be intermediate ground between what
20 we have now, where as best I can tell the
21 firms will perform a wide range of services as
22 long as it is profitable and growing, versus

1 audit-only, right? Those are potentially two
2 endpoints.

3 The argument around allowing firms
4 to do services beyond the audit, and not going
5 to audit-only firms, is they do need a broader
6 skill set. So one argument might be to --
7 where those skill sets are part of the
8 consulting practice, not to be as troubled or
9 not to discourage them -- things like
10 valuation, actuarial fraud, systems tax, those
11 certainly seem to be core skills that you need
12 to do effective audit.

13 As we were sitting here, I pulled
14 up my handy-dandy iPad, Ann, and I pulled up
15 one of the Big Four firms. And I won't
16 mention the name because we could use any of
17 them, they would all be the same. And
18 performance improvement, finance, supply
19 chain, customer, it's not obvious to me how
20 doing that makes me necessarily a better
21 auditor.

22 Transaction services, corporate

1 development, lead advisory, restructuring,
2 operational transaction services, transaction
3 support -- I'm not sure how that makes me a
4 better auditor.

5 Human capital consulting, global
6 mobility, performance and/or award -- how does
7 that make me a better auditor?

8 I could give more. I could give
9 more. You get the general idea.

10 So some of these services are
11 there to make money. There is nothing wrong
12 with making money. But that, at some point,
13 potentially compromises the culture of an
14 organization, where with an audit the focus
15 should be on the benefit of third parties,
16 benefit of investors. With consulting, you
17 should be a client advocate. That is why
18 you're there. Those are fundamentally
19 different mindsets.

20 MS. HILL: Steve, a quick question
21 here, or at least a comment. If I were one of
22 the Big Four, Five, Six, whatever you want to

1 call it, and it came down to, well, you can't
2 do absolutely any other functions outside of
3 audit, whatever "audit" is defined as, why not
4 just spin off, have another company set it up
5 independently, you know, completely separate.

6 You've got a whole other revenue
7 stream, and what you've done is just simply
8 set up another business to do the business
9 that you can't do as an auditing firm. I
10 mean, come on, that's what a lot of the HR
11 firms did when they were told they could do no
12 other work for, you know, the company, if they
13 were working for the compensation committee.

14 So what happened? You spin off
15 and you set up another business. I think we
16 probably really need to get real about what we
17 are doing and what is going to happen and what
18 the end result is, because people just find
19 ways to get done what they want to do.

20 You know, and then you will have
21 another body sitting around talking about the
22 consulting firm that has been spun off and

1 whether or not they are doing the right things
2 and did they leak into audit. I just have
3 concerns about how far we continue to go and
4 what the real purpose is. What is the intent?
5 What are we afraid of?

6 I mean, I know the concern in
7 terms of fraud, and maybe nobody is keeping
8 their eye on the ball, because we are doing so
9 many different things. But there must be ways
10 -- Joe, you said somewhere in there there is
11 a middle ground. There probably is a middle
12 ground, but right now I don't think we are
13 touching on it, and it's just a personal
14 feeling.

15 JUDGE SPORKIN: I really think we
16 are onto something here. Why would I want to
17 combine forensic with the financial audit?
18 It's because, to take care of looking for the
19 fraud, and the concept came about because the
20 firm has a forensic group, and they have a
21 financial group. But they weren't -- the
22 forensic group was doing other clients.

1 And the concept was: why can't we
2 use them for this client? And I do like the
3 fact that you can have a broad array of
4 services being performed, so long as they are
5 not being performed for this client. There is
6 no reason why they can't be engaged in
7 valuation and these other things, as long as
8 it is not being done for the client.

9 They have to erect a wall, so that
10 they cannot be doing that for that particular
11 client. For that particular client, it will
12 be audit-only and with -- I would throw the
13 forensic in there, but not do the -- I
14 wouldn't do tax. I think that ought to be
15 done somewhere else, because tax involves
16 strategies, and what not, that I do believe
17 can be detrimental to a financial-only audit.

18 But, yes, we are going to have to
19 -- one size doesn't fit all. But we are going
20 to have to be a little bit strategic and say
21 what is it that -- where do you draw the line?
22 And I think you can draw the line.

1 MR. HARRIS: Judge, what are the
2 cost implications to the issuer?

3 JUDGE SPORKIN: Well, the cost
4 implications to the issuer are, it seems to
5 me, if they are not going to be paying for
6 these other services, it so happens that the
7 forensic -- they like it, at least -- because
8 of the money laundering, because of the FCPA
9 and other things, they want to have some
10 assurance that their people are not engaged in
11 that kind of stuff. And this the auditor can
12 do. They can perform those services. And
13 they can give you what the public wants.

14 If you look at any man on the
15 street, he thinks an accountant is going to
16 ferret out fraud, right? He is not going to
17 think that they are in there to give you just
18 what the Generally Accepted -- they don't know
19 what a Generally Accepted Accounting Principle
20 is.

21 And so they are looking for those
22 kinds of things, but I don't see any reason

1 why you cannot have -- you do want a healthy
2 firm. You do want a firm that is robust and
3 can do some of these other -- making it in
4 another areas. There is nothing wrong with
5 that. But I do think that you -- I think the
6 concept of audit-only, it might sound right,
7 but I don't know if it's the right way to go.

8 MR. HARRIS: I think you might
9 have a tough sell with the business community.
10 But once you got your client able to talk to
11 us about the model that you are talking about,
12 I think the Board would --

13 JUDGE SPORKIN: Well, they're not
14 going to pay for it.

15 MR. HARRIS: -- be very open and
16 look forward to seeing it.

17 And then, finally, I would like to
18 raise one issue, get back to what you brought
19 up, Ann, and Brandon as well. We are budget-
20 constrained, as you know. You brought up the
21 Center for Excellence and the Fraud Center.

22 We do have it in the strategic

1 plan, but could you go over once again --
2 Jeanette is new and other Board members have
3 not heard -- you lay the foundation
4 aggressively for it. What is your rationale
5 for it in a budget-constrained environment?

6 MR. BECKER: We think it goes back
7 to the conversation begun this morning about
8 getting the basics right, and to what Judge
9 Sporkin just highlighted in terms of
10 protection from fraud, getting the numbers
11 right.

12 And while we recognize that the
13 overall work of the Board and its inspections
14 helps contribute to that, we think that more
15 targeted focus -- fraud aspects, forensic, or
16 otherwise -- will help propagate an
17 educational process.

18 It will strengthen the focus of
19 fraud and preventing fraud, and it will
20 respond both to an investor concern, because
21 while investors have a wide range of concern
22 or interest in future earnings, I wouldn't

1 speak for all the investors here, but most
2 fundamentally we want to know that the
3 numbers, even the historical numbers, are
4 correct.

5 So that verification process is
6 sufficiently critical that we think it is
7 worth the Board considering a more targeted
8 focus on fraud and the historical assessment
9 of how that happens and what steps we would
10 expect the accounting profession to take to
11 try and prevent it in the future.

12 Let me just pause and see what my
13 colleagues want to add.

14 MR. HARRISON: Yes. I would agree
15 with everything that Brandon just said, Steve,
16 and I understand -- I think targeting is an
17 important idea, especially given the budget
18 issues that you alluded to. But I think there
19 is also value in a -- sort of a retrospective
20 and a compilation of lessons learned.

21 I think also, though, that, you
22 know, there can sometimes be, in exercises

1 like that, too much of a focus on solving the
2 last crime. And so I think that, you know,
3 some balance in the approach -- it occurred to
4 me as I was thinking about this the other day
5 that there are areas now that are very
6 clearly targets of enforcement by the SEC and
7 by the DOJ.

8 The FCPA comes to mind. I mean,
9 we are in the midst of a third or fourth
10 annual year of enforcement actions being
11 commenced at record rates in the area of FCPA
12 enforcement, and it is a good example,
13 perhaps, because FCPA violations take the form
14 of activities that hit the financial
15 statements and impact the audit process in a
16 couple of ways.

17 One is that there are improper
18 payments, illegal payments, allegedly being
19 made that are not correctly being accounted
20 for. Attempts are made to conceal them in the
21 accounts and the records of the enterprise.

22 And, secondly, in most cases,

1 there has been some breakdown in or some
2 absence of an internal control environment
3 where the process around requesting and
4 obtaining approval for, and obtaining
5 authorization to remit payments to consultants
6 or advisors or other intermediaries who then
7 pay the bribes are absent. So there is an
8 internal control implication.

9 Something perhaps that the Center
10 for Excellence or Fraud Center could do would
11 be to -- as a trend, as an enforcement trend
12 begins to emerge, to serve as a clearinghouse
13 or a source of guidance or information on best
14 practices relating to the audit process. That
15 might help raise the bar or enhance the
16 ability of the profession to advise their
17 clients or conduct better audits of companies
18 that are in exposed industries. So just --

19 MS. HILL: Steve, you mentioned
20 resources, and the whole concept of an audit
21 fraud center makes it sound like really an
22 expensive endeavor. It might be that, at a

1 bare minimum, you could begin by making an
2 assignment somewhere within PCAOB where there
3 might be capacity to take on this kind of an
4 assignment, and then to begin to grow it as
5 long as, you know, there is a way for the
6 function to be done.

