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.

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PROCEEDINGS

MR. HARRIS: Good morning. Welcome to the first meeting of the PCAOB Investor Advisory Group. I want to thank all of you for participating and agreeing to donate your time, expertise, and commitment to this advisory group.

Particularly, I welcome SEC Commissioner Elisse Walter. Commissioner Walter, your long-standing commitment to the protection of investors is well known; and your presence here means a great deal to us, as does your interest in the PCAOB; and Elisse was telling me her dad was an accountant and a CFO.

So we welcome that background, your heredity, and at one point, you indicated that you might have wanted to be an accountant but you went into a different direction. I think it was Harvard Law School and a lawyer. In any event, we are delighted to have you and your interest.

This group was formed to provide a public forum specifically for the board to obtain the views of and advice from the broad investor community on

auditor oversight matters affecting investors.

Too often, in my opinion, regulators hear for the most part from those they regulate and not enough from their other key stakeholders. Today, we are reaching out specifically to representatives of the investor community. As such, we seek your direct input and want to hear your views and specific recommendations for the priorities of the PCAOB.

Our mandate is spelled out in the very first sentence of Title I of the Sarbanes-Oxley Act of 2002, to "oversee the audit of public companies that are subject to the securities laws and related matters in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

In assigning the board this mandate, Congress recognized that high quality independent auditors are vital for maintaining the transparency and investor trust in reported financial information that enables our markets to function effectively.

We look forward to your input on ways to

improve our programs and how best to accomplish our mandate to protect and serve the interests of investors.

All of the board members and senior staff of the PCAOB are here today because we recognize how much we can benefit from your expertise and experience.

Turning to the format for today's meeting: As you know, we solicited input from all of you as to your top four or five priorities for the PCAOB to consider; and you provided us with lists of important and far-ranging topics.

We have taken your recommendations and structured them into broad categories; and I particularly want to thank Joanne Hindman for her efforts in both the staffing and administrative organization of this meeting and the spreadsheet that you have in front of you.

Each of you should have received a spreadsheet summarizing recommendations and should have a copy in front of you together with a folder including a variety of information about today's meeting.

We tried to structure our meeting around these broad topics with the objective of providing every member with an opportunity to discuss his or her top priority.

More specifically, the topics will be presented today as part of five panel discussions as follows: First, we will have a discussion on lessons learned from the financial crisis and the establishment of a fraud center. Initiating discussion will be Brandon Becker and Mike Head.

Next, we will discuss foreign inspections with Joe Carcello and Ann Yerger leading those discussions.

After lunch, we will talk about greater transparency and governance of auditor firms with Pete Nachtwey, Anne Simpson, and Lynn Turner doing the introductions.

Lynn, I want to thank you personally for being here. I know you were invited to testify this morning on the Hill in front of Senator Specter at the Judiciary Committee, so we appreciate your

presence. I know Barbara Roper and Damon Silvers did accept that invitation, and they will be here later.

Then we will focus on greater transparency of the audit process with Kelvin Blake, Norman Harrison, and Bonnie Hill.

And the last panel discussion will be on auditor expertise and responsibilities with Tony Sondhi, Judge Stanley Sporkin, and Bob Tarola.

After a very brief introduction of the panel by one of the PCAOB board members, each panel will initiate and discuss their topic and then lead the other group members in a discussion of the topic.

At the end of the day, there will be a sixth session reserved for an open discussion on any topics not adequately addressed by the panel discussions.

In short we have structured this meeting in order to provide an opportunity for an open discussion by the group so we can hear your views and priorities for the PCAOB. Throughout today's meeting, I would ask of you keep in mind and seek to answer the question: How do we make audits more

relevant to investors?

We would also note today's meeting is being webcast. Since we would like the open discussions to be informal and free-flowing, please do not feel as though you have to be recognized to speak. We would ask, however, that for the benefit of those listening to the webcast, you identify yourself the first time you speak and periodically throughout the day.

This meeting is open to the public and the group members' written statements that we received have been posted on our website.

Before getting started, let me recognize our acting chairman, Dan Goelzer. Then SEC Commissioner Walter and our board members, Bill Gradison and Charlie Niemeier, and open the floor up to them for any opening remarks they would like to make.

CHAIRMAN GOELZER: I would like to join you in welcoming everyone to this inaugural meeting of the Public Company Accounting Oversight Board's Investor Advisory Group.

As Steve noted, the board's mission is investor protection. Our job is to further the interests of investors in reliable audited financial reporting.

Despite that fact, understanding what investors want and need -- I think -- has proven to be somewhat of a challenge for us.

We certainly hear frequently from individual auditors, from accounting firms, from preparers; and naturally so, because our work directly affects them.

But I think we have less input from investors, and this group has been created in order to try to change that state of affairs.

Under Steve's leadership, as he already outlined, we put together I think a very ambitious and wide ranging agenda of topics together. I'm certainly looking forward to hearing everyone's views on what we ought to be doing to address these issues that confront us.

I'd just add I think this advisory group has been created at an especially appropriate moment in the life of the Public Company Accounting Oversight Board. We've been in operation about seven years now. It is hard for me to believe that seven years have passed.

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

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

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

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

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

COMMISSIONER WALTER: Unfortunately.

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

Do you have comments to make at the beginning?

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

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

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

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

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

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

Thank you for having me here.

CHAIRMAN GOELZER: Thank you.

Bill?

MR. GRADISON: Thank you, Dan.

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

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

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

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

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

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

CHAIRMAN GOELZER: Charlie?

MR. NIEMEIER: Certainly, this is a very

important event for us. I think Dan put it well. We are at a pivotal point in the evolution of the PCAOB and where we fit into the system.

We have, I believe, a good foundation; but it is time to really take a look at what we've done to take a look at what we need to do to improve; and sort of where I sit, there's still a lot of room for improvement. We're very interested in hearing what you have to say and what we can do to make these things reality.

Thank you.

MR. HARRIS: Before we actually get started, if we could go around the room and everybody briefly introduce themselves.

Judge, I'm not sure you need an introduction. Why don't you start?

JUDGE SPORKIN: Stan Sporkin.

MR. TAROLA: Robert Tarola. Good morning.

MR. HARRIS: Well, you can actually identify yourself a little more than that. I think the judge headed up the Division of Enforcement, was at the CIA, was at Weil Gotshal.

I know time is pressing, but Bob.

MR. TAROLA: Robert Tarola. My current involvement from an investor perspective is I serve on the board of directors of 15 mutual funds sponsored by Legg Mason, an operating company listed on NASDAQ based in Denver.

My experience is about a dozen years as a public company CFO, a dozen years as a public company auditor; and currently serve on two audit committees.

MS. HILL: (Inaudible -- microphone not working.)

How's that? Do I need to start all over? Bonnie Hill. I think I've said enough.

MR. SONDHI: Tony Sondhi. I run a financial consulting advisory firm. I'm also a member of the emerging issues task force of the FASB, and I've been involved in standards setting as a financial analyst and as a user of financial statements for a little more than nine years in a direct form.

I've also written books on financial analysis and on various accounting issues that --

fortunately, for me, are widely used.

Thank you.

MR. HARRISON: I'm Norman Harrison with Breeden Capital Partners. My firm is headed by Richard Breeden, a former chairman of the SEC.

We invest in public companies with a view toward increasing value for shareholders by focusing on improvements in governance and the manner in which improved governance translates into improved strategies.

I'm a lawyer and investment banker by training, not an accountant. So I'm a bit humbled by the company in which I sit, but very glad to be a part of this group.

MR. BLAKE: I'm Kelvin Blake, a lawyer for the Division of Securities for the State of Maryland which is part of the attorney general's office. I work in the investment adviser broker-dealer unit.

MR. SAUTER: I am Gus Sauter, chief investment officer of Vanguard Mutual Funds. We have over 150 mutual funds investing more than a trillion dollars in public companies, so we're very interested

in gaining more information and being able to better analyze financial statements.

MR. WILLIAMS: I'm Meredith Williams. I work for about 460,000 of the very best people in the State of Colorado, running the public pension plan called PERA.

Thank you.

MS. SIMPSON: I'm Anne Simpson. And improbable though it sounds, I work for CALPERS.

I'm the senior portfolio manager, and I'm responsible for the governance program there. I think Steve originally invited me to join this group because of my international background.

Prior to that, I worked for the International Corporate Governance Network which represents investors in some 40 odd countries.

Before that, I headed the World Bank's governance program in the wake of the Asia crisis. There were very familiar debates there about audit and accounting.

Before that I was managing director of an investment firm in London for many years.

MR. NACHTWEY: Pete Nachtwey, CFO for Carlyle. That's my primary day job although I think chief cook and bottle washer with everything that goes on in our firm.

Prior to joining Carlyle, I was a partner at Deloitte & Touche, where I was employed there for about 27 years. The last job I had there was heading up the management practice in the northeast.

MR. TURNER: Lynn Turner.

I serve on the board of a mutual fund complex and also serve those 460,000 people in Colorado as a trustee of COPERA.

MS. YERGER: Ann Yerger with the Council of Institutional Investors. That's an association of public, corporate, and union employee benefit plans, with about 3 trillion in assets. They have a very significant commitment to U.S. markets, investing about 60 percent of their portfolios in stocks and bonds of public companies here, and all have a deep interest in the quality of the financial statements that are provided to them.

MR. CARCELLO: Joe Carcello, I'm an

accounting professor at the University of Tennessee and co-founder and director of research of our corporate governance center.

I've done a lot of research on fraud, public company fraud, including a study coming out by COSO shortly, based on SEC enforcement actions.

I work on audit committees. I chair the audit committee of a governmental entity, and had the privilege of serving on the PCAOB's SAG for the previous four years.

MR. HEAD: My name is Michael Head.

I'm managing director of corporate audit for TD Ameritrade. About 30 years of combination public and private audit experience. Serve on the board of the Institute of Internal Auditors, the global body that oversees internal auditing around the world, and actually serve as the chair of their audit committee.

And obviously, hope to bring some of the perspective of how internal and external audit work together and in particular in the brokerage industry and how we can advise and help the PCAOB strengthen

some of how that audit approach can be considered going forward with some of their oversight.

MR. BECKER: Brandon Becker.

I'm executive vice president and chief legal officer of TIAA-CREF, one of the largest private pension managers. We have 3.7 million participants.

Prior to that, I was a partner in Wilmer Hale, responsible for its broker-dealer program; and prior to that, I was director of market regulation at the SEC.

MR. HARRIS: Thank you very much.

Before we get to our first discussion, I want to point out in your folder, you should find a copy of the PCAOB's ethics policy. We ask that you please read the policy and provide us with a signed copy before you leave today.

Now, turning to our first topic, lessons learned from the financial crisis and the establishment of a fraud center. This topic was mentioned by a number of you as a top priority for the PCAOB to consider.

Brandon Becker, you suggested that we should "review the PCAOB and auditor firms' performance leading up to the financial crisis." More specifically, you asked how did audit firms measure risk and did auditors have the necessary level of expertise?

Mike Head, you brought it up in the context of broker-dealers; and those of you who have listed these issues as very high on your priority list include Joe Carcello, Barbara Roper, Anne Simpson, Meredith Williams, and Ann Yerger. Some of you tried the concept of reviewing lessons learned from the financial crisis to the recommendations by the Treasury's Advisory Committee on the Auditing Profession and that the PCAOB establish a fraud center.

As you know, last month we announced we were seeking to fill a newly created position of director of the financial reporting fraud resource center which is being established in response to the treasury advisory committee recommendations.

So it is very timely that we hear your

thoughts on these topics, particularly given the level of interest expressed by the IAG members as well as recent events in the news.

For example, just last week, the Financial Times reported that the European Commission is planning to scrutinize the role played by auditors adding to a growing international focus on the profession in the aftermath of the financial crisis which could lead to tighter supervision.

Brandon, I would ask that you and Mike kick off the conversation on this first topic and then we'll open up to all the members.

MR. BECKER: Thank you, Steve.

At the risk of breaking your flow and taking a little editorial license, let me just add before turning to that topic how much all members of the investor advisory group appreciate the board's willingness to make itself available to listen to our views and, in particular, how much we appreciate the efforts that you made, Steve, as well as your staff, Joanne O'Rourke Hindman, to make this a successful advisory group and a seamless process.

We very much appreciate your and the board's efforts to participate in this process as well as those of the Securities and Exchange Commission.

Many thanks to you and the board.

Turning to the topic of the panel, Steve has nicely recapitulated the overall arching theme. I think that I'll just try to put it in a little context before I turn it over to Mike to talk about some of the particular areas with respect to financial services.

As the participants know, at least since Professor Andrew Lowe of MIT began his efforts to stimulate interest in a so-called capital markets safety board modeled after the CAB, there's been an active dialogue about whether there is some method short of enforcement where you could go back diagnostically and try to look at what's happened over the last couple of years with a view toward identifying problem areas and potential solutions or at least best practices on a going forward basis.

One of the criticisms or at least

practical limitations on that that has been highlighted by some commentators is that the issue is too broad, the problem was global, the markets involved were of such scope that the idea that one could actually go back and look at this particular event in the same way that, for example, the SEC special study looked at the 1962 market break or comparable more textured reviews is just not within the realm of the doable, at least not within our lives and being.

I think that is a little too stark a definition of the issue. If you look at the way in which various of our colleagues' papers talk about a fraud center, there can be a more targeted assessment. Steve has already mentioned and the SEC has already begun its own assessment of how we were dealing with 105 transactions, so that you can, I think, if not aspire to a global encyclopedia of the crash, notwithstanding the fact that we seem to get a new book every week on the bubble and its consequences, one could envision looking at targeted practices and asking yourself whether when we look

back at those practices, there's something we can do going forward.

At its heart, I think that instinct is to take a step beyond the -- it was an act of God, it was unforeseeable, received wisdom said that no one could know how this was going to happen.

Actually, as it has developed over time, there were voices. There were critics. There were people pointing out potential risks. They were just not the majority view or the consensus view. Part of what we want to ask ourselves is why weren't those voices heard? What can we do to incorporate those voices going forward, and where can we identify failures in our practices.

Some of the areas that at least have captured our attention and are described in more detail in my written testimony are, how do we assess quality of earnings? How do we go back and look at unrealized gains and losses? How do we assess earnings-based models and estimates when we haven't been through the entire earnings cycle of a financial instrument? What can we do about tail risk going forward?

It seems obvious we are not going to eliminate the reliance upon modeling and trying to give estimates of quality of earnings; but at some point, we should be able to get smarter in trying to deal with the kinkiness of tail risk and some of the problems of trying to rely upon that in any particular financial reporting period. That's just another example. Whether it is repose, table risk, other evaluation issues, it strikes us that one could go back and try to look on a horizontal basis and assess whether we did the job correctly and how we can do it better.

In doing that, I think one of the common sense instincts here, I would argue, is that if we can do that outside of the enforcement context, the enforcement context is critical in terms of accountability, it is critical in terms of developing data, subpoena power, the like; but sometimes it doesn't give you the broad horizontal assessment of how you want an industry going forward. Trying to pull together a diverse set of resources to assess

that, economists and traders, lawyers and accountants, forensics and diagnostics, we think could provide valuable lessons for the industry as we confront what will undoubtedly be recurring issues as we come out of the situation.

With that pitch, why don't you let me turn it over to Mike to talk about some of the particulars in the financial services industry.

MR. HEAD: Thank you, Brandon. Due to my background, I'll be fairly focused on broker-dealer and registered broker-dealers, and that environment, and probably one of the obvious things to analyze and see if there's lessons learned can tie into situations like the Madoff and the energy that myself, my company, and our industry probably were looking at that and trying to assess, were there some things like that that could have been done to either avoid that, minimize it, or identify it and address it in a more timely manner before some of the damage that took place did take place.

As an internal audit professional and long term investor advocate, I'm very pleased that the

PCAOB has made this very timely decision to focus on investor protection.

I'm also pleased that the PCAOB is interested in considering ways it can target their efforts to increase investor confidence in the auditing financial information and audit reports and make that information in reports more useful to the individual investors. To that end, I offer some of the following thoughts on strategic direction and future emphasis that the PCAOB, through the Investor Advisory Group efforts, could address in lessons learned.

One of the primary things that I think we need to look at is not only the fraud center and analyzing and looking back, but are there some systemic opportunities here. As an auditor, we focus on processes. We focus on trying to get consistency in processes and then addressing exceptions or things like that seem to be out of that norm.

And to that end, I think there's three, four, five things that the PCAOB should advocate and where possible require some consistent audit

requirements for registered broker-dealers both on the introducing broker-dealer side and the custodial broker-dealer side. Some of those could include in addition to requiring independent auditing firms of broker-dealers to register with the PCAOB, the audit firm should also be subject to inspection by the PCAOB.

The retail adviser does not realize today that being registered with the PCAOB does not bring with it any true oversight by the PCAOB if it's not part of a publicly audited situation.

Once the broker-dealer registered auditing firms are subject to inspection and oversight by the PCAOB, clearing broker-dealer organizations should be subject to the Sarbanes-Oxley section 404 or similar requirements for compliance. There's been a lot of debate about has that achieved the objective that was intended; but I think if we're all really honest with ourselves, that it has brought the needed and appropriate attention to the internal controls or financial reporting disclosure that was lacking prior to that, and that's still absent in the registered

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brokerage environment.

It's gotten there through banking and through some others; but if you're a pure introducing or custodial broker-dealer and not publicly traded, you aren't subject to similar audit requirements nor management certifying their internal controls; and that discipline, I think, is a key element in improving the financial services broker-dealer environment.

As a result, those auditing firms would be subject to auditing standard number 5. I think that's critical, too. Where today if you are not in a publicly traded broker situation, those auditing firms are not necessarily subject to auditing standard 5.

