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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Investor Advisory Group Meeting

Tuesday, May 4, 2010

9:00 a.m.

The University Club

1135 Sixteenth Street, N.W.

Washington, D.C.

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1 meeting.

2 We tried to structure our meeting around

3 these broad topics with the objective of providing

4 every member with an opportunity to discuss his or

5 her top priority.

6 More specifically, the topics will be

7 presented today as part of five panel discussions as

8 follows: First, we will have a discussion on lessons

9 learned from the financial crisis and the

10 establishment of a fraud center. Initiating

11 discussion will be Brandon Becker and Mike Head.

12 Next, we will discuss foreign inspections

13 with Joe Carcello and Ann Yerger leading those

14 discussions.

15 After lunch, we will talk about greater

16 transparency and governance of auditor firms with

17 Pete Nachtwey, Anne Simpson, and Lynn Turner doing

18 the introductions.

19 Lynn, I want to thank you personally for

20 being here. I know you were invited to testify this

21 morning on the Hill in front of Senator Specter at

22 the Judiciary Committee, so we appreciate your

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1 presence. I know Barbara Roper and Damon Silvers did

2 accept that invitation, and they will be here later.

3 Then we will focus on greater transparency

4 of the audit process with Kelvin Blake, Norman

5 Harrison, and Bonnie Hill.

6 And the last panel discussion will be on

7 auditor expertise and responsibilities with Tony

8 Sondhi, Judge Stanley Sporkin, and Bob Tarola.

9 After a very brief introduction of the

10 panel by one of the PCAOB board members, each panel

11 will initiate and discuss their topic and then lead

12 the other group members in a discussion of the topic.

13 At the end of the day, there will be a

14 sixth session reserved for an open discussion on any

15 topics not adequately addressed by the panel

16 discussions.

17 In short we have structured this meeting

18 in order to provide an opportunity for an open

19 discussion by the group so we can hear your views and

20 priorities for the PCAOB. Throughout today's

21 meeting, I would ask of you keep in mind and seek to

22 answer the question: How do we make audits more

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1 relevant to investors?

2 We would also note today's meeting is

3 being webcast. Since we would like the open

4 discussions to be informal and free-flowing, please

5 do not feel as though you have to be recognized to

6 speak. We would ask, however, that for the benefit

7 of those listening to the webcast, you identify

8 yourself the first time you speak and periodically

9 throughout the day.

10 This meeting is open to the public and the

11 group members' written statements that we received

12 have been posted on our website.

13 Before getting started, let me recognize

14 our acting chairman, Dan Goelzer. Then SEC

15 Commissioner Walter and our board members, Bill

16 Gradison and Charlie Niemeier, and open the floor up

17 to them for any opening remarks they would like to

18 make.

19 CHAIRMAN GOELZER: I would like to join

20 you in welcoming everyone to this inaugural meeting

21 of the Public Company Accounting Oversight Board's

22 Investor Advisory Group.

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1 As Steve noted, the board's mission is

2 investor protection. Our job is to further the

3 interests of investors in reliable audited financial

4 reporting.

5 Despite that fact, understanding what

6 investors want and need -- I think -- has proven to

7 be somewhat of a challenge for us.

8 We certainly hear frequently from

9 individual auditors, from accounting firms, from

10 preparers; and naturally so, because our work

11 directly affects them.

12 But I think we have less input from

13 investors, and this group has been created in order

14 to try to change that state of affairs.

15 Under Steve's leadership, as he already

16 outlined, we put together I think a very ambitious

17 and wide ranging agenda of topics together. I'm

18 certainly looking forward to hearing everyone's views

19 on what we ought to be doing to address these issues

20 that confront us.

21 I'd just add I think this advisory group

22 has been created at an especially appropriate moment

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1 in the life of the Public Company Accounting
2 Oversight Board. We've been in operation about seven
3 years now. It is hard for me to believe that seven
4 years have passed.

5 In that time, much of what we've done has
6 been devoted to taking the blueprint that the
7 Sarbanes-Oxley Act laid out and making it into a
8 functioning, active set of programs.

9 And indeed, we do have an inspection
10 program, standards setting program, enforcement
11 program, risk assessment effort, all of which -- if
12 not fully mature -- are at least robust adolescents
13 at this point. So I think it is a good time for us
14 now to step back a bit and ask ourselves what
15 challenges have emerged along the way and what we
16 ought to be doing better or differently in order to
17 accomplish our mission. I certainly see this meeting
18 today as part of that kind of assessment process.

19 As Steve noted, we are fortunate to have
20 one of the SEC commissioners here with us today,
21 Elisse Walter. This is particularly a treat for me
22 because Elisse and I go way back. We worked together

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1 on the staff of the SEC in the '70s and '80s.

2 It is okay to say that, isn't it, Elisse?

3 COMMISSIONER WALTER: Unfortunately.

4 CHAIRMAN GOELZER: Elisse went on to serve
5 at the CFTC and work at FINRA, so I think she has a
6 unique background for the sort of issues that we're
7 going to discuss here. I'm glad she's willing to
8 devote her time to us here today.

9 Do you have comments to make at the
10 beginning?

11 COMMISSIONER WALTER: Thank you, Dan. I
12 want to thank Steve as well for his very kind words.
13 Whether because of heredity or because of my years
14 with Dan or my years in the Division of Corporation
15 Finance at the Commission, I think accounting is
16 somewhat in my blood; and I do think that auditors
17 are particularly important to the proper working of
18 our investor protection and capital formation
19 systems. They are really critical gatekeepers.

20 What the PCAOB does -- and it was a long
21 time in coming, but it is good to have it here -- is
22 so critical to the Commission's overall mission and

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1 being successful in carrying it out. We share with
2 you the challenges of effectively receiving investor
3 voices; and in large part, through the efforts of
4 some of the people in this room whom I know well, I
5 think we are getting better at it.

6 But we are not all the way there. I too
7 want to congratulate Steve for spearheading, setting
8 up this group, and I look forward to what I get to
9 hear today and becoming more educated.

10 I do find perhaps the greatest
11 concentration of my time as a commissioner has been
12 in the accounting and auditing area. So I confess to
13 already spending a lot of time with accountants, and
14 I'd like to actually spend a bit more.

15 So I stand ready to be educated this
16 morning and add any value I can.

17 Thank you for having me here.

18 CHAIRMAN GOELZER: Thank you.
19 Bill?

20 MR. GRADISON: Thank you, Dan.

21 I want to add my word of thanks to Steve
22 for taking the lead in recommending that this group

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1 be created and introducing so many of you who bring
2 so much knowledge to the table to join us here today
3 and in the future.

4 My old background actually was working
5 directly with investors as the general partner of a
6 small New York Stock Exchange firm in my hometown of
7 Cincinnati for years.

8 We were mostly dealing with individuals
9 and small businesses, small pension funds, profit
10 sharing funds, charities, and things of that kind.

11 Of course the world has changed enormously
12 since that time. Investors are far more involved in
13 working through institutions, and that's been a very
14 dramatic change.

15 Many of you -- perhaps all of you -- bring
16 to bear experiences that go way beyond the things
17 like that I learned when I was out in the field years
18 ago; and I look forward to learning from you in the
19 course of not only this session but others in the
20 future.

21 CHAIRMAN GOELZER: Charlie?
22 MR. NIEMEIER: Certainly, this is a very

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1 important event for us. I think Dan put it well. We
 2 are at a pivotal point in the evolution of the PCAOB
 3 and where we fit into the system.
 4 We have, I believe, a good foundation; but
 5 it is time to really take a look at what we've done
 6 to take a look at what we need to do to improve; and
 7 sort of where I sit, there's still a lot of room for
 8 improvement. We're very interested in hearing what
 9 you have to say and what we can do to make these
 10 things reality.
 11 Thank you.
 12 MR. HARRIS: Before we actually get
 13 started, if we could go around the room and everybody
 14 briefly introduce themselves.
 15 Judge, I'm not sure you need an
 16 introduction. Why don't you start?
 17 JUDGE SPORKIN: Stan Sporkin.
 18 MR. TAROLA: Robert Tarola. Good morning.
 19 MR. HARRIS: Well, you can actually
 20 identify yourself a little more than that. I think
 21 the judge headed up the Division of Enforcement, was
 22 at the CIA, was at Weil Gotshal.

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1 I know time is pressing, but Bob.
 2 MR. TAROLA: Robert Tarola. My current
 3 involvement from an investor perspective is I serve
 4 on the board of directors of 15 mutual funds
 5 sponsored by Legg Mason, an operating company listed
 6 on NASDAQ based in Denver.
 7 My experience is about a dozen years as a
 8 public company CFO, a dozen years as a public company
 9 auditor; and currently serve on two audit committees.
 10 MS. HILL: (Inaudible -- microphone not
 11 working.)
 12 How's that? Do I need to start all over?
 13 Bonnie Hill. I think I've said enough.
 14 MR. SONDHI: Tony Sondhi. I run a
 15 financial consulting advisory firm. I'm also a
 16 member of the emerging issues task force of the FASB,
 17 and I've been involved in standards setting as a
 18 financial analyst and as a user of financial
 19 statements for a little more than nine years in a
 20 direct form.
 21 I've also written books on financial
 22 analysis and on various accounting issues that --

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1 fortunately, for me, are widely used.
 2 Thank you.
 3 MR. HARRISON: I'm Norman Harrison with
 4 Breeden Capital Partners. My firm is headed by
 5 Richard Breeden, a former chairman of the SEC.
 6 We invest in public companies with a view
 7 toward increasing value for shareholders by focusing
 8 on improvements in governance and the manner in which
 9 improved governance translates into improved
 10 strategies.
 11 I'm a lawyer and investment banker by
 12 training, not an accountant. So I'm a bit humbled by
 13 the company in which I sit, but very glad to be a
 14 part of this group.
 15 MR. BLAKE: I'm Kelvin Blake, a lawyer for
 16 the Division of Securities for the State of Maryland
 17 which is part of the attorney general's office. I
 18 work in the investment adviser broker-dealer unit.
 19 MR. SAUTER: I am Gus Sauter, chief
 20 investment officer of Vanguard Mutual Funds. We have
 21 over 150 mutual funds investing more than a trillion
 22 dollars in public companies, so we're very interested

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1 in gaining more information and being able to better
 2 analyze financial statements.
 3 MR. WILLIAMS: I'm Meredith Williams. I
 4 work for about 460,000 of the very best people in the
 5 State of Colorado, running the public pension plan
 6 called PERA.
 7 Thank you.
 8 MS. SIMPSON: I'm Anne Simpson. And
 9 improbable though it sounds, I work for CALPERS.
 10 I'm the senior portfolio manager, and I'm
 11 responsible for the governance program there. I
 12 think Steve originally invited me to join this group
 13 because of my international background.
 14 Prior to that, I worked for the
 15 International Corporate Governance Network which
 16 represents investors in some 40 odd countries.
 17 Before that, I headed the World Bank's
 18 governance program in the wake of the Asia crisis.
 19 There were very familiar debates there about audit
 20 and accounting.
 21 Before that I was managing director of an
 22 investment firm in London for many years.

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1 MR. NACHTWEY: Pete Nachtwey, CFO for
 2 Carlyle. That's my primary day job although I think
 3 chief cook and bottle washer with everything that
 4 goes on in our firm.
 5 Prior to joining Carlyle, I was a partner
 6 at Deloitte & Touche, where I was employed there for
 7 about 27 years. The last job I had there was heading
 8 up the management practice in the northeast.
 9 MR. TURNER: Lynn Turner.
 10 I serve on the board of a mutual fund
 11 complex and also serve those 460,000 people in
 12 Colorado as a trustee of COPERA.
 13 MS. YERGER: Ann Yerger with the Council
 14 of Institutional Investors. That's an association of
 15 public, corporate, and union employee benefit plans,
 16 with about 3 trillion in assets. They have a very
 17 significant commitment to U.S. markets, investing
 18 about 60 percent of their portfolios in stocks and
 19 bonds of public companies here, and all have a deep
 20 interest in the quality of the financial statements
 21 that are provided to them.
 22 MR. CARCELLO: Joe Carcello, I'm an

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1 accounting professor at the University of Tennessee
 2 and co-founder and director of research of our
 3 corporate governance center.
 4 I've done a lot of research on fraud,
 5 public company fraud, including a study coming out by
 6 COSO shortly, based on SEC enforcement actions.
 7 I work on audit committees. I chair the
 8 audit committee of a governmental entity, and had the
 9 privilege of serving on the PCAOB's SAG for the
 10 previous four years.
 11 MR. HEAD: My name is Michael Head.
 12 I'm managing director of corporate audit
 13 for TD Ameritrade. About 30 years of combination
 14 public and private audit experience. Serve on the
 15 board of the Institute of Internal Auditors, the
 16 global body that oversees internal auditing around
 17 the world, and actually serve as the chair of their
 18 audit committee.
 19 And obviously, hope to bring some of the
 20 perspective of how internal and external audit work
 21 together and in particular in the brokerage industry
 22 and how we can advise and help the PCAOB strengthen

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1 some of how that audit approach can be considered
 2 going forward with some of their oversight.
 3 MR. BECKER: Brandon Becker.
 4 I'm executive vice president and chief
 5 legal officer of TIAA-CREF, one of the largest
 6 private pension managers. We have 3.7 million
 7 participants.
 8 Prior to that, I was a partner in Wilmer
 9 Hale, responsible for its broker-dealer program; and
 10 prior to that, I was director of market regulation at
 11 the SEC.
 12 MR. HARRIS: Thank you very much.
 13 Before we get to our first discussion, I
 14 want to point out in your folder, you should find a
 15 copy of the PCAOB's ethics policy. We ask that you
 16 please read the policy and provide us with a signed
 17 copy before you leave today.
 18 Now, turning to our first topic, lessons
 19 learned from the financial crisis and the
 20 establishment of a fraud center. This topic was
 21 mentioned by a number of you as a top priority for
 22 the PCAOB to consider.

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1 Brandon Becker, you suggested that we
 2 should "review the PCAOB and auditor firms'
 3 performance leading up to the financial crisis."
 4 More specifically, you asked how did audit firms
 5 measure risk and did auditors have the necessary
 6 level of expertise?
 7 Mike Head, you brought it up in the
 8 context of broker-dealers; and those of you who have
 9 listed these issues as very high on your priority
 10 list include Joe Carcello, Barbara Roper, Anne
 11 Simpson, Meredith Williams, and Ann Yerger. Some of
 12 you tried the concept of reviewing lessons learned
 13 from the financial crisis to the recommendations by
 14 the Treasury's Advisory Committee on the Auditing
 15 Profession and that the PCAOB establish a fraud
 16 center.
 17 As you know, last month we announced we
 18 were seeking to fill a newly created position of
 19 director of the financial reporting fraud resource
 20 center which is being established in response to the
 21 treasury advisory committee recommendations.
 22 So it is very timely that we hear your

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1 thoughts on these topics, particularly given the
 2 level of interest expressed by the IAG members as
 3 well as recent events in the news.
 4 For example, just last week, the Financial
 5 Times reported that the European Commission is
 6 planning to scrutinize the role played by auditors
 7 adding to a growing international focus on the
 8 profession in the aftermath of the financial crisis
 9 which could lead to tighter supervision.
 10 Brandon, I would ask that you and Mike
 11 kick off the conversation on this first topic and
 12 then we'll open up to all the members.
 13 MR. BECKER: Thank you, Steve.
 14 At the risk of breaking your flow and
 15 taking a little editorial license, let me just add
 16 before turning to that topic how much all members of
 17 the investor advisory group appreciate the board's
 18 willingness to make itself available to listen to our
 19 views and, in particular, how much we appreciate the
 20 efforts that you made, Steve, as well as your staff,
 21 Joanne O'Rourke Hindman, to make this a successful
 22 advisory group and a seamless process.

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1 We very much appreciate your and the
 2 board's efforts to participate in this process as
 3 well as those of the Securities and Exchange
 4 Commission.
 5 Many thanks to you and the board.
 6 Turning to the topic of the panel, Steve
 7 has nicely recapitulated the overall arching theme.
 8 I think that I'll just try to put it in a little
 9 context before I turn it over to Mike to talk about
 10 some of the particular areas with respect to
 11 financial services.
 12 As the participants know, at least since
 13 Professor Andrew Lowe of MIT began his efforts to
 14 stimulate interest in a so-called capital markets
 15 safety board modeled after the CAB, there's been an
 16 active dialogue about whether there is some method
 17 short of enforcement where you could go back
 18 diagnostically and try to look at what's happened
 19 over the last couple of years with a view toward
 20 identifying problem areas and potential solutions or
 21 at least best practices on a going forward basis.
 22 One of the criticisms or at least

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1 practical limitations on that that has been
 2 highlighted by some commentators is that the issue is
 3 too broad, the problem was global, the markets
 4 involved were of such scope that the idea that one
 5 could actually go back and look at this particular
 6 event in the same way that, for example, the SEC
 7 special study looked at the 1962 market break or
 8 comparable more textured reviews is just not within
 9 the realm of the doable, at least not within our
 10 lives and being.
 11 I think that is a little too stark a
 12 definition of the issue. If you look at the way in
 13 which various of our colleagues' papers talk about a
 14 fraud center, there can be a more targeted
 15 assessment. Steve has already mentioned and the SEC
 16 has already begun its own assessment of how we were
 17 dealing with 105 transactions, so that you can, I
 18 think, if not aspire to a global encyclopedia of the
 19 crash, notwithstanding the fact that we seem to get a
 20 new book every week on the bubble and its
 21 consequences, one could envision looking at targeted
 22 practices and asking yourself whether when we look

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1 back at those practices, there's something we can do
 2 going forward.
 3 At its heart, I think that instinct is to
 4 take a step beyond the -- it was an act of God, it
 5 was unforeseeable, received wisdom said that no one
 6 could know how this was going to happen.
 7 Actually, as it has developed over time,
 8 there were voices. There were critics. There were
 9 people pointing out potential risks. They were just
 10 not the majority view or the consensus view. Part of
 11 what we want to ask ourselves is why weren't those
 12 voices heard? What can we do to incorporate those
 13 voices going forward, and where can we identify
 14 failures in our practices.
 15 Some of the areas that at least have
 16 captured our attention and are described in more
 17 detail in my written testimony are, how do we assess
 18 quality of earnings? How do we go back and look at
 19 unrealized gains and losses? How do we assess
 20 earnings-based models and estimates when we haven't
 21 been through the entire earnings cycle of a financial
 22 instrument? What can we do about tail risk going

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1 forward?
2 It seems obvious we are not going to
3 eliminate the reliance upon modeling and trying to
4 give estimates of quality of earnings; but at some
5 point, we should be able to get smarter in trying to
6 deal with the kinkiness of tail risk and some of the
7 problems of trying to rely upon that in any
8 particular financial reporting period. That's just
9 another example. Whether it is repose, table risk,
10 other evaluation issues, it strikes us that one could
11 go back and try to look on a horizontal basis and
12 assess whether we did the job correctly and how we
13 can do it better.
14 In doing that, I think one of the common
15 sense instincts here, I would argue, is that if we
16 can do that outside of the enforcement context, the
17 enforcement context is critical in terms of
18 accountability, it is critical in terms of developing
19 data, subpoena power, the like; but sometimes it
20 doesn't give you the broad horizontal assessment of
21 how you want an industry going forward. Trying to
22 pull together a diverse set of resources to assess

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1 that, economists and traders, lawyers and
2 accountants, forensics and diagnostics, we think
3 could provide valuable lessons for the industry as we
4 confront what will undoubtedly be recurring issues as
5 we come out of the situation.
6 With that pitch, why don't you let me turn
7 it over to Mike to talk about some of the particulars
8 in the financial services industry.
9 MR. HEAD: Thank you, Brandon. Due to my
10 background, I'll be fairly focused on broker-dealer
11 and registered broker-dealers, and that environment,
12 and probably one of the obvious things to analyze and
13 see if there's lessons learned can tie into
14 situations like the Madoff and the energy that
15 myself, my company, and our industry probably were
16 looking at that and trying to assess, were there some
17 things like that that could have been done to either
18 avoid that, minimize it, or identify it and address
19 it in a more timely manner before some of the damage
20 that took place did take place.
21 As an internal audit professional and long
22 term investor advocate, I'm very pleased that the

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1 PCAOB has made this very timely decision to focus on
2 investor protection.
3 I'm also pleased that the PCAOB is
4 interested in considering ways it can target their
5 efforts to increase investor confidence in the
6 auditing financial information and audit reports and
7 make that information in reports more useful to the
8 individual investors. To that end, I offer some of
9 the following thoughts on strategic direction and
10 future emphasis that the PCAOB, through the Investor
11 Advisory Group efforts, could address in lessons
12 learned.
13 One of the primary things that I think we
14 need to look at is not only the fraud center and
15 analyzing and looking back, but are there some
16 systemic opportunities here. As an auditor, we focus
17 on processes. We focus on trying to get consistency
18 in processes and then addressing exceptions or things
19 like that seem to be out of that norm.
20 And to that end, I think there's three,
21 four, five things that the PCAOB should advocate and
22 where possible require some consistent audit

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1 requirements for registered broker-dealers both on
2 the introducing broker-dealer side and the custodial
3 broker-dealer side. Some of those could include in
4 addition to requiring independent auditing firms of
5 broker-dealers to register with the PCAOB, the audit
6 firm should also be subject to inspection by the
7 PCAOB.
8 The retail adviser does not realize today
9 that being registered with the PCAOB does not bring
10 with it any true oversight by the PCAOB if it's not
11 part of a publicly audited situation.
12 Once the broker-dealer registered auditing
13 firms are subject to inspection and oversight by the
14 PCAOB, clearing broker-dealer organizations should be
15 subject to the Sarbanes-Oxley section 404 or similar
16 requirements for compliance. There's been a lot of
17 debate about has that achieved the objective that was
18 intended; but I think if we're all really honest with
19 ourselves, that it has brought the needed and
20 appropriate attention to the internal controls or
21 financial reporting disclosure that was lacking prior
22 to that, and that's still absent in the registered

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1 brokerage environment.
 2 It's gotten there through banking and
 3 through some others; but if you're a pure introducing
 4 or custodial broker-dealer and not publicly traded,
 5 you aren't subject to similar audit requirements nor
 6 management certifying their internal controls; and
 7 that discipline, I think, is a key element in
 8 improving the financial services broker-dealer
 9 environment.
 10 As a result, those auditing firms would be
 11 subject to auditing standard number 5. I think
 12 that's critical, too. Where today if you are not in
 13 a publicly traded broker situation, those auditing
 14 firms are not necessarily subject to auditing
 15 standard 5.
 16 We would assume those firms through firm
 17 practices would employ similar, but it is not
 18 required from oversight from a PCAOB point of view.
 19 These measures would enhance investor
 20 protection and the quality of the financial reporting
 21 available to and relied upon by the retail investor
 22 and they don't understand, if you ask them, they

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1 would assume there's not any difference in an audited
 2 opinion they get on a non-public registered
 3 broker-dealer and a publicly traded registered
 4 broker-dealer.
 5 Once the broker-dealer registered auditing
 6 firms are subject to inspection and oversight by the
 7 PCAOB, custodial broker-dealers, in particular, I
 8 think should be subject and required to have SAS 70
 9 type 2 service organization audits performed of their
 10 custodial controls. Currently only affiliated
 11 custodial broker-dealers are required to comply with
 12 the SEC custody rule, the 2064-2, and are subject to
 13 the SAS 70 type 2 audits under the recently revised
 14 SEC custody rules.
 15 Requiring a custodial control SAS 70 type
 16 audit of all clearing broker-dealers, no matter if it
 17 is affiliated or not, would help enhance investor
 18 protection and the quality of the financial
 19 reporting.
 20 In both the SOX 404 compliance and
 21 custodial controls related to a custodial or clearing
 22 controlling broker-dealer, these are more focused on

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1 not just internal controls over all the financial
 2 reporting but all operating controls that support the
 3 processing of transactions and compliance with laws
 4 and regulations that ultimately the scorekeeping and
 5 the financial statements rely upon.
 6 But again, the retail investor assumes
 7 their assets are safe and they exist; and obviously
 8 from what we saw with the Madoff situation that may
 9 or may not be true and we don't have the safety nets
 10 in place to allow for oversight auditing and review
 11 by both internal auditors and external auditors to
 12 help ensure with those retail investors -- that those
 13 assets exist or are safeguarded, and the controls to
 14 protect them are in place. And I think the SOX 404
 15 and the SAS 70 type 2 are two just blocking and
 16 tackling table stakes that should be there for all
 17 registered broker-dealers.
 18 I also think we have an opportunity and
 19 was somewhat disappointed when AS 5 came out to
 20 replace AS 2, that in AS 2 there was mention of the
 21 internal auditing global standards; and that went
 22 away in AS 5. Now, just being recognized for the

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1 sake of being recognized is not what's important.
 2 What I think it emphasized there was the importance
 3 of consistency between companies' and firms' internal
 4 audit functions, that they should be there and that
 5 there should be consistency, so that people,
 6 regulators, shareholders, investors, and external
 7 auditors know when certain internal audit practices
 8 are in place if they're adhering to standards.
 9 They have more reliance that it's
 10 consistent, that it's the same from one company to
 11 the next. And by acknowledging those standards and
 12 setting a specification that when there's internal
 13 audit function in place that is functioning at what
 14 is considered an adequate level, that they know what
 15 that means, that there's definitions in the standards
 16 that people can go to, retail investors, others to
 17 tie to that.
 18 Finally, when we have internal audit
 19 functions that are comprehensive and can be relied
 20 upon, there is a lot of benefit for synergies and
 21 efficiencies both for the regulators and external
 22 auditors to review that work, place some reliance on

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1 it; but the standard that presently exists that kind
 2 of guides when and how you can do that, the current
 3 SAS 65, is quite dated; is over 20 years old; and
 4 does not and could not at that time consider the
 5 roles and responsibilities that internal auditors,
 6 professionals, currently take on.

7 There's a unique timing and opportunity
 8 here with the IFAC and the convergence and
 9 consolidation and the GAAP and international
 10 standards to not miss this opportunity that currently
 11 IFAC is currently revising ISA 610, use of work of
 12 internal auditors; and this is a perfect opportunity
 13 for the PCAOB and from an auditing standards point of
 14 view, to consider either revising or replacing SAS 65
 15 and working with IFAC. The Institute of Internal
 16 Auditors is currently partnering with IFAC to revise
 17 610 and would like the opportunity to work with the
 18 PCAOB to either revise or develop a new standard that
 19 would be similar and fit in with the goals going
 20 forward that are consistent global standards.

21 Those are some of my initial thoughts. I
 22 know they're fairly tailored directly to

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1 broker-dealers and not as broadly to the financial
 2 services industry; but I think there were a lot of
 3 problems we encountered similar to the Madoff
 4 situation where some of these basic -- once we looked
 5 at the hindsight situation -- maybe couldn't have
 6 been totally prevented, but maybe could have
 7 mitigated or minimized some of the damage that was
 8 done if we had some of these things in place.

9 With that, I open it up.

10 MR. HARRIS: Mike, thank you and Brandon
 11 very much. I know in terms of these two topics, a
 12 number of members put them very high on their
 13 priority list.

14 So in terms of lessons learned, I know
 15 that Anne Simpson and others have put that on a
 16 priority, but I know on the fraud center, Anne, you
 17 mentioned that as a high priority. Maybe we'll start
 18 with you.

19 I know Meredith Williams, Lynn Turner, Joe
 20 Carcello have also mentioned the fraud centers as a
 21 very high priority.

22 That is an issue that the PCAOB is

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1 addressing. We welcome your comments on
 2 that, because I guess for lack of a better word, I
 3 view the fraud center as low hanging fruit that maybe
 4 we can all agree upon in terms of what ought to be
 5 done.

6 I don't know, Anne Simpson, do you want to
 7 start with the lessons learned or Ann Yerger, the
 8 fraud center?

9 MS. YERGER: This is Ann Yerger. I'm sort
 10 of right now representing also Damon Silvers who
 11 called me yesterday sending his regrets he couldn't
 12 be here. He looks forward to joining us after he's
 13 on the Hill. The sum total of what he told me to say
 14 fits on this note card.

15 I'm confident his presentation would be
 16 far more expansive and articulate than what I will
 17 share. Largely we are on the same page. I think
 18 Damon and my thoughts are that we were so supportive
 19 of establishment of the PCAOB, and I think it was
 20 instrumental in helping restore public trust in the
 21 auditing profession, but obviously fraud continues.
 22 Madoff is a perfect example. There's no stopping

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1 fraud, I don't think, because there are always people
 2 who will try to break the laws or play fast and loose
 3 with the rules. But there's an opportunity here to
 4 learn from problems. And as a result, we feel very
 5 strongly that the establishment of this national
 6 fraud center is absolutely critical.

7 Damon and I and Lynn served on the
 8 Treasury Department's Advisory Commission on the
 9 Auditing Profession; and one of the core
 10 recommendations was we believed the PCAOB should
 11 establish this fraud center. Just as background,
 12 there was a lot of debate about who should own the
 13 center. And the fact is that some folks wanted it to
 14 be housed with the profession; and I think that the
 15 majority of members, at least of the ACAP agreed very
 16 strongly the appropriate place for this was with the
 17 PCAOB. You are an independent body. We felt that
 18 the establishment of this entity could ultimately
 19 really assist the board in doing its work in terms of
 20 standards setting.

21 Clearly, not only are there concerns about
 22 fraud, but I think the public, rightly so, has been

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1 concerned about the quality of, in some cases,
 2 accounting standards which I understand is not the
 3 purview of the PCAOB, but certainly auditing
 4 standards and professional conduct surrounding things
 5 varying from fair value accounting for financial
 6 statements or instruments -- excuse me, off-balance
 7 sheet vehicles; repo 105s; and even loan loss
 8 reserves.

9 Obviously, right now, we are centering a
 10 lot on financial entities because that has been where
 11 the most interest and I think concerns are centering.
 12 I think the fraud center could play a really
 13 important role not just addressing fraud but
 14 addressing areas where there's the potential for
 15 fraud.

16 So I think Damon and my message would be,
 17 we encourage the board to make certain that the
 18 center is not simply a library for fraud, but it goes
 19 far beyond that.

20 Damon recommended that the board consider
 21 applying some sort of safe harbor so there's a
 22 comfort zone to share non-public information that may

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1 assist the board in developing audit standards and
 2 even get the FASB and ISB in terms of setting
 3 accounting standards.

4 So with that, I'll stop. Happy to answer
 5 any questions. And, I'll pass it to you.

6 MS. SIMPSON: Thank you. Anne Simpson,
 7 CALPERS. We didn't strike up the fraud center in
 8 particular as a priority because we felt that really
 9 the legacy of the unfinished business from ACAP is
 10 something that we hope the PCAOB will turn to.
 11 There's much there that's really important.

12 We applaud the group that worked on it.
 13 We realize events have overtaken everyone. It is
 14 time to return to that. This is one piece of that
 15 work program. I suppose our reflection is more that
 16 the banality of the run up to the disaster is what
 17 troubles us.

18 The fact that everybody was seduced in the
 19 situation. We know boards of directors are
 20 reconsidering what went wrong; as investors we are
 21 reconsidering what we weren't paying attention to.
 22 The credit rating agencies have been rightly the

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1 focus of attention for their role.

2 But auditors have been relatively
 3 unexamined. And I'm struck -- this is probably for
 4 me, speaking my age now -- the third crisis
 5 discussion about what went wrong. Remember the days
 6 of Maxwell, Foreign and Colonial, a whole heap of
 7 British companies that collapsed following the
 8 issuing of clean audit reports. That gave rise to
 9 the now named Capri code.

10 And sort of invented corporate governance
 11 for the U.K. Then we had the Asia crisis; the U.S.
 12 disasters around Enron and WorldCom. Now we are in
 13 the wake of the current disaster. So I suppose what
 14 we are puzzling on is how many things do we need to
 15 put right in order to really introduce safety and
 16 soundness into the system?

17 Some of things that are needed are quite
 18 ordinary, not extraordinary. We still are looking at
 19 some basic issues around transparency. As Ann said
 20 about audit standards that do not capture relevant
 21 activity. Very concerning off-balance sheet activity
 22 being an obvious example. Concepts of internal

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1 controls that don't extend to all of the activities
 2 that particularly in the financial sector that were
 3 undertaken.

4 Boards of directors who claim they did not
 5 understand what was going on. Very troubling. If
 6 you're a dentist and don't understand teeth, pretty
 7 soon you move on to another dentist. This whole
 8 related discussion around majority voting, proxy
 9 access to hold boards accountable is very important.

10 Also there are responsibilities for
 11 investors on what they're paying attention to as
 12 well. We share responsibility.

13 Fraud is certainly the dramatic TV, CSI
 14 end of this; but it is the ordinary, banal routine
 15 activities of companies where we really want to
 16 tighten up the standards of old fashioned
 17 transparency and accountability. So I really think
 18 this group has an important job to do.

19 In practical terms, what is it we need to
 20 know? What is it we need to have reported? What is
 21 it -- you know -- that the job of the auditor needs
 22 to be in order to play that critical role because

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1 they're really one of the dogs that didn't bark.
 2 They weren't the only ones, but certainly we need to
 3 examine that.
 4 MR. HARRIS: Hold on for a second. Before
 5 we get to responding to your comments and statements,
 6 I would like to stick with the fraud center for just
 7 another five or 10 minutes; and I know that,
 8 Meredith, you have some ideas on that; Lynn, you
 9 clearly have. Joe, you have.
 10 Bob Burns on our staff is taking the lead
 11 on that. I think the more you can input here, we can
 12 help define the fraud center and then broadly discuss
 13 the other issues.
 14 Why don't the three of you and anybody
 15 else comment on your views of the fraud center and
 16 then, Judge, we'll recognize you.
 17 Meredith?
 18 MR. WILLIAMS: I'll start that out. The
 19 fraud center has great promise, but I think we need
 20 to be careful with expectations.
 21 I see it as a device that will do
 22 post-mortems on what I will call audit failures.

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1 Though auditors would probably argue that we're
 2 following the audit standards and unless something
 3 shows up on our sample, in our confirmations, we're
 4 clean. Well, I think that requires an attitude
 5 adjustment.
 6 And I think by doing a series of
 7 post-mortems and hopefully using the safe harbor sort
 8 of approach that Ann suggests, they can be done on a
 9 relatively timely basis so we don't have to wait for
 10 all the court cases to be cleared before we can sit
 11 down and say what went wrong, what might have been
 12 done different, how might we have alerted the
 13 investment public.
 14 And I think over time, by going through
 15 this exercise, I think that there will be a mindset
 16 change for auditors. And I think the so-called
 17 expectation gap between the investment community and
 18 the audit community might be significantly narrowed.
 19 But I don't think that just is going to be movement
 20 on the part of the investment community.
 21 I think there will have to be movement on
 22 the part of the audit community, too, and perhaps

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1 PCAOB will have to take a good strong look at the
 2 results that come out of the audits, the findings
 3 that come out of the fraud center; and perhaps there
 4 will be a need to redirect the audit effort to have
 5 more of a focus on fraud to serve the investing
 6 public.
 7 I think those are my comments. I think it
 8 is very important -- but I think it is a long-term
 9 sort of effort. We're not going to turn around in
 10 the next 30, 60, 90 days. It is a long-term
 11 education effort.
 12 MR. HARRIS: Joe? Lynn?
 13 MR. CARCELLO: I, first of all, applaud
 14 the board for moving forward on this. I think it is
 15 the right thing to do. I am a little disappointed in
 16 the scope. I think the -- at least as I've read the
 17 scope, I think the board has pretty clearly just
 18 mimicked what was in the ACAP report. And as you can
 19 tell from some of comments we received, particularly
 20 from Barb Roper, Meredith, myself, Lynn, probably
 21 others, there was a hope the board might do more. As
 22 I understand it, essentially the aim of this center

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1 is to share fraud prevention and detection
 2 experiences, practices, data, and commission
 3 research.
 4 When you think about sharing fraud
 5 prevention and experiences and practices, I think to
 6 some extent, that is going on between the major firms
 7 at the CAQ. So it is not obvious to me that this
 8 body needs to do that. There's a large body of
 9 research on fraud that's going on and sponsored by
 10 academic institutions and other bodies. If you
 11 wanted to have a -- commission research, you put
 12 money out there, you get research done. One of the
 13 main problems in this area, and this is, I think,
 14 what Damon was alluding to, is data is confidential,
 15 both at the level of the board and the level of the
 16 individual first.
 17 And unless all the research is going to be
 18 done by this fraud center and tightly controlled in
 19 terms of dissemination which kind of defeats the
 20 point, unless you're able to deal with the issue of
 21 confidentiality of data, you have a problem.
 22 I think there had been a hope on my part

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1 as well, as I said, others, that the fraud center
2 might be able to go further than even what I've just
3 discussed. That is to essentially replicate the
4 National Transportation Safety Board and when there's
5 a major fraud, not necessarily every fraud, but a
6 major fraud, particularly where the auditor has
7 culpability, particularly in a 102 E case, or even if
8 they are alleged to have a fraud responsibility
9 beyond 102 E, that the fraud center would go in --
10 and there would have to be some sort of safe harbor
11 as Ann talked about -- and do a detailed examination
12 of what happened there with the objective really of
13 informing the board in terms of standard setting.