7 I wouldn't want you to think we
8 are thinking of, you know, a really -- I don't
9 know what the recommendation was, but --

10 MR. HARRISON: A new building.

11 MS. HILL: -- in terms of the
12 building --

13 (Laughter.)

14 -- yes, building a center, or what
15 have you, but perhaps in some way assignment
16 could be made to begin work on it where you
17 might have some young people, because that is
18 -- all of us would like to be young people
19 starting out -- who might have a real interest
20 in this and could do it perhaps on an
21 internship basis or something to begin. But
22 we think it is important to be able to help

1 start this process.

2 MS. YERGER: At least from my life
3 experiences, there has been no greater teacher
4 than my past mistakes. And that is why I
5 think it is so important that there be some,
6 whatever we want to call it, center, division,
7 something, that focuses on this particular
8 issue. And I appreciate that it is something
9 that the Board does routinely as part of its
10 work, but it is just, I think, raising it,
11 moving it to a higher place where there is
12 some focus.

13 And I guess I might respectfully
14 disagree about whether I think it is the
15 appropriate place for a whole lot of, you
16 know, right-out-of-school interns to tackle,
17 because I think experience is a value
18 sometimes as you are exploring some of these
19 issues, especially complex ones that might be
20 resulting from fraud.

21 MR. HARRIS: Well, I have said it
22 before, but I want to say it again. I very

1 much appreciate the effort that has gone into
2 each of the panel presentations. I know how
3 much work it has been throughout, and we are
4 three for four, and I know that we are going
5 to be four for four in 15 minutes.

6 So I would like to take a 15-
7 minute break and convene back here promptly at
8 3:30.

9 Thank you.

10 (Whereupon, the above-entitled
11 matter went off the record at 3:14 p.m., and
12 resumed at 3:31 p.m.)

13 MR. HARRIS: Saving the least
14 controversial until last, our final
15 presentation is by the Working Group that has
16 been examining auditor independence,
17 objectivity, and professional skepticism.
18 Barbara Roper led this Working Group and
19 members included Kelvin Blake, Judge Sporkin,
20 Eric Vincent, and Meredith Williams. Barbara,
21 thank you very much and take it away.

22 MS. ROPER: Sure. So, obviously,

1 this is a natural segue from our last panel,
2 which dealt with a number of issues that
3 relate to independence. And just in preparing
4 this presentation we took sort of -- we did
5 not come here with specific recommendations on
6 the policy proposals that are before the
7 Board. Instead, we thought we'd take a
8 historic look at the issues as they've
9 developed over the years and how that informs
10 a discussion about the proposals that the
11 Board is considering, so open that up to get
12 a broader set of viewpoints in the second
13 half.

14 So, I thought it was useful to
15 start with a reminder. We throw around this
16 word about auditor independence. What's the
17 basis for that? And the Supreme Court decision
18 in United States v. Arthur Young says, "This
19 public watchdog function demands that the
20 accountant maintain total independence from
21 the client at all times and requires complete
22 fidelity to the public trust."

1 And one of the things that struck
2 me as we talk about these issues about
3 independence is how far we are from that
4 ideal. I mean, even in the strongest, sort of
5 most extreme proposals in this area, no one is
6 really talking in any meaningful way about
7 getting to total independence from the audit
8 client at all times. So, I think that's worth
9 keeping in mind as we consider these issues.

10 Second, when the SEC was updating
11 its auditor independence standards in 2000,
12 one of the things -- it talked about why
13 independence matters. Why do we care? And
14 they talk about two goals; one is to foster
15 high-quality audits by minimizing the
16 possibility that any external factors will
17 influence an auditor's judgment. And it seems
18 to me that when we talk about this issue we
19 spend a lot of time, I think appropriately,
20 focused on this issue of: will the reforms
21 we're discussing lead to higher quality
22 audits?

1 But the other related goal that
2 the Commission talked about is to promote
3 investor confidence in the financial
4 statements of public companies. Investors are
5 more likely to invest and pricing is more
6 likely to be efficient the greater the
7 assurance that the financial
8 information disclosed by issuers is reliable.
9 And I think, again, it's worthwhile as we're
10 thinking about that to ponder how confident do
11 we think investors are today in the
12 reliability of the financial statements in the
13 independence of the audit, because that
14 matters, independent of the issue of audit
15 quality.

16 And then just more generally,
17 taking this issue one step forward, why
18 independence matters. In sort of a fundamental
19 way, the audit has no value if it's not
20 independent. You know, if it's just another
21 set of eyes confirming management's view, they
22 have -- we have sort of an internal financial

1 reporting function at companies to provide
2 that. We look to the auditor to provide an
3 outside objective, skeptical view of that
4 information. And that has become more
5 important, not less, as we move to more
6 principles-based standards, greater reliance
7 on judgment.

8 And, yet, we have this basic
9 conflict in the business model, the client
10 pays business model, that says, in essence,
11 we've decided we're not going to have a truly
12 independent audit, so the auditor independence
13 rules are really designed simply to minimize
14 the conflict, mitigate its effects and promote
15 objectivity and professional skepticism in the
16 conduct of the audit. And so really,
17 independence, in my view, at least, is sort of
18 a means towards an end. It is the role of
19 independence in promoting that professional
20 skepticism that's what we're really talking
21 about here.

22 In looking back over this issue,

1 one of the things that struck me is just how
2 long we have been having various different
3 versions of this debate. So, 1977, in the wake
4 of the scandals at Penn Central, you have
5 Senator Lee Metcalf and his Subcommittee
6 publishing a report in which they express
7 grave concern over the alarming lack of
8 independence shown by the large accounting
9 firms. And in that, they discuss both the
10 issue of non-audit services and the long
11 tenure of audit engagements.

12 There was at about that same time,
13 I don't have a slide on this, but at about
14 that same time, so Congressman Dingell was
15 having hearings in the House Financial -- I
16 mean, the House Energy and Commerce Committee
17 about auditor conflicts.

18 There was an up-and-coming young
19 man who gave a speech at the American
20 Accounting Association at that time in which
21 he talked about the need for realism in
22 financial statements. Stanley Sporkin talked

1 about how the accounting literature is now
2 replete with cases where the independent
3 auditor simply ignored facts which they knew
4 or were readily available to them, and one of
5 his ultimate recommendations was that in all
6 instances, an accountant should maintain a
7 healthy skepticism. So, that was 1982.

8 So, when this came up at the SEC
9 in response, in part, to the hearings that
10 Congressman Dingell had been holding, the SEC
11 actually issued a report in 1994 indicating
12 that they didn't think any fundamental changes
13 were needed at that time. But what you see
14 soon after that is, you know, a real change in
15 attitude at the SEC, and evidence of growing
16 concern at the Agency, so that in 1998, I
17 think Lynn referred to this earlier, you have
18 the numbers game speech that Arthur Levitt
19 gave. And what he was talking about there --
20 it's actually not primarily on accounting.
21 He's talking about the pressure that companies
22 were feeling to make the numbers in terms of

1 earnings estimates, in a market where missing
2 the numbers by a penny or two could have
3 dramatic consequences for companies.

4 He talked about a game of nods and
5 winks between corporate managers, auditors,
6 and analysts in which the zeal to satisfy
7 consensus earnings estimates and project a
8 smooth earnings path, wishful thinking may be
9 winning the day over faithful representation.

10 And then there's another change
11 directly related to what we were talking about
12 earlier that started to occur over the 1990s,
13 and that was the growing importance of
14 consulting services within the audit firms.
15 The consulting services were both becoming
16 more important to the bottom lines of the
17 audit firms during that period, and to
18 individual auditors' compensation and
19 advancement within the firm.

20 So, you saw a progression from
21 where 1991 you had consulting revenues just 13
22 percent of total revenues. By 1999, for the

1 Big Five firms, consulting services accounted
2 for roughly half the revenues. And you would
3 see this play out in some fairly dramatic ways
4 with specific audit clients.

5 There was a 2001 report which said
6 that, as a general rule, companies were paying
7 \$2.69 in consulting service fees for every
8 \$1.00 they were paying in audit fees, but at
9 certain companies you see this much more
10 dramatic skewing. And you can see some of the
11 examples here; KPMG's audit of Motorola, \$3.9
12 million for the audit, \$62.3 million for other
13 services.

14 And, obviously, these were the
15 extreme examples but they weren't isolated
16 examples. There were actually a fairly
17 surprising number that had sort of this
18 dramatic skewing between the role of the audit
19 and the role of the consulting services.

20 And at that time, Arthur Wyatt,
21 who had been with Arthur Andersen for years
22 gave a speech at the AAA Conference in 2003.