We would assume those firms through firm practices would employ similar, but it is not required from oversight from a PCAOB point of view.

These measures would enhance investor protection and the quality of the financial reporting available to and relied upon by the retail investor and they don't understand, if you ask them, they

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would assume there's not any difference in an audited opinion they get on a non-public registered broker-dealer and a publicly traded registered broker-dealer.

Once the broker-dealer registered auditing firms are subject to inspection and oversight by the PCAOB, custodial broker-dealers, in particular, I think should be subject and required to have SAS 70 type 2 service organization audits performed of their custodial controls. Currently only affiliated custodial broker-dealers are required to comply with the SEC custody rule, the 2064-2, and are subject to the SAS 70 type 2 audits under the recently revised SEC custody rules.

Requiring a custodial control SAS 70 type audit of all clearing broker-dealers, no matter if it is affiliated or not, would help enhance investor protection and the quality of the financial reporting.

In both the SOX 404 compliance and custodial controls related to a custodial or clearing controlling broker-dealer, these are more focused on

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not just internal controls over all the financial reporting but all operating controls that support the processing of transactions and compliance with laws and regulations that ultimately the scorekeeping and the financial statements rely upon.

But again, the retail investor assumes their assets are safe and they exist; and obviously from what we saw with the Madoff situation that may or may not be true and we don't have the safety nets in place to allow for oversight auditing and review by both internal auditors and external auditors to help ensure with those retail investors -- that those assets exist or are safeguarded, and the controls to protect them are in place. And I think the SOX 404 and the SAS 70 type 2 are two just blocking and tackling table stakes that should be there for all registered broker-dealers.

I also think we have an opportunity and was somewhat disappointed when AS 5 came out to replace AS 2, that in AS 2 there was mention of the internal auditing global standards; and that went away in AS 5. Now, just being recognized for the

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sake of being recognized is not what's important. What I think it emphasized there was the importance of consistency between companies' and firms' internal audit functions, that they should be there and that there should be consistency, so that people, regulators, shareholders, investors, and external auditors know when certain internal audit practices are in place if they're adhering to standards.

They have more reliance that it's consistent, that it's the same from one company to the next. And by acknowledging those standards and setting a specification that when there's internal audit function in place that is functioning at what is considered an adequate level, that they know what that means, that there's definitions in the standards that people can go to, retail investors, others to tie to that.

Finally, when we have internal audit functions that are comprehensive and can be relied upon, there is a lot of benefit for synergies and efficiencies both for the regulators and external auditors to review that work, place some reliance on it; but the standard that presently exists that kind of guides when and how you can do that, the current SAS 65, is quite dated; is over 20 years old; and does not and could not at that time consider the roles and responsibilities that internal auditors, professionals, currently take on.

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

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

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

With that, I open it up.

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

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

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

That is an issue that the PCAOB is

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

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

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

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

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

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

Clearly, not only are there concerns about fraud, but I think the public, rightly so, has been concerned about the quality of, in some cases, accounting standards which I understand is not the purview of the PCAOB, but certainly auditing standards and professional conduct surrounding things varying from fair value accounting for financial statements or instruments -- excuse me, off-balance sheet vehicles; repo 105s; and even loan loss reserves.

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

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

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

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

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

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

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

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

focus of attention for their role.

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

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

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

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

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

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

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

In practical terms, what is it we need to know? What is it we need to have reported? What is it -- you know -- that the job of the auditor needs to be in order to play that critical role because they're really one of the dogs that didn't bark. They weren't the only ones, but certainly we need to examine that.

MR. HARRIS: Hold on for a second. Before we get to responding to your comments and statements, I would like to stick with the fraud center for just another five or 10 minutes; and I know that, Meredith, you have some ideas on that; Lynn, you clearly have. Joe, you have.

Bob Burns on our staff is taking the lead on that. I think the more you can input here, we can help define the fraud center and then broadly discuss the other issues.

Why don't the three of you and anybody else comment on your views of the fraud center and then, Judge, we'll recognize you.

Meredith?

MR. WILLIAMS: I'll start that out. The fraud center has great promise, but I think we need to be careful with expectations.

I see it as a device that will do post-mortems on what I will call audit failures.

Though auditors would probably argue that we're following the audit standards and unless something shows up on our sample, in our confirmations, we're clean. Well, I think that requires an attitude adjustment.

And I think by doing a series of post-mortems and hopefully using the safe harbor sort of approach that Ann suggests, they can be done on a relatively timely basis so we don't have to wait for all the court cases to be cleared before we can sit down and say what went wrong, what might have been done different, how might we have alerted the investment public.

And I think over time, by going through this exercise, I think that there will be a mindset change for auditors. And I think the so-called expectation gap between the investment community and the audit community might be significantly narrowed. But I don't think that just is going to be movement on the part of the investment community.

I think there will have to be movement on the part of the audit community, too, and perhaps

PCAOB will have to take a good strong look at the results that come out of the audits, the findings that come out of the fraud center; and perhaps there will be a need to redirect the audit effort to have more of a focus on fraud to serve the investing public.

I think those are my comments. I think it is very important -- but I think it is a long-term sort of effort. We're not going to turn around in the next 30, 60, 90 days. It is a long-term education effort.

MR. HARRIS: Joe? Lynn?

MR. CARCELLO: I, first of all, applaud the board for moving forward on this. I think it is the right thing to do. I am a little disappointed in the scope. I think the -- at least as I've read the scope, I think the board has pretty clearly just mimicked what was in the ACAP report. And as you can tell from some of comments we received, particularly from Barb Roper, Meredith, myself, Lynn, probably others, there was a hope the board might do more. As I understand it, essentially the aim of this center

is to share fraud prevention and detection experiences, practices, data, and commission research.

When you think about sharing fraud prevention and experiences and practices, I think to some extent, that is going on between the major firms at the CAQ. So it is not obvious to me that this body needs to do that. There's a large body of research on fraud that's going on and sponsored by academic institutions and other bodies. If you wanted to have a -- commission research, you put money out there, you get research done. One of the main problems in this area, and this is, I think, what Damon was alluding to, is data is confidential, both at the level of the board and the level of the individual first.

And unless all the research is going to be done by this fraud center and tightly controlled in terms of dissemination which kind of defeats the point, unless you're able to deal with the issue of confidentiality of data, you have a problem.

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

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

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

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

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

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

PCAOB and its inspections.

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

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

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

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

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

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

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

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

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

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

MR. HARRIS: Judge, you had a comment?

JUDGE SPORKIN: There's no question that the fraud center makes sense. But what does concern me -- and I think Ann hit on it -- was the role of the auditor, what -- we don't hear anything about what happened.

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

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to the case, what's the key to the case.

One of the keys is in the -- is why is this case with the securitized mortgages much different than the salad oil case? In the salad oil case, there was no salad oil.

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

Am I right or wrong?

Look at the cases that you found where valuation was a big issue: Again, isn't that an auditor's role to see if the assets are there.

And that's why I'm trying to figure out if we're going to have the fraud center, why aren't we going to look to see why -- what beyond just the rating agency, who was looking at these things?

If somebody said there was no value to these mortgages or very low value, why were we

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treating it?

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

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

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

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

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25 percent, it was okay, because they followed the rules.

But nobody said, looked at the guy that bought it, a guy they picked off the streets of Phoenix, put him into the room and say you now own this property, here's 50,000 for your help.

That was the deal. Nobody says does this make economic sense?

Again, it seems to me somebody has to look to see whether we should have been examining those mortgages or those portfolios and finding out, the accountants saying, yeah, these don't have that.

We understand that somebody put a rating on this. But so what?

And -- but looking ahead -- not back all the time. Not look back. These were the rules at the time. Look ahead. Accountants need creativity as much as anybody else. Am I making any sense? I don't know.

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

MR. BECKER: I agree with everything generally that's been said about the fraud center, its importance, including the Judge's comments.

I do think without putting too much value on nominalism, calling it a fraud center is a mistake. Because if you limit yourself to instances of found fraud, you're going to miss exactly what the Judge is describing. What happens when the industry follows the rules as articulated, follows appropriate standards in valuing synthetic CDOs, but it turns out that the procedures that were followed didn't work?

So I'm just as interested in an assessment of after the crash, to use the NTSB example, it may be that the design of the road bed was wrong and somebody should go off and figure out whether there is someone we're going to hold culpable for it.

That's an interesting question.

But as a passenger on the train, what's more important to me is that the road beds get fixed and on a going forward basis, we know how to design the road bed.

Somebody else can go do the enforcement

job of that; but we need to be able to look at how we set our guidelines for best practices even in situations that don't rise to the level of fraud.

I'm afraid if we only look for fraud, bad actors, who else did the wrong thing under articulated standards, we will miss the far more or at least equally significant situations where good people follow the right standards and the best practices; and they go off the cliff like lemmings.

MR. HARRIS: Norm?

MR. HARRISON: I think Brandon, Lynn, Judge Sporkin all were getting at this point; but I wanted to just make it a little more clear. I think again I agree with the concept that the idea of a fraud center or an organization designed to conduct the analysis of factors coming out of a major fraud or crisis is a good idea.

I think the trick always with exercises or initiatives of this sort is I think we've demonstrated a real talent as a profession, regulators, Congress, all who looked at the Enron, WorldCom frauds, the frauds of the past, we do a good

job of solving the last crisis.

I think Lynn is right. We are unlikely to see another fraud that involves a massive mischaracterization of operating expenses. We are unlikely to see another fraud like Enron or Refco that involves massive use of end party transactions. Those aren't going to happen again. We know what those look like. We are going to be sure they don't happen again.

I think the real trick is to conduct the audit opinion, the forensics, the analysis and the trick is figuring out areas in our economy where there are circumstances afoot that give rise to new risks and applying the lessons learned from the past in a preemptive way to try to head off crises or frauds or misdeeds that may be in their infancy. I think that is the real challenge. It is doable but requires a tremendous amount of thought and analysis and awareness what lies ahead as opposed to what occurs in the past.

MR. HARRIS: Tony? Bonnie? Gus? Tony?

MR. SONDHI: I remember many years ago a

study was sent to me and it purported to talk about whether cash flows were the bottom line, and what it did was said let's see if cash flows are good or accrual are good predictors of bankruptcy.

Well, the problem is that bankruptcies are negotiated. It is not something you can observe in a way as if through negotiations you manage to avoid it. But that doesn't mean cash flows did not catch the problem. These people, for example, the authors of the study said in the seventies because Chrysler and Massey Ferguson did not declare bankruptcy at certain points in time, cash flows were misleading.

When you look at it that way, it is a stupid statement to say they were misleading. Fraud, as Brandon points out, may not be the right way to go about it.

We need to look at it far more critically and think of this thing differently in order to understand the lessons of this.

MS. HILL: I was trying to think how I would use all this information in the board room. You know, when something happens, the first thing that comes up is where was the board of directors.

And if we're all sitting around here trying to figure out perhaps where the next best fraud will be, it makes it extremely difficult for us when we're dealing with issues that come before us, particularly if you're looking back which is a good thing. Let's look back and see what took place, I think as the Judge said. But I will tell you I don't think the next best fraud is going to be one that already has been perpetuated so everyone is now looking out for that and you just move on to something new.

I think the idea of a center is a good idea but I think more forward-looking and in terms of how I as a board member take a look at what is being presented to me and I'm depending on the experts who are the auditors who have been working with the internal auditors and somehow or other now I'm suspect of that.

So where is the next best place to go? I think when we talk about the tools that are necessary to review what is brought before the board and how

you look at it in the deep dive, particularly where fraud is possible and where it may come from, it just gets to be one of those things like that I hope there is as we have our discussions today there will be some tools to help directors take a look at what's broadly in front of us as well.

NEW SPEAKER: I'd like to address some of the comments. Brandon mentioned the fact there are sceptics about a fraud prevention center. I think those people are talking about the enormity of the problem; the fact that a lot of the analysis is basically back testing and perhaps data mining and in terms that we use in research.

Nevertheless, I think it is important that we glean whatever information we can, that even if it is very difficult to project going forward as a number of people talked about, it is important to learn what we can and to change audit standards as Joe mentioned to change practices; so perhaps there would be a world of information that could be utilized by FASB as well in setting up the accounting standards. I think there's a lot that could be

shared there.

I think it is important that even if -- it's a very difficult effort. If we can shrink the size of the fraud box, that's very worthwhile. So we think that those that say -- that are skeptical about it really don't recognize the advantages.

I would agree with what many people have said that things have to be forward-looking, that we need to try to figure out how to minimize not only fraud but misrepresentation of full financial information, so we would fully support the fraud center.

MR. HARRIS: Bob? And I see there are a number of labels up.

Clearly somebody has hit a nerve.

MR. TAROLA: Bob Tarola. It strikes me obviously there needs to be a type of post-mortem on frauds and the PCAOB regarding where the audit lapses may have occurred is the right place.

But within the managements in the board room, there are every quarter the CEO and CFO are signing off on the financial statements, certifying

their accuracy, certifying that any matters of a fraud or concern were brought to the attention of the audit committee and the board.

It seems like as a system, we don't trust that part of the reporting process, that the certifications of officers are less important than the opinion of an auditor.

And that, it seems to me, exists because we don't really think that the internal process is professional; whereas the examination process, the auditor examination process is professional and it is professional because this board insists that it be.

If we're really going to protect investors, we need to do it at the source. We will not be able to review in or audit in quality. The quality really has to be -- there has to be trust in the system that there's quality reporting coming from the companies; and that there's quality auditing to make sure it stays that way.

So a fraud center is great.

But I think professionalization of preparation of financial information is even a better way to avoid bad reporting in the future.

MR. HARRIS: Pete?

MR. NACHTWEY: Thanks, Steve. A lot of good things have been said. Just not everybody said them. I want to add a couple of things maybe to what others have focused on that I think are good ideas. One, Lynn mentioned the fact that despite his long list of companies that we all recognize either are failed or failing out of the last crisis, really hasn't been any misstatements that have arisen from the financial statements, at least not yet.

Yet I don't think any of us would look at the financial situations of those organizations based on what investors could know at the time and say the financial statements weren't misleading because how could that many companies all of a sudden go down in a crash.

I do think as Bob said the certification process I do think helps. I've sat across the table from people in my prior life as an auditor where they get really crystalized and focused on their personal risk when they had to sign something. I think that

process is great and has helped in terms of not -- helping to prevent misstatements. But on the other hand, in terms of misleading, I think that's the next step we have to get to and how do we do it. I think a lot is about the risks.

I'm not blessed or cursed with being a lawyer, but I worked with lots of lawyers on designing risk disclosures in public filings. They tend to be very voluminous. They tend to be very articulate, but in a very legal form as opposed to plain English.

I know there are people like Gus around the table that are required by plain English standards to describe and disclose things to their investors. The question is, can we help foster that a little bit whether coming out of this fraud center or something else we might label as to how we inform the investing public about what the risks are in the business.

That feeds to the second point. A lot of what happened here wasn't just the massive frauds like the McKessons, the salad oil things where a

really bad operator did something bad and probably should have been caught; but I think one of the lessons that came out of this last crisis is we have the systemic failure, bad design, there are many different parts of the financial system you can look at. Just looking at subprime mortgages, mortgage securitization example. We went from a day where the S&L originated a loan. They had to hold it. They may still have originated bad loans but at least the guy that was going to service the loan sat down the hall from the person that originated it. The CEO was that was going to have to report the financial reports, knew that that stuff was staying in the house. If it was toxic it gave you presumably some pause.

We went from that over the course of two decades of setting up a system where the originator originated. May have sold it to some wholesale lender who then sold it to somebody who would securitize it who sold it to somebody in Norway.

It became impossible during the course of all that, little -- you know -- well meaning people

just doing wickedly difficult jobs probably 70 to 80 hours a week cutting corners here and there. By the time you cut enough corners off the product that ended up at the back end was garbage.

It was very difficult to find that out because we had the imprimaturs of auditors or rating agencies or others along the way. This is where I think again a fraud center or some sort of financial reporting center that gets at not just operators but systemic risks could be helpful.

JUDGE SPORKIN: A quick question. Have the auditors changed what they're doing based upon -- we don't need a fraud center to tell us what we know now. Are they changing what they're doing? Do we know that? Do we know -- did they learn anything from this?

I mean, that's -- have they changed the way they do business? Is there an auditor that can answer that question? Where are the auditors here?

NEW SPEAKER: You need the SAG.

NEW SPEAKER: I'm an auditor. If I understand the question right, there's not been any change in what they're required to do, which is validate existence, fair valuation, and proper disclosure of the assets and what's included in the financial statements.

Now, were they doing that is a different question, but what they're required to do to follow their auditing standards says yes, you are right, Judge, they have to get comfortable the assets exist and they are fairly stated and are properly disclosed.

I'm not sure that was consistently being done.

MR. HARRIS: Joe, let's go down and around the table.

Kelvin, I know that this was not a priority of yours, but everybody else has spoken, so before we leave this panel, I want to give you -- if not the last word -- a word.

I'm sorry. Charlie?

MR. NIEMEIER: I want to respond to Judge Sporkin and add something that's been said. We talk about disclosure. I think it causes all of us

especially as a regulator of the audit profession to particularly focus on the words in the audit opinion that often are not focused on. That is fairly presented.

In conformity with GAAP is one thing. Maybe it is not misstated that it is in conformity with GAAP but fairly presented is also extremely important.

If what you have is financial statements that are misleading, that are in conformity with GAAP, I would say how can they be fairly presented? And recently when you talk about have auditors learned something, I think auditors are very mindful today of what happened; but it also means it is a wake up call for all of us as part of the system to focus on the words that what is material?