14 The board -- one of the advantages the
15 board has that no other standards setter has is the
16 ability to get access to data that other parties
17 can't right now, through your inspection program.
18 But if you structure the fraud center in a certain
19 manner, you'd be able to get data and information as
20 to how the fraud happened, what could have been done
21 to prevent the fraud, and where did the auditors
22 fail.

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1 I'm not talking about failure from a legal
2 perspective, but what could they have done that might
3 have uncovered the fraud, detected the fraud,
4 ultimately leading to better standards, ultimately
5 leading to better inspections; and then ultimately
6 leading to better financial reporting. I think
7 that's, at the end of the day, what you guys care
8 about.

9 MR. TURNER: Steve, when I go back and
10 look at all the cases, the big names we've had in the
11 paper, Countrywide, Lehman, Merrill, Bear, AIG, New
12 Century, Wachovia, Citigroup, GM, Freddie, Fannie
13 with perhaps the exception of perhaps New Century, no
14 one has said the financial statements were misstated.

15 They have all been claims, including the
16 SEC's claims and enforcement actions to date, have
17 all been around disclosure issues.

18 One might say especially coming out of the
19 Enron and WorldCom time period and periods before
20 that, in fact, the auditors did do a much better job
21 this time than what they did in the past. If that's
22 the case, it's probably due to at least in part the

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1 PCAOB and its inspections.

2 But this go around, I think the fraud was
3 much more subtle, if you will. It wasn't the type
4 Enron or WorldCom multi-billion dollar cooking of the
5 books; it is more a repeat of what we had two decades
6 ago with the S&L crisis that a number of us at the
7 Commission lived with.

8 To that extent, I think the fraud center
9 is an excellent idea. I think that's exactly why you
10 have the fraud center, to go in and dissect these
11 cases, find out what really went wrong and what can
12 be learned from that; and more importantly, what
13 should be done to make the system work better going
14 forward.

15 Sometimes, that's happened in the past,
16 but often -- and I can count no less than six of such
17 episodes during my career -- quite often, we don't go
18 back and get those things or haven't gotten those
19 things fixed.

20 I think if you have a fraud center that
21 actually looks at this stuff, dissects it, tries to
22 find the lessons learned, and then also come forward

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1 with recommendations, I think if you don't have the
2 recommendation part to it, you're really missing the
3 boat big time here.

4 But I think as long as you have that, then
5 it will provide an enormous benefit and will be well
6 worth whatever the costs are to that system.

7 So I do think the lessons that we'll find
8 from this one are much more subtle than what we've
9 had in the past, which going on to the lessons
10 learned part of this discussion, I think if there is
11 a lesson that we've learned here, it goes back to
12 something that I remember Warren Buffett telling me
13 and Chairman Levitt at the time; and Warren said we
14 should -- and certainly in the audit committee
15 rooms -- we should be asking the question of the
16 auditor: What is it that the auditor knows that if
17 they were investing in this company, they would want
18 to know and have out there publicly.

19 And yet that type of information never
20 came out of the audit of the companies like AIG, like
21 New Century, like Lehman, Fannie, Freddie, where it
22 was very clear there was very material information,

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1 very important information, a particular FASB
2 standard or SEC standard hadn't been written on it;
3 and yet -- and as a result wasn't required despite
4 the SEC's disclosure requirements for material
5 information. And the auditors sat there and did
6 nothing with it.

7 So if there is one major lesson here, I
8 think we see it in the Lucas report in spades. That
9 is we've got to come up with some scheme whereby if
10 the auditor is sitting on that type of information,
11 is aware of it, somehow that he has to either
12 disclose it himself or force that disclosure, is
13 certainly the number one lesson that I get out of
14 this from the auditors' side of it.

15 MR. HARRIS: Judge, you had a comment?
16 JUDGE SPORKIN: There's no question that
17 the fraud center makes sense. But what does concern
18 me -- and I think Ann hit on it -- was the role of
19 the auditor, what -- we don't hear anything about
20 what happened.

21 I look at partially what happened -- I
22 always look because of my judicial background the key

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1 to the case, what's the key to the case.
2 One of the keys is in the -- is why is
3 this case with the securitized mortgages much
4 different than the salad oil case? In the salad oil
5 case, there was no salad oil.

6 Here we had mortgages that were made out
7 of air, if they're called synthetic; we had very low
8 value -- someone said, well, there's some rating
9 agency that said these are good mortgages. The
10 accountants said we'll buy that. Why? Accountants
11 are not supposed to buy because somebody else says
12 something.

13 Am I right or wrong?
14 Look at the cases that you found where
15 valuation was a big issue: Again, isn't that an
16 auditor's role to see if the assets are there.

17 And that's why I'm trying to figure out if
18 we're going to have the fraud center, why aren't we
19 going to look to see why -- what beyond just the
20 rating agency, who was looking at these things?
21 If somebody said there was no value to
22 these mortgages or very low value, why were we

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1 treating it?
2 I think the answer might be that the
3 auditors were looking back instead of forward. And I
4 just think they got to look to see where -- we got a
5 new instrument we're creating here. And yet we're
6 having trouble figuring out how to deal with it.

7 Instead we're looking at these rules and
8 all those rules, I love them. I am glad I was with
9 the CIA because I can figure out the code of what you
10 are saying before. Otherwise, you have to break the
11 code of all these numbers we are talking about.

12 What I'm -- so that's what I'm trying
13 to -- I mean, by having all these numbers that we're
14 looking at, do they comply with this, do they comply
15 with that, we're missing the big picture. We're
16 missing the forest because of the trees.

17 In my Keating case, when the accountants
18 were telling me because the guy, because -- here the
19 Keating's bank was financing someone buying a
20 property from it for \$13 million when the cost was a
21 million dollars; and because somebody -- one of the
22 clients of the bank put the \$2 million up or gave it

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1 25 percent, it was okay, because they followed the
2 rules.
3 But nobody said, looked at the guy that
4 bought it, a guy they picked off the streets of
5 Phoenix, put him into the room and say you now own
6 this property, here's 50,000 for your help.

7 That was the deal. Nobody says does this
8 make economic sense?
9 Again, it seems to me somebody has to look
10 to see whether we should have been examining those
11 mortgages or those portfolios and finding out, the
12 accountants saying, yeah, these don't have that.

13 We understand that somebody put a rating
14 on this. But so what?
15 And -- but looking ahead -- not back all
16 the time. Not look back. These were the rules at
17 the time. Look ahead. Accountants need creativity
18 as much as anybody else. Am I making any sense? I
19 don't know.

20 MR. HARRIS: Brandon, let's open it up.
21 I'd love to ask you some questions. I want to hear
22 from everybody. Brandon, why don't you go ahead.

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1 MR. BECKER: I agree with everything
 2 generally that's been said about the fraud center,
 3 its importance, including the Judge's comments.
 4 I do think without putting too much value
 5 on nominalism, calling it a fraud center is a
 6 mistake. Because if you limit yourself to instances
 7 of found fraud, you're going to miss exactly what the
 8 Judge is describing. What happens when the industry
 9 follows the rules as articulated, follows appropriate
 10 standards in valuing synthetic CDOs, but it turns out
 11 that the procedures that were followed didn't work?
 12 So I'm just as interested in an assessment
 13 of after the crash, to use the NTSB example, it may
 14 be that the design of the road bed was wrong and
 15 somebody should go off and figure out whether there
 16 is someone we're going to hold culpable for it.
 17 That's an interesting question.
 18 But as a passenger on the train, what's
 19 more important to me is that the road beds get fixed
 20 and on a going forward basis, we know how to design
 21 the road bed.
 22 Somebody else can go do the enforcement

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1 job of that; but we need to be able to look at how we
 2 set our guidelines for best practices even in
 3 situations that don't rise to the level of fraud.
 4 I'm afraid if we only look for fraud, bad
 5 actors, who else did the wrong thing under
 6 articulated standards, we will miss the far more or
 7 at least equally significant situations where good
 8 people follow the right standards and the best
 9 practices; and they go off the cliff like lemmings.
 10 MR. HARRIS: Norm?
 11 MR. HARRISON: I think Brandon, Lynn,
 12 Judge Sporkin all were getting at this point; but I
 13 wanted to just make it a little more clear. I think
 14 again I agree with the concept that the idea of a
 15 fraud center or an organization designed to conduct
 16 the analysis of factors coming out of a major fraud
 17 or crisis is a good idea.
 18 I think the trick always with exercises or
 19 initiatives of this sort is I think we've
 20 demonstrated a real talent as a profession,
 21 regulators, Congress, all who looked at the Enron,
 22 WorldCom frauds, the frauds of the past, we do a good

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1 job of solving the last crisis.
 2 I think Lynn is right. We are unlikely to
 3 see another fraud that involves a massive
 4 mischaracterization of operating expenses. We are
 5 unlikely to see another fraud like Enron or Refco
 6 that involves massive use of end party transactions.
 7 Those aren't going to happen again. We know what
 8 those look like. We are going to be sure they don't
 9 happen again.
 10 I think the real trick is to conduct the
 11 audit opinion, the forensics, the analysis and the
 12 trick is figuring out areas in our economy where
 13 there are circumstances afoot that give rise to new
 14 risks and applying the lessons learned from the past
 15 in a preemptive way to try to head off crises or
 16 frauds or misdeeds that may be in their infancy. I
 17 think that is the real challenge. It is doable but
 18 requires a tremendous amount of thought and analysis
 19 and awareness what lies ahead as opposed to what
 20 occurs in the past.
 21 MR. HARRIS: Tony? Bonnie? Gus? Tony?
 22 MR. SONDH: I remember many years ago a

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1 study was sent to me and it purported to talk about
 2 whether cash flows were the bottom line, and what it
 3 did was said let's see if cash flows are good or
 4 accrual are good predictors of bankruptcy.
 5 Well, the problem is that bankruptcies are
 6 negotiated. It is not something you can observe in a
 7 way as if through negotiations you manage to avoid
 8 it. But that doesn't mean cash flows did not catch
 9 the problem. These people, for example, the authors
 10 of the study said in the seventies because Chrysler
 11 and Massey Ferguson did not declare bankruptcy at
 12 certain points in time, cash flows were misleading.
 13 When you look at it that way, it is a
 14 stupid statement to say they were misleading. Fraud,
 15 as Brandon points out, may not be the right way to go
 16 about it.
 17 We need to look at it far more critically
 18 and think of this thing differently in order to
 19 understand the lessons of this.
 20 MS. HILL: I was trying to think how I
 21 would use all this information in the board room.
 22 You know, when something happens, the first thing

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1 that comes up is where was the board of directors.
2 And if we're all sitting around here
3 trying to figure out perhaps where the next best
4 fraud will be, it makes it extremely difficult for us
5 when we're dealing with issues that come before us,
6 particularly if you're looking back which is a good
7 thing. Let's look back and see what took place, I
8 think as the Judge said. But I will tell you I don't
9 think the next best fraud is going to be one that
10 already has been perpetuated so everyone is now
11 looking out for that and you just move on to
12 something new.
13 I think the idea of a center is a good
14 idea but I think more forward-looking and in terms of
15 how I as a board member take a look at what is being
16 presented to me and I'm depending on the experts who
17 are the auditors who have been working with the
18 internal auditors and somehow or other now I'm
19 suspect of that.
20 So where is the next best place to go? I
21 think when we talk about the tools that are necessary
22 to review what is brought before the board and how

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1 you look at it in the deep dive, particularly where
2 fraud is possible and where it may come from, it just
3 gets to be one of those things like that I hope there
4 is as we have our discussions today there will be
5 some tools to help directors take a look at what's
6 broadly in front of us as well.
7 NEW SPEAKER: I'd like to address some of
8 the comments. Brandon mentioned the fact there are
9 sceptics about a fraud prevention center. I think
10 those people are talking about the enormity of the
11 problem; the fact that a lot of the analysis is
12 basically back testing and perhaps data mining and in
13 terms that we use in research.
14 Nevertheless, I think it is important that
15 we glean whatever information we can, that even if it
16 is very difficult to project going forward as a
17 number of people talked about, it is important to
18 learn what we can and to change audit standards as
19 Joe mentioned to change practices; so perhaps there
20 would be a world of information that could be
21 utilized by FASB as well in setting up the accounting
22 standards. I think there's a lot that could be

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1 shared there.
2 I think it is important that even if --
3 it's a very difficult effort. If we can shrink the
4 size of the fraud box, that's very worthwhile. So we
5 think that those that say -- that are skeptical about
6 it really don't recognize the advantages.
7 I would agree with what many people have
8 said that things have to be forward-looking, that we
9 need to try to figure out how to minimize not only
10 fraud but misrepresentation of full financial
11 information, so we would fully support the fraud
12 center.
13 MR. HARRIS: Bob? And I see there are a
14 number of labels up.
15 Clearly somebody has hit a nerve.
16 MR. TAROLA: Bob Tarola. It strikes me
17 obviously there needs to be a type of post-mortem on
18 frauds and the PCAOB regarding where the audit lapses
19 may have occurred is the right place.
20 But within the managements in the board
21 room, there are every quarter the CEO and CFO are
22 signing off on the financial statements, certifying

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1 their accuracy, certifying that any matters of a
2 fraud or concern were brought to the attention of the
3 audit committee and the board.
4 It seems like as a system, we don't trust
5 that part of the reporting process, that the
6 certifications of officers are less important than
7 the opinion of an auditor.
8 And that, it seems to me, exists because
9 we don't really think that the internal process is
10 professional; whereas the examination process, the
11 auditor examination process is professional and it is
12 professional because this board insists that it be.
13 If we're really going to protect
14 investors, we need to do it at the source. We will
15 not be able to review in or audit in quality. The
16 quality really has to be -- there has to be trust in
17 the system that there's quality reporting coming from
18 the companies; and that there's quality auditing to
19 make sure it stays that way.
20 So a fraud center is great.
21 But I think professionalization of
22 preparation of financial information is even a better

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1 way to avoid bad reporting in the future.

2 MR. HARRIS: Pete?

3 MR. NACHTWEY: Thanks, Steve. A lot of

4 good things have been said. Just not everybody said

5 them. I want to add a couple of things maybe to what

6 others have focused on that I think are good ideas.

7 One, Lynn mentioned the fact that despite his long

8 list of companies that we all recognize either are

9 failed or failing out of the last crisis, really

10 hasn't been any misstatements that have arisen from

11 the financial statements, at least not yet.

12 Yet I don't think any of us would look at

13 the financial situations of those organizations based

14 on what investors could know at the time and say the

15 financial statements weren't misleading because how

16 could that many companies all of a sudden go down in

17 a crash.

18 I do think as Bob said the certification

19 process I do think helps. I've sat across the table

20 from people in my prior life as an auditor where they

21 get really crystalized and focused on their personal

22 risk when they had to sign something. I think that

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1 process is great and has helped in terms of not --

2 helping to prevent misstatements. But on the other

3 hand, in terms of misleading, I think that's the next

4 step we have to get to and how do we do it. I think

5 a lot is about the risks.

6 I'm not blessed or cursed with being a

7 lawyer, but I worked with lots of lawyers on

8 designing risk disclosures in public filings. They

9 tend to be very voluminous. They tend to be very

10 articulate, but in a very legal form as opposed to

11 plain English.

12 I know there are people like Gus around

13 the table that are required by plain English

14 standards to describe and disclose things to their

15 investors. The question is, can we help foster that

16 a little bit whether coming out of this fraud center

17 or something else we might label as to how we inform

18 the investing public about what the risks are in the

19 business.

20 That feeds to the second point. A lot of

21 what happened here wasn't just the massive frauds

22 like the McKessons, the salad oil things where a

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1 really bad operator did something bad and probably

2 should have been caught; but I think one of the

3 lessons that came out of this last crisis is we have

4 the systemic failure, bad design, there are many

5 different parts of the financial system you can look

6 at. Just looking at subprime mortgages, mortgage

7 securitization example. We went from a day where the

8 S&L originated a loan. They had to hold it. They

9 may still have originated bad loans but at least the

10 guy that was going to service the loan sat down the

11 hall from the person that originated it. The CEO was

12 that was going to have to report the financial

13 reports, knew that that stuff was staying in the

14 house. If it was toxic it gave you presumably some

15 pause.

16 We went from that over the course of two

17 decades of setting up a system where the originator

18 originated. May have sold it to some wholesale

19 lender who then sold it to somebody who would

20 securitize it who sold it to somebody in Norway.

21 It became impossible during the course of

22 all that, little -- you know -- well meaning people

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1 just doing wickedly difficult jobs probably 70 to 80

2 hours a week cutting corners here and there. By the

3 time you cut enough corners off the product that

4 ended up at the back end was garbage.

5 It was very difficult to find that out

6 because we had the imprimaturs of auditors or rating

7 agencies or others along the way. This is where I

8 think again a fraud center or some sort of financial

9 reporting center that gets at not just operators but

10 systemic risks could be helpful.

11 JUDGE SPORKIN: A quick question. Have

12 the auditors changed what they're doing based upon --

13 we don't need a fraud center to tell us what we know

14 now. Are they changing what they're doing? Do we

15 know that? Do we know -- did they learn anything

16 from this?

17 I mean, that's -- have they changed the

18 way they do business? Is there an auditor that can

19 answer that question? Where are the auditors here?

20 NEW SPEAKER: You need the SAG.

21 NEW SPEAKER: I'm an auditor. If I

22 understand the question right, there's not been any

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1 change in what they're required to do, which is
2 validate existence, fair valuation, and proper
3 disclosure of the assets and what's included in the
4 financial statements.
5 Now, were they doing that is a different
6 question, but what they're required to do to follow
7 their auditing standards says yes, you are right,
8 Judge, they have to get comfortable the assets exist
9 and they are fairly stated and are properly
10 disclosed.
11 I'm not sure that was consistently being
12 done.
13 MR. HARRIS: Joe, let's go down and around
14 the table.
15 Kelvin, I know that this was not a
16 priority of yours, but everybody else has spoken, so
17 before we leave this panel, I want to give you -- if
18 not the last word -- a word.
19 I'm sorry. Charlie?
20 MR. NIEMEIER: I want to respond to Judge
21 Sporkin and add something that's been said. We talk
22 about disclosure. I think it causes all of us

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1 especially as a regulator of the audit profession to
2 particularly focus on the words in the audit opinion
3 that often are not focused on. That is fairly
4 presented.
5 In conformity with GAAP is one thing.
6 Maybe it is not misstated that it is in conformity
7 with GAAP but fairly presented is also extremely
8 important.
9 If what you have is financial statements
10 that are misleading, that are in conformity with
11 GAAP, I would say how can they be fairly presented?
12 And recently when you talk about have auditors
13 learned something, I think auditors are very mindful
14 today of what happened; but it also means it is a
15 wake up call for all of us as part of the system to
16 focus on the words that what is material?
17 And it is hard to define materiality when
18 you're talking about words, but we have to recognize
19 that if those words aren't right, if the disclosures
20 aren't there, then the financial statements are not
21 fairly presented if it is misleading. And that's --
22 anyway --

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1 NEW SPEAKER: Bob talked about how
2 investors often don't rely on CEO and CFO
3 certifications as it relates to fraud. If you don't
4 get the preparer right, you don't get the whole
5 system right. I agree with him. I think he's right.
6 I think part of the problem is when you look at fraud
7 and the study that we did in the late nineties, 83
8 percent of the frauds that resulted in enforcement
9 actions, the CEO and/or the CFO was involved.
10 In the study that's going to come out in a
11 few weeks as the PCAOB and SEC knows because we've
12 briefed them, in frauds from 1998 through 2007 that
13 resulted in an SEC enforcement action, 89 percent of
14 the time the CEO or the CFO was involved.
15 And so when it comes to fraud, who's going
16 to hurt you? It is going to be the CEO or the CFO.
17 Not in most companies. In most companies, they are
18 honest competent people, but where you have risk
19 that's generally where you have the risk.
20 I think that's part of the problem. There
21 were a number of comments that the past won't repeat
22 itself. And I do think the flavor of fraud changes a

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1 little bit; but the past does repeat itself, guys.
2 It's top management. If auditors could do
3 a better job of assessing the CEO and the CFO's
4 integrity, they wouldn't need liability reform; and
5 in terms of revenue recognition in our '90s study, 50
6 percent of the frauds involved improper revenue
7 recognition. In the study coming out in a few weeks,
8 60 percent.
9 Most of the frauds are not complex Enron
10 type frauds. They are plan vanilla, cutoff issues,
11 just making up revenue transactions, very basic stuff
12 that everybody in the room could easily understand.
13 Last thing, very quickly, performance of
14 the profession. I would second Lynn and a couple of
15 others who said things: If you go back to earlier
16 this decade, just to remind everybody in the room,
17 WorldCom, Enron, Adelphia, Global Crossing, Tyco, on
18 and on, Health South, it was essentially a fraud a
19 week, a financial statement fraud a week. If you
20 look at the depth of the recession coming out of the
21 dot-com bubble, it was significantly less severe than
22 what we experienced now.

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1 If you would say based on the magnitude of
 2 the recession now vis-a-vis what we had 10 years ago,
 3 we should have had a hundred, 200 financial statement
 4 frauds. We haven't had that. As Lynn pointed out as
 5 I agree most of what we had are disclosure issues
 6 even where there have been allegations. There have
 7 been issues where maybe the business model wasn't
 8 sustainable, the auditor might have known that, the
 9 audit partner hasn't done anything.

10 I've had people ask me and this is
 11 obviously something that should be of concern to the
 12 SEC and PCAOB, obviously 404 has failed. Risk
 13 assessment was very poorly done. Then you explain to
 14 people, take the COSO framework, slice out two thirds
 15 of it because all 404(a) and 404(b) does is talk
 16 about internal control over financial reporting are
 17 the GAAP standards set in Norwalk, Connecticut
 18 correctly applied.

19 That's all the auditor is saying. As it
 20 relates to the failure of risk management, operating
 21 effectiveness and efficiency in compliance with laws,
 22 rules, and regulations. It is not primarily a

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1 financial reporting issue.

2 I'm not saying there aren't issues we
 3 should look at as a society at the PCAOB, at the SEC,
 4 and at the FASB. But I think in general the
 5 profession actually acquitted themselves certainly
 6 vis-a-vis the other players in this crisis like
 7 rating agencies, significantly better than many, and
 8 I think not to be obsequious, I think a large amount
 9 of that credit goes to the board and their
 10 activities.

11 NEW SPEAKER: Can I piggyback on what Joe
 12 said? I agree with Joe as well as Lynn that we need
 13 to look both historically at the types of fraud and
 14 improper practices that took place because as you
 15 have new management coming on board, you know, 30
 16 year old CEO, he may not remember what took place 20
 17 or 30 years ago. He may be repeating the same
 18 improper practice.

19 Also, as you have new audit staff come on
 20 board, some of the new auditors may not recognize
 21 some of these old frauds that took place. But they
 22 may be repeating themselves. I think the fraud will

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1 probably be detected faster or sooner by the PCAOB
 2 when they come in and actually inspect the auditor
 3 firms and what they have done; but I think the frauds
 4 will repeat themselves.

5 MS. YERGER: I think I have a question
 6 about whether that is the fraud center's job or the
 7 board's job on a going forward basis. I think
 8 clearly the markets evolve constantly and staying
 9 ahead of the market is such a challenge. Judge, I
 10 wanted to follow up on your comment and your
 11 question.

12 I guess I want to share frustration from
 13 the investor side, which is I appreciate the due
 14 diligence that goes into standards setting; but I
 15 think the glacial pace sometimes of those activities
 16 means that the market just moves way ahead of you.
 17 By the time the standards are released, there's
 18 something else to be worrying about. I guess I would
 19 encourage you and that's something I have in my
 20 written statement in terms of issuing staff guidance
 21 on hot issues, I think -- and I think in a rapid way,
 22 that's a value -- great value to the auditing

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1 profession and to the investing public at large.

2 I'm never sure about resource issues for
 3 the PCAOB. I probably should know this. I guess it
 4 goes without saying, I don't know, commissioner, if
 5 this should be directed at you, that the PCAOB should
 6 have the resources. I'm very supportive of the fraud
 7 center. I hope this doesn't mean you are robbing
 8 Peter to pay Paul to get this set up and that the
 9 board can develop whatever strategy it needs and
 10 articulate a budget and get the resources it needs to
 11 get this up and running in a way beneficial to
 12 everybody.

13 MR. HARRIS: As we go around the table, we
 14 have about 15 minutes left to this panel, you made a
 15 specific recommendation that I heard. That is that
 16 you applaud the audit alerts whereby we get ahead of
 17 the curve or are putting the industry on notice.

18 But if all of you can kind of begin to
 19 summarize your recommendations as we go around this
 20 panel, that way it would be very helpful.

21 Lynn?

22 MR. TURNER: Steve, Ann got ahead of me on

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1 one of the things I was going to say. That is that
2 the PCAOB does have a risk management office right
3 now that does look forward from that perspective.
4 People need to realize that function is already in
5 the PCAOB and they have identified, along with other
6 staff in the PCAOB, issues just two weeks ago in this
7 town, the chief auditor teed up the fact we have a
8 couple hundred Chinese companies listed, incorporated
9 in Bermuda, audited by someone in Buffalo, New York
10 that doesn't speak Chinese.
11 Clearly, they're doing that. They're
12 trying to find the next problem and appropriately
13 trying to deal with it in a timely basis.
14 That's not something that's lacking in the
15 current system. It is something in the system and
16 the PCAOB has worked on it.
17 With respect to the loan issue, one has to
18 keep in mind, too, I think Stanley, the Judge raised
19 a lot of good questions about where were the auditors
20 on the loans. But you also have to recognize the
21 regulators in this town, especially the banking
22 regulators, have basically come in and bludgeoned

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1 with the help of some very influential people in
2 Congress, bludgeoned the auditors to death to make
3 sure that losses absolutely were not taken.
4 And so the regulators sent a very strong
5 message to the auditors go very carefully here and
6 that makes it extremely difficult for an auditor to
7 stand up then and start telling people to all of a
8 sudden take losses.
9 So it wasn't just an auditor question. It
10 is where were the banking regulators that were, along
11 with Congress, beating these people up. We probably
12 haven't seen all the losses yet on the loans. That
13 frankly is why we haven't seen a bunch of
14 restatements come out in that area that probably
15 should have otherwise come out.
16 The other thing, talking about lessons
17 learned, we do know that time and time again the
18 number one way we find these frauds is not from
19 internal auditors; it is not from external auditors,
20 it is from the whistleblowers inside the companies.
21 By three, four, five times higher rate than internal
22 auditors and external auditors. Yet today, the

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1 auditing standards by which the profession has to
2 practice doesn't mention and doesn't require the
3 auditor to even look or understand that system.
4 And sitting on audit committees, I have
5 time and time again, sat there and asked the audit
6 partner to describe to me exactly how our
7 whistleblower program works; how the issues are
8 resolved; you know, tell me about whether it is
9 really independent or not; and I'm talking with some
10 Big Four auditors. Not in a single case has the
11 partner ever been able to describe that for me.
12 So it is very clear there are lessons to
13 be learned. It will be interesting to see what Joe's
14 report has to say about that. The bottom line is
15 there are lessons to be learned; and incorporated in
16 the standards and we haven't done a good job so far
17 to date.
18 MS. SIMPSON: Thank you. I think I have
19 two comments. The first is that really there needs
20 to be a way for the fraud center to capture
21 foolishness, not just criminal behavior. So I don't
22 know how we do that. There's an old saying in

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1 English -- you know -- that to be ruined by a fool is
2 the same as to be ruined by a knave.
3 Greed and stupidity probably made as much
4 of bringing us to the brink as out-and-out attempts
5 at criminal behavior.
6 On that, I wanted to flag something that
7 CALPERS is doing in an effort to try to understand in
8 our own portfolio why some banks did better than
9 others; and so we're actually involved in a whole
10 series of meetings with the boards of companies, not
11 just where it went wrong, but where it went right.
12 Back to your point, Bonnie, what didn't
13 they do so they didn't become foolish, greedy, drink
14 the Kool-Aid with the rest of the pushers of these
15 products?
16 I think out of that we'll get something
17 that may be useful -- Ann's idea which I like very
18 much that you could issue some guidance notes.
19 Actually things like the structure of
20 compensation makes a big difference to risk. Should
21 the auditors be paying attention there. We know
22 that's something that's on the table. Should we be

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1 looking at far more carefully reporting lines.
2 And specifying what the auditors' roles
3 are not just in a 404 style of internal controls, but
4 I think the mind set issue is the problem. We've
5 actually got a structure in which auditors in
6 particular because of the litigation and liability
7 issue are on a compliance track; and a lot of the
8 problems that we're facing are not about compliance;
9 they're about the real substance of what's going on.
10 So how we get to that, the spirit, not the
11 legal letter of the law is the biggest challenge
12 we're facing.
13 MR. TAROLA: I think we do know the
14 economic crisis was not caused by poor audits. It
15 was poor mortgages, that led to a financial crisis,
16 that led to the economic crisis.
17 By and large, audits served us well in
18 doing what they are prescribed to do to date. I do
19 think it is important to establish a fraud center
20 that is actually focusing on fraud, not focusing on
21 other issues as well.
22 There is a separate issue, other than

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1 fraud, and it's been discussed here. That's really
2 incomplete information. Are we getting the true
3 picture.
4 I think on average, we have gotten the
5 true picture. The problem is there's a distribution
6 around that picture. There are plenty of scenarios
7 where AIG does not fail. On average, perhaps AIG
8 does not fail, but we experienced the tail of the
9 event and I think that's where auditors can help us
10 totally separate from the fraud that we're talking
11 about; but they could help us understand the risk of
12 the audit. I think we'll tease this more out in a
13 later session.
14 I think that should be handled separately.
15 So I would prefer to not see fraud try to encompass
16 everything, try to be totally forward-looking, try to
17 analyze whether we are getting complete information.
18 We need accurate information. We need to understand
19 the tail, what is the risk to us that the AIG
20 scenario does play out. Hopefully we will tease that
21 out later today.
22 MR. SONDHI: I want to take a slightly

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1 different tack to some of the comments that have been
2 made. I remain unconvinced that the auditors have
3 done a good job.
4 How many -- what do we think or how should
5 we view companies that are serial restaters?
6 What do you do when a company -- one of
7 the largest companies in this country in the last
8 three or four years has had to restate several times?
9 We look at companies as Joe has pointed
10 out where revenue recognition today is about 60
11 percent, you said; it used to be 50 percent; we never
12 think about impairments, for example. Consider the
13 number of good will impairments. Companies make
14 acquisitions and generally speaking from the research
15 that I've seen, they effectively end up writing off
16 the good will within 18 months of the acquisition.
17 If more than 70 percent of the acquisition
18 of good will gets written off that quickly, what are
19 the resulting numbers? What do they mean afterwards?
20 You've bought an asset from someone, paid them 10
21 dollars, written off 8 of it and afterwards you sell
22 it for three and you announce that profit of 50

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1 percent?
2 Is that really not misleading? Is it
3 really -- does that mean that we're now fairly
4 presenting this information as Charlie was asking?
5 Or as the Judge was asking: What are the
6 auditors doing?
7 If you look at the specifics of the way in
8 which material information is presented, I think
9 there are other ways, other problems that we have;
10 and that's what I meant when I said earlier that I
11 used the example of bankruptcy.
12 The fact that someone doesn't announce
13 bankruptcy, but the investors lose all the money that
14 they've invested in that company I think is pretty
15 bad. I don't care if they don't declare bankruptcy.
16 We've lost the money.
17 There ought to be some way of looking at
18 that. We've got to try to think of it from that
19 perspective.
20 MR. HARRIS: I would ask everybody -- I've
21 been reminded if everybody could put their name up
22 since this is being Webcast. It is not clear who is

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1 speaking.

2 But just following up on your point, Tony,

3 which I think is an extremely good one with respect

4 to the impairment of good will and other issues which

5 you brought up, what would you have the PCAOB do that

6 we're not doing? What specific recommendations would

7 you make on the issues that you've raised?

8 MR. SONDHI: I think the issue is that we

9 need to find a way to be able to talk about what

10 effect that has on financial statements.

11 So if there are, in effect, as I said

12 serial restatements, if there are certainly

13 repetitions of impairments, or adjustments to the

14 financial statements, there has to be a way of asking

15 what is it that was wrong? Is it internal controls?

16 Is it the fact that we're not actually following the

17 accounting standards?

18 As Joe pointed out, if you look at the

19 number of revenue recognition restatements that you

20 see, you have to ask yourself, is it really that

21 complex? But Joe also pointed out that some of the

22 errors with respect to revenue recognition are fairly

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1 simple. How is it possible that we continue to miss

2 that?

3 I found a company the other day that says

4 their auditors permitted them to apply the multiple

5 element arrangement accounting standard on service

6 transactions but hasn't asked them to apply it to

7 products.

8 The first line of that standard says that

9 it applies to everything. It starts off actually by

10 saying this standard applies to everything. It

11 doesn't fool around. I doesn't say it in any complex

12 language or anything.

13 How do you do that for seven years?

14 So those are the kind -- there has to be

15 some way of asking auditors and the -- or finding a

16 way in the financial statements, I think as Charlie

17 said: What is the meaning of fairly presented if I

18 end up with 17 restatements.

19 By the way, I speak of the impairments on

20 the basis of having done a fairly extensive study of

21 impairments several years ago. The repetition of

22 those impairments is just extraordinary.

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1 So the specific recommendations I think

2 we'd have to find a way to be able to talk about

3 these restatements and these impairments.

4 MR. HARRIS: Bob? Then we have about

5 seven more minutes on this panel. Mike, we'll get to

6 you definitely. We'll get to everything.

7 And then we'll wrap up. If you can be

8 fairly brief?

9 And then actually, Brandon, I think I'd

10 like to give you the last word because you made some

11 very specific recommendations in your statement.

12 So why don't we spend more than the seven

13 minutes and go right around.

14 MR. TAROLA: In the way of

15 recommendations, I encourage the board to look at the

16 audit function more closely around what boards and

17 managements have to satisfy for SEC requirements or

18 otherwise.

19 To Charlie's point earlier about financial

20 statements being fairly stated: The officer

21 certification says fairly stated. It doesn't say in

22 conformity with GAAP. It stops with fairly stated.

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1 That was wise on the SEC's part to truncate that

2 statement.

3 Secondly, I met with auditing firms a few

4 times now. The topic was what can we do as a CFO and

5 board member to help you.

6 My answer generally has been focus on the

7 80 percent of the things I do, not just on the 20

8 percent.

9 The 20 percent around keeping the books

10 right is fine. But the 80 percent around risk

11 management, around whistleblowing monitoring, around

12 monitoring operating controls and regulatory

13 controls, around whether or not the business model is

14 still working, those are the risks that managements

15 and boards are looking at that the auditor is not.

16 The interesting thing is that the

17 disclosure model now requires boards and managements

18 to talk about all of that. Whether it is risk

19 factors, or enterprise risk management approaches or

20 compensation models, all of that is now in the public

21 domain, yet the auditors almost spend no or very

22 little time assessing those disclosures; and those

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1 are the disclosures that mean as much to investors as
 2 the accuracy of the balance sheet today.
 3 Because these are the factors that are
 4 going to affect the accuracy of the balance sheet
 5 tomorrow.
 6 JUDGE SPORKIN: I will ask the question
 7 again. I asked a very simple question. Do we know
 8 what the auditors do when they look at a securitized
 9 mortgage? Do we know what they do? They tell us
 10 what they do. If they tell us what they do and then
 11 we find out, did they find it or didn't they find it?
 12 If they didn't, they have got to change.
 13 I don't know why we're making this thing
 14 so complex. What did the auditors do here? You're
 15 an auditor. You're looking at auditing. Did they
 16 properly audit something?
 17 When your people go in, are they going to
 18 ask the auditor what do they do when they look to a
 19 securitized mortgage? Do they look at the rating and
 20 give up? Or go beyond that? And if they didn't go
 21 beyond that, should they go beyond that?
 22 Are those hard questions?