1 He's actually looking back now, a
2 retrospective of what he'd seen happen over
3 those years leading up to Enron, and he talks
4 about how the firm leaders in this environment
5 where consulting services were becoming more
6 important had failed to recognize how the
7 widening range of services was impairing the
8 appearance of their independence, but also how
9 certain services were changing the internal
10 culture of the firms, which is something I
11 think Mike was getting at with his comments
12 earlier; that he said in that environment you
13 started to see within the firms a growing
14 focus on revenue growth and profit margins,
15 and that, as a result of that, that the
16 auditors were more willing to take on
17 additional risk in order to maintain revenue
18 levels, that clients found it easier to
19 persuade auditors to see issues their way, and
20 as he said, healthy skepticism was replaced by
21 concurrence. So, this was sort of the
22 insider's view at that time of what effect

1 this growing role for the non-audit services
2 had played within the audit firms.

3 And one of the things that we saw
4 -- we tend to think -- you know, we talk about
5 Enron or WorldCom, in fact, at the period
6 right before Sarbanes-Oxley, we had seen just
7 a dramatic increase in the number of
8 restatements, so we'd gone from 33
9 restatements in 1990 to 157 in 2000 to 233 in
10 2001, so this was not -- you know, when
11 Congress started drafting Sarbanes-Oxley, yes,
12 they were intimately focused on Enron, but
13 they were also looking at a broader phenomenon
14 that had occurred where there seemed to be
15 indicators that the audit simply was not
16 providing the effective assurance that it had
17 in previous years.

18 So, in that environment and before
19 Sarbanes-Oxley Act, the SEC took some actions.
20 They had started throughout the '90s to start
21 raising questions about these consulting
22 services, both particular consulting services

1 that they thought were in direct conflict with
2 the auditing role, and with the amount of
3 money that firms were getting from the non-
4 audit services.

5 In July 2000, they famously
6 proposed their rules to limit non-audit
7 services. They actually had a list of non-
8 audit services that they wanted auditors not
9 to be able to provide to audit clients. They
10 also addressed some of the issues with regard
11 to financial relationships between the
12 auditors and their audit clients, such as
13 receipt of contingent fees. And in that
14 regard, they added an express prohibition on
15 contingent fees.

16 Now, we've seen in the current
17 environment where we're talking about audit
18 rotation, mandatory rotation, a dramatic
19 response from the accounting firms in
20 opposition to that proposal. It is nothing, in
21 my view, compared to -- maybe we haven't seen
22 it all yet, but compared to the response that

1 they launched to the SEC rule proposal on
2 these non-audit services. Massive lobbying
3 campaign, really sort of scorched earth
4 rhetoric, they were going to members of
5 Congress, getting them not only to write
6 letters to the SEC in opposition, but to
7 include riders on Appropriations Bill to
8 defund the effort if the SEC insisted on
9 moving forward with the independence rules.

10 And in the end, the response was
11 that the SEC significantly watered down those
12 rules, so they took certain of the services
13 off the prohibited list, including internal
14 audits, financial system design. They opened
15 up loopholes in some of the other services
16 that were on the list in terms of the
17 definitions. And one of the things they did -
18 - the way the rule had initially been written,
19 it spelled out certain principles for
20 determining auditor independence, so that,
21 beyond a list of prohibited services, you'd
22 also have sort of a general principles-based

1 standard for what was and what was not a
2 permitted service. And that was moved out of
3 the language of the rule itself and into sort
4 of a more guidance role, sort of making it
5 less prominent, less enforceable.

6 And then shortly thereafter, Enron
7 implodes, and in imploding brought renewed
8 attention to this issue, in part because Enron
9 was sort of Exhibit A for all of the things
10 that people had been talking about for years,
11 for decades even, when they talked about
12 issues of concern about lack of independence
13 in the independent audit.

14 So, there came out in various
15 different reports evidence that Arthur
16 Andersen had been aware at various different
17 times of questions, had had serious questions
18 about some of Enron's accounting, had
19 dismissed it as not material, had perhaps
20 helped design some of the transactions that
21 were keeping debt off the balance sheet,
22 viewed the audit engagement that Enron is too

1 big a client to lose, certainly for that
2 particular office, had been both the internal
3 and external auditor and had lobbied heavily
4 against having internal audit on the list of
5 prohibited services, had been Enron's auditor
6 since 1985, so long tenure, had the revolving
7 door so that the Chief Financial Officers,
8 Chief Accounting Officers at Enron were
9 alumni.

10 And the press accounts at the
11 time, they talk about this chummy atmosphere,
12 so Andersen had office space at Enron, and the
13 Andersen employees were wearing the Enron T-
14 shirts and they're drinking from the Enron
15 coffee mugs, and they're going on the Enron
16 ski trips. And they describe a culture in
17 which there doesn't appear to be any sort of
18 meaningful cultural division between the
19 company being audited and the auditors who are
20 responsible for that review.

21 So, just quickly, I mean, Enron
22 was sort of the Exhibit A, but there were a

1 number of contemporary examples -- there were
2 a host of accounting scandals at the time.
3 There were a number of contemporary examples
4 where you saw the same kind of things;
5 auditors who were applying for jobs at the
6 company they were auditing while conducting
7 the audit; compensation based on the auditor's
8 ability to cross-sell non-audit services.

9 And then, again, I won't run
10 through them all again, but again Waste
11 Management was another example where really
12 every single one of these features that people
13 were focusing on as a concern about auditor
14 independence was evident in that particular
15 case.

16 So, it was in that environment
17 that Congress set about writing the Sarbanes-
18 Oxley Act. And at the time, certainly, if you
19 go and look at the legislative record there is
20 a huge amount of testimony that's focused on
21 this issue of: how do we promote auditor
22 independence?

1 And the Senate -- the report for
2 the Senate Banking Committee, Steve probably
3 wrote it, says: "The issue of auditor
4 independence is at the heart of this
5 legislation. Public confidence in the
6 integrity of financial statements of publicly
7 traded companies is based on the belief in the
8 independence of the auditor from the audit
9 clients."

10 So, when you look at the Sarbanes-
11 Oxley Act, there's a section of the Act, Title
12 II, that is called "Auditor Independence." And
13 it's there that you find -- so, they took the
14 SEC rules that they had previously approved on
15 prohibited non-audit services and they both
16 codified it and basically restored the
17 original list, added back in the things that
18 had been deleted, closed the loopholes that
19 had been added into the definitions of the
20 various different services. They added in the
21 concept of audit committee preapproval of
22 audit and non-audit services, mandatory

1 partner rotation. I mean, you all know the
2 list, all of the things that we've been
3 talking about since SOX that have been put in
4 place to improve the independence and
5 oversight of the audits.

6 There are also, scattered
7 throughout the legislation in other places,
8 provisions that definitely distinctly relate
9 to this issue. For example, the provisions
10 making audit committees responsible for
11 appointing and paying the auditor, overseeing
12 the conduct of the audit, strengthened
13 independence and financial expertise
14 requirements for audit committees, and not
15 least, the PCAOB responsibility both to set
16 standards in this area and to inspect for
17 compliance with those standards and bring
18 enforcement actions for violations of those
19 standards.

20 I throw this slide up here just to
21 make the point, if you look at the legislative
22 history, there was a lot of testimony in which

1 people recommended independence reforms that
2 are not included in SOX. There was strong
3 advocacy at that time for things like a total
4 or much broader ban on provision of non-audit
5 services to audit clients, mandatory rotation
6 of audit firms. There were discussions of
7 ideas about how you could put a third-party,
8 like an exchange or someone else into the role
9 of hiring the auditor so that the -- get rid
10 of the client pays model, more robust
11 provisions related to cooling off period. So,
12 even at the time when SOX was adopted, there
13 was a pretty extensive record in favor of
14 going beyond the reforms that were on auditor
15 independence that were actually included in
16 the legislation.

17 And then we came to
18 implementation. And I'd sort of forgotten
19 before I went back and got out my files on
20 this just how really annoyed I was at the
21 time. It's nice to know that I'm not just
22 cranky now, I was back then equally distraught

1 that when it came to the SEC to implement some
2 of the rules on the legislation, a number of
3 things that the audit firms didn't win from
4 Congress, they got almost immediately from the
5 SEC. So, there had been an issue of: could you
6 pre-approve non-audit services through
7 policies and procedures? Congress had said no,
8 SEC said yes, and they not only said yes, but
9 they said pre-approving through policies and
10 procedures was just as good as explicitly
11 individually approving them.

12 The SEC, in their initial rule
13 proposal had talked about the role that the
14 principles for auditor independence would play
15 in an evaluation of the approval of non-audit
16 services, the final rule, any suggestion that
17 audit committees were expected to look at
18 those principles for independence in
19 evaluating audit services was gone.

20 There was also the change I --
21 there were some others, but the change I
22 mentioned earlier, there was no requirement in

1 SOX that the SEC go back and look at these
2 categorizations, these disclosures firms were
3 required to provide about what they were
4 paying for audit and non-audit services. But
5 the accounting firms lobbied heavily to get
6 those definitions changed, and what they did
7 then is go in and take a number of services
8 and either classify some audit-related
9 services, the audit services and more of the
10 non-audit services into an audit-related
11 category, so that what was left in the pool of
12 non-audit services was much smaller. And,
13 also, any ability to compare pre and post-SOX
14 this percentage of fees for audits and non-
15 audit services sort of went out the window.