And it is hard to define materiality when you're talking about words, but we have to recognize that if those words aren't right, if the disclosures aren't there, then the financial statements are not fairly presented if it is misleading. And that's -- anyway --

NEW SPEAKER: Bob talked about how investors often don't rely on CEO and CFO certifications as it relates to fraud. If you don't get the preparer right, you don't get the whole system right. I agree with him. I think he's right. I think part of the problem is when you look at fraud and the study that we did in the late nineties, 83 percent of the frauds that resulted in enforcement actions, the CEO and/or the CFO was involved.

In the study that's going to come out in a few weeks as the PCAOB and SEC knows because we've briefed them, in frauds from 1998 through 2007 that resulted in an SEC enforcement action, 89 percent of the time the CEO or the CFO was involved.

And so when it comes to fraud, who's going to hurt you? It is going to be the CEO or the CFO. Not in most companies. In most companies, they are honest competent people, but where you have risk that's generally where you have the risk.

I think that's part of the problem. There were a number of comments that the past won't repeat itself. And I do think the flavor of fraud changes a

little bit; but the past does repeat itself, guys.

It's top management. If auditors could do a better job of assessing the CEO and the CFO's integrity, they wouldn't need liability reform; and in terms of revenue recognition in our '90s study, 50 percent of the frauds involved improper revenue recognition. In the study coming out in a few weeks, 60 percent.

Most of the frauds are not complex Enron type frauds. They are plan vanilla, cutoff issues, just making up revenue transactions, very basic stuff that everybody in the room could easily understand.

Last thing, very quickly, performance of the profession. I would second Lynn and a couple of others who said things: If you go back to earlier this decade, just to remind everybody in the room, WorldCom, Enron, Adelphia, Global Crossing, Tyco, on and on, Health South, it was essentially a fraud a week, a financial statement fraud a week. If you look at the depth of the recession coming out of the dot-com bubble, it was significantly less severe than what we experienced now.

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

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

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

financial reporting issue.

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

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

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

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

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

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

profession and to the investing public at large.

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

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

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

Lynn?

MR. TURNER: Steve, Ann got ahead of me on one of the things I was going to say. That is that the PCAOB does have a risk management office right now that does look forward from that perspective. People need to realize that function is already in the PCAOB and they have identified, along with other staff in the PCAOB, issues just two weeks ago in this town, the chief auditor teed up the fact we have a couple hundred Chinese companies listed, incorporated in Bermuda, audited by someone in Buffalo, New York that doesn't speak Chinese.

Clearly, they're doing that. They're trying to find the next problem and appropriately trying to deal with it in a timely basis.

That's not something that's lacking in the current system. It is something in the system and the PCAOB has worked on it.

With respect to the loan issue, one has to keep in mind, too, I think Stanley, the Judge raised a lot of good questions about where were the auditors on the loans. But you also have to recognize the regulators in this town, especially the banking regulators, have basically come in and bludgeoned

with the help of some very influential people in Congress, bludgeoned the auditors to death to make sure that losses absolutely were not taken.

And so the regulators sent a very strong message to the auditors go very carefully here and that makes it extremely difficult for an auditor to stand up then and start telling people to all of a sudden take losses.

So it wasn't just an auditor question. It is where were the banking regulators that were, along with Congress, beating these people up. We probably haven't seen all the losses yet on the loans. That frankly is why we haven't seen a bunch of restatements come out in that area that probably should have otherwise come out.

The other thing, talking about lessons learned, we do know that time and time again the number one way we find these frauds is not from internal auditors; it is not from external auditors, it is from the whistleblowers inside the companies. By three, four, five times higher rate than internal auditors and external auditors. Yet today, the

auditing standards by which the profession has to practice doesn't mention and doesn't require the auditor to even look or understand that system.

And sitting on audit committees, I have time and time again, sat there and asked the audit partner to describe to me exactly how our whistleblower program works; how the issues are resolved; you know, tell me about whether it is really independent or not; and I'm talking with some Big Four auditors. Not in a single case has the partner ever been able to describe that for me.

So it is very clear there are lessons to be learned. It will be interesting to see what Joe's report has to say about that. The bottom line is there are lessons to be learned; and incorporated in the standards and we haven't done a good job so far to date.

MS. SIMPSON: Thank you. I think I have two comments. The first is that really there needs to be a way for the fraud center to capture foolishness, not just criminal behavior. So I don't know how we do that. There's an old saying in

English -- you know -- that to be ruined by a fool is the same as to be ruined by a knave.

Greed and stupidity probably made as much of bringing us to the brink as out-and-out attempts at criminal behavior.

On that, I wanted to flag something that CALPERS is doing in an effort to try to understand in our own portfolio why some banks did better than others; and so we're actually involved in a whole series of meetings with the boards of companies, not just where it went wrong, but where it went right.

Back to your point, Bonnie, what didn't they do so they didn't become foolish, greedy, drink the Kool-Aid with the rest of the pushers of these products?

I think out of that we'll get something that may be useful -- Ann's idea which I like very much that you could issue some guidance notes.

Actually things like the structure of compensation makes a big difference to risk. Should the auditors be paying attention there. We know that's something that's on the table. Should we be looking at far more carefully reporting lines.

And specifying what the auditors' roles are not just in a 404 style of internal controls, but I think the mind set issue is the problem. We've actually got a structure in which auditors in particular because of the litigation and liability issue are on a compliance track; and a lot of the problems that we're facing are not about compliance; they're about the real substance of what's going on.

So how we get to that, the spirit, not the legal letter of the law is the biggest challenge we're facing.

MR. TAROLA: I think we do know the economic crisis was not caused by poor audits. It was poor mortgages, that led to a financial crisis, that led to the economic crisis.

By and large, audits served us well in doing what they are prescribed to do to date. I do think it is important to establish a fraud center that is actually focusing on fraud, not focusing on other issues as well.

There is a separate issue, other than

fraud, and it's been discussed here. That's really incomplete information. Are we getting the true picture.

I think on average, we have gotten the true picture. The problem is there's a distribution around that picture. There are plenty of scenarios where AIG does not fail. On average, perhaps AIG does not fail, but we experienced the tail of the event and I think that's where auditors can help us totally separate from the fraud that we're talking about; but they could help us understand the risk of the audit. I think we'll tease this more out in a later session.

I think that should be handled separately. So I would prefer to not see fraud try to encompass everything, try to be totally forward-looking, try to analyze whether we are getting complete information. We need accurate information. We need to understand the tail, what is the risk to us that the AIG scenario does play out. Hopefully we will tease that out later today.

MR. SONDHI: I want to take a slightly

different tack to some of the comments that have been made. I remain unconvinced that the auditors have done a good job.

How many -- what do we think or how should we view companies that are serial restaters?

What do you do when a company -- one of the largest companies in this country in the last three or four years has had to restate several times?

We look at companies as Joe has pointed out where revenue recognition today is about 60 percent, you said; it used to be 50 percent; we never think about impairments, for example. Consider the number of good will impairments. Companies make acquisitions and generally speaking from the research that I've seen, they effectively end up writing off the good will within 18 months of the acquisition.

If more than 70 percent of the acquisition of good will gets written off that quickly, what are the resulting numbers? What do they mean afterwards? You've bought an asset from someone, paid them 10 dollars, written off 8 of it and afterwards you sell it for three and you announce that profit of 50

percent?

Is that really not misleading? Is it really -- does that mean that we're now fairly presenting this information as Charlie was asking?

Or as the Judge was asking: What are the auditors doing?

If you look at the specifics of the way in which material information is presented, I think there are other ways, other problems that we have; and that's what I meant when I said earlier that I used the example of bankruptcy.

The fact that someone doesn't announce bankruptcy, but the investors lose all the money that they've invested in that company I think is pretty bad. I don't care if they don't declare bankruptcy. We've lost the money.

There ought to be some way of looking at that. We've got to try to think of it from that perspective.

MR. HARRIS: I would ask everybody -- I've been reminded if everybody could put their name up since this is being Webcast. It is not clear who is speaking.

But just following up on your point, Tony, which I think is an extremely good one with respect to the impairment of good will and other issues which you brought up, what would you have the PCAOB do that we're not doing? What specific recommendations would you make on the issues that you've raised?

MR. SONDHI: I think the issue is that we need to find a way to be able to talk about what effect that has on financial statements.

So if there are, in effect, as I said serial restatements, if there are certainly repetitions of impairments, or adjustments to the financial statements, there has to be a way of asking what is it that was wrong? Is it internal controls? Is it the fact that we're not actually following the accounting standards?

As Joe pointed out, if you look at the number of revenue recognition restatements that you see, you have to ask yourself, is it really that complex? But Joe also pointed out that some of the errors with respect to revenue recognition are fairly

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

I found a company the other day that says their auditors permitted them to apply the multiple element arrangement accounting standard on service transactions but hasn't asked them to apply it to products.

The first line of that standard says that it applies to everything. It starts off actually by saying this standard applies to everything. It doesn't fool around. I doesn't say it in any complex language or anything.

How do you do that for seven years?

So those are the kind -- there has to be some way of asking auditors and the -- or finding a way in the financial statements, I think as Charlie said: What is the meaning of fairly presented if I end up with 17 restatements.

By the way, I speak of the impairments on the basis of having done a fairly extensive study of impairments several years ago. The repetition of those impairments is just extraordinary.

So the specific recommendations I think we'd have to find a way to be able to talk about these restatements and these impairments.

MR. HARRIS: Bob? Then we have about seven more minutes on this panel. Mike, we'll get to you definitely. We'll get to everything.

And then we'll wrap up. If you can be fairly brief?

And then actually, Brandon, I think I'd like to give you the last word because you made some very specific recommendations in your statement.

So why don't we spend more than the seven minutes and go right around.

MR. TAROLA: In the way of recommendations, I encourage the board to look at the audit function more closely around what boards and managements have to satisfy for SEC requirements or otherwise.

To Charlie's point earlier about financial statements being fairly stated: The officer certification says fairly stated. It doesn't say in conformity with GAAP. It stops with fairly stated.

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

Secondly, I met with auditing firms a few times now. The topic was what can we do as a CFO and board member to help you.

My answer generally has been focus on the 80 percent of the things I do, not just on the 20 percent.

The 20 percent around keeping the books right is fine. But the 80 percent around risk management, around whistleblowing monitoring, around monitoring operating controls and regulatory controls, around whether or not the business model is still working, those are the risks that managements and boards are looking at that the auditor is not.

The interesting thing is that the disclosure model now requires boards and managements to talk about all of that. Whether it is risk factors, or enterprise risk management approaches or compensation models, all of that is now in the public domain, yet the auditors almost spend no or very little time assessing those disclosures; and those are the disclosures that mean as much to investors as the accuracy of the balance sheet today.

Because these are the factors that are going to affect the accuracy of the balance sheet tomorrow.

JUDGE SPORKIN: I will ask the question again. I asked a very simple question. Do we know what the auditors do when they look at a securitized mortgage? Do we know what they do? They tell us what they do. If they tell us what they do and then we find out, did they find it or didn't they find it? If they didn't, they have got to change.

I don't know why we're making this thing so complex. What did the auditors do here? You're an auditor. You're looking at auditing. Did they properly audit something?

When your people go in, are they going to ask the auditor what do they do when they look to a securitized mortgage? Do they look at the rating and give up? Or go beyond that? And if they didn't go beyond that, should they go beyond that?

Are those hard questions?

MR. HARRIS: I think they're extremely tough questions. I want to get back to you, but not in this session. During your Keating opinion you asked the fundamental question where were the watchdogs? I remember that vividly. We'll get back to that later on today.

But I think it is a very difficult question to figure out exactly what the role of the watchdog is.

JUDGE SPORKIN: What did they do? We don't know what they did. Let's find out what they did.

MR. HARRIS: That's I think part and parcel of what we're getting at directly with respect to one of the items the fraud center is going to be looking at.

Let's keep going around. We have to wrap this up shortly. Let's take the extra time so we hear from everybody.

MR. HEAD: I have to applaud and appreciate comments Bob and Joe both have made -- and this is Mike Head.

To get back to announcing -- that when you talk about -- and I call it the iceberg theory, I've done that for years. What I mean by that is the financial statements are what's above water, when you talk about an iceberg. It is the smallest piece of what's going on. Bob and Joe are alluding to in the full COSO framework, where you have financial reporting, operating efficiency and effectiveness and compliance with applicable rules and regulations, the iceberg -- part of the iceberg you can see is the financial reporting -- a lot of us that are historic law accountants and auditors will call that the scorekeeping -- are very important because it's what investors see and rely on in making decisions. Where you manage risk, where governance is delegated, where you are trying to prevent fraud and hold management accountable and the board is trying to do what they're saying.

That's the large portion of that iceberg is the operating procedures and the compliance portions that by design the auditors' opinion is not intended to cover except indirectly; and it is why

one of the things from a broker-dealer point of view that as things from the -- whatever center you set up or you're talking about trying to influence what auditors can do, that's why a SAS 70 type of approach and why I applaud where the SEC went with the custodial rules and modifying it, if there's something that management, boards, PCAOB, the SEC feels are critical for the safeguards of assets and the protection of the investors, to get at that, you can't do that through the financial statements in an audit opinion of the financial statements.

You have to look at it at the operational and compliance control structure; and the best way to get to that is not through the vehicle of material misstatement and fair statement and financial statements; it is by doing a service audit that falls under the SAS 70 type 2 audit.

So if we think custody controls is where we're really concerned about protecting investors' assets, then you require them to do a SAS 70 covering a period that's covering the operating and compliance procedures and you don't try to get at that through the financial statements.

If someone thinks there's elements that come out of the post-mortem of this fraud stuff that are critical to protect the investors, and it is operationally relied upon, then you go to something like the SEC custodial rules and you put a rule in place that requires management and the auditing firm to look at the controls around those operating procedures; and if governance and compensation are things that hit that hot button, then you include them in a required audit of operating procedures, not try to get at it through just disclosure and financial statement presentation. You'll never get there.

And that's what you and Joe were saying, Bob; but that's not what a financial statement audit opinion is trying to give you comfort on. A SAS 70 or other targeted controls are FINRA, put into place a few years ago, the requirement for the compliance structure to be certified and reported on.

If you took 404 and expanded it to be, we want you to opine on the COSO framework and not make

it a point in time at year-end, but to make it for the operating year of the -- for the company, and you made it cover financial operating and compliance and turn that into a service-type audit for the company, you would get much further than trying to disclose the world in the financial statements.

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

MR. HARRIS: Pete, we do welcome your comments.

MR. BECKER: Two quick things. I think since the beginning of time, in terms of looking at fraud, it has almost always been hidden in the same place. Somebody said earlier unrealized gains, stuck in the inventory. How do we come up with practical guidance that comes up with new things being created on Wall Street or other places because there's a reason the Madoff scandal was referred to as a Ponzi scheme. We talked a bit about things are new, but Ponzi has been around for a hundred years.

What can we learn from the old ones? But how do we stay on the leading edge of the new ones.

Lastly we talked about risks and risk disclosures and how can the PCAOB collaborate with other standard setters and regulatory bodies to come up with some sort of framework.

It's not up to the auditors to disclose those in the financials. Maybe we should ask them to disclose it in their opinions but I think having management disclose it in their financials and having the auditors responsible for reviewing risk disclosures, I think would be helpful.

MR. HARRIS: We're clearly going to get to that a little later.

MR. BECKER: I think Kierkegaard said life is understood looking backwards but lived going forward.

It seems your advisory committee universally supports a fraud center and urges you to implement it promptly and robustly. We also support it focusing on old time fraud whether it is Ponzi or salad oil and looking for ways to make sure we avoid those instances again.

We also think that in terms of lessons

learned, whether it is Lynn's more subtle problems, Ann's structural issue, or Tony's individual concerns, that there are more important concerns that go beyond fraud or at least of equal importance which go to risk and its measurement and the assessment of risk above and beyond the focus on the financial statements. The ability to make sure that fairly presented appropriately incorporates an assessment of risk is an important aspect that we would hope to see a fraud center or a -- as Anne might amend that -- a fools and fraud center would take into consideration on a going forward basis.

We also at least at TIAA-CREF think that looking at some particulars even if you don't take on the entire comprehensive assessment, whether it is rule 105 or the quality of earnings and in our view whether or not we're picking up the entire earnings life cycle of a financial instrument are areas that warrant further consideration on a going forward basis; but the core message, I think, of your group is we need a fraud center that's robust and we need to not only deal with regular fraud, we need to deal with systemic risk assessment issues on a going forward basis.

MR. HARRIS: Commissioner Walter?

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

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

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

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

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

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

MR. HARRIS: Thank you very much.

That's a terrific closing to the first panel.

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

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

(Recess.)

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

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

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

Dan, let me turn it over to you.

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

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

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

periodically inspected.

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

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

So what's the problem?

There are major obstacles to us being able to conduct the inspections that the Sarbanes-Oxley Act expects and requires us to conduct. Currently we are unable to conduct inspections in any of the countries in the European Union, in China, or in Switzerland. As to China, we are conducting inspections in Hong Kong although there are some issues about workpaper access in some cases there.

I don't have complete market figures as to how that affects our ability to -- our inability to perform these inspections affects U.S. investors, but I think that is safe to say it has an important and profound impact on them. The U.S. market cap for foreign private issuers in the places that we're unable to inspect is certainly in the hundreds of billions of dollars, but probably at least a trillion based on the numbers we have.

You can add to that, that would just be the range of market cap for foreign private issuers where their auditor is located outside the United States. Obviously in many cases, even though the signing auditor is in the United States, a substantial amount of the audit work is performed by a non-U.S. audit firm.

I think in the -- for example, in the Lehman audit, the last Lehman audit that was

performed seems to have been in the news somewhat lately, almost half the assets were located outside the United States and almost half the audit work was, therefore, performed by firms outside the United States.