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1 MR. HARRIS: I think they're extremely
 2 tough questions. I want to get back to you, but not
 3 in this session. During your Keating opinion you
 4 asked the fundamental question where were the
 5 watchdogs? I remember that vividly. We'll get back
 6 to that later on today.
 7 But I think it is a very difficult
 8 question to figure out exactly what the role of the
 9 watchdog is.
 10 JUDGE SPORKIN: What did they do? We
 11 don't know what they did. Let's find out what they
 12 did.
 13 MR. HARRIS: That's I think part and
 14 parcel of what we're getting at directly with respect
 15 to one of the items the fraud center is going to be
 16 looking at.
 17 Let's keep going around. We have to wrap
 18 this up shortly. Let's take the extra time so we
 19 hear from everybody.
 20 MR. HEAD: I have to applaud and
 21 appreciate comments Bob and Joe both have made -- and
 22 this is Mike Head.

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1 To get back to announcing -- that when you
 2 talk about -- and I call it the iceberg theory, I've
 3 done that for years. What I mean by that is the
 4 financial statements are what's above water, when you
 5 talk about an iceberg. It is the smallest piece of
 6 what's going on. Bob and Joe are alluding to in the
 7 full COSO framework, where you have financial
 8 reporting, operating efficiency and effectiveness and
 9 compliance with applicable rules and regulations, the
 10 iceberg -- part of the iceberg you can see is the
 11 financial reporting -- a lot of us that are historic
 12 law accountants and auditors will call that the
 13 scorekeeping -- are very important because it's what
 14 investors see and rely on in making decisions. Where
 15 you manage risk, where governance is delegated, where
 16 you are trying to prevent fraud and hold management
 17 accountable and the board is trying to do what
 18 they're saying.
 19 That's the large portion of that iceberg
 20 is the operating procedures and the compliance
 21 portions that by design the auditors' opinion is not
 22 intended to cover except indirectly; and it is why

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1 one of the things from a broker-dealer point of view
 2 that as things from the -- whatever center you set up
 3 or you're talking about trying to influence what
 4 auditors can do, that's why a SAS 70 type of approach
 5 and why I applaud where the SEC went with the
 6 custodial rules and modifying it, if there's
 7 something that management, boards, PCAOB, the SEC
 8 feels are critical for the safeguards of assets and
 9 the protection of the investors, to get at that, you
 10 can't do that through the financial statements in an
 11 audit opinion of the financial statements.
 12 You have to look at it at the operational
 13 and compliance control structure; and the best way to
 14 get to that is not through the vehicle of material
 15 misstatement and fair statement and financial
 16 statements; it is by doing a service audit that falls
 17 under the SAS 70 type 2 audit.
 18 So if we think custody controls is where
 19 we're really concerned about protecting investors'
 20 assets, then you require them to do a SAS 70 covering
 21 a period that's covering the operating and compliance
 22 procedures and you don't try to get at that through

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1 the financial statements.

2 If someone thinks there's elements that

3 come out of the post-mortem of this fraud stuff that

4 are critical to protect the investors, and it is

5 operationally relied upon, then you go to something

6 like the SEC custodial rules and you put a rule in

7 place that requires management and the auditing firm

8 to look at the controls around those operating

9 procedures; and if governance and compensation are

10 things that hit that hot button, then you include

11 them in a required audit of operating procedures, not

12 try to get at it through just disclosure and

13 financial statement presentation. You'll never get

14 there.

15 And that's what you and Joe were saying,

16 Bob; but that's not what a financial statement audit

17 opinion is trying to give you comfort on. A SAS 70

18 or other targeted controls are FINRA, put into place

19 a few years ago, the requirement for the compliance

20 structure to be certified and reported on.

21 If you took 404 and expanded it to be, we

22 want you to opine on the COSO framework and not make

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1 it a point in time at year-end, but to make it for

2 the operating year of the -- for the company, and you

3 made it cover financial operating and compliance and

4 turn that into a service-type audit for the company,

5 you would get much further than trying to disclose

6 the world in the financial statements.

7 But that's just me. I'll get off my

8 soapbox.

9 MR. HARRIS: Pete, we do welcome your

10 comments.

11 MR. BECKER: Two quick things. I think

12 since the beginning of time, in terms of looking at

13 fraud, it has almost always been hidden in the same

14 place. Somebody said earlier unrealized gains, stuck

15 in the inventory. How do we come up with practical

16 guidance that comes up with new things being created

17 on Wall Street or other places because there's a

18 reason the Madoff scandal was referred to as a Ponzi

19 scheme. We talked a bit about things are new, but

20 Ponzi has been around for a hundred years.

21 What can we learn from the old ones? But

22 how do we stay on the leading edge of the new ones.

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1 Lastly we talked about risks and risk disclosures and

2 how can the PCAOB collaborate with other standard

3 setters and regulatory bodies to come up with some

4 sort of framework.

5 It's not up to the auditors to disclose

6 those in the financials. Maybe we should ask them to

7 disclose it in their opinions but I think having

8 management disclose it in their financials and having

9 the auditors responsible for reviewing risk

10 disclosures, I think would be helpful.

11 MR. HARRIS: We're clearly going to get to

12 that a little later.

13 MR. BECKER: I think Kierkegaard said life

14 is understood looking backwards but lived going

15 forward.

16 It seems your advisory committee

17 universally supports a fraud center and urges you to

18 implement it promptly and robustly. We also support

19 it focusing on old time fraud whether it is Ponzi or

20 salad oil and looking for ways to make sure we avoid

21 those instances again.

22 We also think that in terms of lessons

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1 learned, whether it is Lynn's more subtle problems,

2 Ann's structural issue, or Tony's individual

3 concerns, that there are more important concerns that

4 go beyond fraud or at least of equal importance which

5 go to risk and its measurement and the assessment of

6 risk above and beyond the focus on the financial

7 statements. The ability to make sure that fairly

8 presented appropriately incorporates an assessment of

9 risk is an important aspect that we would hope to see

10 a fraud center or a -- as Anne might amend that -- a

11 fools and fraud center would take into consideration

12 on a going forward basis.

13 We also at least at TIAA-CREF think that

14 looking at some particulars even if you don't take on

15 the entire comprehensive assessment, whether it is

16 rule 105 or the quality of earnings and in our view

17 whether or not we're picking up the entire earnings

18 life cycle of a financial instrument are areas that

19 warrant further consideration on a going forward

20 basis; but the core message, I think, of your group

21 is we need a fraud center that's robust and we need

22 to not only deal with regular fraud, we need to deal

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1 with systemic risk assessment issues on a going
2 forward basis.

3 MR. HARRIS: Commissioner Walter?

4 COMMISSIONER WALTER: Thank you, Steve. I
5 applaud everything I heard this morning. Keeping in
6 mind that of course I must disclaim speaking for
7 anyone else at the Commission, hopefully, I speak for
8 myself.

9 I think it is also important and I think
10 what you heard coming here today is to think about in
11 setting up a fraud center, and I agree with Brandon
12 it really needs to go beyond fraud and not involve
13 labeling yourself as having committed fraud which is
14 perhaps even more important that you need to set out
15 at the first instance the kinds of things you may
16 come up with and to cooperate with other people.

17 It strikes me we heard a lot this morning
18 about a variety of different levels.

19 At base what we really want to accomplish
20 is what one might call the impossible dream which
21 otherwise is to change culture, things, behavior, so
22 that everyone does the right thing. We'll need to

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1 strive for that even though we know you can't get
2 there.

3 We need to come out with evolving
4 solutions for incentives for good behaviors,
5 prophylactics and sanctions for bad behavior and a
6 combination of rules and principles not to use what
7 have become really trite terms, and think about the
8 kinds of solutions and also given your focus on
9 auditors, also working with other people who can
10 focus on other people who are involved in the chain
11 in terms of coming up with recommendations. I know I
12 look forward to working with you on it and I'm sure
13 my colleagues at the Commission do as well.

14 MR. HARRIS: Thank you very much.

15 That's a terrific closing to the first
16 panel.

17 Commissioner Walter, we certainly
18 appreciate that support for the center.

19 Why don't we take a 15-minute break and
20 reconvene at 10 after 11:00?

21 (Recess.)

22 MR. HARRIS: Why don't we start on our

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1 second panel, if we could get everybody's attention
2 here and people could come in and take their seats?

3 I'd like to ask Chairman Goelzer to start
4 the next forum on the foreign inspections.

5 Dan, let me turn it over to you.

6 CHAIRMAN GOELZER: Thank you, Steve. I'll
7 just be brief in setting a little bit of a
8 background. I think I've said publicly on other
9 occasions that I regard one of the most serious and
10 challenging problems that the PCAOB currently faces
11 as our inability to make comprehensive and fully
12 effective our foreign inspection program.

13 We have approximately 930 accounting firms
14 registered with us outside of the United States.
15 They're located in 87 different jurisdictions.

16 So we have in that sense worldwide
17 responsibilities. Not all of those 930 firms are
18 required to be inspected because many of them are not
19 actually issuing audit reports, but are filed with
20 the SEC and, therefore, don't come within the scope
21 of our existing PCAOB inspection program. But
22 several hundred of them are required to be

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1 periodically inspected.

2 We do have an active foreign inspection
3 program, and I don't want to leave the impression
4 that we're not performing inspections outside the
5 United States. In the six years or so that our
6 inspection program has been operating, we've
7 conducted about 200 inspections of non-U.S. based
8 firms in 33 different jurisdictions.

9 Many of those inspections were conducted
10 jointly with the home country audit oversight body.
11 And as a general matter, when there is an inspection
12 program operating in a country, we usually try to
13 conduct our inspections jointly with the home country
14 authority. This year in 2010, we are scheduled,
15 required under our inspection frequency rules to
16 conduct an additional 91 inspections in 26 different
17 countries.

18 So what's the problem?

19 There are major obstacles to us being able
20 to conduct the inspections that the Sarbanes-Oxley
21 Act expects and requires us to conduct. Currently we
22 are unable to conduct inspections in any of the

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1 countries in the European Union, in China, or in
2 Switzerland. As to China, we are conducting
3 inspections in Hong Kong although there are some
4 issues about workpaper access in some cases there.
5 I don't have complete market figures as to
6 how that affects our ability to -- our inability to
7 perform these inspections affects U.S. investors, but
8 I think that is safe to say it has an important and
9 profound impact on them. The U.S. market cap for
10 foreign private issuers in the places that we're
11 unable to inspect is certainly in the hundreds
12 of billions of dollars, but probably at least a
13 trillion based on the numbers we have.
14 You can add to that, that would just be
15 the range of market cap for foreign private issuers
16 where their auditor is located outside the United
17 States. Obviously in many cases, even though the
18 signing auditor is in the United States, a
19 substantial amount of the audit work is performed by
20 a non-U.S. audit firm.
21 I think in the -- for example, in the
22 Lehman audit, the last Lehman audit that was

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1 performed seems to have been in the news somewhat
2 lately, almost half the assets were located outside
3 the United States and almost half the audit work was,
4 therefore, performed by firms outside the United
5 States.
6 We certainly aren't taking this problem
7 calmly. Although we are trying to proceed on a
8 number of fronts on some it, perhaps the most obvious
9 is negotiating with the audit oversight authorities
10 in those places where we're not currently permitted
11 to enter to try to resolve the issues of sovereignty
12 or privacy of information or whatever the objection
13 might be.
14 We believe that the enactment of the
15 financial services legislation currently pending in
16 Congress would be an important step for us because
17 that contains a provision that would let us share
18 inspection information with foreign oversight bodies
19 on the same terms we can share first domestically.
20 At least in some cases, our inability to engage in
21 that kind of sharing is one of the objections that
22 has been raised to our ability to come in and perform

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1 inspections.
2 We're also, I think, mindful of the fact
3 that investors do need to have information about our
4 ability to conduct inspections in some cases. We now
5 have information on our website about firms that
6 we've been unable to inspect despite the fact that
7 the inspection cycle has passed for them. Those are
8 generally I guess without exception foreign firms and
9 we're thinking about whether that disclosure should
10 be expanded perhaps to include the clients of those
11 firms.
12 There are other tools in our regulatory
13 kit we might be able to use. For example, U.S.
14 signing auditor whose use, rely on the work of
15 foreign firms that we're not able to inspect, whether
16 they should have to make some disclosure, have
17 additional requirements with respect to themselves
18 having possession of foreign workpapers, other things
19 in that range. And of course, ultimately, we also
20 have enforcement tools that could be brought to bear
21 against foreign firms we're unable to inspect
22 although using those tools would raise its own set of

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1 policy issues.
2 So that's probably longer than you
3 intended, Steve, my kickoff to this discussion. I'd
4 be interested to hear this group's views.
5 MR. CARCELLO: Thanks, Chairman Goelzer.
6 You hit on some of the issues we're going to hit on.
7 This is a topic that we were assigned by
8 Steve and Joanne and worked collaboratively -- I'm
9 going to make the presentation but I worked on these
10 slides with Barbara Roper from the Consumer
11 Federation of America and Ann Yerger from the Council
12 of Institutional Investors.
13 Quickly, as you look at the slides, what
14 we're going to talk about is some very quick
15 background information on the act. Current state of
16 the inspections, challenges, a number and size of
17 foreign registrants, relative size of international
18 subs. We looked at a little bit the PCAOB inspection
19 resources and rigor, lack of access by the PCAOB
20 inspectors to certain foreign countries, the other
21 independent audit regulators.
22 As Steve requested we do make some

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1 recommendations for the board's consideration and
 2 then to maybe jump start the conversation, some
 3 questions for the group.

4 So this is the inspection mandate per the
 5 Sarbanes-Oxley Act. Again, you have it on the slide
 6 so I won't read this to you. We have it in front of
 7 you. The intent of the inspections to evaluate the
 8 sufficiency of the firm's quality control system and
 9 the manner of documentation and communication of that
 10 system by the firm.

11 The scope covers any registered public
 12 accounting firm that audits a company traded on a
 13 U.S. exchange regardless of domicile. One thing
 14 that's important to understand is the United States
 15 Congress would have been aware of some of these
 16 territorial claims that have been asserted at the
 17 time they passed the law; and the United States
 18 Congress chose to indicate that all firms registered
 19 with the board regardless of domicile should be
 20 inspected.

21 There are approximately 2500 firms
 22 registered with the board, including about 40 firms

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1 from 86 foreign countries outside the United States.
 2 Frequency, annually for registered public accounting
 3 firms that regularly audit more than a hundred
 4 issuers. There's 10, all in the United States. At
 5 least once every three years for all other registered
 6 public accounting firms that have issued an audit
 7 report on an issuer during the preceding year.

8 Our numbers suggest there's approximately
 9 450 firms in the U.S. and 200 firms outside the U.S.
 10 that would be subject to inspection requirements, so
 11 about 650; and then the 10, the very large firms,
 12 660. No exemptions. All U.S. firms must register
 13 with the PCAOB.

14 The intent is to ensure compliance with
 15 the PCAOB's auditing and professional standards
 16 inspections and disciplinary regimes. There had been
 17 some discussion by the board of the full reliance
 18 approach on foreign regulators. At the moment it
 19 looks like the board is leaning against that
 20 approach.

21 Based on PCAOB release 2000405, PCAOB
 22 retains all authority over inspections,

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1 investigations and enforcements. They did make a
 2 proposal for full reliance in 2007. No action taken.
 3 Going on for years. So my gut says at least right
 4 now that's probably cool.

5 High cooperation. PCAOB cooperates as
 6 much as possible with counterparts around the globe.

7 PCAOB rule 4012 deals with foreign
 8 inspections and may rely on the independent audit
 9 oversight entities located in home countries of
 10 registered non-U.S. firms.

11 And to the extent that the board relies on
 12 these other independent audit regulators, here are
 13 the characteristics that the board considers.

14 As Chairman Goelzer said, there's a number
 15 of challenges posed by foreign inspections. Not all
 16 registered non-U.S. firms have been inspected as of
 17 the end of '09. 75 firms in 29 foreign countries
 18 have not been inspected even though four years have
 19 passed since the end of the year in which the firm
 20 first issued an audit report while registered with
 21 the PCAOB. If you do the math here right, guys and
 22 gals, that's five years or more.

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1 PCAOB difficulties inspecting some
 2 registered non-U.S. firms, access denied to PCAOB
 3 based on legal conflicts with home country laws or
 4 objections based on national sovereignty. Chairman
 5 Goelzer indicated some of the actions the board has
 6 taken. Disclose names of firms not yet inspected;
 7 disclose names of jurisdictions that deny access.
 8 There's been a deferral in getting all this done to
 9 2012.

10 Proposed recommendation that the chairman
 11 alluded to that may end up as part of the financial
 12 regulatory bill.

13 Also, we need to understand that the
 14 largest auditing firms are composed of global
 15 networks of affiliates.

16 Affiliates are separate legal entities. I
 17 question whether most U.S. investors understand that.

18 Independent and autonomous. Affiliates of
 19 a U.S. accounting firm may be subject to quality
 20 assurance, risk management, overall business reviews,
 21 codes of ethics, and professional conduct and
 22 practice laws. They do attempt to integrate in these

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1 dimensions but in terms of legal structure, they
 2 typically are separate.

3 Audits of global clients, as Dan said, are
 4 handled by affiliated firms. When I was in public
 5 accounting, we had a few multinationals that we got
 6 on planes and jetted around the glob. We used these
 7 foreign affiliates of our firm to do that work.

8 Foreign registrants audited by non-U.S.
 9 auditors are significant to the U.S. capital market.
 10 We used audit analytics and a little over 10 percent
 11 of all companies on audit analytics which is most of
 12 the SEC universe, around 9,000 public companies, over
 13 10 percent are foreign registrants. Some market cap
 14 numbers, European Union and Norway, over 500 billion;
 15 Switzerland, over 75 billion; China and Hong Kong,
 16 over 75 billion.

17 It is hard to get exact numbers on this,
 18 as Chairman Goelzer indicated, but these are big
 19 numbers no matter how you slice it.

20 And I -- keep in mind these foreign
 21 registrants are not being audited by the Big Four
 22 firms that we all know and love here in the United

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1 States.

2 So I'm handing out another piece of paper
 3 for you that I think you'll find quite interesting.
 4 This piece of paper, we took the hundred largest --
 5 I'm sorry, the 50 largest foreign registrants. So
 6 these are the 50 largest foreign registrants and
 7 looked to see who signed the opinion.

8 Seems interesting, right? Six different
 9 flavors of Deloitte. Ten different flavors of Ernst.
 10 Nine different flavors of KPMG. And 10 different
 11 flavors of PWC.

12 So I have some questions to spur your
 13 intellectual curiosity this morning: Do U.S.
 14 investors even realize that some of these entities
 15 are not the U.S. firm?

16 Okay. So let's look at
 17 PricewaterhouseCoopers. Remember, remember tick
 18 marks in public accounting? Remember that, Lynn? A
 19 and B.

20 PricewaterhouseCoopers in brackets, that's
 21 me, that's not on the signature, okay. So it says
 22 PricewaterhouseCoopers in brackets Hong Kong, that's

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1 on the signature to the extent they put the city, the
 2 state, the country. But they don't call it
 3 PricewaterhouseCoopers Hong Kong. They call it
 4 PricewaterhouseCoopers. You think if a U.S. investor
 5 saw that, what would they think?

6 Where it is obvious that the firm is not a
 7 U.S. firm, I love KPMG's affiliate in Germany, I
 8 can't even write the thing. Would U.S. investors
 9 think this is a wholly owned sub of a U.S. firm?

10 I think some of them wouldn't.

11 Do U.S. investors realize that in the case
 12 of litigation, that each of these firms are generally
 13 legally separate entities?

14 And there are 35 separate affiliated Big
 15 Four firms on this list in approximately 15
 16 countries.

17 Do investors expect a Big Four firm to
 18 deliver uniform audit quality given a U.S. listing
 19 and compliance with PCAOB standards? I would think
 20 the answer to that is yes, and is that happening?
 21 That's obviously an empirical question. And
 22 obviously why foreign inspections are so important.

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1 In addition to what we did with foreign
 2 registrants, as Chairman Goelzer indicated, the thing
 3 that worries me as much as the foreign registrants is
 4 U.S. multinationals. That's where so much of our
 5 market cap is, and a huge amount of the work is being
 6 done overseas by foreign affiliate firms.

7 So what we did is we polled the geographic
 8 area disclosure, and I need to thank Matt Hogue and
 9 Dereck Hobbey who are students at the University of
 10 Tennessee. This is a significant amount of data
 11 polling in a short amount of time. Advantages of
 12 being at a university. Geographic area disclosures,
 13 the old FAS 131, for the Fortune 100. What we did is
 14 we looked at revenues, foreign revenues, total
 15 revenues, and foreign assets, total assets.

16 And we also looked at the number of
 17 subsidiaries, both domestic subsidiaries and U.S.
 18 subsidiaries. So if you use medians, you see that
 19 there's about 113 subsidiaries for these companies,
 20 28 of which are foreign.

21 So that's, what, more than 25 percent of
 22 the subsidiaries of the Fortune 100 are outside the

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1 United States.

2 If you compare international revenues, if

3 you do it based on companies that include all

4 companies -- if you include all companies including

5 those with no international revenue, mean revenue to

6 total revenue is 24 percent; mean assets to total

7 assets, 16 percent. If you exclude companies with no

8 international revenue, some companies that are purely

9 U.S. domestic, mean revenue from foreign operations

10 to total revenue is 36 percent. Mean assets to total

11 assets, 30 percent.

12 So, however you slice it, it is a very

13 significant chunk of U.S. multinational financial

14 statements.

15 We also looked -- tried to compare the

16 PCAOB inspection process here in the United States to

17 the PCAOB inspection process of foreign affiliates.

18 This was difficult to do with any degree

19 of reliability using the public portions of

20 inspection reports. So we kind of cheated. We used

21 the PCAOB's office of internal oversight and

22 performance assurance report that was issued on

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1 December 4, 2009; and this is a public document. It

2 has been submitted to the chairman of the SEC with

3 Chairman Goelzer's cover letter so there's nothing

4 the board and the SEC don't know here.

5 But issues related to rigor of

6 international inspections related to scope until

7 recently was lack of a system of accountability.

8 Even in -- not to be unkind but even where the board

9 is getting in, there are still issues where they can

10 get in to do inspections, and it is not going as

11 smoothly as they would like.

12 Then there's the issue of lack of access

13 by PCAOB inspectors to certain foreign countries; and

14 among these countries, again as the chairman

15 indicated, China, third in the world in Gross

16 Domestic Product, Germany, fourth in the world in

17 Gross Domestic Product, France, fifth in the world in

18 Gross Domestic Product. United Kingdom, sixth in the

19 world in Gross Domestic Product. You are okay in the

20 U.S. if you are in Boston, Atlanta, Los Angeles.

21 Other than that, you have an issue.

22 Okay. Then we looked at independent audit

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1 regulators and their inspection regimes. So we

2 focused on examining the independent audit regulator

3 in the 10 largest countries based on Gross Domestic

4 Product. Website content and reporting was sporadic

5 and inconsistent across various countries.

6 This is rough. This was off. There was

7 not any degree of uniformity here. Most usable

8 reports in our judgment were from the U.S., Japan,

9 U.K., Italy, and Canada. Reports were not available

10 in English for France and Germany. We were unable to

11 locate reports for China, Brazil and Spain.

12 It appeared that the board of the

13 independent audit regulator was independent in the

14 U.S., Japan, Germany, U.K., Canada.

15 The board does not appear to be

16 independent in Italy and Brazil. We could not

17 determine if the board was independent in China,

18 France and Spain.

19 Also in Japan and Canada, there weren't

20 separate inspection reports on the Big Four firms but

21 rather they issue a combined report.

22 We also looked at kind of resources

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1 available. For the 2008 fiscal year, the PCAOB's

2 operating expenses were 134 million, the million in

3 Canada, 5 million in the U.K. PCAOB had 258

4 inspection employees. Japan had 39. Canada had 24.

5 The U.K. had 18. In 2008, the PCAOB completed 255

6 inspections. Canada, 42; the United Kingdom,

7 completed 19.

8 Japan completed 120, but it appeared to us

9 it was done by what I'll call the Japanese analog of

10 the AICPA. So since the United States Congress has

11 specifically rejected that approach, I put that down

12 kind of indented not at the same level -- not

13 comparable to the others.

14 Okay. So in addition, reasoning by

15 analogy, let's compare U.S. regulators -- this is you

16 Commissioner Walter -- with international securities

17 regulators.

18 From 1987 to 1997, there were 300

19 enforcement actions by the Securities and Exchange

20 Commission. 300 unique companies. There were many

21 more enforcement actions. Not uncommon for there to

22 be two, three, four enforcement actions coming out of

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1 one case. The company, management of the company,
2 maybe the auditor. 300 unique what I'll call
3 instances of fraud.

4 And the study that will be released in a
5 couple of weeks, there's 350. Fraud is not going
6 away. Becoming slightly more prevalent. Lasting a
7 little longer. And as you'll see when the study
8 comes out, the size of the fraud is significantly
9 larger.

10 Even if we truncated the 95th percentile
11 and take Enron and WorldCom out, it is still
12 significantly larger. There's a study in Canada by
13 Magnan, et al.

14 In 2010, 15, 15 enforcement actions by
15 the -- over the 11 year period from 1995 to 2005 in
16 Canada. Other than the United Kingdom, probably the
17 country closest to us in terms of culture,
18 background, so forth.

19 Being a good academic, I have a rhetorical
20 question. You don't have to answer, right. That's
21 what a good rhetorical question is for the group.
22 Given the difference in the apparent rigor of the

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1 enforcement program between the U.S. securities
2 regulator and at least one foreign counterpart, why
3 should we expect the rigor of inspections between the
4 U.S. independent audit regulator and foreign
5 independent audit regulators to be any different? It
6 can't be. You have to come up with a good reason as
7 to why it would be.

8 So recommendations for the PCAOB, per
9 Steve's request.

10 Redouble efforts to get access to these
11 foreign accounting firms through political and
12 diplomatic negotiations.

13 In our view, me, Barbara, Ann, the board
14 should not take any of its options off the table at
15 this point. Deregistering foreign accounting firms
16 where inspections cannot be conducted. We're not
17 suggesting the board go there first by any stretch of
18 the imagination. But in any negotiations, to take
19 your strongest weapon off the table before the
20 negotiation starts strikes us as ill advised.

21 In the interim, the board should require
22 disclosure of names of foreign registered accounting

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1 firms that have not been inspected. This is already
2 being done as Chairman Goelzer indicated. Names of
3 foreign registrants in countries where inspections
4 have not occurred. Name the companies as Dan
5 suggested. They're not there yet but they've talked
6 about that.

7 Names of U.S. multinationals if material
8 foreign subsidiaries have been audited by foreign
9 accounting firms that have not been inspected and the
10 percentages of consolidated revenues, income, and
11 assets of foreign subs audited by foreign accounting
12 firms that have not been inspected.

13 Gus is sitting over there in Valley Forge
14 and says I have this audit report and it says 60
15 percent of consolidated revenues, income, and assets
16 have been audited by foreign affiliates in countries
17 that maybe he's concerned about transparency and the
18 rule of law and so forth, and there's no inspection
19 going on of the audit work in this country.

20 Then as the investor, he has a choice to
21 make. He's fully informed. He doesn't have lack of
22 information. He may say I don't care, I don't care,

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1 I'm still going to own that stock or say, no,
2 forewarned is forearmed, I don't want to own the
3 stock.

4 In addition, for foreign subs of U.S.
5 multinationals audited by foreign affiliates of a
6 U.S. firm, the board should require the U.S.
7 accounting firm to conduct detailed internal
8 inspection of its foreign affiliates.

9 I think this is what the chairman was
10 getting at. The board could put in place additional
11 requirements on the U.S. firm that's relying on the
12 work of the foreign affiliate.

13 Okay. And so the foreign -- the foreign
14 government may block the board, you use the U.S. firm
15 as your proxy. Review those -- these internal
16 inspections and inspect its division of enforcement.
17 I want to make sure that Claudius doesn't get bored.
18 To hold U.S. accounting firms responsible for the
19 failures of the foreign affiliates when auditing
20 material foreign subsidiaries of U.S. multinationals.

21 And then we have questions.
22 But we obviously will talk about whatever

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1 you guys want to talk about. I tried to do that
 2 quickly. I wanted to make sure there's plenty of
 3 time for people to talk.
 4 MR. BECKER: Could I ask you one quick
 5 question on your recommendations?
 6 You don't seem to have linked the ability
 7 to do inspections to convergence issues. Do you see
 8 a connection between those two?
 9 MR. CARCELLO: The ability to do
 10 inspections between accounting standards or auditing
 11 standards?
 12 MR. BECKER: Accounting standards. Or do
 13 you view that as two parallel tracks?
 14 MR. CARCELLO: If there's a diagram,
 15 overlap, we might have opinions as to how much
 16 overlap there is. As you rightly point out now,
 17 certainly on foreign registrants in all likelihood
 18 they're filing with the SEC using IFRS as issued by
 19 the IAASB. That won't be the case for foreign subs
 20 of U.S. multinationals. They'll still be using U.S.
 21 GAAP.
 22 For that part of it, no issue. Right.

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1 But for foreign registrants, yes, there's obviously
 2 an issue the board will need the capacity in an
 3 inspection sense to not only evaluate auditing which
 4 is still the same PCAOB standards are still the same,
 5 but be able to evaluate the application of IFRS
 6 effectively for these foreign registrants. You're
 7 right. That's a fair point. That's a capability
 8 they need to have to be able to do that.
 9 COMMISSIONER WALTER: I'm surprised to
 10 move on from accounting standards to talk about
 11 international auditing standards, that there's no
 12 recommendation that relates to that. And to moving
 13 forward with people around the globe with FERN and
 14 otherwise towards having auditing standards converge
 15 because even if you solve the inspection problem, if
 16 you have a variety of qualities of auditing
 17 standards, the problem is still in some ways going to
 18 persist.
 19 MR. CARCELLO: Yes. This is on the agenda
 20 for today, Commissioner Walter. It wasn't
 21 specifically on our chart. My understanding that if
 22 you are a foreign registrant and you are filing with

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1 the SEC, regardless of the country you are in, you
 2 can use IFRS right now. You still have to do the
 3 audit using PCAOB auditing standards.
 4 And so you might be in Brazil and you
 5 might be using ISAs; and my understanding is most of
 6 the Big Four, their underlying platform, their audit
 7 methodology platform is based on the ISAs, the
 8 international standards of auditing. But then for
 9 companies that file with the SEC, they lay on top of
 10 that any incremental PCAOB requirements. Now, a
 11 discussion of whether or not the PCAOB should move in
 12 the direction of adopting the ISAs broadly, I think
 13 we'll have that discussion later; and so I don't want
 14 to take us too far afield.
 15 I did look at the IAASB, and I'm sure
 16 you've looked at it as well; and when you look at the
 17 current composition of the IAASB and its 18 people
 18 and you count the people who are currently -- not
 19 talking about past, because Marty is past, he has
 20 done inspections here for the PCAOB, currently,
 21 currently working in public accounting, it is about
 22 50 percent.

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1 And it is heavily represented by the Big
 2 Four. Which again was the model we had at the
 3 auditing standards board. That was the model that I
 4 had since I was in my twenties, that Charlie had when
 5 he practiced accounting, that Dan had for the few
 6 years he was in accounting.
 7 The United States Congress specifically
 8 rejected that approach.
 9 Okay.
 10 Now, they gave the board the option of
 11 delegating standards setting. The board has chosen
 12 not to do that.
 13 COMMISSIONER WALTER: I guess the point
 14 I'm making is a little bit different than that. Not
 15 so much a movement towards international auditing
 16 standards, but rather the notion that if you look at
 17 the Big Four and you say their platform is based on
 18 one set of standards with others as an add on, that
 19 that's not necessarily the healthiest underlying
 20 condition.
 21 I mean, long term, if the issues that
 22 underlie this issue are going to be solved, you want

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1 one very robust set of auditing standards to be
 2 applied across-the-board.
 3 And that I think is particularly
 4 troublesome when you have things as an add on. It's
 5 not what you do daily. Remembering I have to do
 6 extra things for this guy but not that guy is not a
 7 good thing.
 8 MR. CARCELLO: You are right. That's a
 9 good point. I think the discussion is how to get so
 10 to one set of global auditing standards the same as
 11 one set of global accounting standards that are
 12 uniformly high quality, in the investors' best
 13 interest and promulgated by bodies that are
 14 independent of the profession itself; and right now,
 15 the IAASB in at least my view is not quite there.
 16 But I think, Steve, that's on the agenda for later
 17 today, isn't it?
 18 MR. HARRIS: I think it is on the agenda
 19 for later today. I don't know whether Marty Baumann
 20 wants to take a brief moment to discuss our standards
 21 setting process. Sarbanes-Oxley, the spirit, the
 22 conviction of the underlying bill was that the PCAOB

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1 be the gold standard in items of setting standards.
 2 For this particular group, I think it is important to
 3 know first and foremost in terms of standards
 4 setting, certainly a very high priority is how do our
 5 standards -- how do they improve from an investor
 6 protection standpoint, the standpoint of standards
 7 that are already out there.
 8 We're doing a very, very careful analysis
 9 of the interim standards, the international standards
 10 in terms of setting our own standards.
 11 Marty, do you want to take a second?
 12 MR. BAUMANN: I think Joe has kind of
 13 alluded to some of the points that are important in
 14 this regard. Steve, you did also.
 15 Congress under Sarbanes-Oxley intended for
 16 standards setting to change, intended for a lot of
 17 things to change in the context of auditing. And
 18 right now standards setting is in the hands of an
 19 independent regulator as opposed to standards setting
 20 largely dominated by the profession as Joe Carcello
 21 just pointed out.
 22 So we are writing and updating and writing

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1 a lot of new standards. We look to see what the
 2 international and other standard setters have done;
 3 but we take a thorough and comprehensive look and add
 4 whatever requirements we think are appropriate to
 5 have the -- what we think are the highest quality
 6 auditing standards that are -- can be inspected
 7 against and can be appropriately enforced.
 8 And, therefore, can result in the highest
 9 degree of audit quality. We have an ambitious
 10 standards setting agenda and program that we think
 11 will achieve those goals.
 12 MR. HARRIS: Barbara, why don't we turn to
 13 you and Damon. And thank you for testifying, for the
 14 public service. Thank you for getting out of that
 15 hearing as quickly as you could and joining us on
 16 this panel. We missed you on the first panel. We
 17 welcome you here.
 18 Barbara? Damon?
 19 MS. ROPER: You know me well enough to
 20 know you shouldn't issue those kind of blanket thank
 21 yous when I get in front of a microphone.
 22 First of all, Joe did a disservice on

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1 giving us credit for contributing, and I think Ann
 2 did. I did essentially nothing. There may be one
 3 sentence in this which I contributed which is not an
 4 effort on my part to walk away from it but I think
 5 Joe did a terrific job. He put a lot of work into
 6 it. I think it shows.
 7 On this issue of what was raised, how does
 8 this issue relate to IFRS and audit standard
 9 convergence, I feel strongly it does not relate to
 10 them at all. There is a mandate in the
 11 Sarbanes-Oxley Act that the PCAOB inspect foreign
 12 firms.
 13 An effort was made in committee to strip
 14 that out -- in the conference committee, both Senator
 15 Gramm and Representative Oxley attempted to strip
 16 that out in conference committee. It was rejected.
 17 It was rejected in the face of all the arguments that
 18 had been brought to bear by a number of foreign
 19 entities.
 20 Congress thought about this long and hard.
 21 They made this decision. They made it despite
 22 considerable opposition. So I think it has to be

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1 taken very seriously that they viewed this as an
 2 essential component of effective PCAOB operation.
 3 On the questions of the international
 4 audit standards, those of us who lobbied on this
 5 legislation fought very hard to ensure that this body
 6 would have the authority to set the audit standards.
 7 And that we would change the system in
 8 which audit standard setting was dominated by the
 9 industry because we felt it had given us standards
 10 that were written primarily to protect or with an
 11 excessive eye to protecting the auditors from
 12 liability rather than resulting in effective audits.
 13 Given the current state of affairs in the
 14 international audit standard setting process, to move
 15 too precipitously toward some sort of international
 16 convergence with standards would simply put us back
 17 to the system as Joe suggested that Congress
 18 specifically rejected when it offered this model. We
 19 would be back to having considerable and excessive --
 20 in my view -- input from the auditors in the setting
 21 of those standards and that would not, I think,
 22 benefit the standards themselves.