16 And Jonathan, I'm pretty sure it
17 was Jonathan Weil, wrote a column at the time
18 when this had come up, the SEC was describing
19 its rules, and they said that they had adopted
20 these changes in response to public comment.
21 And the SEC, he said, asked who outside the
22 audit firms had suggested the change? The SEC

1 official said it would be a good time to move
2 on to a new topic. This was something that was
3 actually strongly opposed by the investor
4 groups in the proposal but was adopted in the
5 final rules.

6 So, right after the -- shortly
7 after this all went through the implementation
8 process, we actually got our hands on this
9 document, and it happens to be an Ernst &
10 Young document. There's no reason to believe
11 Ernst and Young was alone with this. This just
12 happens to be where we got the documentation;
13 how they were presenting this new
14 responsibility to audit committees for their
15 clients. How you're -- let us provide you with
16 our guidance on how you should fill your role
17 in approving non-audit services, in which they
18 suggested that it was perfectly fine for the
19 audit committee to just rubber-stamp through
20 policies and procedures whole classes of
21 services, suggesting that the SEC did not
22 intend, having taken it out of the final

1 proposal, that the non-audit services be
2 reviewed in light of these principles for
3 auditor independence, and encouraging the
4 clients to group virtually everything into
5 this audit-related service category.

6 So, at that point, you know, that
7 soon after the adoption of SOX, a lot of these
8 provisions that had been placed in the
9 legislation were weakened. Now, that doesn't
10 mean that audit committees followed this
11 guidance. You know, I'm not here to suggest
12 that this then became common practice, but my
13 point is that at a point when the SEC could
14 have sent the message that they were really
15 serious about this, they sent a very different
16 message. And we don't know what the effect was
17 on how those decisions were being made at
18 companies at that time.

19 And then beyond that -- I'm just
20 going to go quickly through these, because
21 everybody knows that. Beyond that, you have
22 this authority for the PCAOB in terms of

1 setting standards, conducting inspections,
2 enforcement, and they have used that authority
3 in all three categories since the Act was
4 adopted and they were created.

5 They did new standards on tax
6 services that had been hotly fought during the
7 legislative battle, and they came back looking
8 at at least limiting advice about tax shelters
9 and some other related issues. They've also
10 taken a number of enforcement actions since
11 they were established. Kelvin actually went
12 through all of the enforcement actions related
13 to auditor independence and professional
14 skepticism and looked at what some of the
15 allegations were in those cases, and what the
16 sanctions. Did you want to add anything?

17 MR. BLAKE: Sure, just to give you
18 a break. As a state regulator who does both
19 compliance audits where I issue deficiency
20 comments to help the investment advisor or
21 broker dealer better run their practice and
22 provide better services to the investor. Also,

1 as an attorney where I bring enforcement
2 actions, I was very encouraged by the PCAOB's
3 track record, I guess, not only in issuing
4 perhaps hundreds of thousands of deficiency
5 letters where you try to encourage the audit
6 companies to better serve the client and the
7 public, but also in the number of enforcement
8 actions brought by the PCAOB. And in those
9 enforcement actions, which there are 47 total,
10 27 of the 47 involved violations of
11 professional skepticism. And that shows how
12 seriously you take that type of violation.

13 But I was also encouraged by the
14 level of sanctions imposed by not only --
15 against not only the accounting firm where you
16 have in many instances revoked the
17 registrations of the accounting firms, but
18 also against the accounting professionals,
19 where you have barred many of the accounting
20 professionals for engaging in violations of
21 independence or professional skepticism. So,
22 I was truly encouraged by the actions taken by

1 the PCAOB. Thanks.

2 MS. ROPER: So, you know, that's
3 sort of the history of how we got to where we
4 are today, which reflects both some -- as I
5 said, some long-simmering concerns, some
6 persistent pushback from the audit firms
7 against any suggestion that dramatic reforms
8 were needed, steps by Congress, by the
9 regulators to address certain of the issues,
10 and yet here we find ourselves today hearing
11 from the PCAOB, from international regulators
12 that they're still very concerned about what
13 they're seeing in terms of lack of
14 professional skepticism, objectivity,
15 independence in the audits of public
16 companies. And in the interest of time, I'm
17 not going to dwell on these except to say that
18 we're talking not just about problems in small
19 audit firms, audits of small companies, they
20 involve some of the largest issuers. And they
21 see a direct connection in many of these cases
22 between the serious deficiencies that are

1 found and the lack of professional skepticism
2 in the conduct of the audit.

3 One of the other things that has
4 come out in some of the inspections are
5 materials -- marketing materials in which the
6 auditor is described as a partner with a role
7 of supporting the issuer, where they would
8 stand by the conclusions reached and not
9 second-guess our joint decisions.

10 Now, I don't want to put too much
11 emphasis on marketing materials, but this is
12 actually something we've heard over the years
13 a number of times, which is this idea -- it's
14 come up in some of these -- like the
15 Complexity Commission, this notion, or SAG
16 discussions. We shouldn't be second-guessing
17 professional judgments. But I think to me, at
18 least, and maybe I'm alone in this but the
19 point of the audit is to second-guess. It
20 doesn't mean it always second-guesses and
21 differs but it is, in fact, sort of a -- it
22 should be an independent second look at the

1 issues, not just finding a way to support
2 management's position.

3 And then there have been a number
4 of specific examples out of recent inspection
5 reports, folks at the PCAOB and at some of the
6 European and Australian auditor oversight
7 boards. I thought it was interesting in the
8 Netherlands where the Authority for the
9 Financial Markets did -- took a look at the
10 audits of Big Four firms and found issues
11 related to professional skepticism. Their
12 conclusion was that a fundamental change of
13 conduct is necessary to improve the quality of
14 audits. The point being that both here at the
15 PCAOB and at the European Commission, the
16 suggestion has been made that we're not
17 talking about something where we need to be
18 sort of tweaking the system, useful as that
19 might be, but we're talking about something
20 where regulators are suggesting that
21 fundamental changes are needed to address what
22 they see as a very serious problem.

1 In the European Commission, I look
2 at their response to the financial crisis as
3 if they're having their Enron moment. A lot of
4 the issues that they're seeing in the wake of
5 the financial crisis mirror the responses we
6 heard after Enron, and some of the policies
7 that they're looking at in terms of limits on
8 provision of non-audit services are similar to
9 the issues that we addressed earlier in the
10 U.S. and are looking at now.

11 So, meanwhile, we have at the
12 PCAOB the Concept Release that came out where
13 we've had a little interest, 630 comment
14 letters as of mid-March, which if not a record
15 has got to be up there in terms of the level
16 of interest it's prompted. And the comment
17 period is still open, so it's not too late.
18 And then we had last week a two-day roundtable
19 here devoted to this topic.

20 Now, in the interest of full
21 disclosure I should say that I have not, in
22 fact, read every one of the 630 comment

1 letters, though I have at least browsed all of
2 the public statements from the two-day hearing
3 which is no small accomplishment. There were
4 how many speakers, 40 whatever. And some of
5 them I read in depth. And what I've tried to
6 do on the next series of slides is give a
7 sense of what messages come out of those
8 comments, because I think the hearing did a
9 good job of at least getting all the various
10 different viewpoints out into the public.

11 So, I mean, I think you see
12 there's a vast majority of commenters agree
13 that the combination of enhanced audit
14 committee responsibility, improved
15 communication between auditors and audit
16 committees, and not least PCAOB's inspection
17 and remediation authority have improved the
18 quality of audits and of financial reportings.

19 There's hardly anyone who fails to
20 acknowledge up front that they think they've
21 seen improvement since Sarbanes-Oxley was
22 adopted. Beyond that, though, you get this

1 sort of the spectrum of views from a sense
2 that really everything is pretty much okay,
3 that maybe we -- it might be appropriate to do
4 some tinkering with the system, but really the
5 system is working just fine as it is, to at
6 the other end of the spectrum people who still
7 see just a fundamental breakdown, a
8 fundamental lack of independence and a need to
9 radically reform, get rid of the client pays
10 model. And in the middle a group of people who
11 agree system is improved but there needs to be
12 some fairly significant reforms adopted. And
13 it's actually in that middle category that I
14 put the advocates of mandatory rotation
15 because while that's being viewed as sort of
16 a radical proposal that's out there right now
17 compared to some of the other suggestions that
18 are on the table it's really sort of in the
19 middle range of working within the existing
20 system rather than trying to go after the
21 client pays business model in a more
22 fundamental way.

1 So, I threw in the slides, and
2 since you can read I won't feel the need to
3 read them to you. A series of some -- pulled
4 out just some of the quotes from different
5 statements that are representative of those
6 different viewpoints.