We certainly aren't taking this problem calmly. Although we are trying to proceed on a number of fronts on some it, perhaps the most obvious is negotiating with the audit oversight authorities in those places where we're not currently permitted to enter to try to resolve the issues of sovereignty or privacy of information or whatever the objection might be.

We believe that the enactment of the financial services legislation currently pending in Congress would be an important step for us because that contains a provision that would let us share inspection information with foreign oversight bodies on the same terms we can share first domestically. At least in some cases, our inability to engage in that kind of sharing is one of the objections that has been raised to our ability to come in and perform

inspections.

We're also, I think, mindful of the fact that investors do need to have information about our ability to conduct inspections in some cases. We now have information on our website about firms that we've been unable to inspect despite the fact that the inspection cycle has passed for them. Those are generally I guess without exception foreign firms and we're thinking about whether that disclosure should be expanded perhaps to include the clients of those firms.

There are other tools in our regulatory kit we might be able to use. For example, U.S. signing auditor whose use, rely on the work of foreign firms that we're not able to inspect, whether they should have to make some disclosure, have additional requirements with respect to themselves having possession of foreign workpapers, other things in that range. And of course, ultimately, we also have enforcement tools that could be brought to bear against foreign firms we're unable to inspect although using those tools would raise its own set of

policy issues.

So that's probably longer than you intended, Steve, my kickoff to this discussion. I'd be interested to hear this group's views.

MR. CARCELLO: Thanks, Chairman Goelzer. You hit on some of the issues we're going to hit on.

This is a topic that we were assigned by Steve and Joanne and worked collaboratively -- I'm going to make the presentation but I worked on these slides with Barbara Roper from the Consumer Federation of America and Ann Yerger from the Council of Institutional Investors.

Quickly, as you look at the slides, what we're going to talk about is some very quick background information on the act. Current state of the inspections, challenges, a number and size of foreign registrants, relative size of international subs. We looked at a little bit the PCAOB inspection resources and rigor, lack of access by the PCAOB inspectors to certain foreign countries, the other independent audit regulators.

As Steve requested we do make some

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Independent and autonomous. Affiliates of a U.S. accounting firm may be subject to quality assurance, risk management, overall business reviews, codes of ethics, and professional conduct and practice laws. They do attempt to integrate in these dimensions but in terms of legal structure, they typically are separate.

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

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

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

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

States.

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

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

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

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

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

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

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

I think some of them wouldn't.

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

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

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

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

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

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

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

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United States.

If you compare international revenues, if you do it based on companies that include all companies -- if you include all companies including those with no international revenue, mean revenue to total revenue is 24 percent; mean assets to total assets, 16 percent. If you exclude companies with no international revenue, some companies that are purely U.S. domestic, mean revenue from foreign operations to total revenue is 36 percent. Mean assets to total assets, 30 percent.

So, however you slice it, it is a very significant chunk of U.S. multinational financial statements.

We also looked -- tried to compare the PCAOB inspection process here in the United States to the PCAOB inspection process of foreign affiliates.

This was difficult to do with any degree of reliability using the public portions of inspection reports. So we kind of cheated. We used the PCAOB's office of internal oversight and performance assurance report that was issued on

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December 4, 2009; and this is a public document. It has been submitted to the chairman of the SEC with Chairman Goelzer's cover letter so there's nothing the board and the SEC don't know here.

But issues related to rigor of international inspections related to scope until recently was lack of a system of accountability. Even in -- not to be unkind but even where the board is getting in, there are still issues where they can get in to do inspections, and it is not going as smoothly as they would like.

Then there's the issue of lack of access by PCAOB inspectors to certain foreign countries; and among these countries, again as the chairman indicated, China, third in the world in Gross Domestic Product, Germany, fourth in the world in Gross Domestic Product, France, fifth in the world in Gross Domestic Product. United Kingdom, sixth in the world in Gross Domestic Product. You are okay in the U.S. if you are in Boston, Atlanta, Los Angeles. Other than that, you have an issue.

Okay. Then we looked at independent audit

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regulators and their inspection regimes. So we focused on examining the independent audit regulator in the 10 largest countries based on Gross Domestic Product. Website content and reporting was sporadic and inconsistent across various countries.

This is rough. This was off. There was not any degree of uniformity here. Most usable reports in our judgment were from the U.S., Japan, U.K., Italy, and Canada. Reports were not available in English for France and Germany. We were unable to locate reports for China, Brazil and Spain.

It appeared that the board of the independent audit regulator was independent in the U.S., Japan, Germany, U.K., Canada.

The board does not appear to be independent in Italy and Brazil. We could not determine if the board was independent in China, France and Spain.

Also in Japan and Canada, there weren't separate inspection reports on the Big Four firms but rather they issue a combined report.

We also looked at kind of resources

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available. For the 2008 fiscal year, the PCAOB's operating expenses were 134 million, the million in Canada, 5 million in the U.K. PCAOB had 258 inspection employees. Japan had 39. Canada had 24. The U.K. had 18. In 2008, the PCAOB completed 255 inspections. Canada, 42; the United Kingdom, completed 19.

Japan completed 120, but it appeared to us it was done by what I'll call the Japanese analog of the AICPA. So since the United States Congress has specifically rejected that approach, I put that down kind of indented not at the same level -- not comparable to the others.

Okay. So in addition, reasoning by analogy, let's compare U.S. regulators -- this is you Commissioner Walter -- with international securities regulators.

From 1987 to 1997, there were 300 enforcement actions by the Securities and Exchange Commission. 300 unique companies. There were many more enforcement actions. Not uncommon for there to be two, three, four enforcement actions coming out of one case. The company, management of the company, maybe the auditor. 300 unique what I'll call instances of fraud.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

And then we have questions.

But we obviously will talk about whatever you guys want to talk about. I tried to do that quickly. I wanted to make sure there's plenty of time for people to talk.

MR. BECKER: Could I ask you one quick question on your recommendations?

You don't seem to have linked the ability to do inspections to convergence issues. Do you see a connection between those two?

MR. CARCELLO: The ability to do inspections between accounting standards or auditing standards?

MR. BECKER: Accounting standards. Or do you view that as two parallel tracks?

MR. CARCELLO: If there's a diagram, overlap, we might have opinions as to how much overlap there is. As you rightly point out now, certainly on foreign registrants in all likelihood they're filing with the SEC using IFRS as issued by the IAASB. That won't be the case for foreign subs of U.S. multinationals. They'll still be using U.S. GAAP.

For that part of it, no issue. Right.

But for foreign registrants, yes, there's obviously an issue the board will need the capacity in an inspection sense to not only evaluate auditing which is still the same PCAOB standards are still the same, but be able to evaluate the application of IFRS effectively for these foreign registrants. You're right. That's a fair point. That's a capability they need to have to be able to do that.

COMMISSIONER WALTER: I'm surprised to move on from accounting standards to talk about international auditing standards, that there's no recommendation that relates to that. And to moving forward with people around the globe with FERN and otherwise towards having auditing standards converge because even if you solve the inspection problem, if you have a variety of qualities of auditing standards, the problem is still in some ways going to persist.

MR. CARCELLO: Yes. This is on the agenda for today, Commissioner Walter. It wasn't specifically on our chart. My understanding that if you are a foreign registrant and you are filing with

the SEC, regardless of the country you are in, you can use IFRS right now. You still have to do the audit using PCAOB auditing standards.

And so you might be in Brazil and you might be using ISAs; and my understanding is most of the Big Four, their underlying platform, their audit methodology platform is based on the ISAs, the international standards of auditing. But then for companies that file with the SEC, they lay on top of that any incremental PCAOB requirements. Now, a discussion of whether or not the PCAOB should move in the direction of adopting the ISAs broadly, I think we'll have that discussion later; and so I don't want to take us too far afield.

I did look at the IAASB, and I'm sure you've looked at it as well; and when you look at the current composition of the IAASB and its 18 people and you count the people who are currently -- not talking about past, because Marty is past, he has done inspections here for the PCAOB, currently, currently working in public accounting, it is about 50 percent.

And it is heavily represented by the Big Four. Which again was the model we had at the auditing standards board. That was the model that I had since I was in my twenties, that Charlie had when he practiced accounting, that Dan had for the few years he was in accounting.

The United States Congress specifically rejected that approach.

Okay.

Now, they gave the board the option of delegating standards setting. The board has chosen not to do that.

COMMISSIONER WALTER: I guess the point I'm making is a little bit different than that. Not so much a movement towards international auditing standards, but rather the notion that if you look at the Big Four and you say their platform is based on one set of standards with others as an add on, that that's not necessarily the healthiest underlying condition.

I mean, long term, if the issues that underlie this issue are going to be solved, you want one very robust set of auditing standards to be applied across-the-board.

And that I think is particularly troublesome when you have things as an add on. It's not what you do daily. Remembering I have to do extra things for this guy but not that guy is not a good thing.

MR. CARCELLO: You are right. That's a good point. I think the discussion is how to get so to one set of global auditing standards the same as one set of global accounting standards that are uniformly high quality, in the investors' best interest and promulgated by bodies that are independent of the profession itself; and right now, the IAASB in at least my view is not quite there. But I think, Steve, that's on the agenda for later today, isn't it?

MR. HARRIS: I think it is on the agenda for later today. I don't know whether Marty Baumann wants to take a brief moment to discuss our standards setting process. Sarbanes-Oxley, the spirit, the conviction of the underlying bill was that the PCAOB

be the gold standard in items of setting standards. For this particular group, I think it is important to know first and foremost in terms of standards setting, certainly a very high priority is how do our standards -- how do they improve from an investor protection standpoint, the standpoint of standards that are already out there.

We're doing a very, very careful analysis of the interim standards, the international standards in terms of setting our own standards.

Marty, do you want to take a second?

MR. BAUMANN: I think Joe has kind of alluded to some of the points that are important in this regard. Steve, you did also.

Congress under Sarbanes-Oxley intended for standards setting to change, intended for a lot of things to change in the context of auditing. And right now standards setting is in the hands of an independent regulator as opposed to standards setting largely dominated by the profession as Joe Carcello just pointed out.

So we are writing and updating and writing

a lot of new standards. We look to see what the international and other standard setters have done; but we take a thorough and comprehensive look and add whatever requirements we think are appropriate to have the -- what we think are the highest quality auditing standards that are -- can be inspected against and can be appropriately enforced.

And, therefore, can result in the highest degree of audit quality. We have an ambitious standards setting agenda and program that we think will achieve those goals.

MR. HARRIS: Barbara, why don't we turn to you and Damon. And thank you for testifying, for the public service. Thank you for getting out of that hearing as quickly as you could and joining us on this panel. We missed you on the first panel. We welcome you here.

Barbara? Damon?

MS. ROPER: You know me well enough to know you shouldn't issue those kind of blanket thank yous when I get in front of a microphone.

First of all, Joe did a disservice on

giving us credit for contributing, and I think Ann did. I did essentially nothing. There may be one sentence in this which I contributed which is not an effort on my part to walk away from it but I think Joe did a terrific job. He put a lot of work into it. I think it shows.

On this issue of what was raised, how does this issue relate to IFRS and audit standard convergence, I feel strongly it does not relate to them at all. There is a mandate in the Sarbanes-Oxley Act that the PCAOB inspect foreign firms.

An effort was made in committee to strip that out -- in the conference committee, both Senator Gramm and Representative Oxley attempted to strip that out in conference committee. It was rejected. It was rejected in the face of all the arguments that had been brought to bear by a number of foreign entities.

Congress thought about this long and hard. They made this decision. They made it despite considerable opposition. So I think it has to be taken very seriously that they viewed this as an essential component of effective PCAOB operation.

On the questions of the international audit standards, those of us who lobbied on this legislation fought very hard to ensure that this body would have the authority to set the audit standards.

And that we would change the system in which audit standard setting was dominated by the industry because we felt it had given us standards that were written primarily to protect or with an excessive eye to protecting the auditors from liability rather than resulting in effective audits.

Given the current state of affairs in the international audit standard setting process, to move too precipitously toward some sort of international convergence with standards would simply put us back to the system as Joe suggested that Congress specifically rejected when it offered this model. We would be back to having considerable and excessive -- in my view -- input from the auditors in the setting of those standards and that would not, I think, benefit the standards themselves.

Which doesn't mean there shouldn't be some sort of general discussion of trying to move in the same direction. You reach agreement when it is possible, but it can't become an end in itself. Beyond that, I think there's something of a myth about the benefits of this even in a theoretical sense, which is the idea that uniform standards would produce uniform audits.

We know, for example, with IFRS that uniform accounting standards don't produce uniform accounting. There is at least some sort of theoretical logic to having one language that everybody speaks in terms of accounting standards.

I just don't see the same logic on audit standards; and I think that if you don't solve this basic problem first of getting the inspections and the enforcement and everything working, that simply moving towards comparable standards won't do anything to get us closer, anything significant to get us closer to comparable audits. It is on this end of getting the inspections system functioning that we need to bring us all closer together to performing

the highest quality audits.

MR. HARRIS: Damon, identify yourself for the public.

MR. SILVERS: I'm Damon Silvers. I'm the policy director of the AFL-CIO.

First let me say I apologize for not being here earlier this morning.

As you noted, the Senate Judiciary Committee requested that Barbara and I be there to talk about some related issues to this meeting.

I wanted to impose upon you for a moment on the subject of the last panel and just say that we -- I think that the notion of a fraud center is extremely important, that it needs to be seen in a critical sense as a way of -- as a filter for moving the considerable amount of non-public information that the PCAOB has about the practices of the auditing profession in relationship to fraud detection and prevention and making it available to current practitioners.

It is a device for essentially solving an information problem inherent in the confidentiality

issues associated with what the board does.

Also a way of systematizing, learning in sort of a forensic National Transportation Safety Board type way when we have major frauds that occur. I would note that I understand Commissioner Walter was supportive of that -- of the general concept in the discussion. I wanted to commend her for that.

Now I come to this matter.

I have been involved in my other capacity in the PCAOB at the Standing Advisory Group in a variety of conversations about the issue of the foreign inspections and the obstacles the PCAOB faces in relation to foreign inspections.

I would echo what Barbara Roper said about the current state of affairs in relation to international convergence in audit standards. It was very clear to me at the time this idea was being broached in the waning days of the Bush administration that it was part of a comprehensive push to essentially, in labor movement terms, to whipsaw investor protections internationally, to force a further weakening of U.S. investor protections across a wide range of the regulatory system.

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

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

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

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

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

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

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

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

and politics in economies 2 through 6.

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

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

JUDGE SPORKIN: Stan Sporkin.

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

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

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

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

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

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

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

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

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

Foreign practices, we said we'll destroy the world or destroy our companies because they can't compete in the world. We didn't back down.

I don't understand why it is you have to back down. You say that's your rule. You either comply. You don't comply. With respect to the umbrella companies, the umbrella -- either -- and as I understand it, the affiliated companies are registered with the PCAOB, am I right on some of them? I know one of my clients is registered. They considered it very important.

So we're trying to accommodate something that we don't know; and I would assume with this administration, they'd be pretty firm.

Look, that's the way I used to do things. Maybe they're done differently now.

COMMISSIONER WALTER: There's an aspect of this that has not been mentioned. Which is that this is not a fight between foreign companies and the PCAOB or foreign auditors and the PCAOB. There are countervailing laws in countries.

That is conflict between foreign law and U.S. law. And that dynamic really has to be taken into account and hasn't been mentioned here.

JUDGE SPORKIN: I understand that. Let's assume you are right. But foreign law understands if you go into their country, you comply with their law. If they come into our country, they have to comply with our law.

That's a very simple thing.

COMMISSIONER WALTER: Stanley, in all fairness, they view this as us coming into their country and refusing to comply with their law. The dynamic is in the eye of the beholder. I'm not meaning to sound like an apologist for this, but it is a complicated issue, one that has strong international ramifications and needs to be approached with delicacy.

We want to get there. We don't want to create an international incident.

JUDGE SPORKIN: Look, I don't want to debate this. I see things differently. I think we create our own problems a lot of times by assuming

certain things. Either we do have it, we got to follow our rules, or we don't.

I think it is that simple. I don't understand how we make exceptions. Why do we make simple issues complex? What -- test it. Test these companies. See what happens. If you have to, some of these securities won't trade here. It is very simple. But it is a question of might.

Well, I assume -- we're the greatest country in the world, why don't we show it?

MR. HARRIS: Tony, we'll go to you and then go around.

MR. SONDHI: First, I thank the -- Joe and his team for putting this together. It was really very informative. Just a couple of quick comments.

I think Barbara said it. Uniform standards don't produce uniform accounting.

I think there is this widely held belief that the IFRS is going to do all kinds of good things. Unfortunately the way I see it from what I have found, there are 23 different versions of the IFRS floating around. There are companies that used

to say -- they don't say it anymore -- that used to say these financial statements are prepared in accordance with IFRS except where home country GAAP is better. They just neglected to tell us where it was better. That's one thing.

The other thing is if we look around today and find for example in Spain there's dynamic provisioning for banks, that's not what the IFRS allows. I understand it is not in any one of those 23 versions either. How come Spain's banks are allowed to do this?

We've talked about this at the CFA Institute. We talked about this with the SEC. There are things they are doing that will help over time.

The other thing is I definitely agree that the clients ought to be disclosed. The investors need to know where a significant portion of the financial statements can't be relied upon. The other thing is I applaud -- as I said earlier -- the work you have done in using FAS 131 on segment reporting.

Unfortunately knowing it is 24 percent of the assets and X percent of the revenues does not tell me what percentage of the liabilities and risks. It does not tell me how many off-balance sheet obligations there are. They don't. I know. What I am saying is I agree. Unfortunately, we're not asking them to disclose it.

I understand we have these things about off-balance sheet obligations. The problem I have with that is the definition of an off-balance sheet obligation which I worked on several years ago is simply this: It is something that has an economic consequence, but does not get accounting and regulatory recognition. The problem I have with that is using resources provided by investors.