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1 Which doesn't mean there shouldn't be some
 2 sort of general discussion of trying to move in the
 3 same direction. You reach agreement when it is
 4 possible, but it can't become an end in itself.
 5 Beyond that, I think there's something of a myth
 6 about the benefits of this even in a theoretical
 7 sense, which is the idea that uniform standards would
 8 produce uniform audits.
 9 We know, for example, with IFRS that
 10 uniform accounting standards don't produce uniform
 11 accounting. There is at least some sort of
 12 theoretical logic to having one language that
 13 everybody speaks in terms of accounting standards.
 14 I just don't see the same logic on audit
 15 standards; and I think that if you don't solve this
 16 basic problem first of getting the inspections and
 17 the enforcement and everything working, that simply
 18 moving towards comparable standards won't do anything
 19 to get us closer, anything significant to get us
 20 closer to comparable audits. It is on this end of
 21 getting the inspections system functioning that we
 22 need to bring us all closer together to performing

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1 the highest quality audits.
 2 MR. HARRIS: Damon, identify yourself for
 3 the public.
 4 MR. SILVERS: I'm Damon Silvers. I'm the
 5 policy director of the AFL-CIO.
 6 First let me say I apologize for not being
 7 here earlier this morning.
 8 As you noted, the Senate Judiciary
 9 Committee requested that Barbara and I be there to
 10 talk about some related issues to this meeting.
 11 I wanted to impose upon you for a moment
 12 on the subject of the last panel and just say that
 13 we -- I think that the notion of a fraud center is
 14 extremely important, that it needs to be seen in a
 15 critical sense as a way of -- as a filter for moving
 16 the considerable amount of non-public information
 17 that the PCAOB has about the practices of the
 18 auditing profession in relationship to fraud
 19 detection and prevention and making it available to
 20 current practitioners.
 21 It is a device for essentially solving an
 22 information problem inherent in the confidentiality

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1 issues associated with what the board does.
 2 Also a way of systematizing, learning in
 3 sort of a forensic National Transportation Safety
 4 Board type way when we have major frauds that occur.
 5 I would note that I understand Commissioner Walter
 6 was supportive of that -- of the general concept in
 7 the discussion. I wanted to commend her for that.
 8 Now I come to this matter.
 9 I have been involved in my other capacity
 10 in the PCAOB at the Standing Advisory Group in a
 11 variety of conversations about the issue of the
 12 foreign inspections and the obstacles the PCAOB faces
 13 in relation to foreign inspections.
 14 I would echo what Barbara Roper said about
 15 the current state of affairs in relation to
 16 international convergence in audit standards. It was
 17 very clear to me at the time this idea was being
 18 broached in the waning days of the Bush
 19 administration that it was part of a comprehensive
 20 push to essentially, in labor movement terms, to
 21 whipsaw investor protections internationally, to
 22 force a further weakening of U.S. investor

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1 protections across a wide range of the regulatory
 2 system.

3 By trying to push us to the lowest common
 4 denominator of what existed in other markets. As it
 5 turned out, our investor protections in the financial
 6 regulatory system was woefully underpowered even as
 7 it was then, let alone weakened further.

8 This is not to say -- and here I may
 9 disagree with Barbara, a rare occasion, that is not
 10 to say that the idea of having a global -- strong
 11 global auditing standards would not be a good idea if
 12 we could get such a thing. As long as we have a
 13 process that would inevitably be dominated by the
 14 firms themselves given the composition of the PCAOB's
 15 counterparts, I don't see how we can get there.

16 That's also my view about accounting --
 17 Financial Accounting Standards. There's nothing
 18 wrong with common Financial Accounting Standards as a
 19 concept. The question is how do you get there with
 20 some integrity.

21 The board -- I'm very sympathetic with the
 22 board's problem of what to do about this, about

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1 numbers 2 through 6 in the global economy being off
 2 limits. One suggestion I have in addition to the
 3 items that are on the list that Joe prepared is that
 4 this is something where the Commission may have a
 5 very strong role to play.

6 The basic political dynamic I see is that
 7 we have foreign governments fronting for foreign
 8 audit firms and there's -- really no price is being
 9 paid by foreign issuers for this arrangement.

10 A giant stamp in 18 point type on the
 11 front cover of a 20-F or a 10-K that says material
 12 portions of this financial statement have been
 13 prepared, have been audited by audit firms that have
 14 not been inspected by the PCAOB or anyone working in
 15 concert with the PCAOB and cannot be relied upon, I
 16 think that would motivate some folks.

17 And whether or not it should do 18 point
 18 type, that's not really the Commission's style; but
 19 some kind of coordinated activity around disclosure
 20 between the board and the Commission addressed not
 21 just at audit firms but at issuers might do wonders
 22 in this area to alter the general set of motivations

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1 and politics in economies 2 through 6.

2 JUDGE SPORKIN: Am I missing something
 3 here? A company that's registered with the SEC has
 4 to have -- required --

5 MR. HARRIS: Judge, identify yourself for
 6 the audio.

7 JUDGE SPORKIN: Stan Sporkin.

8 A company that's registered with the SEC
 9 or trading in the SEC has to have an auditor. That
 10 auditor has to be a member of the PCAOB; and that
 11 auditor, I assume, as a requirement of becoming a
 12 member, has to agree that it will be inspected.

13 Have I missed something in that? What is
 14 it if they do not agree, then you take their license
 15 away; and then the company can't be -- has to get a
 16 new auditor.

17 Is there something I missed here? I'm a
 18 simple person, but I don't know what it is I'm
 19 missing.

20 MR. CARCELLO: You haven't missed
 21 anything. It put the board in a tough position. You
 22 haven't missed anything. They have the authority to

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1 do that, if they did that, let's be practical. If
 2 they did that without the support of Chairman
 3 Schapiro, there'd be a major problem.

4 And if they did that probably even without
 5 the support of the Treasury and the White House,
 6 they'd have a problem. There'd be major
 7 international repercussions.

8 JUDGE SPORKIN: Can I tell you something?
 9 I hate to say when I was at the SEC, but when I was
 10 at the SEC we had the five biggest banks in Mexico
 11 trading here in the United States and the securities
 12 were not registered. By a stroke of the pen, we put
 13 them on a foreign restricted list which said you
 14 cannot trade these securities in the United States.
 15 Okay?

16 And you will not believe -- yeah, I had
 17 the State Department, everybody else banging on my
 18 door. But I will tell you this: They registered
 19 within two or three days.

20 I must tell you, you can't back down. I
 21 don't understand -- this is not anything different
 22 than a lot of other issues that we've had over the

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1 years. You don't back down.
 2 Foreign practices, we said we'll destroy
 3 the world or destroy our companies because they can't
 4 compete in the world. We didn't back down.
 5 I don't understand why it is you have to
 6 back down. You say that's your rule. You either
 7 comply. You don't comply. With respect to the
 8 umbrella companies, the umbrella -- either -- and as
 9 I understand it, the affiliated companies are
 10 registered with the PCAOB, am I right on some of
 11 them? I know one of my clients is registered. They
 12 considered it very important.
 13 So we're trying to accommodate something
 14 that we don't know; and I would assume with this
 15 administration, they'd be pretty firm.
 16 Look, that's the way I used to do things.
 17 Maybe they're done differently now.
 18 COMMISSIONER WALTER: There's an aspect of
 19 this that has not been mentioned. Which is that this
 20 is not a fight between foreign companies and the
 21 PCAOB or foreign auditors and the PCAOB. There are
 22 countervailing laws in countries.

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1 That is conflict between foreign law and
 2 U.S. law. And that dynamic really has to be taken
 3 into account and hasn't been mentioned here.
 4 JUDGE SPORKIN: I understand that. Let's
 5 assume you are right. But foreign law understands if
 6 you go into their country, you comply with their law.
 7 If they come into our country, they have to comply
 8 with our law.
 9 That's a very simple thing.
 10 COMMISSIONER WALTER: Stanley, in all
 11 fairness, they view this as us coming into their
 12 country and refusing to comply with their law. The
 13 dynamic is in the eye of the beholder. I'm not
 14 meaning to sound like an apologist for this, but it
 15 is a complicated issue, one that has strong
 16 international ramifications and needs to be
 17 approached with delicacy.
 18 We want to get there. We don't want to
 19 create an international incident.
 20 JUDGE SPORKIN: Look, I don't want to
 21 debate this. I see things differently. I think we
 22 create our own problems a lot of times by assuming

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1 certain things. Either we do have it, we got to
 2 follow our rules, or we don't.
 3 I think it is that simple. I don't
 4 understand how we make exceptions. Why do we make
 5 simple issues complex? What -- test it. Test these
 6 companies. See what happens. If you have to, some
 7 of these securities won't trade here. It is very
 8 simple. But it is a question of might.
 9 Well, I assume -- we're the greatest
 10 country in the world, why don't we show it?
 11 MR. HARRIS: Tony, we'll go to you and
 12 then go around.
 13 MR. SONDEHI: First, I thank the -- Joe and
 14 his team for putting this together. It was really
 15 very informative. Just a couple of quick comments.
 16 I think Barbara said it. Uniform
 17 standards don't produce uniform accounting.
 18 I think there is this widely held belief
 19 that the IFRS is going to do all kinds of good
 20 things. Unfortunately the way I see it from what I
 21 have found, there are 23 different versions of the
 22 IFRS floating around. There are companies that used

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1 to say -- they don't say it anymore -- that used to
 2 say these financial statements are prepared in
 3 accordance with IFRS except where home country GAAP
 4 is better. They just neglected to tell us where it
 5 was better. That's one thing.
 6 The other thing is if we look around today
 7 and find for example in Spain there's dynamic
 8 provisioning for banks, that's not what the IFRS
 9 allows. I understand it is not in any one of those
 10 23 versions either. How come Spain's banks are
 11 allowed to do this?
 12 We've talked about this at the CFA
 13 Institute. We talked about this with the SEC. There
 14 are things they are doing that will help over time.
 15 The other thing is I definitely agree that
 16 the clients ought to be disclosed. The investors
 17 need to know where a significant portion of the
 18 financial statements can't be relied upon. The other
 19 thing is I applaud -- as I said earlier -- the work
 20 you have done in using FAS 131 on segment reporting.
 21 Unfortunately knowing it is 24 percent of
 22 the assets and X percent of the revenues does not

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1 tell me what percentage of the liabilities and risks.
2 It does not tell me how many off-balance sheet
3 obligations there are. They don't. I know. What I
4 am saying is I agree. Unfortunately, we're not
5 asking them to disclose it.
6 I understand we have these things about
7 off-balance sheet obligations. The problem I have
8 with that is the definition of an off-balance sheet
9 obligation which I worked on several years ago is
10 simply this: It is something that has an economic
11 consequence, but does not get accounting and
12 regulatory recognition. The problem I have with that
13 is using resources provided by investors.
14 You can't do it any other way.
15 Now, if you can't get an off-balance sheet
16 obligation without using my money, I think you ought
17 to tell me how you are using it. I don't care
18 whether it doesn't meet an accounting standard.
19 In that sense, fundamentally we have
20 something very, very serious missing over here. The
21 belief in foreign countries about some of these
22 things -- I remember a few years ago going with a

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1 team put together by U.S. AID to two foreign
2 countries which was starting stock exchanges there.
3 One of them told me I was supposed to help
4 with the accounting end of things. One of them said
5 well our accounting standards are similar to IFRS.
6 I said why don't you send me a summary of
7 your standards. After six months, I finally received
8 it and it said the following: Our accounting
9 standards are similar to IFRS, with the exception of
10 the following: We don't have a standard for
11 consolidation, acquisition accounting, foreign
12 currency translation.
13 I said why do I need to read anything?
14 How are they similar?
15 If you can actually assume your standards
16 are similar without having 80 percent of the
17 accounting standards then one would think, what's the
18 auditing going to do for me?
19 MR. TAROLA: Thank you. In our system,
20 the audit committee is responsible for making sure
21 there's a quality audit done for the company they
22 oversee. I sit on the audit committee of a global

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1 enterprise and we look to the audit team that comes
2 into our meetings every quarter and insist that they
3 answer -- at least answer our questions about the
4 quality of the auditing around the world.
5 That's our job as an audit committee
6 member. It would help, I think, if you insisted that
7 in their standard communications that they talk about
8 that issue as opposed to us having to drag it out of
9 them. But beyond that, I hope you can get the access
10 that would give us all a little more satisfaction
11 that these groups are being inspected; but I don't
12 think that it relieves the audit committee of its
13 responsibility.
14 CHAIRMAN GOELZER: Bob, you raised a
15 question in terms of -- or Joe, you raised a question
16 at the end of your sheet: Do investors expect a big
17 four firm to deliver uniform audit quality, given a
18 U.S. listing, in compliance with PCAOB standards?
19 How would you respond to that question?
20 What do you think ought to be done in that area?
21 MR. CARCELLO: I'm just an individual
22 investor and not a very wealthy one at that. But I

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1 would expect the answer to that would be affirmative.
2 Why not ask people who really manage money? Gus?
3 Norman? Others? Tony? They manage money. They're
4 better to manage that question than me.
5 CHAIRMAN GOELZER: Gus, do you care to
6 take a chance at that?
7 MR. SAUTER: Yeah. Well, certainly the
8 answer would be affirmative. I think -- if I could
9 pass for a minute to gather my thoughts.
10 MR. CARCELLO: Sorry, Gus.
11 MS. SIMPSON: Gus, you're off the hook.
12 CALPERS, although I'm sort of referring back to World
13 Bank days here, going to countries where you would
14 have companies floating under one of the Big Four
15 then Big Six names as though it meant something.
16 And that's the problem. It is snake oil.
17 And the simple solution is to look at how
18 do we deal with abuse of a branding franchise; and
19 I'm going to -- I know we are going to talk about
20 governance issues after lunch. That to me is the
21 problem.
22 If you -- here is PWC's subpar operation

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1 in a market which is not properly regulated without
2 proper standards; and guess what, without even
3 qualified professional staff because in some markets
4 there's simply an absence of qualified people, never
5 mind having the rules on the paper. The World Bank
6 can go in and write all the rules you like. If you
7 don't have qualified people who can serve that
8 function, it doesn't mean a thing.

9 I think the real problem -- we're trying
10 to find ways to deal with -- Jules Mouse saw this as
11 the McDonald's problem. If you go to buy McDonald's
12 in one of a hundred different countries around the
13 world, you expect your hamburger to be made of beef,
14 to a certain standard of cleanliness, hygiene, lack
15 of salmonella, who knows what else. That is what
16 McDonald's does. Is make certain the McDonald's
17 franchise is that that hamburger will taste the same
18 in Mumbai, London, Milwaukee, anywhere you buy it.

19 What the audit firms have done is trade on
20 the idea of a global franchise without delivering the
21 content or quality or the food safety that even
22 McDonald's aspires to. So I think we probably need

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1 to turn back to that issue. I think it is back to
2 old fashioned ideas, caveat emptor. 18 points, 36
3 points but making clear you do not have the comfort
4 of a Big Four quality standard that you expect from
5 the U.S. market. That seems to me disclosure would
6 get us a long way down the road on this.

7 Why? Then the market, people like us, we
8 would start to price that information differently and
9 issuers would begin to understand the real advantage
10 of getting quality audits and actually that would
11 then tie into I think not -- a sort of doomed effort
12 for international standards. I don't see us getting
13 there any way while we're all living. What we need
14 to do is find ways to get competitive pressures to
15 lead us in the direction of high standards.

16 I think that could be more fruitful.

17 MR. HARRIS: Why don't we start with you
18 and go right around the table starting with Mike?

19 MR. SILVERS: I just want to follow on
20 what Ann said. I think specifically what would
21 happen; pricing effects. I think -- I think pricing
22 might be kind of challenging. I don't know how

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1 traders would work with that information. I do think
2 there would be instantaneous governance effects.

3 The institutional investor community prior
4 to Sarbanes-Oxley was extremely active around issues
5 of independent auditors, independent audit committees
6 and the like and essentially after Sarbanes-Oxley
7 said well, this is now resolved. We don't need to
8 take up these issues.

9 I think there would be an instantaneous
10 focus on these disclosures with both the foreign
11 private issuers, but I think more consequentially as
12 long as the standard was a material portion of the
13 financial statement for the disclosure, I think you
14 would immediately see a focus on U.S. private -- on
15 U.S. issuers.

16 And I think the whole climate would change
17 very rapidly in that environment.

18 MR. SAUTER: I did have this conversation
19 with our auditors. As Joe pointed out, many of us
20 assumed that it is more than just a federation of
21 auditors when you think of these multinational
22 auditing firms but, in fact, they were telling me, in

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1 fact, it truly is just a federation. They have less
2 impact to their -- with their international
3 counterparts than they might desire.

4 It might be an interesting tactic to -- I
5 think full disclosure would be very important. I
6 think -- I think Joe brought it out to begin with
7 that there are a lot of investors that really don't
8 realize that you're not getting the same quality when
9 you're getting opinions from outside of the United
10 States.

11 It might be an interesting tactic to try
12 to coerce firms to put more pressure on international
13 standards or oversight committees. I guess it was
14 Anne who said that in the end there is still caveat
15 emptor, and I guess we proceed along those lines with
16 just about everything we do. I think it would be
17 good to try to put more leverage to get standards the
18 same abroad. And I know that our auditor would
19 actually like to see that, but they feel a little bit
20 unempowered to do that.

21 So I think the pressure has to really come
22 from the oversight committee to force that.

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1 MR. HARRISON: I'll be very brief. I'm in
2 violent agreement with Damon, Anne, and Gus.
3 I think there is an issue of holding out;
4 obviously the Big Four they, in particular, market a
5 brand and invest a lot of money in those brands not
6 only in terms of client acceptance or competing for
7 engagements; but I do think it is -- implicit in that
8 is a message that we are part of a global network or
9 federation but nonetheless, there is some minimum
10 standard of quality that we adhere to and that we
11 deliver.
12 And I think we need to begin to ask the
13 questions and peel back the layers of that onion to
14 be certain that that is not the case, which is why I
15 agree that improved disclosure in this area would I
16 think be extremely important and valuable. Not only
17 disclosure about the global structure and the legal
18 affiliation among 9 members of the global enterprise
19 in the firm, but disclosures -- this may bleed into
20 our afternoon panel, but disclosures about their
21 audit, quality control procedures in the other
22 jurisdictions.

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1 And disclosures about regulatory or
2 compliance matters that their foreign affiliates face
3 that would be relevant to a board member joined by
4 two members, one of whom has her placard up who may
5 have some views on that as well, but I think
6 stringent disclosure requirements would be very, very
7 important here.
8 MR. SONDHI: This is Tony Sondhi.
9 I think that there's a lot of work to be
10 done; and yet, I would not want to understate the
11 responsibility of the investors.
12 I think it is up to us to evaluate this.
13 If I am going to make an investment on behalf of my
14 clients I need to know what the auditor has done and
15 I need to be as careful as I can.
16 I need to be aware of it. My coauthor on
17 my book of financial analysis, Gerry White, likes to
18 say that if you accept a financial statement as it is
19 written, if you accept an audit statement as it
20 states, if you accept a rating agency's ratings
21 without asking questions, then you're not a financial
22 analyst, you're a journalist. And I think there's a

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1 distinction that investors need to be aware of and we
2 like to think of it that way.
3 MS. HILL: This is Bonnie Hill.
4 I serve on the board of a company that
5 does business all over the world; and while I'm not
6 currently on the audit committee, I was on the audit
7 committee and I will say we get pretty extensive
8 reports in the board room from the audit committee's
9 deliberations; and our auditors do let us know as
10 well as our internal auditors and CFOs that they're
11 using affiliates of their companies throughout the
12 world. And what we do and think the board is very
13 comfortable with is that our CFO and auditing firm go
14 and work directly with those people throughout the
15 country and throughout the world -- actually
16 throughout the world.
17 What happens is that on occasion our chair
18 of the audit committee, also goes.
19 So we know that we're dealing with a
20 number of different standards. We discuss those. We
21 discuss how to rectify those to the standards that we
22 require of our company. And I think it is very

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1 important that you just don't let it go.
2 You cannot assume that all the information
3 you're getting is clear and is exactly to the
4 standards that you would expect without overseeing it
5 from inside the company. Otherwise, how can you
6 expect investors to have the confidence in your
7 company that you're overseeing it in the way they
8 would like to have overseen. I think it is critical
9 that the company itself, and I agree, Tony, investors
10 as well, but provide oversight and not leave it to
11 chance.
12 JUDGE SPORKIN: You folks have the
13 ability, the regulators have the ability to deal with
14 something. You know the problem. The debacle
15 occurs. You haven't dealt with it. You have Madoff
16 all over again.
17 I think you can't shoulder -- neither the
18 SEC nor your board can shoulder this thing when you
19 have the ability to deal with it. A debacle happens.
20 I don't know how you are going to defend it. If I'm
21 advising you -- as I do clients -- once you have that
22 ability to deal with it and you don't deal with it,

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1 it is a prescription for disaster. There's no way to
2 hide. You can't say it was a complex issue. You
3 can't say it was this. You can't say it was that.
4 We learned time and time again, you can't -- there's
5 no fig leaf anymore.
6 MR. HARRIS: Thanks for making our job so
7 easy, Judge.
8 MR. HEAD: I don't think you can take
9 responsibility away from the board room and the audit
10 committee and management and their oversight
11 responsibility of their accounting firm.
12 I think that's an important point made by
13 multiple people around and I think on a multinational
14 financial statement, you have one partner that's
15 signing the overall opinion on those financial
16 statements; and that partner ultimately is saying
17 that the entire audit, not just the U.S. portion of
18 the audit, is supporting that opinion, and is able to
19 sign that opinion based on the work of all the
20 affiliates. And that that exists and therefore, I
21 would assume a couple of ways, full disclosure,
22 inspection of that firm, requiring them to say how

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1 could they sign that opinion, and not stand behind.
2 That that is the same quality as our audit standards
3 if it is material to the financial statements.
4 I don't understand how they can run and
5 hide. I don't understand why it can't be full
6 disclosure and in their inspections holding them 100
7 percent accountable for the opinion they've signed
8 and if it is a material aspect of the financial
9 statements, they're signing off on that, not the
10 foreign partner.
11 But that doesn't make the problem go away.
12 I just think you have disclosure in your inspection
13 of the signing firm that you can hold accountable and
14 then if you have to deregister foreign ones, I
15 guarantee you if you came to me and said, my
16 accounting firm, we have to take off your list and
17 isn't eligible to do your audit any more, we'd fire
18 them in a heart beat.
19 So you have the power to influence, so I
20 don't want to repeat other things; but I think there
21 are some mechanisms here that through full disclosure
22 and current inspections, you get pretty far down that

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1 path.
2 That's just my thoughts.
3 MR. HARRIS: Mr. Chairman, do you want to
4 briefly indicate that we are considering a standard
5 on that subject.
6 CHAIRMAN GOELZER: Well, you indicated --
7 you asked me to summarize. I think I'll pick that up
8 in my summary.
9 MR. CARCELLO: I wanted to second what
10 Judge Sporkin said. In your own report from the IOPA
11 basically said and I'm quoting, as currently
12 situated, the international inspection program
13 represents a significant risk to the board.
14 I think you guys know that. I think you
15 are in a difficult position. I think the SEC is in a
16 difficult position. I think the Judge is right. If
17 a Fortune 50 company has a major fraud seeded in an
18 international sub, that has not been inspected, and
19 let's not lose sight of the fact a big part of the
20 WorldCom fraud was seeded outside the United States
21 to the same extent there's problems at Lehman, if
22 there was a major fraud that affected U.S. investors

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1 in a Fortune 50 company in a foreign affiliate that
2 had not been inspected, the board is aware of this
3 issue, the SEC is obviously aware of this issue, I
4 think the judgment on both regulators would be severe
5 and unforgiving.
6 MS. YERGER: Ann Yerger with the Council.
7 I agree with almost everything that's been
8 said. I wanted to follow up Commissioner Walter on
9 your comment about convergence of international
10 auditing standards. I wanted to give a
11 recommendation to the board. I'm not an audit
12 partner. This was a new area for me. I did a lot of
13 research. I don't have graduate students. Digging
14 around to get the answer to this was actually quite
15 daunting. I believe very strongly in the need for
16 issuer based disclosures and obviously disclosures to
17 the audit committee.
18 I encourage the board to think about
19 putting more information on its website about those
20 five factors and how those apply to the non-U.S.
21 overseers. I don't really understand the Japanese
22 overseer for the audit profession. It is impossible

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1 to know. I think to a certain extent it would help
2 the assessment of the issuer based disclosures if you
3 could understand what the oversight regimes are like
4 outside the U.S.

5 That is difficult to get your hands around
6 and that might help to move us more in the area of
7 convergence in this area, although I should tell you
8 I am more optimistic about high quality accounting
9 standard convergence before we get to high quality
10 audit standard convergence.

11 MR. TURNER: I was once one of those grad
12 students. I thank your students greatly.

13 First of all, the inspection and standards
14 I do see as two different topics; and I think you do
15 need to get to these inspections. I do strongly
16 support disclosure around which clients, which
17 specific clients the audits aren't being inspected
18 on.

19 To Stanley's point on dealing with the
20 foreign regulators, some of you know I negotiated the
21 agreement that created the ISB. Those were very
22 tough negotiations over some period of time.

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1 I personally don't see this issue any
2 different in terms of what you would have to go
3 through negotiation than what we did; and we got
4 tremendous push back by some people in different
5 parts of the world, especially the European
6 Commission as many people know.

7 But I must say, I am in agreement with
8 Stanley that unless the Commission, Commissioner
9 Walter, stands up and takes a strong stand here and
10 gives strong support to the PCAOB, we are going to
11 find ourselves in our capital markets getting watered
12 down, and ultimately that will have a very negative
13 impact on the competitiveness of our markets so I
14 certainly urge you to give strong support. I know
15 from when we worked together at the Commission, you
16 are a strong supporter in getting this done right.

17 So I thank you for what all you and
18 Chairman Schapiro and the rest of the commissioners
19 are doing.

20 I do agree with Stanley. I think this can
21 be negotiated and can be done and we can't waver
22 either and we need to turn around and get it. It is

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1 not easy. It has to be strategically and
2 thoughtfully pointed out. You can't go -- you can't
3 just drive our tank on the grass as they say in the
4 U.K. On the other hand, there is no question. It
5 has been done. It can be done again.

6 COMMISSIONER WALTER: Let me say I agree
7 with that wholeheartedly, and I am glad we don't need
8 tanks because I don't know how to drive one.

9 MR. TURNER: On the issue of convergence,
10 convergence on IFRS has taken us more of a race to
11 the bottom than a race to the top.

12 I think part of that is due to the
13 concerns that the Council For Institutional Investors
14 have appropriately laid out with respect to the lack
15 of independence. Joe has noted here that there's a
16 lack of independence in this issue in quality
17 standards setters.

18 I don't think the issue is about
19 convergence at all. I think the issue is how do we
20 get to a high set of standards wherever they are
21 being done if, as it has occurred in the
22 international area, that starts to water down and

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1 take on a race to the bottom, we should not be
2 supporting convergence because ultimately it will
3 have, again, a very negative impact on our markets.

4 I watched as IFRS has been debated and I
5 watched the transcripts of those meetings. And time
6 and time again we see members of the IFSB sitting
7 around saying we can't write that standard because we
8 are in a smaller country and we can't get you that
9 information and it is impacting those standards and
10 having a negative impact on those standards. That's
11 not what we should be providing to a market to be
12 very competitive.

13 So in this case, I don't think the issue
14 is about U.S. standards. I don't think it is about
15 international standards.

16 I think it is more about how do we get
17 standards that ensure we get high quality audits
18 wherever we go; and frankly we've had shortfalls in
19 the U.S. in that area. We've certainly had
20 shortfalls internationally in this area. When people
21 say they are following international standards, as
22 Tony mentioned, we don't have -- we -- this notion --

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1 most of the countries, that's baloney.
2 Today in Europe, within the European
3 Commission, not a single central bank in that country
4 despite their endorsement of IFRS, not a single
5 central bank in that whole block of countries follows
6 IFRS. They pick what they want to follow and they
7 pick what they don't want to follow.
8 The French companies aren't following it.
9 We all know that. We have seen analysts report on
10 that. This notion of we've got to have IFRS because
11 it is going to give us comparability just isn't true.
12 And as I've heard former Chairman Richard
13 Breeden say in a public meeting at the Council For
14 Institutional Investors just over six months ago, you
15 know, if all we do is go to IFRS, so everyone is
16 doing the same thing, it will be the darkest day in
17 the history of the SEC. I strongly believe it.
18 We have to focus on getting really good
19 accounting standards that give us better transparency
20 and better information to invest on here and the same
21 thing with auditing standards.
22 COMMISSIONER WALTER: Once again, I must

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1 say I agree with you. The point here is to have high
2 quality standards around the globe. The point that I
3 initially was trying to make is that we can overcome
4 the inspection problem, but if you are inspecting
5 people who are operating under what are not good
6 standards and where you are adding on a few things to
7 meet the PCAOB's requirements, you're still going to
8 have substantive problems.
9 I do think the two things have to go
10 hand-in-glove. If you solve the inspections problem
11 and don't have people operating at a high level,
12 you're inspecting people that are not doing a good
13 job. That doesn't solve the substance problem.
14 MR. TURNER: I agree with that,
15 Commissioner. I will say this: Some of this, we're
16 like the cat chasing its tail. I think certainly in
17 the foreseeable future, any notion that we'll end up
18 with high quality auditing standards in countries
19 like China is a figment of someone's imagination.
20 I've just gotten back six months ago, spent time with
21 regulators over there. It just isn't going to
22 happen.

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1 Until we get by some of the cultural
2 issues in some of these countries; and I think you
3 mentioned, Elisse, aptly so, there are laws in these
4 countries that throw up roadblocks. Quite frankly
5 even during my days at the Commission, we saw where
6 the Big Four firms went into Italy and got Italy to
7 adopt standards or laws that threw up road maps to
8 the SEC.
9 And I will say in that case, we told Italy
10 if they wanted to stick with that, they weren't going
11 to come here. Anyway, I think you make some valid
12 points. I think we also have to recognize with the
13 cultural differences in part of the world and not
14 everyone is the same, the notion that we're going to
15 get everyone to sign up to high quality standards and
16 get to open transparency with good governance and
17 all, it just isn't going to happen. It is certainly
18 not going to happen in my lifetime.
19 MR. HARRIS: Pete, why don't we go to you?
20 I think we're getting past the lunchtime. We
21 short-changed you the last time.
22 MR. NACHTWEY: I don't know if being

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1 between this group and lunch is worse than between
2 this group and the bar. I'm going to add a little
3 bit to what's been said on the convergence issue.
4 Back in my prior life, I was involved in auditing an
5 international company that reported on IFRS. This
6 was back in the early nineties.
7 At that point in time, in the early
8 nineties, U.S. accounting literature, as Tony would
9 know, from serving on the EITF -- it was a stack
10 about a foot high, a stack of literature.
11 International Financial Accounting Standards at that
12 point was about this thick and for those on the
13 webcast, the size of a dime novel you could pick up
14 in a bookstore.
15 That's advanced a lot in the last 20 years
16 but they were playing catch up from being way behind
17 us. The same was true on the auditing standard side.
18 I think we talked about tone from the top. It is
19 going to be very hard to get at this. I agree with
20 Lynn. I think inspections are just the beginning.
21 For Tom's job on the auditing standards side, I think
22 we have to put pressure and tension on that to get

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1 consistency from the top on how audits are viewed and
 2 how auditors should be doing their work around the
 3 globe not just here in the U.S.
 4 MR. HARRIS: I'm sorry, Meredith?
 5 MR. WILLIAMS: That you, Mr. Chairman,
 6 I'll be very brief. I thought the professor's
 7 research findings were dynamite. Quite the eye
 8 opener.
 9 Speaking as -- from a investment
 10 perspective, the universe we deal in has thousands,
 11 thousands of elements in it.
 12 We have people pulling the trigger in one
 13 way or the other each and every day on these
 14 thousands of different companies around the world.
 15 And even if we're dealing with domestic
 16 companies, the portion of their business that occurs
 17 offshore, let alone the international portion of the
 18 economy, I'm scared to death.
 19 We don't have the resources to pick up the
 20 phone and call the audit partner, even if he signs
 21 it. We can't call the audit partner and say, gee,
 22 and how good is your firm or the firm in England that

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1 has your name on it or the firm in another country
 2 that has -- you know, it is nice that a board member
 3 can do that, a company board member.
 4 But as an investor, we don't have the
 5 resources to do that. So we really have to look to
 6 the board to really follow -- I guess this is my
 7 opinion -- to kind of take the Judge Sporkin
 8 approach.
 9 I think we have to have those inspections;
 10 and I would urge the board and -- to make that a high
 11 priority to work through that. I know you can't do
 12 it overnight.
 13 As the investment community needs that
 14 assurance that we have quality firms that have been
 15 inspected doing this work around the world for the
 16 companies that we invest in, and we don't have the
 17 resources to do it.
 18 MR. HARRIS: I'd like to support the
 19 endorsement of the work Joe did and Barbara and Ann.
 20 With respect to slides, they will be on
 21 the PCAOB website underneath the Investment Advisory
 22 Group meeting agenda under inspection panel.

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1 Thank you very much for that work.
 2 Dan?
 3 CHAIRMAN GOELZER: Steve asked me to
 4 summarize the discussion, although he didn't warn me
 5 that two thirds of the lunch hour would be over with.
 6 I would just note briefly the
 7 recommendations to the PCAOB that I've heard in this
 8 discussion: Beginning with the ones that were on
 9 Joe's slides.
 10 First that we -- as he puts it -- redouble
 11 our efforts through negotiations with our foreign
 12 counterparts to resolve these issues so we can
 13 conduct all of our foreign inspections.
 14 We certainly are doing that. Rhonda
 15 Schmeer is our director of international affairs and
 16 works essentially with her staff full time on dealing
 17 with our non-U.S. counterparts. I hope to be able to
 18 resolve those issues.
 19 There were a series of recommendations
 20 related to our increasing the disclosure we provide
 21 with respect to the firms, the countries we can't
 22 inspect and we extend that to the clients, the public

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1 companies, whose engagements we can't inspect and
 2 possibly to the portions of the work of U.S.
 3 registrants, U.S. multinationals.
 4 Those are things we have talked about
 5 internally. I take those recommendations very
 6 seriously. I think you are likely to see progress on
 7 those.
 8 Third, there were a series of
 9 recommendations related to increasing the
 10 requirements applicable to the U.S. firm that relies
 11 on the work of foreign uninspected auditor or that is
 12 part of the same network, is an affiliate of firms
 13 that are inspected.
 14 We do have a -- as Steve alluded to
 15 earlier -- we do have a project looking at the
 16 responsibilities of the principal auditor. I think
 17 that's an area where we can strengthen the standards
 18 and make some progress in this regard.
 19 In addition, I think we have to look at
 20 other steps to increase the responsibilities of the
 21 signing auditor when we're not able to look at all of
 22 the work that's been performed. Some of those are

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1 listed on Joe's slides.
2 There also have been suggestions -- I
3 think Damon in particular made some -- that the SEC
4 look at increased disclosure with respect to the
5 issuers, the public companies, where we can't
6 inspect.
7 I'll leave to the SEC how and whether they
8 might implement that.
9 I would just add maybe a corollary would
10 be to ask Corp-Fin in its review process of foreign
11 filings to perhaps take a little bit different
12 perspective in its dialogue with the issuer, where we
13 are not able to inspect the audit of the financial
14 statements.
15 I think that is likely to focus the mind
16 perhaps more than the 18 point stamp on the cover of
17 the 20-F.
18 There was also, Anne, your suggestion that
19 we have a lot of information about the nature of
20 foreign oversight bodies which by default now people
21 are relying on, where we can't inspect. I think we
22 should be giving consideration to making some of that

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1 available to the public.
2 Finally, however, while I used the word
3 "disclosure," when you look at the Sarbanes-Oxley Act
4 it didn't envision disclosure as a substitute for us
5 conducting the inspections.
6 That brings us to Judge Sporkin's reminder
7 that we do have enforcement authority in this area.
8 I think all I can say is that I'm mindful
9 of the authority we have and the responsibility we
10 have. Few things keep me up at night, but thinking
11 about this one is one of those. I think it is a
12 decision that we would have to make jointly with the
13 SEC because of their ultimate responsibility with
14 respect to our enforcement proceedings.
15 But I -- unfortunately -- think that in at
16 least some of these jurisdictions, negotiations,
17 we're seven years down the road now of negotiating,
18 isn't going to be the full cure, and we do have to
19 think about exercising that authority.
20 Thank you.
21 MR. HARRIS: And with that, why don't we
22 break for lunch? We are way beyond time.