7 I thought this one was interesting
8 just because it comes from a different sort of
9 perspective, but it says, "From the
10 perspective of auditor psychology the question
11 before the Board is easy and obvious. Of
12 course, the current system undermines auditor
13 independence. Indeed, the very notion that the
14 current system allows for truly independent
15 audits is laughably implausible."

16 So, as I say, at one end
17 everything is working fine. It makes me look
18 like a Moderate. I love it. And Chuck Bowsher,
19 you know, it's timely and somewhat overdue
20 that the SEC and PCAOB consider additional
21 issues that would further strengthen auditor
22 independence in addition to the ones enacted

1 in Sarbanes-Oxley legislation. I think it's
2 sort of indicative of the middle ground in
3 this discussion.

4 And then there were some --
5 there's much more than this, but there were
6 some comments within the letters on specific
7 issues. For example, Arnold Wright had
8 research -- we've talked a lot about the role
9 of the audit committee, research that
10 indicates that management rather than audit
11 committees still plays the dominant role in
12 decisions about hiring and firing the auditor.
13 Well, given that that was something that SOX
14 specifically set out to change, if that's
15 true, then that sort of invites the question
16 of what we need to do to revisit what could be
17 done to make that more effective.

18 And then again the issue that was
19 raised earlier of expanding advisory
20 practices, including into areas that are less
21 aligned with traditional audit and tax
22 practices.

1 And then you see the same
2 divisions play out when you look at the
3 comments specifically on mandatory rotation.
4 You have the range from strong opposition
5 particularly among certainly the audit firms,
6 and to those who think it does -- that
7 mandatory rotation doesn't go nearly far
8 enough. So, too far, not far enough, maybe you
9 have, in fact, found Goldilocks' Golden Mean.

10 When you look at those who support
11 mandatory rotation, you have -- so, you know,
12 some of the comments about getting a fresh
13 viewpoint, I thought Peter Clapman's comments
14 were particularly interesting because he's
15 been through it. And he says, "Having
16 participated in three auditor rotations the
17 results were better audits, similar costs, and
18 none of the dire consequences being argued by
19 many of the commentators against the PCAOB
20 Concept Release."

21 So, the positives that people tend
22 to focus on are a new viewpoint, fresh

1 viewpoint, and that limiting auditor tenure
2 might -- if they have less to lose auditors
3 might be more willing to challenge management.

4 There were -- among those who were
5 generally supportive, there were those who
6 were supportive with some reservations that
7 mandatory rotation was really the complete
8 answer. They saw it as a first step, or might
9 make things better, but it wasn't really going
10 to fully address the issue of auditor
11 independence.

12 And here again you get a quote,
13 Max Bazerman at Harvard Business School who
14 says, "The choice should not be between the
15 status quo and the reforms being proposed;
16 rather, the choice should be between whether
17 our society wants independent audits, or
18 whether it does not."

19 And I think this, again, is back
20 to that sort of initial point. We have an
21 assumption about what we say we want in
22 independent audit, and yet we don't actually

1 pursue policies that are designed to create a
2 truly independent audit, was his point, I
3 think.

4 Among the commenters, a number of
5 commenters, probably a majority of commenters
6 who are opposed to mandatory rotation, the
7 basic arguments are it impinges on the
8 authority of audit committees, it increases
9 costs and disruption, and it could undermine
10 audit quality particularly during the
11 transition to a new auditor.

12 There are also some more specific
13 concerns raised that there might -- it might
14 create an incentive for audit firms to invest
15 -- sorry, reduced incentive. I was going to
16 say that made no sense at all. Reduced
17 incentive for audit firms to invest in the
18 audit relationship when their time horizon is
19 short. There were concerns, specific concerns
20 raised that there aren't always enough audit
21 firms available for certain companies, that
22 not all audit firms have the same level of

1 expertise in all issue areas, so there were
2 some sort of practical concerns raised about
3 the workability of the approach.

4 And then, as I said, there were
5 some who opposed mandatory rotation not
6 because they thought it went too far, but
7 because they thought it didn't go far enough.
8 And among these is Jack, whose last name I
9 won't try to pronounce. Thanks, I always get
10 it wrong. Who has a proposal that he's put
11 forward for, as he would say, to try to align
12 the interest of auditors with shareholders in
13 a more fundamental way.

14 And then just beyond that, if you
15 go through the audit, the comment letters and
16 the comments at the roundtable, you know, when
17 we were at the last SAG meeting I said
18 something about don't just tell me if you're
19 against mandatory rotation, don't just tell me
20 why you're against it, tell me what you're
21 for. And the reality of these comments is
22 there are a lot of suggestions in here about

1 what people are for, so even opponents of
2 mandatory rotation have put out a number of
3 very concrete specific suggestions that they
4 think would help to improve the independence
5 and professional skepticism.

6 Some of them have suggestions that
7 are specifically related to making the
8 rotation model more workable, such as
9 requiring a dual audit by two firms in the
10 year preceding the transition starting with
11 just large financial institutions, requiring
12 more reporting by the outgoing auditor.

13 There's another whole set of
14 proposals that I've called tweaks to the
15 existing system. And I don't actually -- I
16 realized when I was looking back at it, that
17 sounds derogatory, and I don't mean it as a
18 derogatory term. I actually think there are a
19 lot of really useful suggestions on this list
20 that regardless of what the Board decides on
21 the broader issue of mandatory rotation are
22 things that ought to be under consideration.

1 And I did a terrible job of organizing them.
2 There's no logic to the way this list is
3 thrown together. I just started pulling them
4 out of letters and threw them onto the list.
5 But I encourage you to look through them with
6 some detail, because on there I think there
7 are some that are interesting. And one of them
8 that came up in a number of contexts, for
9 example, is -- reflects this desire to get
10 more information to audit committees about the
11 results of PCAOB inspections. So, we have --
12 there's a lot of discussion about creating
13 some sort of system that would permit the
14 PCAOB inspectors to discuss directly with
15 audit committees the results on a confidential
16 basis.

17 And, you know, some of the things
18 you would expect about improving training, and
19 communication, some that I found troubling
20 because it seemed to me that they were things
21 that were already required by law. But, at any
22 rate, as I say, I would encourage you to go

1 through them.

2 One of them -- this last one I
3 thought was also interesting. The suggestion -
4 - I don't know if this is realistic in terms
5 of resources, but that audit committees could
6 request the PCAOB perform an enhanced
7 inspection of the audit of their company and
8 report the results, which I actually think, if
9 it were workable, would be something that
10 might be an interesting idea to try.

11 There are a number of other
12 suggestions that are variations on the notion
13 that rather than go to sort of a complete
14 formal mandatory rotation, you have more
15 frequent process for putting the audit out for
16 bid. So, SEC Chairman Breeden has a suggestion
17 where he said rather than having mandatory
18 rotation at 10 years, you'd have a
19 presumption, rebuttable presumption that after
20 10 years independence had been impaired. And
21 prior to that time, the audit committee would
22 either have to at that point either rotate the

1 firm or explain why it had chosen not to do
2 so, what its reasons were. And for the largest
3 such audits he suggests that you could have a
4 PCAOB inspection in the seventh year. And
5 where they found serious problems they could
6 require rotation. But where there were no
7 problems identified, the period would start to
8 run again, so the audit firm could be
9 reappointed and that process would start to
10 run again.

11 Former SEC Chairman Pitt had a
12 similar example, and he talked about having
13 audit committees do more -- to consider more
14 frequently whether to retain the audit firm
15 and to document in a pretty concrete way under
16 appropriate guidance what was the basis for
17 their decision. And, again, he had a provision
18 where audit committees could be required to
19 dismiss their auditors where there's a PCAOB
20 finding of troubles. And then a further
21 example.

22 And then there were a couple of

1 people who suggested, as I said, taking the
2 more radical approach of changing the business
3 model. Jack Bogle from the Vanguard Group
4 talked about trying to find a way to make the
5 institutional investors -- organize them to
6 take more responsibility for overseeing the
7 audit. He didn't spell out what he thought
8 that might look like, but suggested that. And
9 then, as I say, Jack offered a pretty detailed
10 proposal for having financial statement
11 insurance.

12 Now, that's something that the EU
13 looked at and dismissed as not really sort of
14 ready for prime time. But his -- he makes a
15 pretty compelling case that you'd have --
16 you'd be using market incentives to -- would
17 be aligned to create more reliable reporting,
18 because you have the insurer who wants to
19 minimize losses so they're interested in
20 promoting good reporting, and they will set
21 their premiums based on what they see as the
22 risk, and issuers who want to lower their

1 premiums who will then --

2 MS. SIMPSON: Oh, I'm so sorry. I
3 apologize. But I'm just saying perhaps the
4 gentleman addressed this, but the problem here
5 is that that's still coming out of shareholder
6 funds. I mean, just like D&O insurance, you
7 just pay for -- it's like litigation. You
8 know, you pay the first time when you lose the
9 money, and you pay again when it's the -- so
10 unless there's some other source of funding
11 that's supplied you're just picking your own
12 pocket.

13 MR. SONDHI: I'm sitting here as an
14 investor. I now have to pay for the insurance
15 company, I've got to pay for the auditor.