You can't do it any other way.

Now, if you can't get an off-balance sheet obligation without using my money, I think you ought to tell me how you are using it. I don't care whether it doesn't meet an accounting standard.

In that sense, fundamentally we have something very, very serious missing over here. The belief in foreign countries about some of these things -- I remember a few years ago going with a

team put together by U.S. AID to two foreign countries which was starting stock exchanges there.

One of them told me I was supposed to help with the accounting end of things. One of them said well our accounting standards are similar to IFRS.

I said why don't you send me a summary of your standards. After six months, I finally received it and it said the following: Our accounting standards are similar to IFRS, with the exception of the following: We don't have a standard for consolidation, acquisition accounting, foreign currency translation.

I said why do I need to read anything? How are they similar?

If you can actually assume your standards are similar without having 80 percent of the accounting standards then one would think, what's the auditing going to do for me?

MR. TAROLA: Thank you. In our system, the audit committee is responsible for making sure there's a quality audit done for the company they oversee. I sit on the audit committee of a global

enterprise and we look to the audit team that comes into our meetings every quarter and insist that they answer -- at least answer our questions about the quality of the auditing around the world.

That's our job as an audit committee member. It would help, I think, if you insisted that in their standard communications that they talk about that issue as opposed to us having to drag it out of them. But beyond that, I hope you can get the access that would give us all a little more satisfaction that these groups are being inspected; but I don't think that it relieves the audit committee of its responsibility.

CHAIRMAN GOELZER: Bob, you raised a question in terms of -- or Joe, you raised a question at the end of your sheet: Do investors expect a big four firm to deliver uniform audit quality, given a U.S. listing, in compliance with PCAOB standards?

How would you respond to that question? What do you think ought to be done in that area?

MR. CARCELLO: I'm just an individual investor and not a very wealthy one at that. But I

would expect the answer to that would be affirmative. Why not ask people who really manage money? Gus? Norman? Others? Tony? They manage money. They're better to manage that question than me.

CHAIRMAN GOELZER: Gus, do you care to take a chance at that?

MR. SAUTER: Yeah. Well, certainly the answer would be affirmative. I think -- if I could pass for a minute to gather my thoughts.

MR. CARCELLO: Sorry, Gus.

MS. SIMPSON: Gus, you're off the hook. CALPERS, although I'm sort of referring back to World Bank days here, going to countries where you would have companies floating under one of the Big Four then Big Six names as though it meant something.

And that's the problem. It is snake oil.

And the simple solution is to look at how do we deal with abuse of a branding franchise; and I'm going to -- I know we are going to talk about governance issues after lunch. That to me is the problem.

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

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

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

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

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

I think that could be more fruitful.

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

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

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

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

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

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

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

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

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

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

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

MR. HARRISON: I'll be very brief. I'm in violent agreement with Damon, Anne, and Gus.

I think there is an issue of holding out; obviously the Big Four they, in particular, market a brand and invest a lot of money in those brands not only in terms of client acceptance or competing for engagements; but I do think it is -- implicit in that is a message that we are part of a global network or federation but nonetheless, there is some minimum standard of quality that we adhere to and that we deliver.

And I think we need to begin to ask the questions and peel back the layers of that onion to be certain that that is not the case, which is why I agree that improved disclosure in this area would I think be extremely important and valuable. Not only disclosure about the global structure and the legal affiliation among 9 members of the global enterprise in the firm, but disclosures -- this may bleed into our afternoon panel, but disclosures about their audit, quality control procedures in the other jurisdictions.

And disclosures about regulatory or compliance matters that their foreign affiliates face that would be relevant to a board member joined by two members, one of whom has her placard up who may have some views on that as well, but I think stringent disclosure requirements would be very, very important here.

MR. SONDHI: This is Tony Sondhi.

I think that there's a lot of work to be done; and yet, I would not want to understate the responsibility of the investors.

I think it is up to us to evaluate this. If I am going to make an investment on behalf of my clients I need to know what the auditor has done and I need to be as careful as I can.

I need to be aware of it. My coauthor on my book of financial analysis, Gerry White, likes to say that if you accept a financial statement as it is written, if you accept an audit statement as it states, if you accept a rating agency's ratings without asking questions, then you're not a financial analyst, you're a journalist. And I think there's a

distinction that investors need to be aware of and we like to think of it that way.

MS. HILL: This is Bonnie Hill.

I serve on the board of a company that does business all over the world; and while I'm not currently on the audit committee, I was on the audit committee and I will say we get pretty extensive reports in the board room from the audit committee's deliberations; and our auditors do let us know as well as our internal auditors and CFOs that they're using affiliates of their companies throughout the world. And what we do and think the board is very comfortable with is that our CFO and auditing firm go and work directly with those people throughout the country and throughout the world -- actually throughout the world.

What happens is that on occasion our chair of the audit committee, also goes.

So we know that we're dealing with a number of different standards. We discuss those. We discuss how to rectify those to the standards that we require of our company. And I think it is very

important that you just don't let it go.

You cannot assume that all the information you're getting is clear and is exactly to the standards that you would expect without overseeing it from inside the company. Otherwise, how can you expect investors to have the confidence in your company that you're overseeing it in the way they would like to have overseen. I think it is critical that the company itself, and I agree, Tony, investors as well, but provide oversight and not leave it to chance.

JUDGE SPORKIN: You folks have the ability, the regulators have the ability to deal with something. You know the problem. The debacle occurs. You haven't dealt with it. You have Madoff all over again.

I think you can't shoulder -- neither the SEC nor your board can shoulder this thing when you have the ability to deal with it. A debacle happens. I don't know how you are going to defend it. If I'm advising you -- as I do clients -- once you have that ability to deal with it and you don't deal with it, it is a prescription for disaster. There's no way to hide. You can't say it was a complex issue. You can't say it was this. You can't say it was that. We learned time and time again, you can't -- there's no fig leaf anymore.

MR. HARRIS: Thanks for making our job so easy, Judge.

MR. HEAD: I don't think you can take responsibility away from the board room and the audit committee and management and their oversight responsibility of their accounting firm.

I think that's an important point made by multiple people around and I think on a multinational financial statement, you have one partner that's signing the overall opinion on those financial statements; and that partner ultimately is saying that the entire audit, not just the U.S. portion of the audit, is supporting that opinion, and is able to sign that opinion based on the work of all the affiliates. And that that exists and therefore, I would assume a couple of ways, full disclosure, inspection of that firm, requiring them to say how

could they sign that opinion, and not stand behind. That that is the same quality as our audit standards if it is material to the financial statements.

I don't understand how they can run and hide. I don't understand why it can't be full disclosure and in their inspections holding them 100 percent accountable for the opinion they've signed and if it is a material aspect of the financial statements, they're signing off on that, not the foreign partner.

But that doesn't make the problem go away. I just think you have disclosure in your inspection of the signing firm that you can hold accountable and then if you have to deregister foreign ones, I guarantee you if you came to me and said, my accounting firm, we have to take off your list and isn't eligible to do your audit any more, we'd fire them in a heart beat.

So you have the power to influence, so I don't want to repeat other things; but I think there are some mechanisms here that through full disclosure and current inspections, you get pretty far down that

path.

That's just my thoughts.

MR. HARRIS: Mr. Chairman, do you want to briefly indicate that we are considering a standard on that subject.

CHAIRMAN GOELZER: Well, you indicated -- you asked me to summarize. I think I'll pick that up in my summary.

MR. CARCELLO: I wanted to second what Judge Sporkin said. In your own report from the IOPA basically said and I'm quoting, as currently situated, the international inspection program represents a significant risk to the board.

I think you guys know that. I think you are in a difficult position. I think the SEC is in a difficult position. I think the Judge is right. If a Fortune 50 company has a major fraud seeded in an international sub, that has not been inspected, and let's not lose sight of the fact a big part of the WorldCom fraud was seeded outside the United States to the same extent there's problems at Lehman, if there was a major fraud that affected U.S. investors

in a Fortune 50 company in a foreign affiliate that had not been inspected, the board is aware of this issue, the SEC is obviously aware of this issue, I think the judgment on both regulators would be severe and unforgiving.

MS. YERGER: Ann Yerger with the Council.

I agree with almost everything that's been said. I wanted to follow up Commissioner Walter on your comment about convergence of international auditing standards. I wanted to give a recommendation to the board. I'm not an audit partner. This was a new area for me. I did a lot of research. I don't have graduate students. Digging around to get the answer to this was actually quite daunting. I believe very strongly in the need for issuer based disclosures and obviously disclosures to the audit committee.

I encourage the board to think about putting more information on its website about those five factors and how those apply to the non-U.S. overseers. I don't really understand the Japanese overseer for the audit profession. It is impossible to know. I think to a certain extent it would help the assessment of the issuer based disclosures if you could understand what the oversight regimes are like outside the U.S.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

most of the countries, that's baloney.

Today in Europe, within the European Commission, not a single central bank in that country despite their endorsement of IFRS, not a single central bank in that whole block of countries follows IFRS. They pick what they want to follow and they pick what they don't want to follow.

The French companies aren't following it. We all know that. We have seen analysts report on that. This notion of we've got to have IFRS because it is going to give us comparability just isn't true.

And as I've heard former Chairman Richard Breeden say in a public meeting at the Council For Institutional Investors just over six months ago, you know, if all we do is go to IFRS, so everyone is doing the same thing, it will be the darkest day in the history of the SEC. I strongly believe it.

We have to focus on getting really good accounting standards that give us better transparency and better information to invest on here and the same thing with auditing standards.

COMMISSIONER WALTER: Once again, I must

say I agree with you. The point here is to have high quality standards around the globe. The point that I initially was trying to make is that we can overcome the inspection problem, but if you are inspecting people who are operating under what are not good standards and where you are adding on a few things to meet the PCAOB's requirements, you're still going to have substantive problems.

I do think the two things have to go hand-in-glove. If you solve the inspections problem and don't have people operating at a high level, you're inspecting people that are not doing a good job. That doesn't solve the substance problem.

MR. TURNER: I agree with that, Commissioner. I will say this: Some of this, we're like the cat chasing its tail. I think certainly in the foreseeable future, any notion that we'll end up with high quality auditing standards in countries like China is a figment of someone's imagination. I've just gotten back six months ago, spent time with regulators over there. It just isn't going to happen.

Until we get by some of the cultural issues in some of these countries; and I think you mentioned, Elisse, aptly so, there are laws in these countries that throw up roadblocks. Quite frankly even during my days at the Commission, we saw where the Big Four firms went into Italy and got Italy to adopt standards or laws that threw up road maps to the SEC.

And I will say in that case, we told Italy if they wanted to stick with that, they weren't going to come here. Anyway, I think you make some valid points. I think we also have to recognize with the cultural differences in part of the world and not everyone is the same, the notion that we're going to get everyone to sign up to high quality standards and get to open transparency with good governance and all, it just isn't going to happen. It is certainly not going to happen in my lifetime.

MR. HARRIS: Pete, why don't we go to you? I think we're getting past the lunchtime. We short-changed you the last time.

MR. NACHTWEY: I don't know if being

between this group and lunch is worse than between this group and the bar. I'm going to add a little bit to what's been said on the convergence issue. Back in my prior life, I was involved in auditing an international company that reported on IFRS. This was back in the early nineties.

At that point in time, in the early nineties, U.S. accounting literature, as Tony would know, from serving on the EITF -- it was a stack about a foot high, a stack of literature. International Financial Accounting Standards at that point was about this thick and for those on the webcast, the size of a dime novel you could pick up in a bookstore.

That's advanced a lot in the last 20 years but they were playing catch up from being way behind us. The same was true on the auditing standard side. I think we talked about tone from the top. It is going to be very hard to get at this. I agree with Lynn. I think inspections are just the beginning. For Tom's job on the auditing standards side, I think we have to put pressure and tension on that to get consistency from the top on how audits are viewed and how auditors should be doing their work around the globe not just here in the U.S.

MR. HARRIS: I'm sorry, Meredith?

MR. WILLIAMS: That you, Mr. Chairman, I'll be very brief. I thought the professor's research findings were dynamite. Quite the eye opener.

Speaking as -- from a investment perspective, the universe we deal in has thousands, thousands of elements in it.

We have people pulling the trigger in one way or the other each and every day on these thousands of different companies around the world.

And even if we're dealing with domestic companies, the portion of their business that occurs offshore, let alone the international portion of the economy, I'm scared to death.

We don't have the resources to pick up the phone and call the audit partner, even if he signs it. We can't call the audit partner and say, gee, and how good is your firm or the firm in England that

has your name on it or the firm in another country that has -- you know, it is nice that a board member can do that, a company board member.

But as an investor, we don't have the resources to do that. So we really have to look to the board to really follow -- I guess this is my opinion -- to kind of take the Judge Sporkin approach.

I think we have to have those inspections; and I would urge the board and -- to make that a high priority to work through that. I know you can't do it overnight.

As the investment community needs that assurance that we have quality firms that have been inspected doing this work around the world for the companies that we invest in, and we don't have the resources to do it.

MR. HARRIS: I'd like to support the endorsement of the work Joe did and Barbara and Ann.

With respect to slides, they will be on the PCAOB website underneath the Investment Advisory Group meeting agenda under inspection panel.

Thank you very much for that work.

Dan?

CHAIRMAN GOELZER: Steve asked me to summarize the discussion, although he didn't warn me that two thirds of the lunch hour would be over with.

I would just note briefly the recommendations to the PCAOB that I've heard in this discussion: Beginning with the ones that were on Joe's slides.

First that we -- as he puts it -- redouble our efforts through negotiations with our foreign counterparts to resolve these issues so we can conduct all of our foreign inspections.

We certainly are doing that. Rhonda Schneer is our director of international affairs and works essentially with her staff full time on dealing with our non-U.S. counterparts. I hope to be able to resolve those issues.

There were a series of recommendations related to our increasing the disclosure we provide with respect to the firms, the countries we can't inspect and we extend that to the clients, the public

companies, whose engagements we can't inspect and possibly to the portions of the work of U.S. registrants, U.S. multinationals.

Those are things we have talked about internally. I take those recommendations very seriously. I think you are likely to see progress on those.

Third, there were a series of recommendations related to increasing the requirements applicable to the U.S. firm that relies on the work of foreign uninspected auditor or that is part of the same network, is an affiliate of firms that are inspected.

We do have a -- as Steve alluded to earlier -- we do have a project looking at the responsibilities of the principal auditor. I think that's an area where we can strengthen the standards and make some progress in this regard.

In addition, I think we have to look at other steps to increase the responsibilities of the signing auditor when we're not able to look at all of the work that's been performed. Some of those are listed on Joe's slides.

There also have been suggestions -- I think Damon in particular made some -- that the SEC look at increased disclosure with respect to the issuers, the public companies, where we can't inspect.

I'll leave to the SEC how and whether they might implement that.

I would just add maybe a corollary would be to ask Corp-Fin in its review process of foreign filings to perhaps take a little bit different perspective in its dialogue with the issuer, where we are not able to inspect the audit of the financial statements.

I think that is likely to focus the mind perhaps more than the 18 point stamp on the cover of the 20-F.

There was also, Anne, your suggestion that we have a lot of information about the nature of foreign oversight bodies which by default now people are relying on, where we can't inspect. I think we should be giving consideration to making some of that

available to the public.

Finally, however, while I used the word "disclosure," when you look at the Sarbanes-Oxley Act it didn't envision disclosure as a substitute for us conducting the inspections.

That brings us to Judge Sporkin's reminder that we do have enforcement authority in this area.

I think all I can say is that I'm mindful of the authority we have and the responsibility we have. Few things keep me up at night, but thinking about this one is one of those. I think it is a decision that we would have to make jointly with the SEC because of their ultimate responsibility with respect to our enforcement proceedings.

But I -- unfortunately -- think that in at least some of these jurisdictions, negotiations, we're seven years down the road now of negotiating, isn't going to be the full cure, and we do have to think about exercising that authority.

Thank you.

MR. HARRIS: And with that, why don't we break for lunch? We are way beyond time.

Why don't we reconvene at 1:15 to get back on schedule?

(Whereupon, at 12:42 p.m., the meeting recessed, to reconvene at 1:15 p.m., this same day.)

AFTERNOON SESSION

(1:22 p.m.)

MR. HARRIS: Let's get started.

Our next discussion will focus on the greater transparency and governance of audit firms. This was one of your top four priorities for the PCAOB to consider.

This subject matter is clearly an important one.

Many of the topics you brought up reiterated the Treasury advisory committee's recommendations.

Five of you suggested that firms should be required to have some form of annual financial statements, which was also a recommendation from the Treasury advisory committee.

Five of you felt the firm should have independent members, another recommendation from the Treasury advisory committee.

Another five of you indicated that firms should disclose audit quality indicators.

And six of you would have us require the engagement partner's signature on audit reports, also a recommendation of the Treasury advisory committee.

Beyond that, some of you feel we need to better understand the firm's structure and competition, strengthen independence rules, as well as review auditor accountability to shareholders.

Anne Simpson, you stated the review of auditor accountability to share owners in the U.S. is patchy, and a review of international practice may be useful.

Pete, you feel that providing more visibility inside public accounting firms is vital to the investment community given the importance of the audit process to the functioning of our financial system.

Lynn, you were concerned that we require both "the auditor to sign the report, the partner's name, and have the auditors file an annual report with the PCAOB which includes a report and a list of quality indicators, a set of audited financial statements, much as they do in the U.K. and elsewhere, a report on their governance, which I

believe should include -- as the Treasury advisory report recommends -- outside directors."

So without further delay, let me turn the discussion over to you, Anne Simpson, Pete Nachtwey, and Lynn.