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1 Why don't we reconvene at 1:15 to get back
2 on schedule?
3 (Whereupon, at 12:42 p.m., the meeting
4 recessed, to reconvene at 1:15 p.m., this same day.)
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1 AFTERNOON SESSION
2 (1:22 p.m.)
3 MR. HARRIS: Let's get started.
4 Our next discussion will focus on the
5 greater transparency and governance of audit firms.
6 This was one of your top four priorities for the
7 PCAOB to consider.
8 This subject matter is clearly an
9 important one.
10 Many of the topics you brought up
11 reiterated the Treasury advisory committee's
12 recommendations.
13 Five of you suggested that firms should be
14 required to have some form of annual financial
15 statements, which was also a recommendation from the
16 Treasury advisory committee.
17 Five of you felt the firm should have
18 independent members, another recommendation from the
19 Treasury advisory committee.
20 Another five of you indicated that firms
21 should disclose audit quality indicators.
22 And six of you would have us require the

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1 engagement partner's signature on audit reports, also
 2 a recommendation of the Treasury advisory committee.
 3 Beyond that, some of you feel we need to
 4 better understand the firm's structure and
 5 competition, strengthen independence rules, as well
 6 as review auditor accountability to shareholders.
 7 Anne Simpson, you stated the review of
 8 auditor accountability to share owners in the U.S. is
 9 patchy, and a review of international practice may be
 10 useful.
 11 Pete, you feel that providing more
 12 visibility inside public accounting firms is vital to
 13 the investment community given the importance of the
 14 audit process to the functioning of our financial
 15 system.
 16 Lynn, you were concerned that we require
 17 both "the auditor to sign the report, the partner's
 18 name, and have the auditors file an annual report
 19 with the PCAOB which includes a report and a list of
 20 quality indicators, a set of audited financial
 21 statements, much as they do in the U.K. and
 22 elsewhere, a report on their governance, which I

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1 believe should include -- as the Treasury advisory
 2 report recommends -- outside directors."
 3 So without further delay, let me turn the
 4 discussion over to you, Anne Simpson, Pete Nachtwey,
 5 and Lynn.
 6 MS. SIMPSON: Thank you very much.
 7 We're going to keep this short and sweet
 8 and get us back on track with the time, I hope.
 9 I want to start by quoting Gandhi, which
 10 is noble in all circumstances. He was asked what did
 11 he think about western civilization; and he said it
 12 would be a good idea.
 13 So our topic today is transparency and
 14 governance of audit firms. Our panel would like to
 15 recommend it would be a good idea.
 16 (Laughter.)
 17 So let's to the details.
 18 I think that the items which our chairman
 19 has quoted from the ACAP report deserve to be
 20 commended and deserve to be implemented. I just want
 21 to focus on a couple of points which I think are
 22 really important.

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1 I don't think ACAP really dug into the
 2 details. We're assuming the PCAOB has the big stick.
 3 You will talk softly; but you do have a big stick.
 4 We would like to see -- certainly CALPERS
 5 would like to see the big stick -- of regulation
 6 reinforced by some market pressures; and the first is
 7 to ensure that we have a regime in which the audit
 8 firm is ratified by the share owners. If we don't
 9 have a model of accountability that's working, we're
 10 going to be in great difficulty. We know regardless
 11 of the resources, the competence, the energy the
 12 regulator brings to it, we do need shareholders to be
 13 scrutinizing what is put before them on the audit.
 14 Now why don't shareholders particularly
 15 care at the moment about the ratification of the
 16 auditors?
 17 I think because it is just viewed as some
 18 form filling. The structure of the audit market is
 19 so concentrated, there is so little choice and so
 20 little to understand about the quality of one firm
 21 versus the other -- I suggest that really what we've
 22 been focusing on is the board and the audit

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1 committee, which is good, but I think if more
 2 information were to be provided you would find that
 3 the shareholders would buttress what the regulators
 4 need to be paying attention to.
 5 So financial statements, audited, yes,
 6 absolutely.
 7 I would also suggest this needs to be
 8 expanded to include governance information which we
 9 require as a matter of routine from companies.
 10 So the ownership of the firm, the
 11 structure of the corporate affiliations, this is
 12 absolutely critical and relevant to what we were
 13 talking about beforehand.
 14 I would suggest the idea of independence
 15 in the governance structure although -- I don't know
 16 how to put this in a polite way; being British it
 17 sounds so disloyal. The financial reporting council
 18 is now requiring from June 1, U.K., the U.K. part of
 19 these tangled webs of spaghetti called audit firms,
 20 the U.K. part will have to produce audited financial
 21 statements and will have to report on the extent to
 22 which they have independent people involved in the

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1 governance of the partnership.
 2 Now this seems to me very, very awkward
 3 because these firms are partnerships, and
 4 independence only works if you're accountable. And
 5 as there are not external capital providers to whom
 6 the independent board or executives -- or
 7 non-executives -- sorry -- can be made accountable, I
 8 simply don't see how that will work. The U.K. has a
 9 wonderful history of window dressing and making it
 10 look as though it is doing the right thing, and I
 11 fear this will head in the same direction.
 12 The final point I want to flag up is about
 13 some of the other detail in the U.K. code which I do
 14 think is probably worth looking at. And I am not
 15 going to quote in detail, it's all available on the
 16 FRC website.
 17 But They have introduced some interesting
 18 ideas that audit quality indicators need to be
 19 reported upon, which is something the ACAP committee
 20 of inquiry recommended, but they also would like some
 21 parallel provisions to be reported upon around risk
 22 management and mechanisms like whistle blowing.

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1 I think that if we are continuing to rest
 2 the mighty weight of audit upon a handful of opaque,
 3 privately owned partnerships which are not disclosing
 4 their many and myriad corporate relationships around
 5 the world, we really have got a weak link in the
 6 governance chain, not just in the U.S. and U.K. which
 7 have reasonably well regulated markets, but in many
 8 other markets around the world.
 9 So I'll turn over to my esteemed
 10 co-panelists, Pete and Lynn.
 11 MR. NACHTWEY: Thank you, Anne. I wish I
 12 had a great Gandhi quote, but we'll have to pass on
 13 that for now.
 14 But maybe before lunch, and just a couple
 15 of thoughts and ideas to give you a sense of
 16 perspective that I bring to this.
 17 In the interest of full disclosure, I
 18 spent 27 years at Deloitte, almost 20 of those as a
 19 partner. So that's going to be perspective one.
 20 I have three other perspectives coming
 21 from my role at Carlyle since 2007.
 22 Two of those are as a client, because we

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1 hire the accounting firms to help us do due diligence
 2 on companies that we're acquiring. These are
 3 companies that are already audited generally by Big
 4 Four firms. If we feel the need we go hire another
 5 Big Four firm to come in and check what they have
 6 done. Which is an interesting fact of life, and says
 7 something about how audits are conducted and who
 8 they're conducted for.
 9 And in the second place that we are kind
 10 of a client is, they audit our firm, they audit our
 11 funds, they audit our portfolio companies after we've
 12 acquired them.
 13 So those three perspectives.
 14 The last one is probably the reason I'm
 15 sitting here, which is as an investor, we're relying
 16 on or at least looking at the audits and the
 17 financial statements that they've audited of target
 18 companies.
 19 With that in mind, I'm going to speak
 20 mostly from my last perspective, but I'm sure
 21 everybody understands it is informed by a couple
 22 others.

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1 I do think this group and the PCAOB in
 2 particular can be helpful in promoting some
 3 transparency of the audit firms; and I think we have
 4 to do it, or PCAOB has to do it being mindful of the
 5 fact they are private. As Anne pointed out there are
 6 unique challenges to that. They are not only
 7 private, they are private partnerships.
 8 Having said that, they do have a duty to
 9 the public; and society -- not just in our country
 10 and elsewhere -- have entrusted them with an
 11 important duty to the public and, therefore, I think
 12 we have a right to demand transparency, maybe more
 13 than in the past.
 14 I'll add a few things to what Anne said.
 15 I know Lynn has some other great ideas.
 16 The three things I would focus on from a
 17 transparency standpoint and gleaned what my fellow
 18 panelists will say would be client acceptance is one.
 19 Second is global networks. We talked about those
 20 before. Maybe share a couple ideas there.
 21 The third is on kind of insurance and how
 22 they focus on protecting themselves in that regard.

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1 On the client acceptance front, I do think
 2 the old adage that all of our parents or some mentor
 3 generally taught us at an early age is, you're known
 4 by the company you keep.

5 Certainly Andersen we can pick on, since
 6 they are no longer here, wished they had never kept
 7 company with Enron or Sunbeam or Waste Management or
 8 WorldCom. Very often these firms are getting in
 9 trouble not so much because of whether they did a
 10 good job auditing or not but who else did they let in
 11 the door in terms of the people they were going to
 12 audit.

13 That would be one issue of understanding
 14 how they think about client acceptance.

15 Second piece of that is, who do you decide
 16 to retain? Just because a company was great when you
 17 brought them on board doesn't necessarily mean they
 18 continue to be great. How do you think about
 19 management changes, risk, and so forth in terms of
 20 retaining clients?

21 And then corollary to that is the other
 22 end of the pipeline of they are private businesses

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1 that we need to be successful. There are only four
 2 left. As an investor, we get into a wicked amount of
 3 complexity in trying to make sure they are
 4 independent of us, who can we hire that doesn't have
 5 a conflict.

6 To go to three firms I think would be a
 7 bit of tragedy for our U.S. economy and the global
 8 economy. How do we prevent that? One way is to have
 9 a viable stream of revenues that comes from new
 10 clients. This is kind of circular but is an
 11 important aspect of understanding their business
 12 model.

13 In most businesses a key performance
 14 indicator would be who are the new clients that you
 15 let in that year and why; and then who are the ones
 16 that maybe you fired?

17 That again gets into a delicate issue of
 18 disclosure.

19 Second, global networks. We talked a good
 20 bit about this so I'll try not to repeat the things
 21 we said earlier. The quality of the affiliates and
 22 how they think about that. I am intrigued with the

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1 idea that we have the ability, the PCAOB has the
 2 ability maybe to get at some of the things that
 3 foreign regulators don't let us get at by letting the
 4 Big Four firms get at it.

5 They spend a lot of time due diligencing
 6 anybody new to the network and it is less transparent
 7 in terms of who do they retain within the network.
 8 Client acceptance, client retention, a similar issue
 9 with global affiliates.

10 The last item is insurance which we don't
 11 very often talk about. I think most of the Big Four
 12 at this stage used to be insured; back when they were
 13 the Big Eight there was insurance available. I think
 14 there's less so today but there still is insurance.
 15 The fact that they have formed a little bit of a
 16 keiretsu to pass the hat and share liability amongst
 17 the four of them, I don't think is well understood.
 18 It is a delicate balance again in our litigious
 19 society and getting it well understood may be a road
 20 map for the plaintiff's bar.

21 I will close with a vignette since I
 22 didn't open with a Gandhi. There's a tension between

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1 accountants and lawyers. Accountants come in after
 2 the battle is lost and bayonet the wounded. But one
 3 step down, I suppose, in the food chain are the
 4 lawyers. I apologize to the lawyers in the room, but
 5 they come in after the accountants and strip the
 6 bodies.

7 So the challenge is if we just simply put
 8 a big target up there, by having everybody understand
 9 their insurance program that should be there to help
 10 benefit shareholders or stakeholders that are harmed
 11 in a business failure, if all it does is it ends up
 12 being one pull on the lottery, or on the roulette
 13 wheel handle, for one set of lawyers, in one case,
 14 that probably won't do much for the public good.

15 I think those three areas would be --
 16 client acceptance, global networks, insurance
 17 programs would be interesting.

18 MR. TURNER: If I recall right, Charlie
 19 and Dan, aren't you both an auditor and an attorney?

20 When the Treasury committee looked at the
 21 accounting profession, some of the issues that we
 22 raised as well as Anne raised were discussed and

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1 quite frankly vetted in depth. There were concerns
2 about the governance of the profession, whether they
3 were too internally focused and really getting useful
4 outside perspectives like we see the management teams
5 of public companies able to obtain from their boards.
6 There were issues about financial
7 sustainability and viability that Pete raised with
8 the insurance issues.
9 And there was discussion around the
10 concentration, the fact that we only have four of
11 these firms; and I think at the end of the day, the
12 reality set in that we only have four.
13 Even though some of the other firms down
14 below -- Grant Thornton, BDO Seidman, Magladry,
15 Cochise -- may do a fine job, the reality is you can
16 combine all those up and they get to the size of the
17 fourth one. So the reality is we are stuck with
18 these four unless someone decides to go ahead and go
19 in and break them up, and there doesn't seem to be
20 any political stomach here in Washington, D.C. so the
21 reality is we have four.
22 Given that, there is no question that it

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1 is a major, major systemic risk in the system and
2 something that has to be overseen, wisely dealt with,
3 and needs to be regulated.
4 From that perspective, it is somewhat
5 surprising if not even amazing, especially in light
6 of what we've gone through with the focus on risk and
7 what's in the currently pending legislation, that to
8 this day, the PCAOB is not getting the fundamental
9 information it needs to manage such a huge systemic
10 risk; and it is systemic risk to investors, a
11 systemic risk to the public companies, and the
12 participants.
13 And there's no question that
14 Sarbanes-Oxley does give you authority to go get that
15 information. Fundamentally, you have to start
16 with -- obviously your inspections give you a basis
17 for some very useful information; but more
18 importantly, though, it is important that one
19 understands the financial stability of these firms as
20 well. They tend to be lowly capitalized, because
21 they're distributing most of the income each year, so
22 partners can pay the taxes. So there is very little

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1 capital in them.
2 They use a revolving line of credit
3 financed by their receivables that's paid off each
4 year. So that tees up some leverage issues as well.
5 And they have large, huge pensions, to a
6 large degree unfunded. A decade ago on one of them,
7 that number was 9 to \$10 billion. It had to grow
8 exponentially, so it is relatively huge in relation
9 to the revenues of the firms as well. As partners
10 have described it to me it is their version of the
11 Ponzi scheme because they're using their current
12 earnings to pay the retirements of the old partners.
13 And the young partners who are paying for it JUST
14 hope they are able to get old, retire, and get paid
15 before that becomes bigger.
16 So in light of that, it is important that
17 the PCAOB start getting the information that one has
18 to have to manage such a significant systemic risk
19 which would include items that have already been
20 discussed.
21 I think it starts with some of the
22 information we find the motherland quite frankly

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1 requires in the annual report from their large firms.
2 They require an annual report, that it be audited,
3 and it be made publicly available.
4 You would tag on to that the things like
5 that Anne recommended then: A discussion about the
6 governance, a discussion about the structure of the
7 firm, discussing the affiliate notion, because they
8 are clearly just affiliates. And as we have seen in
9 court case after court case now, every time there's a
10 case brought and the shareholders try to reach out to
11 one of the affiliates, the firms make it very
12 clear -- make a very clear argument in each court
13 case -- that they have nothing to do with one
14 another, they don't oversee one another, they don't
15 set their audit quality standards whatsoever.
16 You can look at any of these court
17 documents in any of the court cases, and you see the
18 same arguments being made time and time again. So it
19 is important that you learn and understand the
20 structure in that annual report. There should be THE
21 annual audited financial statements just as they do
22 in the U.K.

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1 The point about client acceptance is so
2 important. We found as we did with Andersen and as
3 Pete appropriately noted time and time again, while
4 people tell us they have great client acceptance
5 standards, it seems always if the fee is big enough,
6 people go for it.

7 We recently have seen the case where one
8 firm has been doing the audit for 4 million, another
9 one came in and picked that audit up for a million
10 bucks, which raises a serious question here.

11 And we should also have disclosure in
12 there about key metrics in terms of quality control
13 factors.

14 It is another thing that the ACAP took up
15 principally because of a recommendation from a former
16 retired Big Four partner that I think put forward
17 some excellent recommendations and focused on the
18 right type of quality control factors.

19 That goes beyond what's in the EU eighth
20 directive which I think is a good starting point. It
21 is only that. It is a starting point.

22 There needs to be -- you cannot manage

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1 such a grave systemic risk if all you are getting is
2 what is in the EU eighth directive. I there's think
3 it is important from an investor perspective -- we
4 talked about a regulator perspective -- investors now
5 are given the chance to vote on these auditors the
6 majority of the times, on an annual basis.

7 And we need to make sure that we give the
8 investors the information to make an informed
9 decision if we're going to ask them, and, in fact,
10 they want to be able to vote on them.

11 So we need to make sure that not only are
12 we getting this annual report out there, but we also
13 want to know who is the audit partner that we're
14 voting on.

15 In many foreign countries, France, U.K.,
16 elsewhere, they tell us not only who the firm is --
17 and that's important because the firm is behind the
18 auditor and setting overall quality control
19 standard -- but it is qualitatively important, I've
20 always believed your audit is only as good as your
21 audit partner. We're entitled as investors to know
22 who is that audit partner that's doing the audit for

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1 us.

2 And some people have complained well, if I
3 do that, it will increase my liability. That's
4 absolutely false and a misnomer. By signing your
5 name, you don't change your liability one iota. The
6 firms have said here in the U.S. we don't want to do
7 the public report like they do in the U.K. because
8 people will be able to see our finances and people
9 will sue us more often or something.

10 That's absolutely a misnomer. In any of
11 these court cases the court always ultimately admits
12 the financial statements of the firm anyway. So they
13 get them regardless; so that's kind of a Chicken
14 Little running around, "the sky is falling" type
15 argument that just doesn't hold water whatsoever.

16 So there's in light of the systemic risk,
17 in light of the investors wanting to vote on this
18 important decision, it is key that we get much more
19 transparent, that the PCAOB gets that transparent
20 information. I fear for the PCAOB; again, if you had
21 a problem with one of these major firms and you
22 hadn't even been getting the financial statements on

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1 that firm, what would your defense be to the public
2 about how you regulated risk?

3 You couldn't even or didn't even get a
4 financial statement that showed on a real GAAP basis
5 what this thing really looked like, with all those
6 pension obligations and liabilities?

7 I don't think there's going to be any
8 answer that would save you on the front page of The
9 New York Times.

10 So I'll leave it at that.

11 MR. HARRIS: Well, there are a large
12 number of categories of issues there. I think we can
13 start with any number of different questions. I
14 don't know who wants to open it up. I have some.

15 Tony, we're here to get your input.

16 MR. SONDHI: I was just wondering, what
17 type of information about the audit firm's risk
18 assessments do you get today? And what is it that
19 you could ask for?

20 Because I have asked audit firms on how
21 they make those decisions. And as Lynn pointed out,
22 when you replace an audit firm that was conducting

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1 your audit for 4 million with somebody conducting it
2 for 1 million, as an investor I'd like to know, which
3 one of those was wrong? And you know -- I mean, I
4 don't think it is obvious directionally by just
5 looking at that number.
6 But I have also asked audit firms what
7 they do. And I think things may have changed today;
8 but for a long time, I don't think they were
9 conducting anything that one could call as worthwhile
10 risk analysis to determine which audits -- which
11 clients they should take.
12 And I think the systemic risk of the --
13 fundamentally the principle that the three of you
14 have told us is that it's too few to fail, that seems
15 just as bad as the too big to fail. I think both of
16 them ought to be permitted to do so; otherwise the
17 risk for the rest of us is rather significant.
18 The other thing I was wondering about
19 though is a recent audit firm that had issues with
20 Bally Fitness, for example, and been asked to hire an
21 outside consultant to tell them whether they're doing
22 a reasonable job of their internal controls and those

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1 kind of things and how they take information up to
2 the technical -- to the national office and so on.
3 I was intrigued. I said, I wonder who is
4 going to be competent enough to do that sort of
5 analysis.
6 And you know, not a word has been heard of
7 that since.
8 I suspect there's something going on
9 there; but that's the kind of thing that I think it
10 would be worth getting additional information on and
11 being able to do something in order to protect the
12 investors and, in effect, to be able to do your job.
13 MR. HARRIS: I want to go back to
14 something you just said. You said that providing
15 more visibility to key aspects of interest to the
16 public inside public accounting firms is vital to the
17 investment community given the importance of the
18 audit process to the functioning of our financial
19 system.
20 I was wondering if you could elaborate on
21 the types of financial information about a public
22 accounting firm that you think is needed.

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1 MR. NACHTWEY: One aspect is the pension
2 liability. There is overhang for that. How do firms
3 manage that? It generally is unfunded, in all cases
4 it is unfunded because there are tax rules that don't
5 allow them to get a deduction and ERISA that doesn't
6 allow you to have an ERISA protective plan for a
7 partnership. They tend to have these unfunded
8 liabilities.
9 How do you deal with the fact there is
10 that overhang? And are we creating such an amount of
11 overhang for the younger partners in terms of being
12 able to operate the firm viably?
13 I think from my prior experience, at least
14 my only experience with one firm, is that it is well
15 managed. But I don't know that for sure for the
16 other three firms.
17 Another aspect is just simple basic
18 blocking and tackling. Are they able to manage the
19 balance sheet and make sure that they have adequate
20 liquidity to operate the business, that they're not
21 having trouble with clients in terms of being able to
22 pay their bills and operate the business; and are

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1 they keeping an appropriate amount of reserve?
2 As Lynn said, for tax reasons, you
3 generally tend to -- tax and other reasons, you
4 generally tend to pay out all the earnings of the
5 firm on an annual basis. What are you saving? These
6 are multi-billion dollar enterprises. How aggressive
7 are they in terms of managing the balance sheet and
8 keeping some sort of liquidity reserve. So those
9 would be the things I would focus on. I don't know
10 if my panelists have anything to add.
11 MS. SIMPSON: What about -- sorry. I'm
12 sharing Pete's questions -- his microphone. I just
13 wondered if you would say more about this insurance
14 issues. It seems to be the root of much evil or
15 certainly much of the problem we're tackling here.
16 Because the introduction of limited liability for the
17 joint stock company was in a sense, you know, what
18 set capitalism running free. The fact we have this
19 partnership structure and reliance on insurance seems
20 to me put a whole model where you've embedded risk
21 aversion into the system, at a time when you actually
22 need auditors to be bold, to be creative, to be

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1 investigative.

2 And you know, how much can insurance solve

3 that problem? Or how are we going to deal with --

4 you know -- the perverse consequences of unlimited

5 liability? It sounds like a good way of holding

6 their feet to the fire; then they don't want to be

7 anywhere near it.

8 MR. TURNER: The liability is probably

9 made bigger in the press media than what it really

10 is. It is a concern to firms and you're always

11 worried about the one lawsuit that might bring you

12 down; but on the other hand the partnership structure

13 does keep skin in the game which keeps people's

14 attention.

15 The one situation where we had a

16 gatekeeper in a corporate structure is credit rating

17 agencies. They didn't have skin in the game so to

18 speak, and we saw the corporate structure drove

19 nothing but a bottom line mentality, and for a

20 gatekeeper it certainly didn't work.

21 So the partnership structure I don't think

22 is the problem. It does keep people focused on I

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1 think to a large degree the right thing.

2 On the liability issue, shareholders have

3 never brought down one of the big firms.

4 Shareholders have always negotiated to settlement.

5 The largest settlement was against Ernst & Young with

6 Cendant, and even there Lazard Frères was brought in,

7 they examined what the liability of the firm was and

8 its ability to pay and came up with a number and the

9 shareholder -- which was TIAA-CREF at the time --

10 agreed to a reasonable number.

11 The only situation where we got into a

12 possibility of a firm failing was where the

13 government itself was instituting a penalty, such as

14 we saw in Andersen or in the earlier 1990s out of the

15 S&L crisis, the Fed came close to imposing a fine on

16 two firms, KPMG and E&Y, that would have felled both

17 of them.

18 At the time the head of the GAO stepped in

19 and was able to talk the Fed into taking a lower

20 number that would allow both firms to survive. So it

21 hasn't been an issue with shareholders; and, in fact,

22 today the largest lawsuits often are not from

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1 shareholders, they are from other companies or the

2 corporations themselves suing the investors.

3 But everyone seems to understand that at

4 the end of the day, you don't want to put one of

5 these firms down. I don't see a shareholder ever

6 putting one of the Big Four firms down at this point.

7 So as long as the government is acting in a

8 responsible fashion, and there's reasonable

9 governance and oversight so they're not doing things

10 like KPMG was doing with the tax shelters, I can't

11 imagine an outside board stepping in in a situation

12 like KPMG where they were selling the tax shelters

13 and actually had discussions about the fact they

14 could make so much more money than any of the fines

15 would ever be, they ought to go ahead and do it.

16 You aren't going to see that. So if you

17 can get good governance in them I think that solves a

18 lot of the insurance issue and the concern.

19 Then it is just up to the PCAOB. They can

20 always get information on the insurance and request

21 that and that along with the financial statements

22 would give them some flavor as to where you are

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1 getting into an untenable situation.

2 MR. NACHTWEY: Norman, I know you raised

3 in terms of your priorities market concentration

4 issues. I don't know whether you want to talk about

5 that here? Or whatever?

6 MR. HARRISON: I think it's a good time.

7 I'll be brief. I know there are those at the table

8 who have views as well.

9 I think there is a broader issue here

10 about market structure. At some point in this group,

11 I hope we'll have a chance to discuss. It has been

12 discussed in other contexts but generally it results

13 in a general proposal to give it further

14 consideration and see if there isn't some way to

15 change the way in which this profession is

16 capitalized.

17 We used to have -- not all that many years

18 ago -- a Big 10 who became a Big Five and now a Big

19 Four. It became a Big Four through a series of

20 mergers. You accumulated economies of scale in that

21 process. That is when the industry really

22 bifurcated, and there is a tremendous bridge to cross

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1 and programs -- an unclosable barrier between the Big
2 Four and those who comprise the rest of the industry.
3 It has primarily to do with capital. The
4 key to being a Big Four and being able to compete as
5 a Big Four firm is the global presence we talked
6 about in the earlier context, having the need to have
7 industry and subject matter expertise across a vast
8 array of areas and IT infrastructure, a lot of
9 capital expenditures to maintain an enterprise of
10 that nature.
11 As Lynn and Pete have so well noted, these
12 are partnerships at the end of the day and there's
13 something of a disconnect between the manner in which
14 a partnership enterprise manages its balance sheet
15 and the way the enterprise needs to function, the
16 financial resources it needs at its disposal.
17 One thing I hope we will have a chance to
18 talk about if not today at another time is whether
19 and how to introduce the possibility -- it may be it
20 falls with the PCAOB but there will be other
21 interested parties and stakeholders -- the
22 possibility that public accounting firms be permitted

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1 and encouraged to organize and incorporate more and
2 raise capital as corporations do from third parties,
3 from outside sources, strengthen their balance sheet,
4 provide a cushion that doesn't exist today. And
5 perhaps through that process to provide opportunities
6 for other providers to become more competitive. I
7 think there's an issue there that really requires
8 some serious consideration.
9 MR. SILVERS: Damon Silvers.
10 Like Lynn, I was a participant in the
11 Treasury panel that had a number of recommendations
12 and engaged in very extensive discussions on these
13 issues.
14 I think there's a couple of take-aways
15 from that process that broadly I think are important.
16 Giving some -- I don't think it is a
17 panacea, and this -- again, this goes to other
18 people's comments, maybe -- but getting some
19 independent voices into the firm governance is
20 certainly an improvement in our major audit firms.
21 Secondly, I think that having financial
22 statements, having those statements accessible to the

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1 board, accessible to investors just seems like common
2 sense to me.
3 I think the notion that these institutions
4 are private entities in any meaningful sense is
5 absurd. Effectively, the way we discuss the systemic
6 risks associated with the failure of any given one of
7 them tells us that they're really no longer private
8 entities in any meaningful way.
9 Therefore, the notion that their
10 financials should be secret seems to be indefensible.
11 That being said, I don't believe -- I'm
12 not sure I fully agree with Lynn that the financials
13 of the audit firms are that important.
14 The fact that their secrecy is
15 indefensible doesn't really -- necessarily mean that
16 you really learn that much important from them.
17 As Lynn alluded to, Arthur Andersen
18 collapsed not because a giant liability appeared on
19 its balance sheet but because all its clients ran
20 away when it got indicted.
21 I think that tells us something about what
22 audit firms really are, which is not a collection of

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1 financial assets in any meaningful sense, but a
2 reputation and a collection of human capital.
3 That being said, the private litigation
4 system in relation to audit firms does fulfill a
5 limited but useful function, which is one of kind of
6 deterrence.
7 And I think there's lots of evidence over
8 the years that private litigants -- for better or
9 worse -- are very measured in relation to their
10 demands on audit firms, with the occasional exception
11 of the sort of non-traditional party, the sort of
12 business actor looking to score a giant score in some
13 one-off situation.
14 The final observation I'll make about
15 this, about these matters, about governance matters,
16 is that I'm deeply skeptical -- in fact, I would say
17 more than skeptical, outright opposed to converting
18 audit firms as partnerships into public corporations
19 or into the corporate form.
20 There's a lot of debate right now about
21 whether, in fact, our stock brokerages, our
22 investment banks were pushed significantly in the

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1 direction of our current financial disaster as a
 2 result of their conversion from partnerships to
 3 public corporations.

4 And I think while the two entities are
 5 very different, I think there's something sort of
 6 going on behind there, which is that the partnership
 7 and the sort of thinness between the institution and
 8 the professionals involved in it is a structure that
 9 in some ways is an attempt to embody the notion that
 10 this is a professional association and not a
 11 profit-maximizing enterprise at some level.

12 I'm not suggesting that's exactly how
 13 these firms are always managed; but it embodies an
 14 aspiration that I think is dangerous to walk away
 15 from. I am certain we would not obtain the public
 16 goods that we are essentially asking audit firms to
 17 deliver were they to be organized as private
 18 profit-maximizing enterprises.

19 MR. CARCELLO: A couple of points. I
 20 wanted to briefly respond to Tony's point about the
 21 \$4 million audit fee and the \$1 million audit fee and
 22 kind of like to know which one was right. I don't

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1 know if you'll ever know unequivocally which one was
 2 right, but for the benefit of the investors in the
 3 room, I have a suggestion. It may not be a good use
 4 of your time. You can run Compustat on size and
 5 industry and if most of the companies in the same
 6 industry at approximately the same size are at 4
 7 million, then you probably have your answer. If most
 8 are at 1 million, you probably have your answer. It
 9 is not perfect, but you get a rough approximation
 10 based on public data.

11 That's one of the benefits of the SEC's
 12 rule, I guess -- probably when you were there, Lynn,
 13 with Arthur -- that disclosure which I think is very
 14 valuable.

15 There was a brief discussion earlier about
 16 transparency reports. I think Anne Simpson mentioned
 17 it. I would point out that -- and I think it is to
 18 their credit. I don't know if the SEC and PCAOB have
 19 seen it, but Deloitte has voluntarily published a
 20 transparency report this year. It is the only Big
 21 Four firm in the United States to have done that.

22 I'm sure there's always room for

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1 improvement but it is their first shot. They did it
 2 voluntarily. I think they need to be publicly
 3 praised for that.

4 In terms of some of the things we've
 5 discussed, I would reinforce those who have spoken in
 6 favor of audit quality indicators. I think the
 7 motivation behind that at ACAP is right on target. I
 8 would not recommend one, but if you have one
 9 indicator the firms will manage to that indicator.
 10 But if you have a series of indicators, 10, 15, 20,
 11 and no one indicator is going to be perfect, but I
 12 think you could come up with a series of indicators
 13 that most people would say are at least directionally
 14 consistent with improving audit quality.

15 And if you had those and you annually
 16 published some portion of them -- not all 20 every
 17 year so the firms would not know which ones you are
 18 going to publish, like SARS 99, introduce an element
 19 of unpredictability. So you publish some of them
 20 every year -- the firms will pay attention to those;
 21 and to the extent they are good proxies for audit
 22 quality, will work to improve their firm's

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1 performance on those measures, because it will be
 2 public.

3 I think -- I remember Damon talking about
 4 this -- I believe it was Damon -- if a New York
 5 Times, pick it up, or Forbes, Business Week, or
 6 whatever, audit committees look at it and it will
 7 affect hiring behavior; so it affects firm behavior.

8 I can speak directly to this. I have seen
 9 what this does at universities. These university
 10 ranks which are ubiquitous. Let me tell you guys,
 11 provosts, chancellors, deans, parents, students --
 12 for all of their warts -- and there's lots of warts
 13 associated with them -- they pay attention to them
 14 and it does effect odd behavior inside universities.

15 And unlike Big Four accounting firms which
 16 may gain or lose clients, at the end of the day, we
 17 are a state-supported university where we are going
 18 to get a certain percentage of the kids from the
 19 state of Tennessee regardless of how we do in those
 20 rankings; but even with that said, it affects our
 21 behavior and I'm sure it will affect the behavior of
 22 the accounting firms.

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1 Independent members on firm governing
2 boards I think is a great idea. I think Anne talked
3 about how it could be gamed in the U.K. I think Lynn
4 has -- in his written statement not sure how
5 effective this would be.

6 The danger is you have independent members
7 on firm governing boards who are independent -- not
8 part of the firm, but they're friendly to the senior
9 management of the firm. That's the risk you have
10 with corporations today, right? Social networks.
11 Commissioner Glassman when she was still at the SEC
12 talked about the risk of social networks. I think
13 that's a very real risk.

14 What I would suggest is if the board goes
15 in that direction that they put in place that firms
16 have independent members on firm governing boards,
17 but that those independent members would select their
18 replacements so that over time, you reduce the
19 influence of management on who are the independent
20 members.

21 It may take a while to get completely
22 independent members on the boards; but I think you

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1 would have some effect. Then I think the audit
2 partner signature recommendation is a good
3 recommendation as well.

4 I've spoken long enough.

5 MR. HARRIS: Actually, let me turn to
6 Judge Sporkin for one second. Judge, I know you've
7 recommended independent advisory boards as well.
8 Anne, Joe, you pointed it out as a priority, maybe
9 you can speak for a second on that, and then we'll
10 turn to the others.

11 JUDGE SPORKIN: I recommended independent
12 advisory boards to the -- yeah. But you're talking
13 now about the Arthur Andersen that started some time
14 back -- that audit firms get ventilated. I found
15 that they are much too closed. When they have a
16 blown audit, they need to have someone with
17 independence look at the blown audit, and to find out
18 what went wrong, what lessons were learned, and to
19 make changes.

20 Andersen -- I don't know if anybody
21 remembers this, but back in the Seventies or so --
22 Dan, you might remember this -- appointed an

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1 independent board, including Newt Minnow and some
2 other -- a former chairman of the FCC -- and some
3 other people, and it worked out well. And you see
4 what happens when they abandon it.

5 But -- there are other reasons for that.

6 But the point is that you need to open it
7 up. You have to -- they need to have someone outside
8 that they can converse with and to be able to give
9 them good advice. And it will work.

10 Does anybody have it now? Any of the
11 firms have it now? None? Then why did they
12 abandon --

13 MR. HARRIS: Before we get to answering
14 the Judge, because we are a little behind schedule,
15 Kelvin, why don't we go to you, Gus, and Tony. Then
16 you can think about it, and if you have an answer go
17 to the Judge.

18 MR. BLAKE: I wanted to say I agree with
19 Norman Harrison. We need to figure out some way to
20 remove the barriers of these regional firms moving up
21 to become the top five, top six accounting firms.
22 However, I agree with Damon that I don't know we want

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1 to necessarily go the corporate route because when
2 you go the corporate route, the audit firm would then
3 have responsibility or primary duty to the
4 shareholders and that duty would be to maximize
5 profit; and my concern is if you -- if the audit firm
6 has to balance audit quality with maximizing profit
7 it may lead to a reduction in audit quality.

8 MR. SAUTER: This is Gus Sauter.

9 Addressing two of the topics previously
10 addressed, the first about signing the audit report.
11 I think that's a fine idea. Maybe with a little F,
12 not a capital F. As Lynn pointed out earlier, the
13 lead auditor already has the financial liability
14 associated with putting their signature on there
15 anyway. So you have to ask yourself why wouldn't
16 they sign it? That would be fine.

17 To me a bigger issue is really ensuring no
18 conflict of interest. There is a conflict if you are
19 the watchdog over somebody who is paying you. I
20 think that it is important that the board actually
21 gets a policy statement from an auditor as to what
22 types of clients they will hire. And that they've

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1 established a culture that will enforce that policy
 2 statement, so that they're really maintaining an
 3 independence from those -- from the company that
 4 they're auditing.