16 MS. SIMPSON: And you alleviate the
17 duty on the directors to get it right.

18 MS. ROPER: So, clearly not a
19 popular idea with this crowd.

20 MS. SIMPSON: The sidelines.

21 MS. ROPER: So that is designed to
22 give you an idea of sort of the scope of ideas

1 that have been put on the table around what
2 the PCAOB could or should be doing to enhance
3 independence, objectivity, and professional
4 skepticism.

5 And just to sum up, there were two
6 quotes that I thought were worth pondering
7 before I throw it open to you all for your
8 broader discussion. One is from a Washington
9 Post editorial. I think it was probably
10 written by Sebastian Mallaby back -- it was
11 back during the Enron era when Congress was
12 considering SOX. And he wrote, "There's a
13 price to regulation. When you tell companies
14 not to hire their auditors you may distort the
15 job market. When you force them to rotate
16 audit firms, you impose real costs, but the
17 efficient allocation of capital depends on
18 accurate bookkeeping, and the books won't be
19 accurate so long as auditors remain conflicted
20 or corrupt. In this contest between audit
21 firms, business models, and the public's
22 interest in disclosure surely somebody will

1 take the public's side."

2 And then more recently, Jonathan
3 Weil writing in a large article about MF
4 Global and Olympus, he writes, "So many large
5 companies have blown up after getting the all-
6 clear from a Big Four accounting firm that
7 many people regard auditor opinion letters as
8 a joke. The biggest fear for the Big Four
9 cartels should be that some day investors will
10 become so fed up that they demand the status
11 quo be chucked entirely figuring they've got
12 nothing left to lose. We're not there yet, but
13 give it time. If the auditing profession can't
14 figure out a way to re-instill value in its
15 most basic product even terrible solutions may
16 start to look like drastic improvements."

17 So here are just some discussion
18 questions that I've thrown together for you to
19 consider, but I throw the floor open to all of
20 you.

21 MR. HEAD: This is, obviously, out
22 of all the things today and not that I have

1 been bashful today because I have not, but of
2 all the things today this is probably one
3 where I'm the most passionate about, because
4 I've been on both sides. I've been an external
5 auditor for a Big Four firm. I started
6 internal audit functions, I've helped create
7 and start enterprise risk management
8 functions, and I currently serve as a Chief
9 Audit Executive for a registrant, TD
10 Ameritrade.

11 And there's -- my first bottom
12 line is I wholeheartedly agree, which this is
13 a very, very well done, thought out
14 presentation, and thank you very much for
15 that, and very balanced and fair, so thank
16 you. That I do think we want to be careful not
17 to address the symptom, and try to address
18 true root causes. So, my headline would be I
19 think audit rotations is addressing a symptom,
20 not a root cause.

21 But then, as you say, well, what
22 would you do? That's nice, Mike, that's great,

1 but what would you do? I really feel some of
2 the root causes that if addressed would make
3 audit rotation a non-issue which is addressing
4 non-audit services and making -- not that they
5 don't provide non-audit services to other
6 clients, but to that client, it's nothing but
7 audit services.

8 I really, really think there's a
9 model that's somewhat of a hybrid of several
10 of these where there could be a pay dues and
11 someone like a PCAOB actually makes the hiring
12 decision of the firm for a registrant, but
13 it's not that an insurance policy -- the
14 company would be paying into a pool, and the
15 audit committee and the PCAOB maybe would have
16 some mechanism of jointly considering hiring
17 the firm, a recommendation coming from PCAOB
18 based on a bid process, and the audit
19 committee selecting it. And that based on
20 performance indicators, and the performance
21 over a period of time, be it five or ten
22 years, and then at the end a reassessment of

1 the firm, how did they perform? Was there
2 consequences if they hadn't?

3 I think part of the bidding
4 process should be a PCAOB examination of that
5 firm and the results of that reported directly
6 back to that audit committee. And as part of
7 what the registrant is paying to -- if it's
8 not PCAOB, another entity of some kind. And
9 that if the performance has been good, and the
10 results of that audit at the end of whatever
11 period of time are good, then based on a
12 competitive bid process they would be the
13 leading candidate because they have the
14 requisite knowledge, they have the accumulated
15 audit knowledge, and they could and should be
16 rehired. And address from that aspect, I think
17 forcing an audit rotation and leaving it --
18 leaving the other things unaddressed, again,
19 I think is taking aspirin for a fever versus
20 addressing that the firm that's hired may be
21 and could very well be the best, most
22 qualified firm to do that audit. And by

1 forcing the audit committee to fire them every
2 six, or seven, or ten years makes no logical
3 sense to me. It should be based on
4 performance, results of the audit, the audit
5 quality, and how you put the things in place
6 to insure that does have objectivity and
7 independence, not force a symptom to address
8 the ultimate solution.

9 And the one thing that I have not
10 heard enough about here is in a well organized
11 governance structure for a company that has
12 the audit committee overseeing all audit
13 services including a qualified internal audit
14 function that is complying with the
15 professional standards that have been
16 established by the Institute of Internal
17 Auditors and they reporting from a functional
18 and fiduciary point of view directly to the
19 audit committee can serve a very important
20 role in assessing management's opinion on
21 internal controls, assessing the effectiveness
22 of the external auditor's role, and be another

1 I'll call it objective because unless they
2 were paid for not by the company, some people
3 get hung up on the term independent. I don't.
4 I think it can be independent and objective if
5 the Chief Audit Executive is evaluated by the
6 audit committee and the audit committee
7 chairman, that they're reporting directly,
8 that they're qualified, they have the right
9 training, they have the right background, they
10 have the right resources, and they can
11 complement and add a lot of assurance and
12 comfort for the audit committee and
13 shareholders if they're structured right. And
14 that partnership between that and addressing
15 some of the root cause I think is a much
16 stronger path to go than forcing a mandatory
17 rotation just because that could be legislated
18 and it ignored all the other things that are
19 really, in my opinion, root causes.

20 So, thank you for listening to me.

21 I'm obviously very passionate on this topic.

22 MR. HARRIS: Thank you. Bob.

1 MR. TAROLA: Barbara and group,
2 thank you for distilling down three days or
3 more of interviews and sessions. It was --
4 now, I don't have to go back and read it all
5 so I appreciate that. But I agree with Mike in
6 terms of getting the root cause, but I don't -
7 - to me, the root cause is the business model.
8 And you have an industry that has a public
9 franchise that has barriers to entry, that no
10 audit committee in their right mind would say
11 I want the cheap audit, not the good audit.
12 So, you have a high demand for services in a
13 very structured industry.

14 The product is independence,
15 objectivity, and professional skepticism, so
16 it seems strange to me that some firm wouldn't
17 take advantage of that situation and step up
18 and basically put forward themselves as that
19 kind of product, not the product of a whole
20 website full of services. And in doing so, and
21 maybe that's where the regulators come in,
22 there's no -- I'm having trouble seeing the

1 disadvantage of moving toward I don't want to
2 say audit only, audit focused, audit
3 insurance, whatever you want to call it, but
4 a way to improve the public's view of the
5 capital markets, and fulfill their public
6 franchise. I don't think they're inconsistent.
7 I don't think making money is inconsistent
8 with that, so I'm a little at odds with the p-
9 - sort of the position being taken.

10 MR. HARRIS: Tony Sondhi.

11 MR. SONDHI: Thank you, Steve. I'm
12 just wondering about the discussion we've had
13 and the evidence you've shown about the split
14 between the audit fees and the non-audit fees.
15 There's a very simple principle in financial
16 reporting that says when you sell two things
17 in a bundled arrangement you can't take what
18 you said the value of each of those was,
19 you've got to figure out what the real value
20 is. So, I think that the audit firms who are
21 supposed to be applying the standard seem to
22 be playing a game with that, too.

1 So, I wonder is it they're
2 deliberately keeping the amount of the audit
3 fees down when you look at the extent to which
4 there's a difference. And I understand that it
5 wouldn't necessarily apply if you were talking
6 about non-audit fees that are sold to a
7 company -- to a firm that you're not auditing.
8 I understand that, but there's an interesting
9 question, I think, in there. I think that they
10 have deliberately played this game with
11 respect to the audit fees.

12 MS. ROPER: So, it's an interesting
13 question. So, pre -- in the initial
14 disclosures, when they first did the
15 disclosures were they deliberately making the
16 audit fee look lower than it was by
17 classifying a bunch of things as not part of
18 the audit fee?

19 They certainly lobbied hard during
20 the rulemaking process to get as much as
21 possible thrown into the audit fee category,
22 presumably because now non-audit fees were --

1 non-audit services were now blackballed, and
2 because the audit committees were expected to
3 look at this issue of proportion between audit
4 fees and non-audit fees.

5 Suppose you look at that
6 proportion in terms of thinking about conflict
7 of interest, so I don't know what -- you know,
8 the incentives have clearly changed in that
9 period between how you want to present the
10 numbers.