MS. SIMPSON: Thank you very much.

We're going to keep this short and sweet and get us back on track with the time, I hope.

I want to start by quoting Gandhi, which is noble in all circumstances. He was asked what did he think about western civilization; and he said it would be a good idea.

So our topic today is transparency and governance of audit firms. Our panel would like to recommend it would be a good idea.

(Laughter.)

So let's to the details.

I think that the items which our chairman has quoted from the ACAP report deserve to be commended and deserve to be implemented. I just want to focus on a couple of points which I think are really important.

I don't think ACAP really dug into the details. We're assuming the PCAOB has the big stick. You will talk softly; but you do have a big stick.

We would like to see -- certainly CALPERS would like to see the big stick -- of regulation reinforced by some market pressures; and the first is to ensure that we have a regime in which the audit firm is ratified by the share owners. If we don't have a model of accountability that's working, we're going to be in great difficulty. We know regardless of the resources, the competence, the energy the regulator brings to it, we do need shareholders to be scrutinizing what is put before them on the audit.

Now why don't shareholders particularly care at the moment about the ratification of the auditors?

I think because it is just viewed as some form filling. The structure of the audit market is so concentrated, there is so little choice and so little to understand about the quality of one firm versus the other -- I suggest that really what we've been focusing on is the board and the audit

committee, which is good, but I think if more information were to be provided you would find that the shareholders would buttress what the regulators need to be paying attention to.

So financial statements, audited, yes, absolutely.

I would also suggest this needs to be expanded to include governance information which we require as a matter of routine from companies.

So the ownership of the firm, the structure of the corporate affiliations, this is absolutely critical and relevant to what we were talking about beforehand.

I would suggest the idea of independence in the governance structure although -- I don't know how to put this in a polite way; being British it sounds so disloyal. The financial reporting council is now requiring from June 1, U.K., the U.K. part of these tangled webs of spaghetti called audit firms, the U.K. part will have to produce audited financial statements and will have to report on the extent to which they have independent people involved in the governance of the partnership.

Now this seems to me very, very awkward because these firms are partnerships, and independence only works if you're accountable. And as there are not external capital providers to whom the independent board or executives -- or non-executives -- sorry -- can be made accountable, I simply don't see how that will work. The U.K. has a wonderful history of window dressing and making it look as though it is doing the right thing, and I fear this will head in the same direction.

The final point I want to flag up is about some of the other detail in the U.K. code which I do think is probably worth looking at. And I am not going to quote in detail, it's all available on the FRC website.

But They have introduced some interesting ideas that audit quality indicators need to be reported upon, which is something the ACAP committee of inquiry recommended, but they also would like some parallel provisions to be reported upon around risk management and mechanisms like whistle blowing.

I think that if we are continuing to rest the mighty weight of audit upon a handful of opaque, privately owned partnerships which are not disclosing their many and myriad corporate relationships around the world, we really have got a weak link in the governance chain, not just in the U.S. and U.K. which have reasonably well regulated markets, but in many other markets around the world.

So I'll turn over to my esteemed co-panelists, Pete and Lynn.

MR. NACHTWEY: Thank you, Anne. I wish I had a great Gandhi quote, but we'll have to pass on that for now.

But maybe before lunch, and just a couple of thoughts and ideas to give you a sense of perspective that I bring to this.

In the interest of full disclosure, I spent 27 years at Deloitte, almost 20 of those as a partner. So that's going to be perspective one.

I have three other perspectives coming from my role at Carlyle since 2007.

Two of those are as a client, because we

hire the accounting firms to help us do due diligence on companies that we're acquiring. These are companies that are already audited generally by Big Four firms. If we feel the need we go hire another Big Four firm to come in and check what they have done. Which is an interesting fact of life, and says something about how audits are conducted and who they're conducted for.

And in the second place that we are kind of a client is, they audit our firm, they audit our funds, they audit our portfolio companies after we've acquired them.

So those three perspectives.

The last one is probably the reason I'm sitting here, which is as an investor, we're relying on or at least looking at the audits and the financial statements that they've audited of target companies.

With that in mind, I'm going to speak mostly from my last perspective, but I'm sure everybody understands it is informed by a couple others.

I do think this group and the PCAOB in particular can be helpful in promoting some transparency of the audit firms; and I think we have to do it, or PCAOB has to do it being mindful of the fact they are private. As Anne pointed out there are unique challenges to that. They are not only private, they are private partnerships.

Having said that, they do have a duty to the public; and society -- not just in our country and elsewhere -- have entrusted them with an important duty to the public and, therefore, I think we have a right to demand transparency, maybe more than in the past.

I'll add a few things to what Anne said. I know Lynn has some other great ideas.

The three things I would focus on from a transparency standpoint and gleaned what my fellow panelists will say would be client acceptance is one. Second is global networks. We talked about those before. Maybe share a couple ideas there.

The third is on kind of insurance and how they focus on protecting themselves in that regard.

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

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

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

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

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

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

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

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

That again gets into a delicate issue of disclosure.

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

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

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

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

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

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

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

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

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

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

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quite frankly vetted in depth. There were concerns about the governance of the profession, whether they were too internally focused and really getting useful outside perspectives like we see the management teams of public companies able to obtain from their boards.

There were issues about financial sustainability and viability that Pete raised with the insurance issues.

And there was discussion around the concentration, the fact that we only have four of these firms; and I think at the end of the day, the reality set in that we only have four.

Even though some of the other firms down below -- Grant Thornton, BDO Seidman, Magladry, Cochise -- may do a fine job, the reality is you can combine all those up and they get to the size of the fourth one. So the reality is we are stuck with these four unless someone decides to go ahead and go in and break them up, and there doesn't seem to be any political stomach here in Washington, D.C. so the reality is we have four.

Given that, there is no question that it

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is a major, major systemic risk in the system and something that has to be overseen, wisely dealt with, and needs to be regulated.

From that perspective, it is somewhat surprising if not even amazing, especially in light of what we've gone through with the focus on risk and what's in the currently pending legislation, that to this day, the PCAOB is not getting the fundamental information it needs to manage such a huge systemic risk; and it is systemic risk to investors, a systemic risk to the public companies, and the participants.

And there's no question that Sarbanes-Oxley does give you authority to go get that information. Fundamentally, you have to start with -- obviously your inspections give you a basis for some very useful information; but more importantly, though, it is important that one understands the financial stability of these firms as well. They tend to be lowly capitalized, because they're distributing most of the income each year, so partners can pay the taxes. So there is very little

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capital in them.

They use a revolving line of credit financed by their receivables that's paid off each year. So that tees up some leverage issues as well.

And they have large, huge pensions, to a large degree unfunded. A decade ago on one of them, that number was 9 to $10 billion. It had to grow exponentially, so it is relatively huge in relation to the revenues of the firms as well. As partners have described it to me it is their version of the Ponzi scheme because they're using their current earnings to pay the retirements of the old partners. And the young partners who are paying for it JUST hope they are able to get old, retire, and get paid before that becomes bigger.

So in light of that, it is important that the PCAOB start getting the information that one has to have to manage such a significant systemic risk which would include items that have already been discussed.

I think it starts with some of the information we find the motherland quite frankly

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requires in the annual report from their large firms. They require an annual report, that it be audited, and it be made publicly available.

You would tag on to that the things like that Anne recommended then: A discussion about the governance, a discussion about the structure of the firm, discussing the affiliate notion, because they are clearly just affiliates. And as we have seen in court case after court case now, every time there's a case brought and the shareholders try to reach out to one of the affiliates, the firms make it very clear -- make a very clear argument in each court case -- that they have nothing to do with one another, they don't oversee one another, they don't set their audit quality standards whatsoever.

You can look at any of these court documents in any of the court cases, and you see the same arguments being made time and time again. So it is important that you learn and understand the structure in that annual report. There should be THE annual audited financial statements just as they do in the U.K.

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

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

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

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

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

There needs to be -- you cannot manage

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

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

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

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

us.

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

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

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

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

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

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

So I'll leave it at that.

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

Tony, we're here to get your input.

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

Because I have asked audit firms on how they make those decisions. And as Lynn pointed out, when you replace an audit firm that was conducting your audit for 4 million with somebody conducting it for 1 million, as an investor I'd like to know, which one of those was wrong? And you know -- I mean, I don't think it is obvious directionally by just looking at that number.

But I have also asked audit firms what they do. And I think things may have changed today; but for a long time, I don't think they were conducting anything that one could call as worthwhile risk analysis to determine which audits -- which clients they should take.

And I think the systemic risk of the -- fundamentally the principle that the three of you have told us is that it's too few to fail, that seems just as bad as the too big to fail. I think both of them ought to be permitted to do so; otherwise the risk for the rest of us is rather significant.

The other thing I was wondering about though is a recent audit firm that had issues with Bally Fitness, for example, and been asked to hire an outside consultant to tell them whether they're doing a reasonable job of their internal controls and those

kind of things and how they take information up to the technical -- to the national office and so on.

I was intrigued. I said, I wonder who is going to be competent enough to do that sort of analysis.

And you know, not a word has been heard of that since.

I suspect there's something going on there; but that's the kind of thing that I think it would be worth getting additional information on and being able to do something in order to protect the investors and, in effect, to be able to do your job.

MR. HARRIS: I want to go back to something you just said. You said that providing more visibility to key aspects of interest to the public inside public accounting firms is vital to the investment community given the importance of the audit process to the functioning of our financial system.

I was wondering if you could elaborate on the types of financial information about a public accounting firm that you think is needed.

MR. NACHTWEY: One aspect is the pension liability. There is overhang for that. How do firms manage that? It generally is unfunded, in all cases it is unfunded because there are tax rules that don't allow them to get a deduction and ERISA that doesn't allow you to have an ERISA protective plan for a partnership. They tend to have these unfunded liabilities.

How do you deal with the fact there is that overhang? And are we creating such an amount of overhang for the younger partners in terms of being able to operate the firm viably?

I think from my prior experience, at least my only experience with one firm, is that it is well managed. But I don't know that for sure for the other three firms.

Another aspect is just simple basic blocking and tackling. Are they able to manage the balance sheet and make sure that they have adequate liquidity to operate the business, that they're not having trouble with clients in terms of being able to pay their bills and operate the business; and are

they keeping an appropriate amount of reserve?

As Lynn said, for tax reasons, you generally tend to -- tax and other reasons, you generally tend to pay out all the earnings of the firm on an annual basis. What are you saving? These are multi-billion dollar enterprises. How aggressive are they in terms of managing the balance sheet and keeping some sort of liquidity reserve. So those would be the things I would focus on. I don't know if my panelists have anything to add.

MS. SIMPSON: What about -- sorry. I'm sharing Pete's questions -- his microphone. I just wondered if you would say more about this insurance issues. It seems to be the root of much evil or certainly much of the problem we're tackling here. Because the introduction of limited liability for the joint stock company was in a sense, you know, what set capitalism running free. The fact we have this partnership structure and reliance on insurance seems to me put a whole model where you've embedded risk aversion into the system, at a time when you actually need auditors to be bold, to be creative, to be investigative.

And you know, how much can insurance solve that problem? Or how are we going to deal with -- you know -- the perverse consequences of unlimited liability? It sounds like a good way of holding their feet to the fire; then they don't want to be anywhere near it.

MR. TURNER: The liability is probably made bigger in the press media than what it really is. It is a concern to firms and you're always worried about the one lawsuit that might bring you down; but on the other hand the partnership structure does keep skin in the game which keeps people's attention.

The one situation where we had a gatekeeper in a corporate structure is credit rating agencies. They didn't have skin in the game so to speak, and we saw the corporate structure drove nothing but a bottom line mentality, and for a gatekeeper it certainly didn't work.

So the partnership structure I don't think is the problem. It does keep people focused on I

think to a large degree the right thing.

On the liability issue, shareholders have never brought down one of the big firms. Shareholders have always negotiated to settlement. The largest settlement was against Ernst & Young with Cendant, and even there Lazard Frères was brought in, they examined what the liability of the firm was and its ability to pay and came up with a number and the shareholder -- which was TIAA-CREF at the time -- agreed to a reasonable number.

The only situation where we got into a possibility of a firm failing was where the government itself was instituting a penalty, such as we saw in Andersen or in the earlier 1990s out of the S&L crisis, the Fed came close to imposing a fine on two firms, KPMG and E&Y, that would have felled both of them.

At the time the head of the GAO stepped in and was able to talk the Fed into taking a lower number that would allow both firms to survive. So it hasn't been an issue with shareholders; and, in fact, today the largest lawsuits often are not from

shareholders, they are from other companies or the corporations themselves suing the investors.

But everyone seems to understand that at the end of the day, you don't want to put one of these firms down. I don't see a shareholder ever putting one of the Big Four firms down at this point. So as long as the government is acting in a responsible fashion, and there's reasonable governance and oversight so they're not doing things like KPMG was doing with the tax shelters, I can't imagine an outside board stepping in in a situation like KPMG where they were selling the tax shelters and actually had discussions about the fact they could make so much more money than any of the fines would ever be, they ought to go ahead and do it.

You aren't going to see that. So if you can get good governance in them I think that solves a lot of the insurance issue and the concern.

Then it is just up to the PCAOB. They can always get information on the insurance and request that and that along with the financial statements would give them some flavor as to where you are

getting into an untenable situation.

MR. NACHTWEY: Norman, I know you raised in terms of your priorities market concentration issues. I don't know whether you want to talk about that here? Or whatever?

MR. HARRISON: I think it's a good time. I'll be brief. I know there are those at the table who have views as well.

I think there is a broader issue here about market structure. At some point in this group, I hope we'll have a chance to discuss. It has been discussed in other contexts but generally it results in a general proposal to give it further consideration and see if there isn't some way to change the way in which this profession is capitalized.

We used to have -- not all that many years ago -- a Big 10 who became a Big Five and now a Big Four. It became a Big Four through a series of mergers. You accumulated economies of scale in that process. That is when the industry really bifurcated, and there is a tremendous bridge to cross and programs -- an unclosable barrier between the Big Four and those who comprise the rest of the industry.

It has primarily to do with capital. The key to being a Big Four and being able to compete as a Big Four firm is the global presence we talked about in the earlier context, having the need to have industry and subject matter expertise across a vast array of areas and IT infrastructure, a lot of capital expenditures to maintain an enterprise of that nature.

As Lynn and Pete have so well noted, these are partnerships at the end of the day and there's something of a disconnect between the manner in which a partnership enterprise manages its balance sheet and the way the enterprise needs to function, the financial resources it needs at its disposal.

One thing I hope we will have a chance to talk about if not today at another time is whether and how to introduce the possibility -- it may be it falls with the PCAOB but there will be other interested parties and stakeholders -- the possibility that public accounting firms be permitted

and encouraged to organize and incorporate more and raise capital as corporations do from third parties, from outside sources, strengthen their balance sheet, provide a cushion that doesn't exist today. And perhaps through that process to provide opportunities for other providers to become more competitive. I think there's an issue there that really requires some serious consideration.

MR. SILVERS: Damon Silvers.

Like Lynn, I was a participant in the Treasury panel that had a number of recommendations and engaged in very extensive discussions on these issues.

I think there's a couple of take-aways from that process that broadly I think are important.

Giving some -- I don't think it is a panacea, and this -- again, this goes to other people's comments, maybe -- but getting some independent voices into the firm governance is certainly an improvement in our major audit firms.

Secondly, I think that having financial statements, having those statements accessible to the

board, accessible to investors just seems like common sense to me.

I think the notion that these institutions are private entities in any meaningful sense is absurd. Effectively, the way we discuss the systemic risks associated with the failure of any given one of them tells us that they're really no longer private entities in any meaningful way.

Therefore, the notion that their financials should be secret seems to be indefensible.

That being said, I don't believe -- I'm not sure I fully agree with Lynn that the financials of the audit firms are that important.

The fact that their secrecy is indefensible doesn't really -- necessarily mean that you really learn that much important from them.

As Lynn alluded to, Arthur Andersen collapsed not because a giant liability appeared on its balance sheet but because all its clients ran away when it got indicted.

I think that tells us something about what audit firms really are, which is not a collection of

financial assets in any meaningful sense, but a reputation and a collection of human capital.

That being said, the private litigation system in relation to audit firms does fulfill a limited but useful function, which is one of kind of deterrence.

And I think there's lots of evidence over the years that private litigants -- for better or worse -- are very measured in relation to their demands on audit firms, with the occasional exception of the sort of non-traditional party, the sort of business actor looking to score a giant score in some one-off situation.

The final observation I'll make about this, about these matters, about governance matters, is that I'm deeply skeptical -- in fact, I would say more than skeptical, outright opposed to converting audit firms as partnerships into public corporations or into the corporate form.

There's a lot of debate right now about whether, in fact, our stock brokerages, our investment banks were pushed significantly in the direction of our current financial disaster as a result of their conversion from partnerships to public corporations.

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

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

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

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

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

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

I'm sure there's always room for

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

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

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

performance on those measures, because it will be public.

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

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

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

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

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

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

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

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

I've spoken long enough.

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

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

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

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

But -- there are other reasons for that.

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

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

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

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

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

MR. SAUTER: This is Gus Sauter.

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

To me a bigger issue is really ensuring no conflict of interest. There is a conflict if you are the watchdog over somebody who is paying you. I think that it is important that the board actually gets a policy statement from an auditor as to what types of clients they will hire. And that they've established a culture that will enforce that policy statement, so that they're really maintaining an independence from those -- from the company that they're auditing.

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

Tony?

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

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

anything about stuff that's coming from Compustat.

NEW SPEAKER: Definitely arrogant.

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

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

The next year they went back into the top 10, and the head of the statistics department asked the same dean, would you like me to write another letter this year?

(Laughter.)

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

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

MR. HARRIS: Tony.