5 MR. HARRIS: I think that is a helpful
 6 suggestion. After today's meeting we have to figure
 7 out what the follow-up is. One follow-up would be
 8 from my perspective how we deal with conflicts of
 9 interest. Maybe you can come back with specific
 10 recommendations dealing with how we deal with
 11 conflicts, I think that would be appreciated.

12 Tony?

13 MR. SONDH: I just wanted to just very
 14 briefly comment. Both of these comments have to do
 15 with the fact that I also, while running my
 16 consulting firm, have been a member of the faculty at
 17 some very good schools for a little more than 16
 18 years.

19 So I did a little bit of work on empirical
 20 research and I cannot say I ever changed my mind and
 21 opinion about the accuracy of Compustat. I think it
 22 is nonexistent. I don't rely on any studies that say

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1 anything about stuff that's coming from Compustat.

2 NEW SPEAKER: Definitely arrogant.

3 MR. SONDH: The other thing I wanted to
 4 mention was about university ranks. I've never seen
 5 anything more farcical than MBA ranks. I don't think
 6 I'm overstating it. There are two simple things.
 7 One, how many schools do people who vote on those
 8 things attend? Do you get an MBA from more than one
 9 school? Why are these things considered comparative?

10 The other point is that one of the
 11 universities I went to the -- I was there for about
 12 two years. The first year that I was there, the
 13 school fell from the top 10 ranking to number 12.
 14 The dean called the statistics department and said, I
 15 want you guys to sit down in one day and come up with
 16 everything that's wrong with the way these ranking
 17 are calculated. And they wrote a letter.

18 The next year they went back into the top
 19 10, and the head of the statistics department asked
 20 the same dean, would you like me to write another
 21 letter this year?
 22 (Laughter.)

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1 MR. HARRIS: I just want to thank
 2 Commissioner Walter who has to leave at the moment.
 3 We very much appreciate your being here. It's
 4 important to us.

5 COMMISSIONER WALTER: It's lovely to be
 6 here with you. I hope to see you all again soon. My
 7 pleasure.

8 MR. HARRIS: Tony.

9 MR. SONDH: That's fine.
 10 (Applause.)

11 COMMISSIONER WALTER: If you promise not
 12 to tell. They will laugh about me and call me an
 13 accounting groupie.

14 MR. HARRIS: Stay that way.
 15 Ann?

16 MS. YERGER: I wanted to quickly support
 17 for the audit partner's signature. You spoke earlier
 18 about the power of the CEO and the CFO's
 19 certification and I think it is the same in this
 20 space. It could make a huge difference to having
 21 that signature.
 22 I wanted to make a few comments about the

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1 need for audited financials. We debated this quite
 2 extensively at the Treasury Department about whether
 3 they should be public or not. At a minimum I don't
 4 see how the PCAOB can do its job without seeing them
 5 and frankly, I think audit committees should also
 6 have them. I think it should be part of the required
 7 communications at the very least provided from the
 8 audit -- to the audit committees.

9 At a minimum, there should be some form of
 10 a truncated audit report that is available to the
 11 public. I think at least some financial information
 12 should be included. I think information about the
 13 firm's governance, affiliate structure, a lot of the
 14 items discussed by prior folks, and also the audit
 15 quality indicators.

16 I guess I'd like to leave that issue at
 17 your doorstep. We discuss that quite a bit at the
 18 Treasury Department. As you might remember from the
 19 report, we are not very specific. We sort of said
 20 let the PCAOB decide what those are. We didn't have
 21 great ideas about what are the perfect audit quality
 22 indicators, but I would urge the PCAOB to really

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1 think about that, because ultimately that's what is
 2 most important I think for financial statement users.
 3 MR. HARRIS: Mike?
 4 MR. HEAD: I know a lot of people said the
 5 same thing but I do think the audit quality
 6 indicators are one of the more important things in
 7 this audit category because of how that will be
 8 reacted to by the firms.
 9 And then my last thought which -- I always
 10 hate throwing out ideas that seem somewhat
 11 impractical, but I feel like I need to throw one out
 12 because one of the inherent problems that has been
 13 alluded is that the auditing firms, even though we
 14 went a long way with independence and reporting to
 15 the audit committee, and technically the audit
 16 committee is hiring with shareholders ratifying the
 17 firms, the funds that are paying and their client
 18 still tends to be the company.
 19 And without turning it into a regulatory
 20 environment, is there a vision at some point in time
 21 where there would be a fee assessment of the publicly
 22 traded companies to create a pool and an organization

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1 like the PCAOB actually hiring the firms to perform
 2 the audits of the financial statements?
 3 And that feels so radical a statement to
 4 me, it is hard for me to say it. But you won't ever
 5 get true independence and true, clear delineation of
 6 who's the boss and whose rules are they going to
 7 follow, until, as you say, when you follow the money,
 8 that's where -- and the money is still coming from
 9 the corporations.
 10 So there's an inherent problem that we're
 11 trying to mitigate here. Even though I'm not a big
 12 proponent of fee assessment and managing that whole
 13 process, it is an idea.
 14 MR. HARRIS: Mike, you are now a wanted
 15 man.
 16 Bob?
 17 MR. TAROLA: Thanks Steve. Bob Tarola. I
 18 want to thank Ann Yerger for explaining all the
 19 things that she ought to be done, because I agree
 20 with her a thousand percent. I want to add two
 21 things to that.
 22 One is I signed about a thousand audit

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1 opinions in my career. The first time I signed an
 2 officer certification, I really worried. It is a
 3 different feeling when you're signing your own name.
 4 Secondly, that officer certification goes
 5 much further than an audit opinion. I would
 6 encourage the board to take a look at it as a model
 7 of what we should be asking auditors to be doing.
 8 Not hiding behind GAAP, looking for "fairly stated"
 9 unequivocally, addressing fraud, addressing controls.
 10 That's all in the officer certification, yet we let
 11 the auditors get away with a lot less.
 12 MR. HARRIS: Lynn, do you want to have the
 13 last word on this panel? I'm sorry, Brandon?
 14 Barbara? And then we have until 2:30. So 15 more
 15 minutes and we'll go to the next one.
 16 MR. BECKER: My word will be short. It is
 17 to agree with Damon and Kelvin that going from
 18 partnerships to privately-held companies is fraught
 19 with risk. It needs to be done carefully. There may
 20 be reasons to try to expand the scope but the change
 21 from partnership to public company has a cultural
 22 implication that I think you can't underestimate.

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1 Also to agree with Bob that I think the
 2 signature of the certification process, I had the
 3 same experience. It was the difference between
 4 signing legal opinions and signing officer
 5 certificates. But I do think it is a very real
 6 difference.
 7 MR. HARRIS: We certainly appreciate or I
 8 appreciate those comments. One of the reasons to
 9 have the investment advisory group is to hear
 10 directly from investors. You often don't have the
 11 time or the resources to comment on a lot of these
 12 issues. Therefore, I think that your views are very
 13 important to get on a record because the overwhelming
 14 comment letters on the engagement partner's signature
 15 were opposed to them. They came primarily from the
 16 profession.
 17 So hearing a number of your views on that
 18 is important in terms of creating a record.
 19 But moving down the table -- Meredith, do
 20 you want to go next?
 21 MR. WILLIAMS: I'm happy to, Mr. Chairman.
 22 I appreciate Mike lighting the fire. I'll throw the

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1 grenade in.
2 I have to use Mike's word inherent. I
3 think there is an inherent conflict any time you have
4 relationships that involve one party paying another
5 for a service, and that service and that relationship
6 is measured in decades if not centuries.
7 So my thought is you rotate them. You get
8 a five-year deal; if perform. You throw them out.
9 Bring in a new team. Throw them out. Bring in a new
10 team.
11 I feel very strongly about that. I
12 practiced that for 20 years with a number of
13 professional service providers, all of them
14 partnership kinds of firms. I'm convinced that every
15 firm providing a professional service -- and I don't
16 care if it is a dentist, an actuary, an investment
17 adviser, an accounting firm -- has a unique and
18 valued perspective.
19 If you're not going to rotate, you better
20 bring someone in to look over their shoulder every
21 several years.
22 It keeps everybody on their toes. It is

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1 expensive. It is darned expensive. That first year
2 of a five year accounting deal, it is a killer to the
3 auditee and a killer to the audit firm. They're not
4 making any money. They make out like bandits in the
5 fifth year, no doubt about it, but overall there's
6 probably some additional costs.
7 But I think there's huge, huge value in
8 having a rotation of those different perspectives.
9 It is a huge value to the auditee, whether it is me
10 as a pension plan, whether it is someone else as a
11 corporate entity.
12 I know it is a wonderful thing to me. I
13 bitch about it 24-7 when we've got a new auditor in.
14 But you know, when it's over with, after that first
15 year, I can step back and say you know what, we've
16 been going down this path, and they shed some light
17 on some things that we're doing that makes a lot of
18 sense; and I think we're better because of it.
19 I feel really strongly about that. I know
20 it is very radical. I think it certainly has worked
21 for us in a number of areas. I think it could work
22 for the corporate world too, as well.

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1 Thanks.
2 MR. HARRIS: Bonnie, we haven't heard from
3 you. Then we will go to Damon, then Lynn.
4 Lynn, you know you're both from Colorado,
5 you can talk about the Sarbanes-Oxley Act in rotation
6 of auditors and the political implications of that
7 issue, not that a lot of people would disagree with
8 you, Meredith; but that issue sort of --
9 MR. WILLIAMS: Mr. Chairman --
10 MR. HARRIS: We'll look forward to the
11 Colorado contingent handling that.
12 MR. WILLIAMS: Mr. Chairman, I'm not
13 talking about partners.
14 MR. HARRIS: Neither are we. But the two
15 of you can fly home together and think great thoughts
16 together on the way to the Sky High State.
17 (Laughter.)
18 Bonnie?
19 MS. HILL: I was interested in Meredith's
20 comments, one because when a public company changes
21 auditors, the Street says, "uh-oh, something's wrong.
22 What's going on?" And then the board is put on the

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1 defense again.
2 So I'm not opposed to that idea, but I
3 think it would certainly have to be made very clear
4 that that's the policy of the board.
5 The other thing is it is pretty disruptive
6 in terms of the work that has to be done within the
7 company and the auditing team and the finance team
8 and all that.
9 So I really would suggest you look at
10 that -- a public company look at it very carefully,
11 because you change the audit partner every five years
12 or so, but to change the whole company just because
13 of a policy might not be the best way to go.
14 And I think in terms of the cost to the
15 shareholders and the disruption to the company, you
16 have to make sure it is worth it.
17 MR. HARRIS: Damon -- Damon Silvers.
18 MR. SILVERS: Thinking about some of these
19 issues, Steve, as you alluded to, they all have a
20 certain history to them.
21 Some of them have been I think discussed
22 and advocated by investors for so long, that some of

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1 us begin to forget things we are advocating, and
2 perhaps get discouraged. So in my prior comments I
3 didn't mention these two matters that have since come
4 up that I think are both wise: One, I think small
5 and almost trivial, but yet savagely resisted by the
6 audit profession, which is to have the audit partner
7 identify who they are.

8 Something which -- I mean those of you who
9 are in the legal profession know that every public --
10 every SEC filing is signed by an attorney. Not by a
11 firm. But by a person. And so I just don't get it.

12 But then that seems like small potatoes
13 compared to Meredith's point which reminds me again
14 going back to Sarbanes-Oxley and the like that this
15 was -- firm rotation was and still is, I think,
16 something that investors have advocated for.

17 I want to go at it from a somewhat
18 different perspective than the ones that Meredith
19 laid out, which I agree with.

20 We have a big problem. We wrestled with
21 it on the ACAP -- it is funny, I can never keep that
22 acronym in my head -- when we wrestled with at great

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1 length, Bonnie and I in particular on the competition
2 subcommittee, of a market for audit services for
3 large firms. It is extraordinarily concentrated in
4 the four -- in the Big Four.

5 And that gives rise to the systemic risk
6 issues associated with the potential failure of any
7 one of those firms and the like.

8 It seems to me that for some of the
9 reasons Bonnie alluded to, in the current regime,
10 changing for a -- for a firm -- for an issuer to
11 change audit firms sends all sorts of signals to the
12 marketplace that nobody wants to send.

13 And then you have to spend a lot of time
14 running around and interpreting what you're doing and
15 the like and nobody may have -- ever fully believe
16 you. They'll keep asking you, investors, journalists
17 will ask you: "Tell me really why you are doing
18 this," and so forth.

19 And it is not just that that leads to the
20 type of sort of embedded relationships that Meredith
21 was talking about; it is an obstacle to developing a
22 more competitive market.

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1 I think it makes it more difficult for
2 there to be processes and entry points for firms that
3 are aspiring and we all know what the firms are,
4 there are a couple of firms that could potentially
5 play for the larger audit clients.

6 I think it makes it more difficult for
7 those firms to do so. I think it makes it more
8 difficult for anyone thinking about, could do you a
9 roll-up of some kind, could you put together a viable
10 competitor to think about then how would you compete?
11 What would you go after?

12 If there was a structured -- you know --
13 rotations without sort of sinister implications, I
14 think it would be a significant -- would be a
15 significant piece of encouragement to seeing some
16 improvement on the competitive side as well.

17 MR. HARRIS: Pete, why don't we go with
18 you? We'll ask the other two to wrap up quickly so
19 we can get to the next panel.

20 MR. NACHTWEY: I'll limit my comments to
21 the last topic that has been discussed. I may be in
22 the minority around this table.

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1 Having been in the shoes of an auditor,
2 the rotation idea I do think it has been helpful in
3 terms of rotating partners within firms.

4 I do think for a whole host of reasons,
5 going back to segregation of duties, back to things
6 like that that have been talked about around this
7 table, that it comes down to the quality of the audit
8 partner very often to put it all together.

9 The challenge -- because I agree we could
10 get more independent audits by rotating firms; then
11 you'd get the ultimate in independence; but I'm not
12 sure with large global enterprises, particularly the
13 most complex beasts that we've been talking about
14 today, the lists that Lynn went down of effectively
15 failed enterprises through the last crisis, for a
16 firm to come in and get up to speed, particularly
17 given the fact that we are in a constant reporting
18 cycle so we don't stop the mill, quarters are going
19 out while a new audit firm is coming in, getting up
20 to speed -- I think if we are going to go that route,
21 as a country and an economy, that we'd want to be
22 very, very thoughtful about how we did it, and how we

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1 deal with the transitions and so forth.

2 I'm not saying again there's a right or

3 wrong answer but -- it would slow us down in terms

4 of just how hard it is to get up to speed on these

5 things.

6 And the fact that at the end of the day

7 everybody wants one person to sign the audit opinion.

8 For one person to get up to speed on General Motors

9 or on J.P. Morgan Chase is just a mind-boggling

10 exercise even with the help of hundreds of people in

11 their firm.

12 MS. SIMPSON: Very briefly: CALPERS is

13 huge, as you all know, \$200 billion plus. But it is

14 required by law locally to rotate its auditors every

15 five years and is not allowed to reappoint the

16 existing firm. We can only give a five-year

17 contract. So there is some experience with large --

18 institutions. Maybe we should look at that.

19 The other thing I wanted to say as you

20 were asking for comments for the record, I don't

21 think I said specifically but CALPERS does support

22 the recommendations in the ACAP report; and I want to

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1 highlight the audit engagement partner's signature is

2 something that would certainly add value -- for this

3 person doing the signing as much as for the readers

4 of the accounts.

5 MR. HARRIS: Lynn?

6 MR. TURNER: Three things, Steve.

7 First of all, the issue of capital and

8 only four firms.

9 About 10 to 12 years ago the profession

10 looked at alternative firm structures. Some firms

11 adopted them. But quite frankly, they never worked

12 out for any of the firms. Some of the firms now

13 regret having gone into those structures.

14 If you look at the size of the regional

15 firms, again if you go and look at the number of

16 offices, number of people, the capital in them, there

17 is no way possible for any of those to grow up into

18 another Big Four.

19 So we are stuck with the "too few to

20 fail." That's the reality of it. There's nothing

21 you can do. To do this, to say we are going to raise

22 capital, create competition is a gross misnomer. It

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1 will never happen. It can't happen. We have let it

2 get so dominated by this oligarchy that we are stuck

3 with it for this point in time until someone has got

4 the guts quite frankly to go do a break-up and even

5 then the firms don't generate the type of rate of

6 return that you'd expect in a public company.

7 So they couldn't raise the public capital,

8 because quite frankly, they aren't going to generate

9 the type of returns you really want to see there to

10 start with. That's the first point.

11 Second point, someone raised the question

12 about can you really get information out of the

13 financials of these? The answer is yes. You can see

14 what liquidity is looking like in the these firms,

15 and cash flows. You can look at what their calls on

16 their cash is and what they are have to use the cash

17 up for, including the revolver.

18 You can turn around and most importantly

19 look and see what they're spending on and investing

20 in, two key components: One technology, one people.

21 If you ever manage one of these units -- I

22 did manage them -- inside the firm there are very key

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1 components as far as what you are spending on people

2 out of every revenue dollar, what you are generating

3 in reference dollar per people. It tells you how

4 much you are leveraging up the people.

5 It tells you whether or not you are

6 putting your money where you need to to make sure you

7 are getting the job done right. That information is

8 available in those financials and only available in

9 those financials, so it is very important you get

10 that.

11 On the last point, rotation. It did used

12 to be that there was a negative connotation with

13 changing auditors; but in the last half years

14 thousands of companies have changed auditors and

15 that's no longer the case. Analysts have gotten so

16 used to seeing a change in auditor, it's a natural.

17 They ask a question about it, you tell them, and it

18 is over. It doesn't have the negative connotation,

19 nothing close to what it used to.

20 If you go to a mandatory rotation, say

21 like every 10 years, then, in fact, everyone knows

22 what it is. So that argument is set aside.

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1 Furthermore, it is extremely expensive for
 2 the firms to rotate the audit partner every five
 3 years, especially on the big companies because you
 4 have these partners you have to move around all the
 5 time and stage them. It becomes very expensive for
 6 the firms. Quite frankly, I've never seen one of
 7 those partners stand up and say let's change our
 8 financial statements from what we were doing as a
 9 firm before, because they know that that results in
 10 litigation.

11 So I don't think you get a whole lot on
 12 partner rotation.

13 So I am a strong supporter of what Damon
 14 says in terms of mandatory rotation; there was a
 15 recent excellent article in CFO magazine where a
 16 number of CFOs talked about how they were changing
 17 auditors and changing to get lower fees. And what
 18 was interesting in the article is not one of them,
 19 while they all talked about how great a job they had
 20 done -- and Bonnie, it was how great a job the CFO
 21 was doing, not the audit committee -- in getting
 22 those lower fees, okay? Not a single one of them

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1 turned around and complained about the cost of
 2 changing auditors.

3 Not a single one of them.

4 MS. HILL: What you haven't addressed
 5 though and what hasn't been addressed is the whole
 6 issue of competition with mega organizations. You
 7 know, if you've been through an audit or two and the
 8 one left has your competitor, you're not going there,
 9 there's no confidence.

10 MR. TURNER: Yeah. I chaired a Fortune
 11 200 audit committee. You make sure you keep one
 12 clean. You can do it.

13 MS. HILL: Keep one clean?

14 MR. TURNER: Keep one clean.

15 MR. HARRIS: I think now we would like to
 16 turn to next panel which is the greater transparency
 17 of the audit process.

18 Bill, I'd like to turn that over to you.

19 MR. GRADISON: We've been talking about
 20 audit firms. Now we want to shift to talking about
 21 the audit process.

22 Really, I think it is a matter that has

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1 been discussed quite a bit today. The objective of
 2 the next panel is to put a little extra focus on the
 3 audit process by pulling back the veil and more
 4 specifically identify what should be disclosed, who
 5 should disclose it; and more specifically what is the
 6 role of the PCAOB in that disclosure.

7 Our designated hitters to get us started
 8 are Kelvin Blake, Norman Harrison, and Bonnie Hill.

9 First up to bat is Kelvin.

10 MR. BLAKE: Given the limited time we have
 11 here, I wanted to focus my comments on achieving
 12 greater transparency in the auditor's report. I'll
 13 turn it over to Bonnie and Norman to share their
 14 comments.

15 The current audit report is not very
 16 transparent and provides the financial statement user
 17 with little information into the audit process and
 18 the underlying financial statements.

19 The current reporting model has been in
 20 existence since the 1930s with very little change and
 21 is considered by many to be a pass-fail model or
 22 boilerplate model. I believe the standard report

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1 should be changed to provide greater transparency to
 2 the investing public.

3 I believe the report should be revised in
 4 two ways. One, I think the report needs to be
 5 expanded to include disclosures relating to both the
 6 auditor's responsibilities and the audit process
 7 itself. Second, I believe the report should be
 8 written in more plain English.

9 I've shared the auditor's report with some
 10 of my colleagues who are actually attorneys and they
 11 have a difficult time understanding what the report
 12 is actually saying.

13 First, I think the auditor's report should
 14 be expanded to include a discussion of the auditor's
 15 responsibilities regarding detecting fraud during the
 16 audit process and the limitations the auditor faces
 17 in detecting fraud.

18 I believe that big part of the
 19 expectations gap that exists between the financial
 20 statement users and the auditing profession comes
 21 from the fact that the users believe that the auditor
 22 should be detecting all types of fraud whereas the --

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1 it is clear from the -- under the current standards
 2 auditors are responsible for searching for fraud, but
 3 they're not necessarily going to find that fraud
 4 because a lot of fraud is basically caused by
 5 management acting in collusion and it is hidden from
 6 the auditors.

7 I also believe that the auditor's report
 8 should be expanded to include a discussion of the
 9 materiality issues that auditors face and both the
 10 qualitative and quantitative issues that the auditors
 11 face when conducting audits.

12 Materiality is determined by what an
 13 auditor believes would have changed or influenced the
 14 judgment of a reasonable financial statement user.
 15 Given that the auditor is relying upon what he or she
 16 believes a reasonable financial statement user would
 17 determine to be material, I think that should be
 18 exposed to the financial statement user.

19 I think the report should discuss
 20 generally the qualitative factors that are considered
 21 in an audit and for the particular audit in question,
 22 the existence or the absence of such factors.

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1 In addition, the audit reports should
 2 discuss the quantitative levels set by the audit
 3 partner and used in planning evidence accumulation
 4 and determining whether the financial statements as a
 5 whole are materially misstated. What basis did the
 6 auditor use in determining materiality, net income
 7 before taxes, total assets, what percentage of the
 8 basis was determined to be material, 5 percent of net
 9 income before taxes? Total assets? What percentage
 10 was determined to be material? Five percent? Ten
 11 percent?

12 Finally I believe the PCAOB should
 13 consider expanding the auditor's report to include a
 14 discussion of the significant accounting principles
 15 used by management, significant estimates made by
 16 management, and the key risk fact areas identified by
 17 the auditor's.

18 While some of this information may, in
 19 fact, be disclosed in the financial statement notes,
 20 I believe it is often overlooked by the investor.

21 Finally, to discuss plain English.
 22 Regardless of whether the auditor's report is

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1 expanded to include the disclosures that I've just
 2 mentioned, I think the report needs to be written in
 3 plain English. Currently the report uses a lot of
 4 accounting terminology that is not easily understood
 5 by the non-accountants.

6 I would imagine the average investor does
 7 not know what it means for an auditor to plan and
 8 perform the audit to obtain reasonable assurance
 9 about whether the financial statements are free of
 10 material misstatement.

11 For example, is it clear to the average
 12 investor that reasonable assurance does not mean that
 13 the auditor is not guaranteeing the financial
 14 statements are without material misstatement?

15 Does the reasonable assurance terminology
 16 provide the financial statement user with the level
 17 of assuredness provided by the audit?

18 Does the average investor know what
 19 constitutes a material misstatement or that
 20 materiality is based upon the auditor's perception of
 21 what the investor finds material?
 22 Is it clear to the average investor that

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1 examining on a test basis means that the auditor is
 2 testing only a sampling of the transactions and then
 3 projecting that sampling onto the entire class of
 4 transactions or the account balance?

5 MR. GRADISON: Thank you.

6 MR. HARRISON: I think I'm next.

7 This is Norman Harrison. Kelvin did a
 8 good job of laying out the framework. I'll expand on
 9 a couple of points. Then I'm going to take the
 10 liberty of pulling forward the independence issue
 11 which we touched on in the last panel. I think it
 12 has relevance here that I'd like to include in the
 13 discussion.

14 We perhaps overly glorify the end product
 15 of the auditor's work by calling it a report. It is,
 16 in effect, a letter.

17 I was reminiscing with colleagues last
 18 night about way back when I was an undergraduate at
 19 business school and went through my first job in New
 20 York as an analyst and began to study financial
 21 statements and went to law school and learned about
 22 due diligence, back in those days it was a three

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1 paragraph letter.

2 If you got to the 10-K or got to the

3 annual report, got to the page, there was a three

4 paragraph letter, you just turned the page and kept

5 reading. Only if there was a fourth paragraph or

6 language you didn't expect to see did a red light go

7 off and you stop and read it.

8 We haven't advanced very much. It is

9 still a highly formulaic report, lot of boilerplate

10 language as Kelvin noted.

11 I think when the investor community thinks

12 about what would be beneficial in terms of greater

13 disclosure around the process of conducting the

14 audit, we mean a real report, an actual narrative

15 description of the approach that the firm took to

16 this particular engagement for this particular year.

17 How was it staffed? What were the

18 resources the firm deemed necessary to contribute to

19 the team? What was the audit plan?

20 What framework did they follow in

21 conducting the audit? What technical expertise or

22 subject matter experts within the firm -- not

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1 necessarily by name but by function -- did they draw

2 upon and why?

3 And I think perhaps most importantly, to

4 tie into Kelvin's comments, a discussion of the

5 principal financial risks that the company faces and

6 which the auditors took into account in designing

7 their audit plan and importantly in developing their

8 measures or standards of materiality, because risk

9 and materiality are hand in hand.

10 I think a well-crafted audit report would

11 describe both of those in an appropriate level of

12 detail and explain how they interconnected in terms

13 of the actual conduct of the audit.

14 Another area where I think it would be

15 helpful to have more disclosure, we've talked in

16 other contexts today about the on-off switch, the

17 toggle switch nature of a lot about what the auditors

18 render an opinion on. In connection with financial

19 risk and with -- in connection with the evaluation of

20 internal control processes.

21 Even in those situations in which no

22 material weakness is found to exist, I think it would

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1 be very helpful from an investor's standpoint to have

2 some narrative discussions of issues that were

3 identified, or emerging trends or emerging areas of

4 concern that while still short of a material weakness

5 may be headed in that direction or require attention

6 on the part of the issuer.

7 I think the fact the auditor identifies

8 those, discloses those, urges management to pay

9 attention to those would be something that investors

10 in the capital markets would be well served by

11 understanding.

12 I think also in the current environment,

13 given in particular the events of the past two years,

14 I think some discussion or disclosure of the degree

15 of regulatory risk an enterprise faces would be a

16 very helpful addition to an auditor's report.

17 And then lastly, a word on independence.

18 Because it is certainly a governance

19 issue, but the independence determination is

20 essential to the conduct of the audit because it is

21 the threshold decision to be made at the outset as to

22 whether or not the firm is actually competent to

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1 conduct the audit for the year in question.

2 I think that it would be extremely useful,

3 we are again in an environment in which audit firms

4 are providing a wide area ray of services to their

5 clients. Everyone is back in the consulting business

6 through the advisory practices. In many cases we

7 provide significant amounts of tax services to our

8 clients. We have the benefit of bodies of rules and

9 regulations, most importantly from the PCAOB but in

10 addition through the SEC that we didn't have in the

11 last rounds of financial frauds.

12 I think the next logical step here is to

13 require disclosure to investors of the process by

14 which the independence determination was made,

15 because I think we're back in an environment where

16 there certainly are in many instances close calls.

17 It would be helpful to know -- to have a

18 description of the firm's internal engagement

19 acceptance process with respect to the specific

20 engagement questions, the steps the firm took to

21 measure and determine its independence; and

22 importantly, discussion of any issues that came up

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1 internally as the firm vetted the engagement and
2 perhaps more importantly in discussions with the
3 audit committee, what questions were raised, what
4 potential compromises to independence were
5 identified, and on what factual basis were they
6 resolved?

7 And I think that would also, Steve, other
8 members of the board, I think that would be important
9 information to better inform your inspection process
10 as you go in and examine independence processes that
11 the firm is following.

12 So those are my highlights or seeds to sow
13 for further discussion and with that I will turn it
14 over to Bonnie who provides the customer's, the
15 client's perspective.

16 MS. HILL: Okay. Bonnie Hill here.

17 My colleagues have said it all. I'm
18 neither an accountant or a lawyer and I'm not going
19 to try to be either. When I started looking at the
20 topics that we had on hand, my first question was who
21 cares? Why do they care? Why does it matter?
22 What's my role in all of this? Why do I need to know

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1 it.

2 I thought about the fact that when we look
3 at shareholders and what they come into in terms of
4 their investments, it is that they want to know, one,
5 whether it is worth their putting their moneys into a
6 particular organization, if that organization is well
7 run.

8 Is this a good investment for me? Are the
9 financial statements clean? Who's overseeing the
10 process? How are they doing it?

11 So those are the things that matter and it
12 matters to shareholders. And when we talk about
13 shareholders we have people here representing, sort
14 of large investors; and yet and still we talk
15 about -- you know -- more transparency, greater
16 disclosure, and sometimes what that means is much
17 more paper, more legal jargon and more accounting
18 jargon. And so the average investor, the mom and pop
19 who puts their money into an organization, can't
20 begin to make anything out of all those disclosures.

21 So when we make the disclosures, when we
22 talk about plain English, does that mean more is

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1 better? I think not. I think it means that perhaps
2 we have two different audiences and we have the
3 financial markets that need to see one thing and need
4 a great deal of disclosure and insight; and then we
5 have the sort of small investor who really wants to
6 understand what it is he or she is reading; and so
7 the plain English to me goes to the sort of smaller
8 investor. Because those of you here and around the
9 table, you don't need a lot of plain English. You
10 know exactly what you are reading. You already
11 demonstrated that in discussions around the table.

12 So it's -- it becomes a question of how do
13 we disclose the information that needs to be there.
14 As a director, you know, and the one for which the
15 blame goes to when something isn't disclosed in the
16 way people think it should be, then I do want to
17 know, I do want to question particularly in the board
18 room how the auditors have gotten to where they got,
19 what have they seen that they won't disclose to me as
20 a director. I want to know how to get to that and I
21 want to know the process that they use.

22 And it is very interesting. I think last

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1 night or with our group, our team, I was saying that
2 when I was on audit committees, the question I would
3 ask at the end of the meetings is okay, what would
4 you have asked if you were sitting in my seat that I
5 have not thought to ask, or any of us have not
6 thought to ask.

7 And the amazing thing is on more than one
8 occasion, we had a auditor say well, I think I would
9 want to know --

10 And you know -- my question was why didn't
11 that come out without me asking the stupid question.
12 And it is probably -- I won't speculate, but I will,
13 I will speculate, it is because a lot of times people
14 don't want to come out -- they don't know if a
15 director really wants to know the good, the bad, and
16 the dirty. I think there are times when the director
17 in the boardroom really has to push the auditor and
18 make certain the auditor has the comfort level in
19 terms of saying what he or she sees.

20 And then in terms of transparency, I think
21 definitely that in our annual reports, an overview of
22 how the auditor has proceeded with his or her work,

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1 is important and how the board uses that. But I
2 think if it can be done concisely and in a readable
3 fashion for the average person, that that would make
4 a tremendous difference.

5 We sort of joked last evening about the
6 fact that maybe what we are looking at are two annual
7 reports, two sets of disclosures. One for the
8 average person like me and one for all the really
9 smart people like you guys.

10 (A little laughter.)

11 With that, I wanted to save us time -- I
12 didn't really have a lot to say -- so we can have a
13 discussion.

14 MR. HARRIS: Before turning it over to
15 Marty who has done a lot of work in the standards in
16 this area, I know Gus, you indicated this was a
17 priority. You had comments. And I would like -- you
18 know, to some extent we are creating a record here.
19 I'd like you to give us the comments that you had;
20 and then Pete, you also mentioned it as a priority,
21 and I'd like to get your comments and any others as
22 well.

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1 In the SAG we've got some of the comments
2 of the other members. We would welcome others.

3 Gus, since we haven't heard from you on
4 this issue, and Pete since we haven't heard from you
5 before on the issue, why don't we do that now? Since
6 Marty and his -- the standards has been doing a lot
7 of work and has vetted this issue a little bit, I'd
8 like to turn it over to him.

9 MR. SAUTER: Great, thanks, Steve. This
10 is Gus Sauter speaking.

11 There are two items I would like to talk
12 about. The first one is what I'll call the distance
13 from the cliff. It seems like the audit is you're
14 okay, you're okay -- whoops! It is a qualified
15 opinion.

16 There's really not much of an indication
17 of how close to the cliff you are all along the
18 process. Clearly, of the audits that are clean --
19 quote, unquote -- "clean," there have to be
20 differences, there has to be a range.

21 So we think that there should be some
22 comment within the audit letter as to things like

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1 that should be considered.

2 It could be in the form of a check list
3 that's perhaps presented in an appendix, things like
4 the types of modeling that were done to determine the
5 value of assets.

6 Perhaps a listing of contingent
7 liabilities. There was discussion earlier about
8 SPVs. Here I'm a little bit torn between what's the
9 domain of FASB versus a PCAOB.

10 But if the auditors could say we think
11 that there's risk here with contingent liabilities or
12 SPVs, that would be very helpful.

13 Again, just perhaps a check list or some
14 indication as to how close a firm might be from a
15 qualified opinion as opposed to just pass-fail.

16 Another point a little bit different from
17 some of the other comments, as opposed to the
18 financial risk of a firm, or the investment risk of a
19 firm, I think we would appreciate discussion as to
20 the risk of the audit itself.

21 So there certainly within an audit there
22 are many things like that are identified that are not

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1 risky. You know for certainty what they are:
2 Cash -- you know what cash is. There are other
3 items, items that might involve fair value
4 accounting; where there's a wide range of potential
5 estimation error; and what we need as analyzers of
6 the financial statements is some help trying to
7 figure out where we should focus the bulk of our
8 time.

9 We need to know that a certain method was
10 used to estimate values of certain types of assets
11 and focus on those so we're not wasting time on the
12 straightforward issues.

13 Fair value accounting is obviously fraught
14 with estimation error. As I mentioned earlier when
15 we were talking about the fraud center, on average
16 the financial statements can depict the financial
17 value of a firm, but there's risk around that
18 average; and we need to know where those areas are.
19 Help within an audit report to know where to go to
20 find to focus on those risks would be beneficial.

21 MR. NACHTWEY: Those are great comments,
22 Gus. I share a lot of those.

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1 I guess the comment that I submitted in
 2 writing was along the lines of the pass-fail. The
 3 idea that you can spend hundreds of thousands of
 4 professional hours on some of these large engagements
 5 on an annual basis and come back with a boilerplate
 6 opinion that is exactly the same no matter -- again
 7 as long as you are not going over the cliff, it is
 8 virtually exactly the same.

9 The firms I don't think are doing that to
 10 be obtuse. They're doing that because that's the
 11 standards they have to follow. I also think it is
 12 because again of the litigious environment we are in.
 13 Any time they get out of a comfort zone, they're
 14 putting themselves at great risk.

15 How do we solve for both of those? You
 16 know, the idea that there's a tremendous amount of
 17 intellectual capital built up amongst the members of
 18 the audit team that could be shared in some fashion,
 19 but how do you protect them from legal risk?

20 At the end of the day, a lot of stuff is
 21 judgmental. Their judgments could be off. Hopefully
 22 they're not 180 degrees off. They're somewhere in

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1 the 360 degree radius that they're probably going to
 2 be 20, 25 degrees of right or wrong. That will be
 3 closer if they talk to us about that than if we have
 4 to guess.

5 So I'm mindful of the fact there are other
 6 organizations that provide their opinions on
 7 companies and their financial stability or their
 8 credit ratings. Obviously the big credit rating
 9 agencies have very finely graded type of -- or
 10 granulated type of rating system, AAA, triple A
 11 minus, triple B plus, you go through with S&P or
 12 Moody's or a Fitch.