11 MR. SONDHI: I think the point
12 really is that you can -- by saying that we
13 are doing X number of things, we'll call all
14 of these audit, but the fee we're charging is
15 much lower. And I think that's the deliberate
16 part of it. So, it's not really a question of
17 what gets called what. That's something that
18 I think is very, very difficult to accept from
19 that perspective.

20 I think the other point that you
21 made which is very important to keep in mind
22 is the weakening of the financial expert

1 requirement. I think that's a critical area.
2 And, again, no surprise that they did that,
3 but it's clearly there, because you can see p-
4 on the other hand, I must say that it also
5 reminded me of the comment by the head of the
6 audit committee for Enron who said that
7 management was -- and he was a chaired
8 professor at Stanford, who said that he didn't
9 know why he would have to check anything.

10 MS. ROPER: Well, there was -- I
11 remember right -- there was right around that
12 time, and I couldn't -- I didn't take the time
13 to dig it out, there was language that went
14 out sort of post-Enron, pre-enactment of
15 Sarbanes-Oxley that clearly some law firm had
16 put out that basically audit committees were
17 using to disclaim any responsibility for any
18 kind of oversight of the numbers. We just sort
19 of look at what's given us, and we don't --
20 so, it seemed to us at the time that there was
21 -- that audit committees were a pretty slender
22 read on which to pin our hopes for reform. And

1 then when they did the rules, as you say, on
2 financial experts there was a concern that if
3 they set the standard too high, or least
4 that's how it was presented, that if they set
5 the standard too high they wouldn't have
6 enough candidates to serve on those positions,
7 which may be a legitimate -- I don't know.

8 MR. SONDHI: But they could phase
9 it in.

10 MS. ROPER: Right.

11 MR. SONDHI: It's not as if you
12 have to do it right away. And it's not as if
13 that couldn't be built. It's not as if there
14 aren't people out there.

15 MS. ROPER: And if you look at what
16 the suggestions are now, particularly from the
17 audit firms in this area of how we can improve
18 the existing system, improving the expertise
19 of audit committees, improving the resources
20 they have available to them, improving
21 training are all sort of up in there. We're
22 still back to this notion of how do we make

1 this audit committee oversight function work
2 better.

3 MS. SIMPSON: Thank you very much
4 to the group. I apologize. Thank you very much
5 to the group, and to the previous group. I
6 didn't get a chance to compliment you, either.
7 This is such a useful day.

8 I have a question which is -- goes
9 back to what's happening in the European
10 Commission. And I know I rattled off a few
11 points before we talked about going concern,
12 but I'm going to make a statement of the
13 bleeding obvious, as they say in London, which
14 is the Big Four at the center of attention
15 here are the same Big Four at the center of
16 attention in Europe. So, the -- what the
17 European Commission thinks it's tackling
18 include an issue of independence, but they're
19 looking at it in a rather more integrated way.
20 And I think there's an advantage for that.

21 So, first of all, they're saying
22 what's the purpose of their reforms? And

1 remember what they're doing, they're proposing
2 to ban non-audit consulting, to make rotation
3 mandatory, and a string of other things. So,
4 whether this all happens and they get it
5 through, I don't know. But the same Big Four
6 are having to deal with that agenda in Europe.
7 It's the same networks. And this is why they
8 think they have to put this package of reforms
9 forward.

10 So, one, a lack of choice for
11 audit clients resulting from high
12 concentration levels, in essence, an
13 oligopoly. Two, systemic risk if one of the
14 Big Four collapses. Three, possible conflicts
15 of interest and issues around the independence
16 of auditors. Four, doubts around the
17 credibility and reliability of the audited
18 financial statements of banks and other
19 institutions and listed companies. These came
20 in for heavy criticism during the crisis.

21 So, I think that something I put
22 really as a question to the PCAOB Board is,

1 are we in danger of trying to think about the
2 Big Four and the structure of this industry,
3 the business model, the numbers, the
4 oligopolistic, the dominance, I mean these
5 same Big Four, just to give you the numbers
6 from the European side. I mean, the dominance
7 is extraordinary.

8 The market share of the Big Four
9 for audits of listed companies is 99 percent
10 of the first C100, 95 percent of the C350, in
11 Germany two of the Big Four have the mandates
12 for 90 percent of the companies on the DAX 30,
13 and Spain all of the IBEX 35 are audited by
14 the Big Four.

15 So, ought we not to be thinking
16 about this from a regulatory point of view,
17 from a global side? So, if we're having -- if
18 Europe is battling all this out, and then the
19 PCAOB is battling it all out, and it's
20 actually the same networks, and the same
21 people we're dealing with, and the same global
22 economy, and the same capital flows, you know,

1 certainly for CalPERS, we're in all these
2 European markets as well as in the U.S. So, I
3 just feel we haven't had the opportunity to do
4 some joined up thinking.

5 So, I apologize for returning to
6 the same point later in the day, but the Big
7 Four are going to have to deal with mandatory
8 rotation after six years in Europe. It's
9 happened for good or ill. Surely, that sets a
10 different conversation over here about what
11 happens next.

12 MR. HARRIS: Well, to punt your
13 question in the interest of time, what I'd
14 like to do is, we've got 20 minutes left, and
15 we've got a number of cards up, so I want to
16 keep the cards up.

17 No, no, it's fine, but what I'd
18 like to do in wrapping up is for the people --
19 everybody to make recommendations in the
20 remaining time. So, rather than us asking
21 questions, I'm punting the question because
22 clearly we can't act in isolation. I mean, we

1 can but we've got to be cognizant of what's
2 going on throughout the rest of the world. But
3 why don't we go around the room, and to the
4 extent that -- Judge -- I don't want all the
5 tent cards to go down otherwise we can finish
6 five minutes early, or ten minutes early,
7 which is fine, as well.

8 Judge, you had a point, and to the
9 extent that anybody wants to make
10 recommendations to the Board in terms of what
11 you think we ought to be doing, in terms of
12 wrap-up, or bringing up any other issues as we
13 close out the day, that would be very helpful.

14 Now, you made the 1982 speech in
15 San Diego, and not a lot has changed since
16 there, so maybe you can take off on that.

17 JUDGE SPORKIN: I want to
18 compliment the PCAOB. I've been around a long
19 time, but this is one agency -- what I like
20 about it, it seems to be free of politics. You
21 seem to all want to be doing the right thing.
22 I have known you what, 50 years. I've known

1 Doty, I know Lew. I don't know the other two,
2 but I know that you all want to do the right
3 thing. We start out with that, so we've got
4 something good to build on.

5 The other thing that occurs to me,
6 we've got -- with auditors you've got two
7 issues, two problems. One, negligence, has
8 someone screwed up and they didn't find
9 something. And the other one is aligning their
10 interests with management. Okay?

11 The negligence one I think you
12 people, if you're not in control now, can be
13 in control of. That's the kind of thing that
14 the person didn't see some -- and, by the way,
15 you and the firm itself is interested in
16 rooting out negligence in a firm, so I don't
17 think that should be the big issue.

18 The real issue is the alignment.
19 The real issue -- and that -- we seem to be
20 going around the subject. We're saying it's
21 independence, it's this, it's that, it's the
22 other thing. And really it is, is alignment.

1 And what these auditors have to do is they're
2 like umpires in a game. They've got to call
3 the balls and strikes as they see them. They
4 cannot take -- just try to accommodate the
5 people -- the company they're working for.
6 That's got to be taken out of the game. You've
7 got to do that.

8 Now, you and your inspections,
9 obviously, ought to be looking for that
10 tendency. Are they then trying to put their --
11 give their support to the issuer, and trying
12 to do the kind of thing that I found in the
13 Keating case and whatnot, in which they
14 weren't doing their job. They weren't looking
15 and say hey, look, this is wrong. Okay? You've
16 got to root that out.

17 Now, what do you have to do here?
18 How are you going to get the good audit? Well,
19 that's really again up to you and the SEC. It
20 seems to me that you could do things two ways.
21 One, you can do a structural basis and do it
22 like in a bureaucratic way. And I'm not trying

1 to be too -- complaining about it, but the
2 other way you can do an exception basis.

3 If you now find that the firms
4 that you regulate are not doing what they're
5 supposed to be doing, you've got to take
6 action against them. And you can't be too big
7 to regulate. Even though there are only four,
8 you cannot be too big to regulate because our
9 system will fill that void. We will get
10 somebody else if we have to get rid of one to
11 do it.

12 So you say okay, yes, if you
13 perform you're going to continuing basis. And
14 one of the things I don't like about trying to
15 do on this rotation basis, it seems to me it's
16 like saying that if somebody is too good and
17 too smart he can't continue. That's not right.
18 In other words, if you have a firm that's
19 doing a good job and they've done it over the
20 years, and they've done all the things we want
21 them to do, there's no reason why they ought
22 not to be able to continue doing that. Our

1 system looks for excellence, and if people are
2 excellent they ought to be continued.

3 But really, that's really on -- I
4 say look at the exception basis. If somebody
5 isn't performing, then they ought to be
6 sanctioned. And you can put severe sanctions
7 on companies. You can say that you cannot
8 continue with that audit. They have to go out
9 and get another auditor, but it means that you
10 can't shirk your job, or the SEC can't shirk
11 its job. They've got to go -- and that will
12 take care of this problem.