MR. SONDHI: That's fine.

(Applause.)

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

MR. HARRIS: Stay that way.

Ann?

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

I wanted to make a few comments about the

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

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

I guess I'd like to leave that issue at your doorstep. We discuss that quite a bit at the Treasury Department. As you might remember from the report, we are not very specific. We sort of said let the PCAOB decide what those are. We didn't have great ideas about what are the perfect audit quality indicators, but I would urge the PCAOB to really think about that, because ultimately that's what is most important I think for financial statement users.

MR. HARRIS: Mike?

MR. HEAD: I know a lot of people said the same thing but I do think the audit quality indicators are one of the more important things in this audit category because of how that will be reacted to by the firms.

And then my last thought which -- I always hate throwing out ideas that seem somewhat impractical, but I feel like I need to throw one out because one of the inherent problems that has been alluded is that the auditing firms, even though we went a long way with independence and reporting to the audit committee, and technically the audit committee is hiring with shareholders ratifying the firms, the funds that are paying and their client still tends to be the company.

And without turning it into a regulatory environment, is there a vision at some point in time where there would be a fee assessment of the publicly traded companies to create a pool and an organization

like the PCAOB actually hiring the firms to perform the audits of the financial statements?

And that feels so radical a statement to me, it is hard for me to say it. But you won't ever get true independence and true, clear delineation of who's the boss and whose rules are they going to follow, until, as you say, when you follow the money, that's where -- and the money is still coming from the corporations.

So there's an inherent problem that we're trying to mitigate here. Even though I'm not a big proponent of fee assessment and managing that whole process, it is an idea.

MR. HARRIS: Mike, you are now a wanted man.

Bob?

MR. TAROLA: Thanks Steve. Bob Tarola. I want to thank Ann Yerger for explaining all the things that she ought to be done, because I agree with her a thousand percent. I want to add two things to that.

One is I signed about a thousand audit

opinions in my career. The first time I signed an officer certification, I really worried. It is a different feeling when you're signing your own name.

Secondly, that officer certification goes much further than an audit opinion. I would encourage the board to take a look at it as a model of what we should be asking auditors to be doing. Not hiding behind GAAP, looking for "fairly stated" unequivocally, addressing fraud, addressing controls. That's all in the officer certification, yet we let the auditors get away with a lot less.

MR. HARRIS: Lynn, do you want to have the last word on this panel? I'm sorry, Brandon? Barbara? And then we have until 2:30. So 15 more minutes and we'll go to the next one.

MR. BECKER: My word will be short. It is to agree with Damon and Kelvin that going from partnerships to privately-held companies is fraught with risk. It needs to be done carefully. There may be reasons to try to expand the scope but the change from partnership to public company has a cultural implication that I think you can't underestimate.

Also to agree with Bob that I think the signature of the certification process, I had the same experience. It was the difference between signing legal opinions and signing officer certificates. But I do think it is a very real difference.

MR. HARRIS: We certainly appreciate or I appreciate those comments. One of the reasons to have the investment advisory group is to hear directly from investors. You often don't have the time or the resources to comment on a lot of these issues. Therefore, I think that your views are very important to get on a record because the overwhelming comment letters on the engagement partner's signature were opposed to them. They came primarily from the profession.

So hearing a number of your views on that is important in terms of creating a record.

But moving down the table -- Meredith, do you want to go next?

MR. WILLIAMS: I'm happy to, Mr. Chairman. I appreciate Mike lighting the fire. I'll throw the

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grenade in.

I have to use Mike's word inherent. I think there is an inherent conflict any time you have relationships that involve one party paying another for a service, and that service and that relationship is measured in decades if not centuries.

So my thought is you rotate them. You get a five-year deal; if perform. You throw them out. Bring in a new team. Throw them out. Bring in a new team.

I feel very strongly about that. I practiced that for 20 years with a number of professional service providers, all of them partnership kinds of firms. I'm convinced that every firm providing a professional service -- and I don't care if it is a dentist, an actuary, an investment adviser, an accounting firm -- has a unique and valued perspective.

If you're not going to rotate, you better bring someone in to look over their shoulder every several years.

It keeps everybody on their toes. It is

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expensive. It is darned expensive. That first year of a five year accounting deal, it is a killer to the auditee and a killer to the audit firm. They're not making any money. They make out like bandits in the fifth year, no doubt about it, but overall there's probably some additional costs.

But I think there's huge, huge value in having a rotation of those different perspectives. It is a huge value to the auditee, whether it is me as a pension plan, whether it is someone else as a corporate entity.

I know it is a wonderful thing to me. I bitch about it 24-7 when we've got a new auditor in. But you know, when it's over with, after that first year, I can step back and say you know what, we've been going down this path, and they shed some light on some things that we're doing that makes a lot of sense; and I think we're better because of it.

I feel really strongly about that. I know it is very radical. I think it certainly has worked for us in a number of areas. I think it could work for the corporate world too, as well.

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Thanks.

MR. HARRIS: Bonnie, we haven't heard from you. Then we will go to Damon, then Lynn.

Lynn, you know you're both from Colorado, you can talk about the Sarbanes-Oxley Act in rotation of auditors and the political implications of that issue, not that a lot of people would disagree with you, Meredith; but that issue sort of --

MR. WILLIAMS: Mr. Chairman --

MR. HARRIS: We'll look forward to the Colorado contingent handling that.

MR. WILLIAMS: Mr. Chairman, I'm not talking about partners.

MR. HARRIS: Neither are we. But the two of you can fly home together and think great thoughts together on the way to the Sky High State.

(Laughter.)

Bonnie?

MS. HILL: I was interested in Meredith's comments, one because when a public company changes auditors, the Street says, "uh-oh, something's wrong. What's going on?" And then the board is put on the

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defense again.

So I'm not opposed to that idea, but I think it would certainly have to be made very clear that that's the policy of the board.

The other thing is it is pretty disruptive in terms of the work that has to be done within the company and the auditing team and the finance team and all that.

So I really would suggest you look at that -- a public company look at it very carefully, because you change the audit partner every five years or so, but to change the whole company just because of a policy might not be the best way to go.

And I think in terms of the cost to the shareholders and the disruption to the company, you have to make sure it is worth it.

MR. HARRIS: Damon -- Damon Silvers.

MR. SILVERS: Thinking about some of these issues, Steve, as you alluded to, they all have a certain history to them.

Some of them have been I think discussed and advocated by investors for so long, that some of us begin to forget things we are advocating, and perhaps get discouraged. So in my prior comments I didn't mention these two matters that have since come up that I think are both wise: One, I think small and almost trivial, but yet savagely resisted by the audit profession, which is to have the audit partner identify who they are.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

I'm not saying again there's a right or wrong answer but -- it would slow us down in terms of just how hard it is to get up to speed on these things.

And the fact that at the end of the day everybody wants one person to sign the audit opinion. For one person to get up to speed on General Motors or on J.P. Morgan Chase is just a mind-boggling exercise even with the help of hundreds of people in their firm.

MS. SIMPSON: Very briefly: CALPERS is huge, as you all know, $200 billion plus. But it is required by law locally to rotate its auditors every five years and is not allowed to reappoint the existing firm. We can only give a five-year contract. So there is some experience with large -- institutions. Maybe we should look at that.

The other thing I wanted to say as you were asking for comments for the record, I don't think I said specifically but CALPERS does support the recommendations in the ACAP report; and I want to

highlight the audit engagement partner's signature is something that would certainly add value -- for this person doing the signing as much as for the readers of the accounts.

MR. HARRIS: Lynn?

MR. TURNER: Three things, Steve.

First of all, the issue of capital and only four firms.

About 10 to 12 years ago the profession looked at alternative firm structures. Some firms adopted them. But quite frankly, they never worked out for any of the firms. Some of the firms now regret having gone into those structures.

If you look at the size of the regional firms, again if you go and look at the number of offices, number of people, the capital in them, there is no way possible for any of those to grow up into another Big Four.

So we are stuck with the "too few to fail." That's the reality of it. There's nothing you can do. To do this, to say we are going to raise capital, create competition is a gross misnomer. It

will never happen. It can't happen. We have let it get so dominated by this oligarchy that we are stuck with it for this point in time until someone has got the guts quite frankly to go do a break-up and even then the firms don't generate the type of rate of return that you'd expect in a public company.

So they couldn't raise the public capital, because quite frankly, they aren't going to generate the type of returns you really want to see there to start with. That's the first point.

Second point, someone raised the question about can you really get information out of the financials of these? The answer is yes. You can see what liquidity is looking like in the these firms, and cash flows. You can look at what their calls on their cash is and what they are have to use the cash up for, including the revolver.

You can turn around and most importantly look and see what they're spending on and investing in, two key components: One technology, one people.

If you ever manage one of these units -- I did manage them -- inside the firm there are very key

components as far as what you are spending on people out of every revenue dollar, what you are generating in reference dollar per people. It tells you how much you are leveraging up the people.

It tells you whether or not you are putting your money where you need to to make sure you are getting the job done right. That information is available in those financials and only available in those financials, so it is very important you get that.

On the last point, rotation. It did used to be that there was a negative connotation with changing auditors; but in the last half years thousands of companies have changed auditors and that's no longer the case. Analysts have gotten so used to seeing a change in auditor, it's a natural. They ask a question about it, you tell them, and it is over. It doesn't have the negative connotation, nothing close to what it used to.

If you go to a mandatory rotation, say like every 10 years, then, in fact, everyone knows what it is. So that argument is set aside.

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

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

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

turned around and complained about the cost of changing auditors.

Not a single one of them.

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

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

MS. HILL: Keep one clean?

MR. TURNER: Keep one clean.

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

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

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

Really, I think it is a matter that has

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

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

First up to bat is Kelvin.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Does the average investor know what constitutes a material misstatement or that materiality is based upon the auditor's perception of what the investor finds material?

Is it clear to the average investor that

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

MR. GRADISON: Thank you.

MR. HARRISON: I think I'm next.

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

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

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

If you got to the 10-K or got to the annual report, got to the page, there was a three paragraph letter, you just turned the page and kept reading. Only if there was a fourth paragraph or language you didn't expect to see did a red light go off and you stop and read it.

We haven't advanced very much. It is still a highly formulaic report, lot of boilerplate language as Kelvin noted.

I think when the investor community thinks about what would be beneficial in terms of greater disclosure around the process of conducting the audit, we mean a real report, an actual narrative description of the approach that the firm took to this particular engagement for this particular year.

How was it staffed? What were the resources the firm deemed necessary to contribute to the team? What was the audit plan?

What framework did they follow in conducting the audit? What technical expertise or subject matter experts within the firm -- not

necessarily by name but by function -- did they draw upon and why?

And I think perhaps most importantly, to tie into Kelvin's comments, a discussion of the principal financial risks that the company faces and which the auditors took into account in designing their audit plan and importantly in developing their measures or standards of materiality, because risk and materiality are hand in hand.

I think a well-crafted audit report would describe both of those in an appropriate level of detail and explain how they interconnected in terms of the actual conduct of the audit.

Another area where I think it would be helpful to have more disclosure, we've talked in other contexts today about the on-off switch, the toggle switch nature of a lot about what the auditors render an opinion on. In connection with financial risk and with -- in connection with the evaluation of internal control processes.

Even in those situations in which no material weakness is found to exist, I think it would

be very helpful from an investor's standpoint to have some narrative discussions of issues that were identified, or emerging trends or emerging areas of concern that while still short of a material weakness may be headed in that direction or require attention on the part of the issuer.

I think the fact the auditor identifies those, discloses those, urges management to pay attention to those would be something that investors in the capital markets would be well served by understanding.

I think also in the current environment, given in particular the events of the past two years, I think some discussion or disclosure of the degree of regulatory risk an enterprise faces would be a very helpful addition to an auditor's report.

And then lastly, a word on independence.

Because it is certainly a governance issue, but the independence determination is essential to the conduct of the audit because it is the threshold decision to be made at the outset as to whether or not the firm is actually competent to

conduct the audit for the year in question.

I think that it would be extremely useful, we are again in an environment in which audit firms are providing a wide area ray of services to their clients. Everyone is back in the consulting business through the advisory practices. In many cases we provide significant amounts of tax services to our clients. We have the benefit of bodies of rules and regulations, most importantly from the PCAOB but in addition through the SEC that we didn't have in the last rounds of financial frauds.

I think the next logical step here is to require disclosure to investors of the process by which the independence determination was made, because I think we're back in an environment where there certainly are in many instances close calls.

It would be helpful to know -- to have a description of the firm's internal engagement acceptance process with respect to the specific engagement questions, the steps the firm took to measure and determine its independence; and importantly, discussion of any issues that came up internally as the firm vetted the engagement and perhaps more importantly in discussions with the audit committee, what questions were raised, what potential compromises to independence were identified, and on what factual basis were they resolved?

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

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

MS. HILL: Okay. Bonnie Hill here.

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

it.

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

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

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

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

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

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

And it is very interesting. I think last

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

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

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

And then in terms of transparency, I think definitely that in our annual reports, an overview of how the auditor has proceeded with his or her work, is important and how the board uses that. But I think if it can be done concisely and in a readable fashion for the average person, that that would make a tremendous difference.

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

(A little laughter.)

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

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

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

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

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

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

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

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

that should be considered.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

qualified opinion. There has to be something in between.

MR. HARRIS: Lynn Turner.

MR. TURNER: I actually have a different view.

I actually do like the pass-fail system.

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

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

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

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

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

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

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

Part of what you're asking for, though, is also not an auditing issue. Part of what you're asking for deals with the FASB's disclosure standards. And the FASB's own investor technical advisory committee has urged the FASB to adopt a disclosure framework, and that disclosure framework, if they would do it, would turn around and provide investors the key assumptions that go into these significant judgments and estimates.

It would give you information about the range of possible outcomes; and the key points that would drive, as well as what within that range was the number that the company picked.

So you'd still get a good number in the financial statement of what they think their best estimate was. But you'd get information in the footnotes about all the flavor and connotation around that so you can make estimates.

You witness that information together within what's in that auditor memo, and I can guarantee you, you know exactly where the risks are in those financial statements and you know exactly the information you need to dig down and analyze and if you want to on your own move the numbers around, move them around.

But that's what you're really trying to get to, and trying to put all that just into the first pass-fail audit report, I don't think works.

I want to be able to just right off the bat go in and say are my financials right or not; and then go get the additional analysis so I can analyze it as analyst or researcher or investor. But I still want that pass-fail report in plain English.

MR. HARRIS: Marty, do you want to take a minute or two, a couple of minutes and discuss what we're up to?

MR. BAUMANN: Sure. This is Marty Baumann, the chief auditor at the PCAOB.

This has been a great discussion. Thanks. It is valuable input to us in our auditing standards setting process.

So let me just talk about a couple of things like that have been discussed. The first one was should the individual auditor sign the audit report.

As was mentioned a couple of times, we've discussed that with the Standing Advisory Group. We've issued a concept release on that.

What's particularly helpful here because as Steve said, the responses that came back to the

concept release were largely from the profession, and largely opposed to that concept of signing the report, clearly the discussion around this table from this investor group sees that that's a pretty good way for accountability on the part of the auditor and would probably help the investor and may even help the auditor as well, as I think I heard somebody say.

We have a project under way in my office kind of pulling that to its final conclusion right now. We will bring a paper to the board with our recommendation from the office of the chief auditor as to how we should move ahead with that project on signing the audit report. The board should be getting that recommendation from my office pretty soon. We've been doing a lot of research on that. And certainly this conversation of record helps that discussion.

Turning to the auditor, the audited report itself, Lynn, thanks for summarizing most of what I was going to say. You did a great job.

We had a very good discussion of this at the very last meeting of the SAG just a month or two

back, and there was a recommendation of the Treasury advisory committee, so we took this up and put a briefing paper before the SAG and had a pretty -- very thorough discussion including break-out session of members of the SAG. I think what Lynn said was held pretty widely by most of the group, that there is a great benefit to the single report that does say whether or not the financial statements present fairly. That making that ambiguous may not be very helpful to investors.

And, therefore, retaining the report that indicates whether the financials present fairly or not is a positive thing. But yet the auditors want more.

So again I have to come to a recommendation to the board, but in doing that, the way we're thinking about that is taking a look at that in line with the comments Kelvin made initially, taking a look at the audit report itself, which would retain the presents fairly, pass-fail type of model, but probably there's some things in the language of that report that could still be improved.

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

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

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

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

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

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

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

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

actually equal what the auditor considers to be material.

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

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

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

MR. HEAD: Mike Head.

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

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

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

If there was a format that required content dictated similar to management's discussion and analysis, that would be the auditor's discussion and analysis that the firm would have to sign a consent, like they do the opinion, I think you add some real value and not create more audit work or cost to the audit, because it all already exists and has to be reported in some form or fashion to the audit committees today. It is just a matter of what's important to the user and reader of the financial statements from the PCAOB's and SEC's opinion.

So I think that's a very, very positive direction to go, that is where I think a lot of the dialogue today has been at.

MR. HARRIS: Ann Yerger.

MS. YERGER: Certainly the council believes the disclosure about the auditing process would be of interest. We do believe more details about key findings would be of particular benefit to the investing public. I'm aware you released a proposal regarding enhanced disclosures between the audit firms and the audit committees. And our view at the council is that some of those disclosures would be of keen interest to the investing public. It seems like some of your work is already being done in this area.

Gus, I think it gets at some of the issues you were talking about, which I think are very, very important.

MS. SIMPSON: Anne Simpson from CALPERS. We are fully in support --

MR. HARRIS: Anne Simpson, I'm just -- identify yourself as you go around. There's a larger audience.

MS. SIMPSON: I am Anne Simpson.