13 Do we want something like that from the
 14 audit firms? I like Gus's idea about a check list,
 15 about the soft spots, the estimates, again be able to
 16 get color on not only what management's views were,
 17 how they're coming up with the estimates about what's
 18 the auditor's judgment beyond a pass-fail, did they
 19 just again pass -- you know, what are the various
 20 gradations of pass, and if fail is so rare it is
 21 almost not worth talking about because it is, rare
 22 that anybody comes back and fails and gets a

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1 qualified opinion. There has to be something in
 2 between.

3 MR. HARRIS: Lynn Turner.

4 MR. TURNER: I actually have a different
 5 view.

6 I actually do like the pass-fail system.

7 When I pick up a financial statement, when
 8 I pick up a financial statement, a set of engagement
 9 teams, I want to know either right or wrong. I don't
 10 want to know that cash is right and receivables is
 11 okay, you know, and that when I get down to
 12 impairment of assets, it is like oh, God, who knows?

13 So I think a pass-fail notion is a good
 14 notion; and I think it's the right way to go with the
 15 report.

16 What I would then build on top of that,
 17 though, is what we discussed at the SAG; and that is
 18 something that has been labeled as an auditor's
 19 discussion or analysis of the numbers.

20 And the things like that Gus is asking for
 21 actually exist, because when we do an audit, at the
 22 end of the day, at the end of each audit, there is

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1 some type of summary memo prepared that goes on top
 2 of the binder that every single partner and the
 3 concurring partner and the audit manager have to sign
 4 off on.

5 And what that memo does is it identifies
 6 the significant items that the auditor was concerned
 7 about that had risk. And any of us that have done
 8 those audits know exactly what memo we're talking
 9 about. Okay?

10 Now if we knew that was going to become
 11 public, we might be a lot more careful how we wrote
 12 it or write it in a different context. But what
 13 you're asking for does exist. It is that summary
 14 memo that is in every single audit; and that's, in
 15 essence, what would go into an auditor's discussion
 16 and analysis.

17 Part of what you're asking for, though, is
 18 also not an auditing issue. Part of what you're
 19 asking for deals with the FASB's disclosure
 20 standards. And the FASB's own investor technical
 21 advisory committee has urged the FASB to adopt a
 22 disclosure framework, and that disclosure framework,

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1 if they would do it, would turn around and provide
 2 investors the key assumptions that go into these
 3 significant judgments and estimates.
 4 It would give you information about the
 5 range of possible outcomes; and the key points that
 6 would drive, as well as what within that range was
 7 the number that the company picked.
 8 So you'd still get a good number in the
 9 financial statement of what they think their best
 10 estimate was. But you'd get information in the
 11 footnotes about all the flavor and connotation around
 12 that so you can make estimates.
 13 You witness that information together
 14 within what's in that auditor memo, and I can
 15 guarantee you, you know exactly where the risks are
 16 in those financial statements and you know exactly
 17 the information you need to dig down and analyze and
 18 if you want to on your own move the numbers around,
 19 move them around.
 20 But that's what you're really trying to
 21 get to, and trying to put all that just into the
 22 first pass-fail audit report, I don't think works.

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1 I want to be able to just right off the
 2 bat go in and say are my financials right or not; and
 3 then go get the additional analysis so I can analyze
 4 it as analyst or researcher or investor. But I still
 5 want that pass-fail report in plain English.
 6 MR. HARRIS: Marty, do you want to take a
 7 minute or two, a couple of minutes and discuss what
 8 we're up to?
 9 MR. BAUMANN: Sure. This is Marty
 10 Baumann, the chief auditor at the PCAOB.
 11 This has been a great discussion. Thanks.
 12 It is valuable input to us in our auditing standards
 13 setting process.
 14 So let me just talk about a couple of
 15 things like that have been discussed. The first one
 16 was should the individual auditor sign the audit
 17 report.
 18 As was mentioned a couple of times, we've
 19 discussed that with the Standing Advisory Group.
 20 We've issued a concept release on that.
 21 What's particularly helpful here because
 22 as Steve said, the responses that came back to the

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1 concept release were largely from the profession, and
 2 largely opposed to that concept of signing the
 3 report, clearly the discussion around this table from
 4 this investor group sees that that's a pretty good
 5 way for accountability on the part of the auditor and
 6 would probably help the investor and may even help
 7 the auditor as well, as I think I heard somebody say.
 8 We have a project under way in my office
 9 kind of pulling that to its final conclusion right
 10 now. We will bring a paper to the board with our
 11 recommendation from the office of the chief auditor
 12 as to how we should move ahead with that project on
 13 signing the audit report. The board should be
 14 getting that recommendation from my office pretty
 15 soon. We've been doing a lot of research on that.
 16 And certainly this conversation of record helps that
 17 discussion.
 18 Turning to the auditor, the audited report
 19 itself, Lynn, thanks for summarizing most of what I
 20 was going to say. You did a great job.
 21 We had a very good discussion of this at
 22 the very last meeting of the SAG just a month or two

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1 back, and there was a recommendation of the Treasury
 2 advisory committee, so we took this up and put a
 3 briefing paper before the SAG and had a pretty --
 4 very thorough discussion including break-out session
 5 of members of the SAG. I think what Lynn said was
 6 held pretty widely by most of the group, that there
 7 is a great benefit to the single report that does say
 8 whether or not the financial statements present
 9 fairly. That making that ambiguous may not be very
 10 helpful to investors.
 11 And, therefore, retaining the report that
 12 indicates whether the financials present fairly or
 13 not is a positive thing. But yet the auditors want
 14 more.
 15 So again I have to come to a
 16 recommendation to the board, but in doing that, the
 17 way we're thinking about that is taking a look at
 18 that in line with the comments Kelvin made initially,
 19 taking a look at the audit report itself, which would
 20 retain the presents fairly, pass-fail type of model,
 21 but probably there's some things in the language of
 22 that report that could still be improved.

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1 That might be a shorter-term term project
2 to deal with improving the language which might deal
3 with some of the responsibilities around fraud, as
4 well as some of the other things you mentioned, what
5 does reasonable assurance mean, and so on and so
6 forth.

7 But maybe staying with that report,
8 improving that report, clarifying some of the
9 language in it and improving it.

10 Potentially a longer term project because
11 it is not quite as simple, to take a look at what
12 Lynn called and what has been referred to by many
13 people as the auditor's discussion and analysis.

14 We'll again make a recommendation to the
15 board on how we think -- my office thinks we should
16 proceed on this; but there are a lot of
17 communications that are made to the audit committee
18 as well, of the type of nature that investors are
19 asking for right here. The close calls,
20 consultations with national office, most complicated
21 estimates and judgments, controversial accounting
22 policies.

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1 Things of that nature that it really seems
2 that investors are looking for that kind of
3 information as well.

4 Adding that supplementary auditor's
5 discussion and analysis I think requires a lot more
6 thought as to what that would look like. The
7 standards around that, guidelines around that, et
8 cetera. And we'll think of the best ways to try to
9 address that, which could include focus groups and
10 the like, to try to get further input on how that
11 might be done.

12 But that's been pretty consistent input in
13 that regard.

14 And I also agree that it's a project that
15 probably needs to be coordinated with FASB. A lot of
16 this, when we're talking about measurement
17 uncertainty, illiquid financial instruments as an
18 example of the last couple of years, the ranges
19 around those numbers can be quite large as to what
20 that actual -- the financial instrument value is; and
21 the actual departures as reported in the financial
22 statement and potential ranges around that might

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1 actually equal what the auditor considers to be
2 material.

3 So disclosure of that somewhere in the
4 financial statements so that investors understand,
5 that that number that they're looking at on the
6 balance sheet might have a range around it that is
7 equal to or greater than what the auditor considers
8 to be material. That might be very important.

9 Those are some of the conversations we
10 have begun. We've started talking to Bob Hearst. I
11 sit on the framework task force project there. I
12 think there is an integrated effort there as well.
13 We are tackling those issues on the auditor's report
14 and these comments have been very, very helpful.

15 MR. HARRIS: Why don't we go around and
16 try to finalize this panel in the next 10 minutes or
17 so.

18 MR. HEAD: Mike Head.

19 My intent here is to kind of reinforce a
20 few things like that have been said, from -- my
21 perspective is that I'm sort of where Lynn and Marty
22 are, that I think it will cause confusion if you try

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1 to put a multipage report in the 10-K for the
2 investor to look at as part of opining on the fair
3 presentation of the financial statements and their
4 accuracy.

5 However, I do think the concept of an
6 auditor discussion and analysis like management's
7 discussion and analysis and having that as a section
8 in the 10-K could add a lot of value; and as we've
9 already described, a roll up that already is in place
10 from it being the audit documentation product that
11 auditors have to put together, how that supports the
12 mandatory communications to the audit committee that
13 covers most of these items, not all of them; and then
14 if you draw upon their planning report that they
15 present at the beginning of the year to the audit
16 committee, most of them call it the integrated audit
17 plan, all of this information exists.

18 If there was a format that required
19 content dictated similar to management's discussion
20 and analysis, that would be the auditor's discussion
21 and analysis that the firm would have to sign a
22 consent, like they do the opinion, I think you add

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1 some real value and not create more audit work or
2 cost to the audit, because it all already exists and
3 has to be reported in some form or fashion to the
4 audit committees today. It is just a matter of
5 what's important to the user and reader of the
6 financial statements from the PCAOB's and SEC's
7 opinion.
8 So I think that's a very, very positive
9 direction to go, that is where I think a lot of the
10 dialogue today has been at.
11 MR. HARRIS: Ann Yerger.
12 MS. YERGER: Certainly the council
13 believes the disclosure about the auditing process
14 would be of interest. We do believe more details
15 about key findings would be of particular benefit to
16 the investing public. I'm aware you released a
17 proposal regarding enhanced disclosures between the
18 audit firms and the audit committees. And our view
19 at the council is that some of those disclosures
20 would be of keen interest to the investing public.
21 It seems like some of your work is already being done
22 in this area.

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1 Gus, I think it gets at some of the issues
2 you were talking about, which I think are very, very
3 important.
4 MS. SIMPSON: Anne Simpson from CALPERS.
5 We are fully in support --
6 MR. HARRIS: Anne Simpson, I'm just --
7 identify yourself as you go around. There's a larger
8 audience.
9 MS. SIMPSON: I am Anne Simpson.
10 One caveat, if the discussion is to be
11 more than just more fluff, is this issue about
12 potential liability litigation; and I don't know --
13 maybe we just leave it on the table for coming back
14 for discussion -- is what do we need by way of safe
15 harbor provisions? The confidentiality is not quite
16 the confessional. Confidentiality between the
17 auditor and the audit committee. But putting that
18 out into the public markets puts it under the glare
19 of publicity for potential litigation. I just wonder
20 if it would continue to be so useful. Maybe we need
21 to look at that. Thank you.
22 MR. WILLIAMS: I'm not Anne Simpson.

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1 My name is Meredith Williams.
2 I want to know how close I am to the
3 cliff. I really do. I want to know on the
4 accounting side how hard the entity is pushing. Are
5 they on the edge there as well? How hard are they
6 leaning on the accounting standards?
7 I want -- I don't get to sit in the board
8 room. I certainly don't have time to call the head
9 of the engagement, the audit partner, top level audit
10 partner.
11 But I've got to know. Again, I don't know
12 the right question to ask. Maybe my right question
13 is would you, head auditor, put your money in this
14 firm? Would you stock in this company?
15 I need some feel. I don't get that now.
16 You know, the pass-fail thing is fine. That allows
17 you in our gate; and we'll then put you through the
18 rest of the analysis to decide whether we want to buy
19 you or sell you.
20 But -- so pass-fail has some significant
21 benefit; but I've got to know more.
22 I really like the idea of perhaps having

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1 some access to an auditor discussion analysis so long
2 as it includes some kind of a sensitivity analysis
3 that others have referred to.
4 In saying this is a going concern and so
5 forth, what number are you using as your analysis?
6 What happens if things go askew in one direction or
7 another? How thick is the ice?
8 So those are my thoughts on these very
9 important matters. Thank you.
10 MR. HARRIS: Damon?
11 MR. SILVERS: I have a couple of comments
12 on this discussion. The first thing is -- and I said
13 this before at the SAG and will say it here: There
14 are some large issues that I think are now fairly
15 clear in relationship to the sort of -- I wouldn't
16 say the reliability or the -- the seriousness with
17 which investors take audited financials and the audit
18 process; and one of them has surfaced in our
19 discussions today, and the other has not. And I just
20 want -- I think it is important to put them own the
21 record in this conversation.
22 And then I want to shift to at least one

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1 type of response that one could imagine to this set
 2 of problems that often seems kind of intractable.

3 The two problems that I think have
 4 surfaced in the last 24 months that are really very
 5 serious and unaddressed are, one, the issue that came
 6 up in relation to the foreign auditors. And -- at
 7 least in China, and the conversation ended and I want
 8 to bring it back up because it is relevant to this
 9 discussion. You know, Lynn asserted that essentially
 10 we have an audit process in China and perhaps other
 11 countries that is simply not reliable and not likely
 12 to be fixed.

13 Given the degree of economic integration
 14 of the United States and U.S. public companies with
 15 China's economy, we're -- if that's true, and we've
 16 had again discussions at the Standing Advisory Group
 17 about this -- if that is true, then that is a very
 18 serious problem for the integrity of our auditing
 19 process and our public company financial statements.

20 Because increasingly Chinese operations,
 21 directly and indirectly, are just -- you know,
 22 they're integrally part of our corporate economy.

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1 The second problem that we have is not one
 2 we can blame on anybody else. And that is in
 3 relationship to our financial institutions.

4 I serve on the oversight panel for TARP.
 5 In that context, we have -- our staff has tried to
 6 determine the extent of impaired assets in our public
 7 companies in the financial sector, particularly in
 8 the very large, systemically significant banks.

9 The question simply can't be answered.
 10 The nature of the way in which audit firms, issuers,
 11 FASB have interacted over the last year or so has
 12 made this fundamental question about our economy and
 13 about the health of these large firms unanswerable.

14 You know -- these are issues, these
 15 post-Sarbanes-Oxley issues that raise profound
 16 systemic doubts about what we are doing here.

17 Now, you know, as long as explicitly -- as
 18 long as explicitly or implicitly the American public
 19 is guaranteeing the financial solvency of those
 20 institutions, it is a little unclear what that means
 21 exactly for investors but I'm not sure that's a
 22 comforting assurance.

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1 Now the -- with those two very large
 2 caveats let's turn to the more ordinary course of
 3 what we were just discussing.

4 So we have this problem that we have a
 5 binary -- a binary auditors opinion, and one switch
 6 is you're fine, the other switch is that you're dead,
 7 effectively. And investors and I think -- and the
 8 general public can sometimes find that unsatisfactory
 9 as a source of information.

10 And there are two type of options that are
 11 often offered and at least I believe that neither one
 12 of them will achieve much of anything.

13 I think the idea of a multi-grade audit
 14 doesn't work, because everyone will turn out to be
 15 above average and we -- and essentially we will
 16 have -- the binary system will continue under
 17 another -- you know -- under another name.

18 The second idea is that we give the
 19 auditors an opportunity to write a long essay about
 20 the company.

21 I think we've all seen what those long
 22 essays turn into; and not much information in the end

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1 gets conveyed because it is dangerous to everybody to
 2 do so.

3 The only thought I would add might be more
 4 productive is I think we all know what we are trying
 5 to get at, which is that in the course of an audit,
 6 at some point, a handful of issues, hopefully, get
 7 identified as being problematic, and sources of
 8 tension between the preparer and the preparer's
 9 financial staff and the auditor.

10 And when -- and those issues get wrestled
 11 around with and eventually, unless things are
 12 going -- unraveling very fast, eventually those
 13 issues get resolved and a clean audit letter is
 14 issued.

15 I think the investors really want to know
 16 is what are those issues. As Lynn said there's a
 17 memo that lists them that the audit firm has, that
 18 the investors don't have. How would we surface those
 19 issues without surfacing everything? Because I'm not
 20 sure we want to surface everything.

21 And I think there's a simple way to do it.
 22 I'm not sure anybody has the sort of the -- as we

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1 were discussing at lunch, I'm not sure anybody has
 2 the guts to do it this way, but there is a simple way
 3 to do it. And that is to require that as part of the
 4 audit letter, that three or five or -- pick your
 5 number -- you know, material items be listed that
 6 were the subject -- that in the auditor's opinion are
 7 the most debatable aspects of the financial
 8 statement.

9 That internal memo exists. If you had
 10 them list three, or five, or even one, it is hard to
 11 imagine how you would avoid doing so given that the
 12 internal memo exists and it can be checked against --
 13 and -- if things were to go badly.

14 That would bring those items out. I think
 15 investors would very much like to see what those
 16 items are. I haven't thought through and I'm not
 17 certain exactly whether you could do that in a way
 18 that would maintain the current dynamics, the current
 19 behind-the-scenes dynamics which in certain scenes
 20 are helpful.

21 You know, there's a value to the incentive
 22 process that the firm has in resolving those items,

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1 the way firms do currently. Right? Obviously if you
 2 meet the auditor's concern then you don't have a
 3 problem.

4 The -- what I'm suggesting is a system in
 5 which there would be no way to avoid having to
 6 actually tell the public what the dodgy items were,
 7 and how they were resolved.

8 And I think that approach would be more
 9 likely to actually generate information than either a
 10 narrative or a graded final audit opinion.

11 So anyway I offer that for people's
 12 contemplation.

13 MR. HARRISON: This is Norman Harrison.
 14 I'm tempted to take my sign down and pass.
 15 That was well said, Damon. I will be brief because
 16 you said it much more succinctly. But I was going to
 17 make a broader point. Damon's suggestion fits neatly
 18 into it.

19 I think in many respects we are all
 20 talking about the same thing here. Whether it is a
 21 matter of whether we change the format of the report
 22 or have a discussion and analysis, what we are

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1 talking about is disclosure. I'm not sure what we
 2 call it, or where in the audit papers it comes, is as
 3 important as what we're getting. I think Damon hit
 4 it.

5 What we are concerned about is in addition
 6 to things we've already discussed about how the
 7 independence determination was made at the threshold,
 8 and how the engagement was staffed, and planned --
 9 most importantly, from an investor standpoint, what
 10 issues of concern came up along the way and how did
 11 the auditor get comfortable? Because at the end of
 12 the day that's what it is all about. It's about
 13 getting comfortable, giving that that grade, whatever
 14 it is, signing your report.

15 I think that is the key disclosure we are
 16 looking for here. Perhaps if that's a good
 17 suggestion there would be some benefit from some
 18 further review by this group, but to use the
 19 conclusion memo, the management letter -- there are
 20 documents prepared in the course of an audit that
 21 contain or highlight those issues -- and distill
 22 those into some type of meaningful disclosure at the

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1 conclusion of the process that auditors, the
 2 investors, the investing public would have access to,
 3 I think would be a breakthrough.

4 That's my final word. Thank you.

5 MR. HARRIS: Tony.

6 MR. SONDHI: Thank you. This is Tony
 7 Sondhi.

8 There are about three or four points that
 9 I wanted to just go back to.

10 One of the issues that was raised was we
 11 would like to know how far we are from the cliff.
 12 Unfortunately you're often told you are a distance
 13 from the cliff and there's a review at the national
 14 office level and you discover that your audit partner
 15 was actually wrong but you don't have any resource
 16 anymore, you have got to fix that.

17 Those -- the seemingly arbitrary nature of
 18 those types of decisions is something that investors
 19 would benefit understanding better. The other issue
 20 though is a little bit different. I'm concerned
 21 whether it is pass or fail or a different type of
 22 grade, the problem is that it is still scorekeeping.

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1 That's what they're telling us. They're
 2 not giving us better information. It is unclear to
 3 me whether to some extent we are really wondering
 4 whether auditors ought to tell us more of their
 5 analyzing the company.

6 One of the things I will briefly tell you
 7 about, one of the ratios or rate analytical methods
 8 that I use a great deal is to look at what I call the
 9 cash cycle of a firm. Look at the number of days it
 10 has inventories on hand. Add that to the number of
 11 days it takes to collect its receivables and subtract
 12 from that the number of days it takes to pay its
 13 suppliers. I call that the cash cycle.

14 It has been shown for the last several
 15 years to be a very, very good indicator of companies
 16 that are in trouble.

17 Now just imagine the amount of time it
 18 takes, and if it takes you about -- you can plan
 19 about two to three years in advance, that means there
 20 was something seriously wrong with those numbers in
 21 the financial statements.

22 When the sales outstanding continues to

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1 climb, is it not normal to expect that the analysis
 2 of uncollectables should have been done a little bit
 3 differently? Well, that's one of the estimates that
 4 I'm assuming auditors are looking at.

5 Another comment that was made was that
 6 there are some issues with respect to the estimation
 7 errors in fair value.

8 Well, what about the estimation errors in
 9 accruals?

10 We've learned lately there are tremendous
 11 estimation errors in the amount of liquidity that
 12 people report, too. If we don't look at the auction
 13 rate preferreds and money markets with some care, you
 14 can tell people yes, they have this one in auction
 15 rate preferreds, but we're not saying whether you are
 16 going to collect them.

17 When you look at it from that perspective,
 18 or you take the issue of whether the existence of
 19 off-balance sheet financing activities, the existence
 20 of special purpose entities, of variable interest
 21 entities, is really an issue between the accounting
 22 standard setters and that between the PCAOB, my

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1 question is the existence of such vehicles such as
 2 special purpose entities and the variable interest
 3 entities, other off-balance sheet activities, they do
 4 suggest a certain amount of risk. The fact that
 5 we're not going to account for them doesn't eliminate
 6 the risk.

7 From that perspective, I think we need to
 8 look at this a little bit differently. Yes. There
 9 are errors in estimation. I served on the expert
 10 advisory panel on measurement of fair value for
 11 illiquid securities. We did come up with ways to do
 12 a sensitivity analysis. Part of that now is part of
 13 the standards.

14 The question is what should I expect the
 15 auditor to be able to tell me about these things,
 16 other than saying that somebody actually showed them
 17 a spreadsheet which had some of this analysis?

18 Is the conduct, is completion of an
 19 analysis a sufficient audit process?

20 MS. HILL: Bonnie Hill.

21 I'd like to go back to something that Anne
 22 said that I think really goes to the heart of the

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1 matter of the disclosures or transparency, however we
 2 want to define it.

3 That has to do with public and non-public
 4 information, how much information -- you know -- is
 5 the company willing to share, or the auditor, because
 6 of the exposure that they have -- you know -- in the
 7 legal sense as well.

8 What comes to my mind is discussions we
 9 have in the board room or in the audit committee on
 10 materiality and what a particular -- what our
 11 auditors thought and what our internal audit partner
 12 and our finance people thought, and if there's a
 13 difference there, how they got to the place that they
 14 did. We have those discussions. There are a lot of
 15 things like that you will discuss as it relates to
 16 the auditor's report even before it is actually
 17 published, that are not things that you're
 18 necessarily going to shed the light on for the
 19 general public, because on a daily basis or a monthly
 20 basis or whatever the case may be, you'd have your
 21 stock price jerked around in some incredible fashion,
 22 because people just don't know how it's going to come

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1 out when you are working through issues.

2 I think when I talk about the

3 transparency, I think the important thing is what is

4 the process that you use, how do you resolve

5 discrepancies and if there are serious issues, then I

6 think of course those have to be disclosed.

7 But from my experience what happens is you

8 go to a certain point and the lawyers will say that's

9 non-public; and you can't disclose that.

10 So as we move forward, I think what we all

11 agree on is very important, which is making certain

12 the investor knows what kind of risk they're taking.

13 Those risks are being evaluated on almost

14 a daily basis inside the company and inside the board

15 room and with the auditors; and much of it, you're

16 just not going to get. You can get a longer report

17 and what it's going to say is we've used this type of

18 process to get to this place and our conclusion is

19 thus.

20 I just don't think you're going to get the

21 detailed description of everything that take place.

22 MR. HARRIS: Well, Bonnie, Norman, Kelvin,

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1 thank you for leading that discussion.

2 Why don't we take a 15-minute break until

3 a quarter of 4:00, and then we'll be back and

4 conclude at 5 o'clock.

5 (Recess.)

6 MR. HARRIS: Why don't we get started with

7 our next panel, which is auditor expertise and

8 responsibilities.

9 And Charlie, why don't you go ahead and

10 introduce the panel?

11 MR. NIEMEIER: I think it is appropriate

12 that our last session with a designated subject

13 matter is kind of wide-ranging, auditor expertise and

14 responsibilities.

15 Certainly we've heard some comments that

16 go from auditors' level of knowledge of complicated

17 financial instruments; certainly knowledge of

18 accounting standards, and accounting standards

19 especially in the environment in which there is a

20 great promise of some fairly drastic changes in the

21 accounting standards; disclosures; issues related to

22 whether to include references to the internal

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1 function in the auditing standards; as well as adding

2 a forensic audit component to the standard audit

3 process.

4 To lead us off Robert Tarola will start,

5 then Tony Sondhi, and then last but not least, Judge

6 Sporkin.

7 MR. TAROLA: Bob Tarola speaking.

8 I want to take the group down memory lane,

9 those of you with gray hair; and there are a few of

10 you in the room.

11 Thirty years ago companies produced

12 financial statements and auditors provided an opinion

13 on those financial statements and that was basically

14 the financial reporting that investors received.

15 Move forward a little bit. Management's

16 discussion and analysis was required, I'm going to

17 guess in the late Seventies, and the auditors

18 reported on the statements.

19 And then more disclosures were requested

20 around risks and exposures, and auditors reported on

21 the financial statements.

22 And then more disclosures around

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1 compensation and enterprise risk management, and

2 auditors reported on the financial statements.

3 The point I'm trying to make here is that

4 companies are producing comprehensive reports about

5 their business, about how they're managing their

6 business, about how they're compensating executives,

7 their philosophies around risk management; but the

8 auditors are looking at the financial statements.

9 From my perspective anyway, that's a far

10 too limited role for auditors in helping investors.

11 That they touch every page of those reports, whether

12 it is a 10-K, a 10-Q, or a proxy, yet their

13 responsibility is to the narrow part of it called

14 financial statements.

15 I've been an auditor and I've worked with

16 auditors as a CFO and as an audit committee member;

17 and they crawl all over the company. They know

18 whether or not the disclosures about the business are

19 fair and reasonable.

20 They assess whether or not the

21 measurements for executive compensation are correct

22 and accurate. Yet, we don't call upon them to make

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1 any sort of comment about the larger aspect of the
 2 company's financial report. We limit their role to
 3 the financial statements.

4 I believe the PCAOB has the ability to
 5 expand the role of the auditor to more than just the
 6 financial statements.

7 I think investors would be well served if
 8 there was a type of validation that was applied to
 9 the entire company report by the auditor, not just
 10 the financial statements themselves, again not even
 11 going to the discussion of the financial statements.

12 So our panel is to talk about auditors'
 13 responsibilities and the expertise to carry out those
 14 responsibilities.

15 If the role of the auditor was to expand
 16 beyond the financial statements, it's going to take a
 17 different expertise; and I'm going to let Tony pick
 18 up on that.

19 But as an investor when I think about
 20 myself personally or my role in investment companies,
 21 what the market really wants is a validation of the
 22 value factors in the marketplace.

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1 Wants a validation of whether or not
 2 market risk is fairly assessed.

3 What role could the auditor play in
 4 helping the market get comfortable with the elements
 5 of valuation, whether it's integrity of management,
 6 ability to continue to grow, whether it's the
 7 prospect of a new product, whatever factors may be in
 8 the marketplace that are generally discussed in
 9 company reports? What role should the auditor play
 10 in helping validate the broad base of information in
 11 the marketplace, not just the financial statement?

12 And then Tony, what expertise would they
 13 need?

14 MR. SONDHI: I'm going to talk about three
 15 specific areas, disclosures, because that's what --
 16 as an analyst -- I always focus on.

17 Securitizations, off-balance sheet
 18 activities and derivatives.

19 Now with respect to disclosures, you know,
 20 those of you, all of us here, of course, have read
 21 footnotes on financial statements and we know that at
 22 the bottom of the page, every one of them, every page

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1 it says these footnotes are an integral part of the
 2 financial statements.

3 But for the 10 years that I've been on the
 4 standards-setting bodies one of the first things I
 5 remember telling the EITF the day I joined them was
 6 that it seems as if there are two laws that we
 7 operate by. One is that we don't talk about
 8 accounting after 4:00 p.m. on Fridays. There is a
 9 corollary to that we never discuss disclosures before
 10 4:30 p.m. on Fridays.

11 And if you go back and look at the EITFs,
 12 you discover so many of them don't have disclosures.
 13 I don't understand that. They're supposed to be
 14 accounting standards. Think about one of the biggest
 15 changes we had in recent years, the accounting
 16 standards on stock options. When 123-R became
 17 required, a lot of companies discovered they didn't
 18 have enough information to calculate certain deferred
 19 taxes. However, they were supposed to have been
 20 doing that for 10 years at that point.

21 And they all had audits for 10 years at
 22 that point; and yet, they didn't know anything about

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1 their -- or sufficient information about their
 2 deferred tax assets.

3 Now that's just in a sense one example.
 4 We've had -- we have more than a hundred accounting
 5 standards on revenue recognition. There are few
 6 components of financial reporting that are as poorly
 7 served by disclosures as revenue recognition.

8 The EITF 00-21 which talks about multiple
 9 element arrangements -- we used to have two
 10 requirements which are fundamentally just
 11 descriptive: Every one of the accounting firms that
 12 was writing about the replacement, the amendment to
 13 0021 EITF 081 starts off by saying there's going to
 14 be a tremendous expansion in your disclosures
 15 requirements, which the way I see it, now you're
 16 going to have to talk about what you were doing.

17 So in that sense, I think disclosures have
 18 been unfortunately neglected. And I don't understand
 19 why auditors don't audit the disclosures to the
 20 extent that they, I believe, they should.

21 Securitizations, the other off-balance
 22 sheet activities, as I said, those accounting

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1 transactions there may be to some extent problems
2 with our accounting standards, special purpose
3 entities, QSBs, for example, which we finally have
4 gotten rid of. But the point is that there is a
5 substantive amount of risk that remains on the books.
6 You don't find a lot of companies actually selling
7 their -- those kinds of assets.

8 However, we created an accounting standard
9 that permits the recognition of a sale transaction.

10 Lawyers give true sale opinions. And they
11 give the consolidation opinions. But you could ask
12 one lawyer or two lawyers or three lawyers and you
13 would get a ton of different explanations of what a
14 true sale means.

15 They're not fundamentally either economic
16 or accounting concepts; and yet they've informed our
17 financial statements -- extremely poorly, I would
18 say -- over the years.

19 Consider the disclosures on derivatives.
20 Do you really think it is rational to expect a
21 company that engages in several billion dollars of
22 trading in derivatives to tell you that an X percent

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1 increase on either side in either the interest rate
2 or the foreign exchange risk is not going to cause us
3 any losses?

4 How many people do you know who are
5 perfect, with respect to derivatives? And yet if I
6 read disclosure, they are not going to have any
7 losses as a result of those derivatives. And yet we
8 have these disclosures that are sent to us over and
9 over again -- with clean opinions.

10 Think about -- I'll give you just as the
11 last point, this is sort of eerily reminiscent to me
12 at least of repo 105 transactions, which most of you
13 are probably aware of.

14 A few years ago -- 1999, to be exact -- a
15 company made the following disclosure, and I'm just
16 going to tell you two sentences in it.

17 Year-end was September 30. On the 10th of
18 September, the company created a finance subsidiary
19 and sold it \$600 million of receivables. And the
20 finance subsidiary is 100 percent owned. And the
21 company, in order to make that sale, set aside \$750
22 million in collateral.

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1 Now what do you think? Do you think a
2 sale occurs for 600 million if you have to put up 750
3 million is collateral? But it gets better. The next
4 line: In October, we repurchased all the receivables
5 and shut down the subsidiary. And this was treated
6 as a sale.

7 It is not all that different from repo
8 105, but I don't want to hold them out as the only
9 company that does that. There are a lot of financial
10 institutions that have been engaging in that game and
11 there are a lots of institutions that we don't think
12 of as financial institutions that have also played
13 that game.

14 The point I think is, from my perspective,
15 we need a better understanding of disclosures on the
16 part of the auditors. We need them to review them.
17 When you open up the Dow 30, for example, and look
18 for the derivative disclosures, and for the Dow 30
19 you find that the derivative disclosures in those 30
20 companies read identically, there has got to be
21 something wrong.

22 These are boilerplate disclosures. How

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1 can Exxon possibly be telling you the same thing as
2 GE? And how can an airline have the same wording for
3 a disclosure requirement as a metals company?

4 So in that sense, we need a better
5 understanding of what these financial statements are
6 supposedly telling investors.

7 JUDGE SPORKIN: Terrific stuff.

8 Let me go back a little bit to banks here.

9 While I might hold the accountants -- give
10 them a little tough love -- it shouldn't denigrate my
11 view of the accounting profession.

12 I think that was shown when we created the
13 Foreign Corrupt Practices Act in the late Seventies;
14 and I must tell you, it was based upon the great
15 esteem we had for the accounting profession, because
16 it was thought when the books and records provisions
17 would be put in, that that was done so the
18 accountants would find all the schmutz and be able to
19 disclose it.

20 But let us now talk about -- we have to
21 differentiate some of things we are talking about
22 today, separate the apples from the oranges.

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1 The first thing we expect the accounting
2 profession to do is mine the data. They have to find
3 the data.
4 The second thing is when they find the
5 data, what are they going to do with it?
6 So there are two big issues that come
7 along that challenge the accounting profession.
8 In other words, if they mine the data and
9 don't find what's gone on, obviously they are not
10 going to be able to issue the kind of report that's
11 necessary.
12 In talking about mining the data,
13 something has cropped up over the years in which the
14 accounting profession says we're going to mine it,
15 but we're only going to be looking for material kinds
16 of things; little stuff we're not going to look at.
17 So, therefore, the people on the other
18 side that's trying to defeat this system -- remember
19 there's a tension taking place here. People trying
20 to beat the system. At the same time, you have the
21 profession and the good guys sort of trying to make
22 sure that it's working -- and so we have -- and so

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1 the people who are trying to defeat the system have
2 learned exactly the way the accounting profession
3 works.
4 So we developed the so-called financial
5 audit. The financial audit as I told you before is
6 looking for big things, looking for materiality. Now
7 comes fraud. The accounting profession says -- used
8 to say; it has changed a little bit -- says we are
9 not looking for fraud. And to bolster that the
10 people that are trying to defeat the system, they
11 understand that, so they go under the radar screen.
12 They go out and deal with the system so they can beat
13 it.
14 For example, if you are trying to bribe
15 somebody and don't want the accountants to find it,
16 you do it by doing the kinds of things in the
17 accounts that they don't look at. Petty cash. I
18 don't want -- we don't want to get into petty cash.
19 It is too small. Yet the people defeating the system
20 use it to get the money to pay the bribes. They do
21 it all the time.
22 The first thing you got to do is devise

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1 this system so that the accounting profession is now
2 going to be looking at that aspect of it.
3 And what is the thing that -- I had to
4 come up with this concept in connection with a
5 client. And so what we did with the client, which is
6 an accounting firm, what we did with the accounting
7 firm is to say okay, wouldn't it be nice to combine
8 forensic accounting with a financial audit, bring the
9 two together so the forensics will look for the under
10 the radar screen and the financial audit will go into
11 their dance with respect to the materiality?
12 This works. We've had one season where we
13 did it. And now we're going back for the second
14 season.
15 I can say to you it will work; and I think
16 hopefully it will become packaged and become maybe a
17 part of the whole system. I don't see any reason why
18 that kind of concept can't work.
19 Second thing that I find when I look at
20 the accounting profession -- remember, I have a -- I
21 was trained as a CPA so I have a little accounting
22 background -- second thing I found which I think is

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1 quite interesting is the fact that when the SEC looks
2 at a transaction is different than when the
3 accounting profession looks at a transaction.
4 Why, I don't know. But it is like night
5 and day sometimes.
6 And so the concept there that I am trying
7 to develop is a concept of a compliance component in
8 an accounting firm, that will look -- at the end of
9 an audit, go through the audit and look at the items,
10 based upon now -- we have a history now, of so many
11 things involved in trying to defeat the system that
12 they will know fully what they are. Whether it is
13 the 105s, whether -- each time we get another one of
14 these -- of these -- these things such as the 105s or
15 the special purpose entities, to build your -- build
16 a -- information concerning them.
17 Have this person who's highly trained in
18 this area to look at the audit, step back, and say
19 wait a second, what is it that this -- does this
20 audit show any of these items? And if so, to be able
21 to see how they were dealt with. And so that's
22 something that I think is important.