13 I saw it done in my day. I hate to
14 go back to that, but I think we did a pretty
15 good job. Look, I brought in my day -- we sued
16 the auditors 28 times in the time I was there
17 because we didn't care. And we told them
18 certain times you can't go and take new
19 business, certain times you can't do certain
20 things, but you've got to have that -- if you
21 don't have that -- if that's not your goal, if
22 that's not your objective, then really, you

1 know -- and nobody can really find fault with
2 that. They could do all they want. They can't
3 go to Congress and say override the PCAOB if
4 you make a decision based on the facts, and if
5 you show that a firm has done something wrong
6 and they're not complying. And try that as
7 something you can do, you don't need any kind
8 of -- you don't need surveys, you don't need
9 anything else. You don't need legislation. All
10 you've got to do is do your job. When they
11 come in with a report, your people, look at
12 the report. If they don't measure up, take
13 your action.

14 MR. HARRIS: Spoken like a former
15 head of enforcement.

16 JUDGE SPORKIN: Saying it like it
17 is.

18 MR. HARRIS: Well, if people would
19 like to make concluding comments, I think now
20 is probably the time to go around. And if you
21 want to offer any suggestions, ask any
22 questions, please feel free.

1 MR. BLAKE: I just wanted to thank
2 Barbara for her leadership, and doing the vast
3 majority of this work. Thanks.

4 MR. HARRIS: I second that.

5 MR. STARR: We probably don't have
6 time to address this, but the panel on -- or
7 the Working Group on Audit Firm Practice and
8 Transparency had under other considerations a
9 question which was, should the PCAOB initiate
10 or issue a Concept Release on whether global
11 networks impact audit quality? And I would
12 have liked to have heard some of your thinking
13 on that.

14 MS. YERGER: We had no thinking on
15 it. We thought it was important, but we really
16 only decided to focus on those two items. I
17 think we kept it as a placeholder and
18 something, I think, of great value for
19 consideration by the Board, this group, and
20 others.

21 MR. STARR: So, when you say --

22 MS. YERGER: Decided we didn't have

1 time to address it. We thought it was
2 important, but kind of tabled it.

3 MR. STARR: Okay, thank you, Ann.

4 MS. ROPER: What they thought was
5 that you'd make a great Committee Chair for a
6 Committee for the next meeting to lead that
7 topic.

8 (Laughter.)

9 MR. STARR: Unfortunately, my views
10 express my views solely, and I can't do that.

11 MR. HARRIS: Well, be careful what
12 you wish for, as well. Does anybody else have
13 any concluding remarks?

14 MS. HILL: Just one thing, well,
15 two things. Tony, I think you had raised the
16 question were audit committees putting
17 pressure on auditors to keep their fees down.
18 And I will tell you that the answer is yes, in
19 all of the committee meetings I'm aware of
20 after the tremendous fees to comply with
21 Sarbanes-Oxley, then people started saying the
22 books are clear. And what you're doing is

1 status quo, and no, you can't raise your fees.
2 So that's been very much a reality.

3 I think the other thing, to
4 Barbara's point, you said that audit
5 committees were told by the auditing firms
6 what they could and could not do. And I would
7 just say that it really is -- it has been
8 governance lawyers, and internal counsel that
9 has interpreted the laws to the audit
10 committees and to the Boards in my experience.

11 MS. ROPER: Right. Can I clarify,
12 because what I said was something specific.
13 That an audit firm, and we had no reason to
14 believe it was isolated, put out an advisory
15 to its audit clients about its advice on how
16 they take on this new role of reviewing non-
17 audit services. And I think I was specific in
18 saying that we did not then assume because
19 they had done that that audit committees then
20 fell into line and followed their pattern. So,
21 I made a distinction between what the
22 literature was advising, how they were seeking

1 to use this process to achieve their ends, not
2 how audit committees --

3 MS. HILL: Okay. And they may
4 advise -- the reality is that that information
5 really does have to come from legal counsel.
6 One of the things that strikes me is that
7 shareholders have been very vocal about a
8 number of other things, so that if for some
9 reason shareholders feel they're not being
10 well served by the auditors, I can't imagine
11 they wouldn't speak out, or perhaps they
12 should. I mean, that -- again, shareholders
13 have an active role in that. But as the Judge
14 has said, as long as the company is being run
15 well, things are going well, they tend to be
16 very satisfied. That's not to say the Board is
17 always, so I think the Board has to continue
18 to take more responsibility, as well as the
19 audit firms. It is not difficult to find
20 financial experts to serve on the Board, so I
21 think we have to continue that. I think that's
22 a good practice, and that we should encourage

1 it.

2 MR. HARRIS: Thank you. Anne.

3 MS. SIMPSON: Thank you, and I
4 wholeheartedly agree with Bonnie. I think that
5 it is time for shareholders to step up. And if
6 we were to look at the votes cast on the
7 reappointment of auditors in recent years,
8 even where there had been grim, grim results
9 that had not been detected in advance, I think
10 we would all look rather ashamed that we
11 weren't paying more attention. So, I think
12 that's a place marker, the role of
13 shareholders and what shareholders could and
14 should be doing to back up the improvement in
15 quality.

16 And just for the record, to say I
17 would welcome the PCAOB looking at the
18 European Commission proposals, there's an
19 underlying, I think, shared interest in making
20 this work. We as global investors would
21 certainly find that extremely helpful. And
22 because you're dealing with the same people

1 through the audit networks it could actually
2 be efficient. It doesn't mean that Europe's
3 got it right, but it would -- I think we would
4 all benefit enormously from that coordination.
5 And if you think there's some work that we can
6 help with -- accomplish through this advisory
7 group, we'd be glad to contribute.

8 MR. FERGUSON: Let me just say that
9 we are very aware of what the European Union
10 is doing. We're in -- our people who do this
11 stuff are in contact with them. We have
12 discussions with them. We are in contact with
13 the Financial Reporting Council of the United
14 Kingdom, so we're -- and aware of the various
15 reports that are being done, so we're very,
16 very aware of that. I think we have not felt
17 it appropriate to put out public statements on
18 what other regulators are doing, but we are
19 very, very aware of that, and very aware --
20 it's part of -- one of the things that
21 motivates the many initiatives we're
22 undertaking, because we're aware that these

1 issues are being considered around the world.

2 MR. HARRIS: Brandon, then Ann,
3 then Brian.

4 MR. BECKER: At the risk of being
5 presumptuous, I think on behalf of the
6 Committee I would just thank the Board members
7 for the gracious extension of their time and
8 their willingness to engage with us. I thought
9 that the one consensus of the entire Committee
10 was how critical the Board's role is in
11 improving audit quality, and our view that by
12 improving audit quality the Board is making a
13 material contribution both to capital raising
14 and protecting investors, and we very much
15 appreciate your efforts and your willingness
16 to listen.

17 MR. HARRIS: Thank you very much.
18 Brian.

19 MR. CROTEAU: Thanks, Steve. I just
20 wanted to comment on a couple of things, a lot
21 of really good and helpful discussion today,
22 and I really appreciate that. I was encouraged

1 by some of the discussion, in particular,
2 relative to insuring we're focusing on root
3 causes not just symptoms. And some of the
4 discussion this morning relative to
5 inspection, process and reporting, and
6 thinking creatively about ways we can even
7 further leverage the results from inspection
8 work, and think about the types of reporting
9 that could be done under Rule 4010. I don't
10 think anyone mentioned it this morning, but I
11 know the PCAOB's Strategic Plan also has an
12 item in it relative to outreach on their
13 inspection reporting, as well, to think about
14 ways to continue and improve their inspection
15 reports, which is, I think, another important
16 area for consideration. So, again, thanks very
17 much for all the helpful input today and look
18 forward to continuing dialogues like this.

19 MR. HARRIS: And I want to conclude
20 where some members began. I want to compliment
21 Joanne Hindman on her really outstanding work
22 in pulling this together.

1 (Applause.)

2 MR. HARRIS: Congratulations, and
3 Jennifer Jumonville did a terrific job in terms
4 of all the logistics, did an outstanding job,
5 as well. And then I can't say enough about Bob
6 Burns, our general counsel, Counsel's office,
7 and Nina Majura Vassad, and finally
8 compliments, plaudits to you. This has taken
9 a terrific amount of effort and time out of
10 your workload. It is a public service. We
11 appreciate it, and we look forward to picking
12 your brain. And as you can tell from the
13 meeting last year, a number of your
14 recommendations were taken very seriously and
15 acted upon by the PCAOB, and I think we will
16 take what you said today under advisement, and
17 presumably get back to you a year from now.
18 Thank you.

19 (Whereupon, the above-entitled
20 matter went off the record at 4:52 p.m.)
21
22

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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Investor Advisory Group

Before: Public Company Accounting Oversight Board

Date: 03-28-12

Place: Washington, DC

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Court Reporter

NEAL R. GROSS

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