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1 Now, the other area -- remember I talked
2 about mining, getting the information, bubbling it
3 up, getting it up to the top.
4 The second area now is what -- how does
5 the accountant handle this? The accountant now
6 knows -- let's assume my system works -- he now knows
7 what the problems are. And now we get back to, I
8 guess it was Turner's point, what I used to call the
9 exception list that the accountants have at the end
10 of the audit; and to take up and sort of getting into
11 negotiation with the company.
12 And here we have the same problem we were
13 talking about today: Does the accountant have the
14 fortitude to be able to stand up to the company and
15 tell them that with respect to these items, they've
16 got to be dealt with right?
17 I remember I had one case where an old
18 fellow named Bluhdorn -- I don't know if that name
19 means anything to anybody anymore -- but he had an
20 asset on Gulf & Western. It was \$28 million. In
21 those days, millions meant something, in a company
22 that was kaput, so he came up with a scheme.

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1 The company invested in sugar plantations.
2 He went around and was buying sugar plantations.
3 What he would do, he would give them cash and some of
4 the kaput company, and say okay, I'll pay 5 million
5 plus I'll give you 2 million of this kaput company.
6 And so he was able through this way of
7 buying a number of these, to take off completely the
8 bad asset, and then went into the sugar plantations
9 where nobody would even know about it. In any event
10 as property went up in value, it would mask what they
11 were doing.
12 And I remember calling in the head of the
13 audit firm, because we were ready to take action, and
14 the fellow was quite candid. He said to me, Stan, he
15 said let me tell you something. At the end of the
16 audit we had five items. We sat down with
17 management, and you know what? We won on four of
18 them, 80 percent. He said that's not a bad
19 percentage. Therefore, we had to give them this one.
20 You know, I had to tell him that 80
21 percent might be good in certain things but it isn't
22 good in accounting.

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1 Therefore, how do you get the profession
2 and the accounting firm to stand up and say look, no,
3 we're not going to go for it, we are going to go for
4 the 100 percent.
5 We saw today where we were talking about
6 this business of the foreign auditor; and -- you
7 know -- it's common for people to be worrying about
8 other people's concerns; and I've learned through my
9 many, many years that once you compromise your
10 principles and say well, it might not be that bad, it
11 is a prescription for disaster. It happened with the
12 SEC in the Madoff case. It happens all the time.
13 So how do you inspire or get the
14 accounting profession -- this is, to me I think is a
15 core issue -- that once they have to make a decision
16 that's tough on their client for them, to say yes,
17 that they're going to go through with it. That I
18 think is really the core issue. The mining can be
19 taken care of, as I told you about the combination.
20 But the real problem is once they know
21 about it -- this is not something they don't know
22 about -- but once they know about it, to carry

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1 through and tell the client no, they cannot do what
2 they want to do. I don't know how you get, other
3 than by getting people like the PCAOB, when they find
4 it, to be able to say folks, you're going to get --
5 it is going to cost you.
6 And I think that's where we have got to do
7 it.
8 That's my sermon for the day.
9 Charlie, what do you think?
10 (Some laughter.)
11 MR. NIEMEIER: You're my hero, Stanley.
12 MR. HARRIS: Kelvin, I think you mentioned
13 in your priorities a modified forensic, either the
14 concept of a modified forensic and then I think you
15 indicated that was in a report, The Global Capital
16 Markets and the Global Economy: A Vision For the
17 CEOs of the International Audit Networks issued in
18 November of 2006 for consideration.
19 Do you want to spend a minute or two and
20 review some of your thoughts on that as well?
21 MR. BLAKE: Sure. I mentioned some type
22 of modified forensic audit where there's been known

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1 fraud.

2 Perhaps the PCAOB and the other auditing

3 agencies should impose some type of forensic audit

4 requirement where it requires to go beyond the

5 routine financial statement audit and require more

6 in-depth analysis of the transactions.

7 One of the things I suggested based upon

8 my background as a compliance auditor is when I do

9 audits and I go and do the audits and notice some of

10 the examiners from other states, they may want to

11 focus on looking at a set -- 10 percent of the

12 transactions, 10 percent of the customer files, and

13 they think they can take that and project it on to

14 the hundred percent of what the transactions would

15 be.

16 But I think that's -- that low threshold

17 is extremely too low, and I think we should require

18 the audit firms to look at more than say 5 or 10

19 percent of the transactions and project it on to the

20 overall population.

21 If you require the audit firm to look at

22 more, a higher percentage of the population, you may

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1 have a better chance of detecting any irregularities.

2 MR. TURNER: Thank you, Steve.

3 I did want to make a couple comments. I

4 have to run to the airport in a couple minutes.

5 I think Tony is absolutely correct in that

6 we spend all week long auditing the numbers but only

7 look at disclosures at 4:30 in the afternoon. That

8 has certainly typically been my experience, and I

9 think he raises a very good point.

10 The professional standards do require the

11 auditors to go get evidence, substantial evidence for

12 the footnotes, but they tend to do it at the last

13 moment, ask a client to give them some schedule that

14 will tie-out to the footnote, and boom, they're done.

15 Actually, probably some more guidance

16 would be helpful; but more than anything, would be

17 some good strict enforcement. If out of your

18 inspections and out of your enforcement program you

19 took a hard look at these, and actually took

20 enforcement actions against some firms that had

21 failed to do -- gather the evidence they needed for

22 the footnotes, I think that would be excellent.

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1 I know you're hamstrung now because of the

2 private nature of your enforcement actions.

3 Fortunately, Stanley had -- and those of us at the

4 SEC -- had a much more public enforcement regime. We

5 made 102Es a public process during Dan's stint as

6 general counsel, much to his credit. I honestly

7 think you absolutely need to go get legislation and

8 get a change here in order to be able to make your

9 enforcement actions public.

10 Keeping them private has proven just to

11 engender the accounting firms to fight you all the

12 way through. I think, one, that dramatically needs

13 to be changed. As an investor I would like to see

14 that happen, so we get timely enforcement.

15 I think if you took a couple of

16 enforcement actions against a couple firms on

17 disclosures, and your inspection process came out

18 with -- I think -- came out with a 4020 report that

19 said here in general are some shortcomings we have

20 seen from the inspections, I think the combination of

21 those things would be very helpful.

22 As far as expanding the auditor's role, I

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1 have been a fan of having the auditor go ahead and

2 give a report on MD&As. Quite some time ago there

3 was a standard the profession floated. Actually, I

4 think about the same time Dan was the general counsel

5 as well. Nothing has happened with that. I think

6 having an auditor report providing some assurance

7 around what is in that MD&A report and the

8 completeness of that report to us, about the trends

9 and what's going on with operations, would be of

10 tremendous help.

11 On the forensic angle I do chair the audit

12 committee of a public entity where we do engage the

13 auditor and pay extra to have a forensic accountant

14 come in each year and do work for us.

15 We design that each year around the

16 particulars; and I sit down with that person and say

17 here is what I want you to do for us, but we do have

18 a forensic piece of it. I think it is very good in

19 that it keeps people on their toes and has been good

20 in framing the mindset of the auditors, the regular

21 auditors, if you will.

22 I think as the O'Malley panel recommended,

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1 building some type of that forensic expertise and
2 notion into the regular audit would be very
3 beneficial. I've done it and find it to be very
4 helpful and good, and I found that it has in some
5 instances done a very good job then of informing the
6 audit staff of some things they haven't focused on
7 and subsequently did. I'd be a big supporter of
8 doing that.

9 MR. HARRIS: Thank you. Joe, before we go
10 to you -- I don't know, Meredith, I know you have to
11 take off for a plane shortly as well. We can go to
12 Joe but if you have comments you'd like to make
13 before you clear out of here, certainly take the
14 opportunity.

15 MR. WILLIAMS: Thank you, Mr. Chairman. I
16 apologize for having to leave earlier. I have an
17 engagement with some of those 463,000 members
18 tomorrow morning in western Colorado.

19 I'm a strong supporter of the forensic
20 approach. I think it is a different mindset. I
21 think it does a wonderful job of keeping the entity
22 on its toes, just knowing a different look will be

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1 taken on a regular basis.

2 Going back to my rotation pitch, I would
3 suggest that it not be the same forensic accounting
4 firm each year. I see them probably working --
5 whether they work separate and then report directly
6 to the company, the audit committee, or if they're an
7 adjunct to the regular audit effort, just to have
8 that presence I think is the most important thing.

9 Thank you.

10 MR. HARRIS: Since we've heard it before,
11 I'd like to get the response from the Judge, Kelvin,
12 and you in terms of the cost and how we deal with
13 that.

14 Judge, we raised it with you. I'd like
15 all three of you to respond to that.

16 JUDGE SPORKIN: This has come up in
17 connection with Foreign Corrupt Practices Act
18 matters.

19 My discussion with my clients, other than
20 the accounting firm, is since I think they all have
21 been faced with FCPA issues, they think it is
22 terrific. They think it is much cheaper than having

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1 to go through a Siemens -- what -- \$1 billion
2 investigation. And so the cost really hasn't been an
3 issue there.

4 Remember, you are going to have to do a
5 lot of risk assessment as to what you are going to
6 look for and how you do it. You are not going to go
7 in and do a general forensic one. It shouldn't be
8 that much. I have not yet seen a pushback on the
9 cost. Probably will be there, but we'll have to wait
10 and see.

11 MR. WILLIAMS: I totally agree with Judge
12 Sporkin. I believe on a risk-reward basis, you can't
13 afford to go in the other direction.

14 Again, I think it would require a regular
15 assessment of where you want to focus those resources
16 in any given time frame. I think that would change
17 over time as the risks change. Small price to pay.

18 MR. HARRIS: I guess you are out of here,
19 too. Why don't we go around that way?

20 MR. TURNER: Just real quickly. I have
21 done this. We made it part of our audit process.
22 The cost was fairly negligible in

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1 comparison to the audit partner audit fee. It was
2 not that significant to have it done.

3 The benefits in terms of what they learned
4 and how that informed the audit, improved the audit
5 process in and of itself, including some risk and
6 some things we needed to change, was very helpful to
7 the audit team, as well as to the audit committee and
8 the board, so that was very helpful.

9 And when you look at the benefit, though,
10 you also have to measure what happens in the market
11 when you find these things; and if we could have
12 avoided even a small fraction of these losses, and
13 headed off some of this stuff, the benefit would have
14 been tremendous.

15 The one thing that I've seen when you did
16 these forensic audits, we've all talked about how is
17 it that the auditors never saw, management never saw,
18 or the board never set up and said anything about
19 these subprime loans, and things people were
20 engaging, the repo 105 transactions, the one thing I
21 found out is that forensic auditor is the person who
22 walks in the room and says "time out. What are you

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1 people thinking?"

2 That's what that -- my experience has been

3 that's what that forensic person does. And the

4 benefit of having had -- if we had some people in

5 these rooms at a Countrywide, you know, at a

6 Citigroup, at an AIG, standing in there and saying

7 "time out, what are you guys thinking about," the

8 benefit would have been immense to us and the costs

9 would have been a drop in the bucket.

10 And you know, like I said, we do do it.

11 MR. HARRIS: Joe. We'll go right around.

12 MR. CARCELLO: Yeah. And that's where I

13 wanted to go, Steve. And I think -- what I heard, I

14 thought was very good, from Bob was talking about if

15 I heard him right additional audit report involvement

16 with the MD&A, maybe the CD&A, ethics hot line, ERM

17 system, I agree that they're all important and I

18 think auditor attestation on those would be useful.

19 Then I hear the Judge talk about the forensic audit.

20 I think that would be extremely useful.

21 As I was sitting here, the issue that came

22 to my mind is exactly the issue that you raised.

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1 That is to the extent the auditor is involved in

2 these phases, would the benefits exceed the costs?

3 And so I want to pose a question to Gus and to Anne

4 and -- Gus is with obviously a very large mutual fund

5 complex. Anne is a large pension fund. To a lesser

6 extent, a little different, Pete, Norman representing

7 what -- in my mind a hedge fund and private equity

8 group.

9 And because if you propose this, here's

10 what's going to happen. Management is going to say

11 no, we don't want to pay the extra fees, but it is

12 not their money. It is in Gus's case my money, my

13 401(b) and 303(b), but he has to make the decision.

14 There's too many of me.

15 So how much value does this have for

16 investors and what is -- you know -- what's -- what

17 are you guys willing to pay for? That's the

18 decision. Not what management says. That's really

19 kind of irrelevant.

20 MR. NACHTWEY: I actually think this

21 dialogue has been great. I expand it beyond the

22 forensic, although I have a healthy respect for what

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1 forensic accounting can do.

2 Look what we do when we buy a company. In

3 our portfolio we have about 500 entities across 67

4 different funds. We rely on our investment

5 professionals basically to go in and identify what

6 the risks are, and what we kind of want to peel back

7 layers of the onion on every single company we look

8 at.

9 We get a matter of weeks if we are in an

10 auction or bidding process. The kind of things we

11 bring in in addition to the forensic side, if we have

12 concerns, are going to be evaluation experts,

13 actuarial experts, oil -- whether it is oil reserves

14 or long term construction contracts or complex

15 manufacturing contracts.

16 Getting that kind of expertise involved,

17 from our standpoint, the diligence a company you are

18 looking at buying is the same thing that auditors

19 need to be doing to say are the financial statements

20 that all of us are relying upon to make investment

21 decisions reliable?

22 The challenges -- and I think most of the

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1 accounting firms have maintained at one point or

2 another resources in all of those areas. I think

3 where most of them are today, forensic accounting,

4 and valuation is almost standard table stakes,

5 because you have got to have those experts and

6 probably actuarial.

7 But the issue is getting the clients to

8 pay for it because that's again one of our big

9 challenges. We didn't spend a lot of time talking

10 about that. At the end of the day the clients pay

11 for the audits. How do we make sure that's -- if it

12 is part of the audit standard where every accounting

13 firm has to do it, so there is no optionality. If I

14 want to go look at -- geez, firm X is going to foist

15 all these experts on me but firm Y is going to say I

16 don't need to use them in the audit, I think we --

17 again something that this group could possibly help

18 with or the PCAOB could help with is taking the

19 optionality out of the audit.

20 Second is how do you maintain the

21 capability. That's more of a business issue. You

22 need world class people facing off. You don't want

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1 to have a young capital markets guy at one of -- a
2 guy or gal at one of the accounting firms going up
3 against Fab whatever his name is at Goldman Sachs,
4 without the same level of talent, energy, experience.
5 And how can they maintain that inside the Big Four if
6 they are just audit support? Allowing them to be in
7 the business commercially helps them to maintain the
8 expertise.

9 Last but not least, we talked a lot about
10 disclosures for companies in financial statements.
11 Maybe there should be some disclosure around the
12 experts used in an audit, so that we as investors or
13 users of the financial statement, if we're looking at
14 an insurance company and there are no actuaries
15 involved or an oil company and there are no engineers
16 involved to understand oil reserves, you might
17 scratch your head a little bit. Just some thoughts.

18 MR. HARRIS: Gus.

19 MR. SAUTER: That is Gus Sauter. Joe
20 asked the question what do we think as investors of
21 other people's money about the costs of requiring
22 forensic accounting?

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1 And number one, I'm going to say I'm
2 probably at odds with the rest of the people around
3 the table, perhaps because I don't know what the
4 costs of forensic accounting would be. Lynn said it
5 is really not much. I think Judge Sporkin pointed
6 out you wouldn't just blindly do it across the board;
7 you would measure risks and apply it accordingly.

8 Costs do matter at the end of the day. It
9 is not just the level of the costs but the total
10 value over time of those costs as well.

11 So if we're talking about really what
12 could be hundreds of millions of dollars of
13 additional costs of accounting, that could
14 be billions of dollars worth of value when you assign
15 a PE ratio to it.

16 Nevertheless, it has been pointed out if
17 you catch one bad actor, that could pay for that.

18 So on the one hand, I ask the question
19 does it need to be an independent forensic accounting
20 or something we require inside of a normal audit?

21 Audit firms perhaps should have this
22 capability themselves. It is not -- forensic

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1 accountants aren't super accountants, why wouldn't
2 this be something that the accounting firm could do?

3 So I come at this from two different
4 directions, saying there certainly can be some
5 benefit to it, particularly when you catch the bad
6 actor; but I am concerned about costs and I do raise
7 the question about what the form should be. Is it
8 truly an independent forensic accountant? Could it
9 be -- should it be required of auditors in general?

10 MR. CARCELLO: Can I follow up with Gus?
11 Some of the Big Four -- they probably all do, but I
12 know specifically on at least some of them they
13 actually have very complex algorithms as they plan
14 the arrangement. Financial characteristics,
15 governance characteristics, a whole bunch of things
16 you could probably think through.

17 They've essentially back-tested these
18 algorithms against restatements, and they assign
19 loadings out of a regression on the factors and come
20 up with a risk score. So it is essentially a risk
21 model. And if the risk score is above a certain cut,
22 this particular firm requires involvement by forensic

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1 auditors.

2 But that's a voluntary decision. Would it
3 make sense from an investor perspective at least --
4 you know -- from your point of view, maybe not to go
5 to a blanket forensic requirement, but to say if risk
6 is assessed as high -- and you have to be careful
7 with language -- but if risk is assessed as high,
8 then that's a requirement on the audit?

9 Then the cost is more targeted to where
10 the risk is higher.

11 JUDGE SPORKIN: Let me mention what my
12 model is and where we're testing it. My model is
13 every firm has a forensic component. The problem is
14 when I went in there, I found out that that forensic
15 component was doing work with third-party companies,
16 not with their own clients. So the answer is yes,
17 you use your own, the accounting firm under my model
18 would use its own forensics so there is a synergy and
19 everything else there.

20 You know, you don't have to be a genius to
21 figure out that if you're doing business in China or
22 in some other foreign country where you have a high

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1 risk of bribery, that right away tells you that you
2 have to do something. Any company that's doing
3 business in those countries, that's doing so like a
4 horse with blinders. And not worrying about this,
5 you know, it is a no-brainer. How can they just walk
6 in and say well, we're not going to consider any of
7 this?

8 So it's -- to me, it became obvious, this
9 kind of thing as to how you have to put these
10 things -- these two together. It is no genius here.
11 You put them together because you see, you know
12 that -- all you have to do is talk to an accountant.
13 He's talking about materiality. He doesn't want to
14 look at that thing, it is not material. You talk to
15 your forensic and he's interested in the low hanging
16 fruit. He's interested in looking at that.

17 So that's it. But you should use the same
18 accounting firm to cut down on costs. There is no
19 reason it has to be independent. I think it would be
20 too disruptive and there would be too many -- already
21 there are some disagreements we're finding in
22 connection with my analysis of the pilot program that

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1 we're using.

2 There is some contention there, but that
3 can be worked out.

4 MR. HARRISON: First on the resource
5 question, I think the Judge is absolutely right.
6 Joe, the -- in my experience, the Big Four firms
7 certainly have a talented pool of auditors and
8 accountants with forensic backgrounds. Most of them
9 reside in the advisory practice. As the Judge said,
10 they're providing those services but perhaps to
11 non-audit clients. But I think the resources are
12 certainly there. It would be a question of
13 allocation, how to build that into the model.

14 With regard to your question, Joe, about
15 how much -- what's the value or how much would
16 investors be willing to pay, I'm going to answer it
17 like a lawyer, not like an investor.

18 My answer is the lawyer's typical answer.
19 It depends. It depends on what we're getting, what
20 incremental comfort or assurance we're getting from
21 the additional effort, I think.

22 Tony in his opening comments made

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1 reference to the expansion of scope of areas or
2 resources in an audit process in an effort to achieve
3 some validation of things.

4 I think when you start down the path to
5 validation or verification, I've often wondered if we
6 were going to go back to square one and design the
7 auditing process or profession all over again, would
8 we find or get to a point where there is sort of a
9 fundamental mismatch between what auditors are
10 selling and what issuers want to buy. Is it more
11 like assurance?

12 If so, what does that tell you about the
13 business model, about pricing, about risk, about
14 liability, all these issues?

15 There are a lot of big macro issues here
16 that I think your subject touches upon in terms of
17 what it is that we hope and expect, and I think
18 sometimes perhaps wrongly assume, that the audit
19 process is delivering to us.

20 If we could really get it, it would be
21 something presumably that you would be willing to pay
22 more.

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1 MR. BECKER: Just a couple of brief
2 observations. Just a reminder, we had a conversation
3 about a fraud center or "some lessons" learned
4 assessment earlier today. And it would seem to me if
5 you had a more robust one, it could help supplement
6 and assist the risk assessment process of what you
7 did with your forensic audits, and help bring a
8 better identification of where you wanted to allocate
9 those resources.

10 With respect to the cost issue, I concur
11 with the "it depends." If it is just another check
12 list of items that are an added expense across the
13 board, I don't think it provides much value added.
14 If it is the kind of sensitive assessment of risks on
15 a targeted basis, and you can assure me that Judge
16 Sporkin is doing that on each menu item, then I think
17 it will provide value added.

18 That would be, the trade-off is whether it
19 became a more mechanical process rather than a well
20 textured assessment of individual risks.

21 Third, I think it was Peter who mentioned
22 earlier, one of the things I'm most concerned about,

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1 apart from forensic, is whether we maintain the
2 expertise and talent within the audit function.
3 So for me, independence, other issues,
4 what migrates into advisory are interesting questions
5 and we use various prophylactics and rules to do
6 that, but what I worry about structurally is if we
7 siphon off all the key talent into those foundations
8 then how do we maintain the talent in the audit
9 function, in the audit process.
10 While I don't want to denigrate the
11 importance of the Foreign Corrupt Practices Act in
12 maintaining the integrity of our payment structure,
13 valuation issues, getting a good assessment of the
14 quality of earnings, is critically important going
15 forward in trying to assess the financial reports of
16 companies. And even more so, I would say, in some
17 instances -- without trying to sound sacrilegious --
18 than running to ground their particular payments in a
19 jurisdiction -- which we should do. But knowing how
20 they are assessing those risks and having the right
21 talent doing that strikes me as critical to this
22 exercise.

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1 MR. HARRIS: In the information that we
2 circulated, we indicated that we wanted everybody to
3 have the opportunity to express their top priority
4 before we left. We're closing in on 5:00. We have
5 got 20 minutes more. I do want to finish on time.
6 There were three areas that have been
7 brought up that weren't covered. Brandon Becker and
8 Bob, you mentioned executive compensation in the
9 context of audits. Investor education, the
10 expectations gap, Kelvin, you mentioned that. Bonnie
11 Hill, you mentioned it and Meredith is gone so we'll
12 save time there.
13 On inspections, Barbara has gone, too.
14 But Bonnie Hill, you mentioned that and
15 Mike also is gone. I think we're going to be in good
16 shape in getting out of here at the allotted time.
17 We would have in any event.
18 On executive compensation, Bob, Brandon,
19 you both mentioned that. If you want to make
20 comments on it we would appreciate it.
21 MR. BECKER: Briefly the point we tried to
22 make in our written statement -- and I will turn it

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1 over quickly to Bob -- we are going through a lot of
2 gymnastics to try to rope in executive compensation,
3 in particular with clawbacks, multi-year payouts,
4 payouts in stock.
5 Those may or may not be relevant to the
6 underlying issues of a company management; and we
7 certainly have encouraged say, on pay and other
8 investor guidance.
9 But they all strike me at one level as
10 highlighting the fact that we don't trust the
11 earnings that we are reporting, because we haven't
12 been able to build in an effective assessment of tail
13 risk when we make a judgment about complicated
14 financial instruments in many regards.
15 To the extent we can improve some of our
16 quality of earnings assessments so that we have
17 greater confidence we are not going to get these
18 surprises because we haven't valued the instruments
19 correctly in the first place, I think it would help
20 assess and remediate some of the issues that we've
21 identified, in terms of trying to deal with the fact
22 that right now, we think it is such a soft number we

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1 don't know whether two years, four years, six years
2 from now the instrument as it goes through its
3 earning life cycle is just going to explode on us.
4 MR. TAROLA: Steve from my perspective,
5 just taking compensation discussion analysis, there's
6 three major components. There's the measure of the
7 compensation which frankly has some complicated
8 formulas involved in it, whether it is the current
9 value of a pension right or a -- or the value of
10 equity type compensation.
11 Secondly, there's the philosophy
12 discussion, and I guess thirdly, it's how it affects
13 the business of the issuer.
14 How -- whether or not it is really driving
15 the behaviors that the board thinks it should be
16 driving.
17 But that's to me just one aspect of a
18 company's disclosure of their story that could be
19 subject to audit that currently isn't.
20 I try to put myself in the shoes of the
21 board and looking for the auditor to help validate
22 what the board does on behalf of the shareholder, so

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1 that the shareholder gets the benefit of an
2 independent look. The board gets the benefit of an
3 auditor's independent look.
4 And it is across the board, across the
5 entire story of the enterprise, not just the balance
6 sheet.
7 MR. HARRIS: What is the auditor looking
8 for in terms of executive compensation?
9 MR. TAROLA: Where I sit on the audit
10 committee of a public company, we ask the internal
11 auditor to check all the calcs for one thing. We ask
12 the comp committee to make sure that the philosophy
13 is well articulated.
14 And as -- and then the audit committee
15 itself takes on the -- I guess the task of assessing
16 whether or not it's being deployed in a way that
17 promotes what the philosophy is intended to
18 promote -- right behaviors, strategic objectives --
19 and it does so effectively.
20 So it is a combination of risk assessment,
21 pure calculating -- pure rechecking calcs and then
22 making sure that it's doing what it ought to do.

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1 MR. HARRIS: Tony? Gus.
2 MR. SONDHI: Steve, I was going to say in
3 response to your question to Bob, one of the things
4 that I have found in my analysis of compensation is
5 that when the compensation exceeds -- for a
6 particular company, top management exceeds their
7 peers and so on, I find that it is worth taking a
8 look at their financial reporting choices, and I find
9 problems and issues.
10 And one of my classic examples is one of
11 the biggest companies in this country, they were
12 reporting the gain on sale of patents as a reduction
13 of their SG&A, and it was partly because their CEO's
14 compensation was tied to a reduction in SG&A
15 expenses.
16 So these are the kinds of things you can
17 find, these relationships when you look for -- and I
18 think that's one of the things I would ask when an
19 auditor -- it is good for them to check the
20 calculations, but I can check most calculations on my
21 own without any help from anybody.
22 MR. HARRIS: Gus? Bonnie.

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1 MR. SAUTER: Thank you, Steve.
2 We deal directly with companies that we
3 own. We talk with them on a constant basis, send
4 them a letter and tell them what we expect them to do
5 with regard to executive compensation. We want to
6 know what incentives they have aligned and whether or
7 not those incentives are aligned with best value for
8 us.
9 We let them know if we don't like their
10 compensation incentives we will vote against all the
11 members of the comp committee. We want to know the
12 magnitude of the compensation. Certainly, you talk
13 about a CEO that supposedly added \$500 million worth
14 of value to a company and is therefore deserving of a
15 hundred million -- quite frankly we find that a
16 little difficult that somebody else could not have
17 added 450 million. Maybe 50 million would have been
18 just fine. There is a maximum level where we think
19 compensation gets to be too high.
20 Nevertheless we are not supporters of say
21 on pay. Honestly, we think it is one of those
22 questions that it is almost like asking have you

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1 stopped beating your spouse? And you almost can't
2 answer it without -- with some degree of objectivity,
3 that most people are going to say, no, I don't like
4 compensation. Well, it is supposedly nonbinding at
5 least at this point in time. I don't know if it is
6 at some point in time, but I think a lot of people
7 just aren't able to say whether or not pay levels are
8 appropriate, and yet have the ability to vote on it.
9 So I must say we are not in favor of say on pay.
10 Steve, you asked what is the auditor's
11 responsibility for this. Is this just -- it's
12 information that's required in the financial
13 statements. I think one thing the auditor could
14 divulge is the incentive. So are the incentives
15 really truly aligned with the investor; and a comment
16 on that from the auditor, I think would be helpful to
17 individual investors.
18 MR. HARRIS: Bonnie?
19 MS. HILL: Bonnie Hill.
20 A couple of things as it relates to
21 compensation. One is there's a tendency to look at
22 just the upper level of compensation when you're

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1 looking at risk. There are levels of compensation
 2 throughout the organization, places where there could
 3 be a real risk of fraud. We would look for the
 4 auditors to help identify those, as a matter of fact
 5 put those down as questions for them when they go
 6 through the organization. Do you see any areas in
 7 which a particular employee or group of employees
 8 have the ability to put the company at risk? And
 9 they may not be the highest paid.

10 So that becomes important.

11 I'm with Gus on the say on pay part. One,
 12 the compensation committees spend countless hours
 13 sorting through compensation. It is not very easy as
 14 you know when you look at the proxies and try to
 15 decipher all of the various charts. We, I am in
 16 favor of shareholders having a conversation with the
 17 compensation committee or the company prior to having
 18 to make that kind of vote.

19 So if they've been following it, and the
 20 year before they saw something they didn't like, I
 21 would encourage that they have that discussion with
 22 the company, because a straight up or down vote does

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1 absolutely nothing. I've had some shareholder groups
 2 say it gives us an opportunity to have dialogue with
 3 the company. Well, you have access to the company
 4 and should have that dialogue in advance.

5 The shareholders own the company and the
 6 board reports to the shareholders for the most part.
 7 In that regard I would rather see dialogue on
 8 compensation prior to a straight up or down vote.

9 MR. HARRIS: Anne?

10 MS. SIMPSON: Anne Simpson, CALPERS.

11 I'm concerned about overstressing the
 12 auditor by suggesting they start looking at
 13 compensation.

14 The board has a job here. Just harking
 15 back to what was said earlier, that we need to look
 16 at this whole series of checks and balances and roles
 17 and relationships in its totality. So this is why it
 18 matters that we have majority voting so that you can
 19 vote no, not just I withhold on compensation
 20 committee members. That really matters.

21 Proxy access really matters.

22 And staggered boards are a problem.

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1 Because of those barriers to the board being
 2 accountable, we're hunting around for these ways,
 3 like say on pay, invented in the U.K. as bit of a
 4 feather duster to tickle public opinion with. It
 5 doesn't get to the heart of the problem.

6 I think there are few circumstances where
 7 you need individual detailed discussion. The big
 8 picture stuff is clear. You need money at risk, you
 9 need performance measures which fit with the strategy
 10 in the life cycle of the industry.

11 And just benchmarking yourself to what
 12 everyone else is doing is often a problem, because
 13 they are all Lake Woebegone, all "above average"
 14 chief executives and before you know it you have
 15 sectors where it is beyond control.

16 I agree with what Bonnie said. For the
 17 auditor's role it is about tying it into risk
 18 management and their appraisal and responsibilities
 19 in that department. Let's not try to load the
 20 auditors up with everything. That's what the board
 21 is there to do.

22 MR. HARRIS: Mike?

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1 MR. HEAD: This is Mike Head.

2 I mirror a lot. I think table stakes is
 3 making sure the disclosures in the proxy are accurate
 4 and reliable. That's a combination of internal
 5 auditors and external auditing. From an audit role
 6 point of view, I think there are some venues that,
 7 other than what's been mentioned that I've heard,
 8 is -- and I think Tony, you were starting to get at
 9 it -- is use of company assets and T&E reimbursement
 10 and other things that are benefits that -- executive
 11 officers' use of corporate planes.

12 The straight-up proxy compensation and
 13 what you can tie to contracts, I think the corporate
 14 governance and holding the board accountable, a comp
 15 committee is the right way to go, and the auditor is
 16 just making sure that process is in place, and the
 17 risk management governance. But where I think the
 18 value of the audit efforts is in these -- the Tyco
 19 stuff, the misuse and -- and not in accordance with
 20 the policies that the company and the board have
 21 said. So the auditors are in a better position to
 22 say whether they are seeing in the financial

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1 statements are aligned with corporate policies that
 2 the governance structure has approved and that the
 3 structure is adequate, versus trying to make -- do
 4 decisions for the board and the board comp committee.
 5 And I think there is going to be more
 6 opportunities for misuse of classification and use of
 7 company assets than the governance structure itself.
 8 MR. HARRIS: Turning to the two remaining
 9 issues just very, very quickly. On inspections,
 10 Barbara Roper, you indicated that the PCAOB should
 11 develop a robust and formalized system for analyzing
 12 inspections findings and using that analysis to
 13 inform other board activities. And then Bonnie, you
 14 mentioned that as well.
 15 And you thought we should do a better job
 16 focusing our inspections on significant issues and
 17 risks.
 18 I think Mike, we have already touched on
 19 your point with respect to inspection. But I was
 20 wondering whether both of you or Bonnie wanted to say
 21 anything on that issue.
 22 Barbara, do you --

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1 MS. ROPER: We talked about this at the
 2 last Standing Advisory Group meeting. It is my
 3 understanding the board is working on ways to use the
 4 information from inspections effectively to inform
 5 the standards setting process.
 6 It is something that we've talked about as
 7 an issue within SAG for a number of years, that the
 8 information comes -- that comes from inspections has
 9 the potential to really be meaningful in terms of
 10 helping to identify problem areas and areas where
 11 there may be changes that are needed to the
 12 standards, the audit standards.
 13 I think it flows together well with the
 14 notion of a fraud center which, as you know, is
 15 something I very strongly support, that the PCAOB
 16 just should think about how to formalize that
 17 process, make sure there's a clear formal process for
 18 how the information that comes out of those
 19 procedures then informs the standards setting
 20 process, and the other things that the board does.
 21 MR. HARRIS: And then Kelvin, you
 22 mentioned -- and this probably is a conversation

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1 which is so large that we might want to save it for
 2 another time -- but in a snippet you mentioned
 3 investor education and the expectation gap. Do you
 4 want to briefly comment on your concerns there?
 5 MR. BLAKE: Sure. Kelvin Blake.
 6 I don't know to what extent the PCAOB
 7 currently reaches out to investors, but I do suggest
 8 that perhaps they can start an investor education
 9 program where they're making investors aware of the
 10 audit process, both the benefits and the limitations
 11 of the audit process. And perhaps in an effort to
 12 narrow the expectation gap that now exists.
 13 I also recommend perhaps encouraging
 14 senior level members of the accounting profession to
 15 meet more often with investor groups so that the
 16 investor groups can explain what their expectations
 17 are from the audit process and -- you know -- how to
 18 improve audit transparency, what effects investors
 19 think the new accounting standards may have on -- you
 20 know -- their decisions; and any other relevant
 21 issues.
 22 MR. HARRIS: Well, before concluding, I'd

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1 like to point out that yesterday the board announced
 2 that the PCAOB is seeking nominations for its
 3 Standing Advisory Group, and a copy of our press
 4 release is in your packet.
 5 As I think most of you know, this Standing
 6 Advisory Group is an integral part of the PCAOB
 7 standard setting process.
 8 It would be extremely helpful if members
 9 of this group could help identify potential
 10 candidates by either nominating them yourself or
 11 asking the candidates to submit a nomination form
 12 which can be found on our website. Or you can feel
 13 free to contact Marty Baumann directly with respect
 14 to that.
 15 In conclusion, because it is very close to
 16 5:00, I want to give Dan the last remarks, and other
 17 board members if they care to make any. I think what
 18 we'll do in terms of follow-up is prepare a generic
 19 summary of today's meeting which we'll distribute to
 20 all of the group members.
 21 I think we'll get back to each of the
 22 panels for any possible follow-up issues prior to our

1 next meeting.

2 I think it has been an extremely
3 productive day and all the panels that have made
4 recommendations -- I'm not sure how realistic or
5 feasible it will be; but I talked to a couple of
6 folks during the break, and there may be follow-up
7 items, which we will want to discuss with each panel
8 and then get a work product out of you, if it makes
9 sense.

10 So we will summarize, get back in touch.

11 I want to thank very much all of you for
12 your participation. I want to particularly thank
13 Joanne Hindman who put this together, both
14 substantively and administratively.

15 (Applause.)

16 MR. HARRIS: Joanne, you did a terrific
17 job. I want to thank Jennifer Stokes. Bob, you've
18 been out of sight, out of mind; but you have been
19 very helpful. Thank you very much.

20 We appreciate very much all of your
21 participation.

22 I don't know whether any of the board

1 members want to make final comments.

2 CHAIRMAN GOELZER: I'll just join you in
3 saying thank you to everybody for your participation.
4 You've given us a lot to think about, and I look
5 forward to the next meeting of this group.

6 MR. HARRIS: Thank you.

7 (At 4:58 p.m., the meeting was adjourned.)
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