One caveat, if the discussion is to be more than just more fluff, is this issue about potential liability litigation; and I don't know -- maybe we just leave it on the table for coming back for discussion -- is what do we need by way of safe harbor provisions? The confidentiality is not quite the confessional. Confidentiality between the auditor and the audit committee. But putting that out into the public markets puts it under the glare of publicity for potential litigation. I just wonder if it would continue to be so useful. Maybe we need to look at that. Thank you.

MR. WILLIAMS: I'm not Anne Simpson.

My name is Meredith Williams.

I want to know how close I am to the cliff. I really do. I want to know on the accounting side how hard the entity is pushing. Are they on the edge there as well? How hard are they leaning on the accounting standards?

I want -- I don't get to sit in the board room. I certainly don't have time to call the head of the engagement, the audit partner, top level audit partner.

But I've got to know. Again, I don't know the right question to ask. Maybe my right question is would you, head auditor, put your money in this firm? Would you stock in this company?

I need some feel. I don't get that now. You know, the pass-fail thing is fine. That allows you in our gate; and we'll then put you through the rest of the analysis to decide whether we want to buy you or sell you.

But -- so pass-fail has some significant benefit; but I've got to know more.

I really like the idea of perhaps having

some access to an auditor discussion analysis so long as it includes some kind of a sensitivity analysis that others have referred to.

In saying this is a going concern and so forth, what number are you using as your analysis? What happens if things go askew in one direction or another? How thick is the ice?

So those are my thoughts on these very important matters. Thank you.

MR. HARRIS: Damon?

MR. SILVERS: I have a couple of comments on this discussion. The first thing is -- and I said this before at the SAG and will say it here: There are some large issues that I think are now fairly clear in relationship to the sort of -- I wouldn't say the reliability or the -- the seriousness with which investors take audited financials and the audit process; and one of them has surfaced in our discussions today, and the other has not. And I just want -- I think it is important to put them own the record in this conversation.

And then I want to shift to at least one type of response that one could imagine to this set of problems that often seems kind of intractable.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

the way firms do currently. Right? Obviously if you meet the auditor's concern then you don't have a problem.

The -- what I'm suggesting is a system in which there would be no way to avoid having to actually tell the public what the dodgy items were, and how they were resolved.

And I think that approach would be more likely to actually generate information than either a narrative or a graded final audit opinion.

So anyway I offer that for people's contemplation.

MR. HARRISON: This is Norman Harrison.

I'm tempted to take my sign down and pass. That was well said, Damon. I will be brief because you said it much more succinctly. But I was going to make a broader point. Damon's suggestion fits neatly into it.

I think in many respects we are all talking about the same thing here. Whether it is a matter of whether we change the format of the report or have a discussion and analysis, what we are

talking about is disclosure. I'm not sure what we call it, or where in the audit papers it comes, is as important as what we're getting. I think Damon hit it.

What we are concerned about is in addition to things we've already discussed about how the independence determination was made at the threshold, and how the engagement was staffed, and planned -- most importantly, from an investor standpoint, what issues of concern came up along the way and how did the auditor get comfortable? Because at the end of the day that's what it is all about. It's about getting comfortable, giving that that grade, whatever it is, signing your report.

I think that is the key disclosure we are looking for here. Perhaps if that's a good suggestion there would be some benefit from some further review by this group, but to use the conclusion memo, the management letter -- there are documents prepared in the course of an audit that contain or highlight those issues -- and distill those into some type of meaningful disclosure at the

conclusion of the process that auditors, the investors, the investing public would have access to, I think would be a breakthrough.

That's my final word. Thank you.

MR. HARRIS: Tony.

MR. SONDHI: Thank you. This is Tony Sondhi.

There are about three or four points that I wanted to just go back to.

One of the issues that was raised was we would like to know how far we are from the cliff. Unfortunately you're often told you are a distance from the cliff and there's a review at the national office level and you discover that your audit partner was actually wrong but you don't have any resource anymore, you have got to fix that.

Those -- the seemingly arbitrary nature of those types of decisions is something that investors would benefit understanding better. The other issue though is a little bit different. I'm concerned whether it is pass or fail or a different type of grade, the problem is that it is still scorekeeping.

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That's what they're telling us. They're not giving us better information. It is unclear to me whether to some extent we are really wondering whether auditors ought to tell us more of their analyzing the company.

One of the things I will briefly tell you about, one of the ratios or rate analytical methods that I use a great deal is to look at what I call the cash cycle of a firm. Look at the number of days it has inventories on hand. Add that to the number of days it takes to collect its receivables and subtract from that the number of days it takes to pay its suppliers. I call that the cash cycle.

It has been shown for the last several years to be a very, very good indicator of companies that are in trouble.

Now just imagine the amount of time it takes, and if it takes you about -- you can plan about two to three years in advance, that means there was something seriously wrong with those numbers in the financial statements.

When the sales outstanding continues to

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climb, is it not normal to expect that the analysis of uncollectables should have been done a little bit differently? Well, that's one of the estimates that I'm assuming auditors are looking at.

Another comment that was made was that there are some issues with respect to the estimation errors in fair value.

Well, what about the estimation errors in accruals?

We've learned lately there are tremendous estimation errors in the amount of liquidity that people report, too. If we don't look at the auction rate preferreds and money markets with some care, you can tell people yes, they have this one in auction rate preferreds, but we're not saying whether you are going to collect them.

When you look at it from that perspective, or you take the issue of whether the existence of off-balance sheet financing activities, the existence of special purpose entities, of variable interest entities, is really an issue between the accounting standard setters and that between the PCAOB, my

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question is the existence of such vehicles such as special purpose entities and the variable interest entities, other off-balance sheet activities, they do suggest a certain amount of risk. The fact that we're not going to account for them doesn't eliminate the risk.

From that perspective, I think we need to look at this a little bit differently. Yes. There are errors in estimation. I served on the expert advisory panel on measurement of fair value for illiquid securities. We did come up with ways to do a sensitivity analysis. Part of that now is part of the standards.

The question is what should I expect the auditor to be able to tell me about these things, other than saying that somebody actually showed them a spreadsheet which had some of this analysis?

Is the conduct, is completion of an analysis a sufficient audit process?

MS. HILL: Bonnie Hill.

I'd like to go back to something that Anne said that I think really goes to the heart of the

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matter of the disclosures or transparency, however we want to define it.

That has to do with public and non-public information, how much information -- you know -- is the company willing to share, or the auditor, because of the exposure that they have -- you know -- in the legal sense as well.

What comes to my mind is discussions we have in the board room or in the audit committee on materiality and what a particular -- what our auditors thought and what our internal audit partner and our finance people thought, and if there's a difference there, how they got to the place that they did. We have those discussions. There are a lot of things like that you will discuss as it relates to the auditor's report even before it is actually published, that are not things that you're necessarily going to shed the light on for the general public, because on a daily basis or a monthly basis or whatever the case may be, you'd have your stock price jerked around in some incredible fashion, because people just don't know how it's going to come out when you are working through issues.

I think when I talk about the transparency, I think the important thing is what is the process that you use, how do you resolve discrepancies and if there are serious issues, then I think of course those have to be disclosed.

But from my experience what happens is you go to a certain point and the lawyers will say that's non-public; and you can't disclose that.

So as we move forward, I think what we all agree on is very important, which is making certain the investor knows what kind of risk they're taking.

Those risks are being evaluated on almost a daily basis inside the company and inside the board room and with the auditors; and much of it, you're just not going to get. You can get a longer report and what it's going to say is we've used this type of process to get to this place and our conclusion is thus.

I just don't think you're going to get the detailed description of everything that take place.

MR. HARRIS: Well, Bonnie, Norman, Kelvin,

thank you for leading that discussion.

Why don't we take a 15-minute break until a quarter of 4:00, and then we'll be back and conclude at 5 o'clock.

(Recess.)

MR. HARRIS: Why don't we get started with our next panel, which is auditor expertise and responsibilities.

And Charlie, why don't you go ahead and introduce the panel?

MR. NIEMEIER: I think it is appropriate that our last session with a designated subject matter is kind of wide-ranging, auditor expertise and responsibilities.

Certainly we've heard some comments that go from auditors' level of knowledge of complicated financial instruments; certainly knowledge of accounting standards, and accounting standards especially in the environment in which there is a great promise of some fairly drastic changes in the accounting standards; disclosures; issues related to whether to include references to the internal

function in the auditing standards; as well as adding a forensic audit component to the standard audit process.

To lead us off Robert Tarola will start, then Tony Sondhi, and then last but not least, Judge Sporkin.

MR. TAROLA: Bob Tarola speaking.

I want to take the group down memory lane, those of you with gray hair; and there are a few of you in the room.

Thirty years ago companies produced financial statements and auditors provided an opinion on those financial statements and that was basically the financial reporting that investors received.

Move forward a little bit. Management's discussion and analysis was required, I'm going to guess in the late Seventies, and the auditors reported on the statements.

And then more disclosures were requested around risks and exposures, and auditors reported on the financial statements.

And then more disclosures around

compensation and enterprise risk management, and auditors reported on the financial statements.

The point I'm trying to make here is that companies are producing comprehensive reports about their business, about how they're managing their business, about how they're compensating executives, their philosophies around risk management; but the auditors are looking at the financial statements.

From my perspective anyway, that's a far too limited role for auditors in helping investors. That they touch every page of those reports, whether it is a 10-K, a 10-Q, or a proxy, yet their responsibility is to the narrow part of it called financial statements.

I've been an auditor and I've worked with auditors as a CFO and as an audit committee member; and they crawl all over the company. They know whether or not the disclosures about the business are fair and reasonable.

They assess whether or not the measurements for executive compensation are correct and accurate. Yet, we don't call upon them to make any sort of comment about the larger aspect of the company's financial report. We limit their role to the financial statements.

I believe the PCAOB has the ability to expand the role of the auditor to more than just the financial statements.

I think investors would be well served if there was a type of validation that was applied to the entire company report by the auditor, not just the financial statements themselves, again not even going to the discussion of the financial statements.

So our panel is to talk about auditors' responsibilities and the expertise to carry out those responsibilities.

If the role of the auditor was to expand beyond the financial statements, it's going to take a different expertise; and I'm going to let Tony pick up on that.

But as an investor when I think about myself personally or my role in investment companies, what the market really wants is a validation of the value factors in the marketplace.

Wants a validation of whether or not market risk is fairly assessed.

What role could the auditor play in helping the market get comfortable with the elements of valuation, whether it's integrity of management, ability to continue to grow, whether it's the prospect of a new product, whatever factors may be in the marketplace that are generally discussed in company reports? What role should the auditor play in helping validate the broad base of information in the marketplace, not just the financial statement?

And then Tony, what expertise would they need?

MR. SONDHI: I'm going to talk about three specific areas, disclosures, because that's what -- as an analyst -- I always focus on.

Securitizations, off-balance sheet activities and derivatives.

Now with respect to disclosures, you know, those of you, all of us here, of course, have read footnotes on financial statements and we know that at the bottom of the page, every one of them, every page

it says these footnotes are an integral part of the financial statements.

But for the 10 years that I've been on the standards-setting bodies one of the first things I remember telling the EITF the day I joined them was that it seems as if there are two laws that we operate by. One is that we don't talk about accounting after 4:00 p.m. on Fridays. There is a corollary to that we never discuss disclosures before 4:30 p.m. on Fridays.

And if you go back and look at the EITFs, you discover so many of them don't have disclosures. I don't understand that. They're supposed to be accounting standards. Think about one of the biggest changes we had in recent years, the accounting standards on stock options. When 123-R became required, a lot of companies discovered they didn't have enough information to calculate certain deferred taxes. However, they were supposed to have been doing that for 10 years at that point.

And they all had audits for 10 years at that point; and yet, they didn't know anything about

their -- or sufficient information about their deferred tax assets.

Now that's just in a sense one example. We've had -- we have more than a hundred accounting standards on revenue recognition. There are few components of financial reporting that are as poorly served by disclosures as revenue recognition.

The EITF 00-21 which talks about multiple element arrangements -- we used to have two requirements which are fundamentally just descriptive: Every one of the accounting firms that was writing about the replacement, the amendment to 0021 EITF 081 starts off by saying there's going to be a tremendous expansion in your disclosures requirements, which the way I see it, now you're going to have to talk about what you were doing.

So in that sense, I think disclosures have been unfortunately neglected. And I don't understand why auditors don't audit the disclosures to the extent that they, I believe, they should.

Securitizations, the other off-balance sheet activities, as I said, those accounting transactions there may be to some extent problems with our accounting standards, special purpose entities, QSBs, for example, which we finally have gotten rid of. But the point is that there is a substantive amount of risk that remains on the books. You don't find a lot of companies actually selling their -- those kinds of assets.

However, we created an accounting standard that permits the recognition of a sale transaction.

Lawyers give true sale opinions. And they give the consolidation opinions. But you could ask one lawyer or two lawyers or three lawyers and you would get a ton of different explanations of what a true sale means.

They're not fundamentally either economic or accounting concepts; and yet they've informed our financial statements -- extremely poorly, I would say -- over the years.

Consider the disclosures on derivatives. Do you really think it is rational to expect a company that engages in several billion dollars of trading in derivatives to tell you that an X percent

increase on either side in either the interest rate or the foreign exchange risk is not going to cause us any losses?

How many people do you know who are perfect, with respect to derivatives? And yet if I read disclosure, they are not going to have any losses as a result of those derivatives. And yet we have these disclosures that are sent to us over and over again -- with clean opinions.

Think about -- I'll give you just as the last point, this is sort of eerily reminiscent to me at least of repo 105 transactions, which most of you are probably aware of.

A few years ago -- 1999, to be exact -- a company made the following disclosure, and I'm just going to tell you two sentences in it.

Year-end was September 30. On the 10th of September, the company created a finance subsidiary and sold it $600 million of receivables. And the finance subsidiary is 100 percent owned. And the company, in order to make that sale, set aside $750 million in collateral.

Now what do you think? Do you think a sale occurs for 600 million if you have to put up 750 million is collateral? But it gets better. The next line: In October, we repurchased all the receivables and shut down the subsidiary. And this was treated as a sale.

It is not all that different from repo 105, but I don't want to hold them out as the only company that does that. There are a lot of financial institutions that have been engaging in that game and there are a lots of institutions that we don't think of as financial institutions that have also played that game.

The point I think is, from my perspective, we need a better understanding of disclosures on the part of the auditors. We need them to review them. When you open up the Dow 30, for example, and look for the derivative disclosures, and for the Dow 30 you find that the derivative disclosures in those 30 companies read identically, there has got to be something wrong.

These are boilerplate disclosures. How

can Exxon possibly be telling you the same thing as GE? And how can an airline have the same wording for a disclosure requirement as a metals company?

So in that sense, we need a better understanding of what these financial statements are supposedly telling investors.

JUDGE SPORKIN: Terrific stuff.

Let me go back a little bit to banks here.

While I might hold the accountants -- give them a little tough love -- it shouldn't denigrate my view of the accounting profession.

I think that was shown when we created the Foreign Corrupt Practices Act in the late Seventies; and I must tell you, it was based upon the great esteem we had for the accounting profession, because it was thought when the books and records provisions would be put in, that that was done so the accountants would find all the schmutz and be able to disclose it.

But let us now talk about -- we have to differentiate some of things we are talking about today, separate the apples from the oranges.

The first thing we expect the accounting profession to do is mine the data. They have to find the data.

The second thing is when they find the data, what are they going to do with it?

So there are two big issues that come along that challenge the accounting profession.

In other words, if they mine the data and don't find what's gone on, obviously they are not going to be able to issue the kind of report that's necessary.

In talking about mining the data, something has cropped up over the years in which the accounting profession says we're going to mine it, but we're only going to be looking for material kinds of things; little stuff we're not going to look at.

So, therefore, the people on the other side that's trying to defeat this system -- remember there's a tension taking place here. People trying to beat the system. At the same time, you have the profession and the good guys sort of trying to make sure that it's working -- and so we have -- and so

the people who are trying to defeat the system have learned exactly the way the accounting profession works.

So we developed the so-called financial audit. The financial audit as I told you before is looking for big things, looking for materiality. Now comes fraud. The accounting profession says -- used to say; it has changed a little bit -- says we are not looking for fraud. And to bolster that the people that are trying to defeat the system, they understand that, so they go under the radar screen. They go out and deal with the system so they can beat it.

For example, if you are trying to bribe somebody and don't want the accountants to find it, you do it by doing the kinds of things in the accounts that they don't look at. Petty cash. I don't want -- we don't want to get into petty cash. It is too small. Yet the people defeating the system use it to get the money to pay the bribes. They do it all the time.

The first thing you got to do is devise

this system so that the accounting profession is now going to be looking at that aspect of it.

And what is the thing that -- I had to come up with this concept in connection with a client. And so what we did with the client, which is an accounting firm, what we did with the accounting firm is to say okay, wouldn't it be nice to combine forensic accounting with a financial audit, bring the two together so the forensics will look for the under the radar screen and the financial audit will go into their dance with respect to the materiality?

This works. We've had one season where we did it. And now we're going back for the second season.

I can say to you it will work; and I think hopefully it will become packaged and become maybe a part of the whole system. I don't see any reason why that kind of concept can't work.

Second thing that I find when I look at the accounting profession -- remember, I have a -- I was trained as a CPA so I have a little accounting background -- second thing I found which I think is

quite interesting is the fact that when the SEC looks at a transaction is different than when the accounting profession looks at a transaction.

Why, I don't know. But it is like night and day sometimes.

And so the concept there that I am trying to develop is a concept of a compliance component in an accounting firm, that will look -- at the end of an audit, go through the audit and look at the items, based upon now -- we have a history now, of so many things involved in trying to defeat the system that they will know fully what they are. Whether it is the 105s, whether -- each time we get another one of these -- of these -- these things such as the 105s or the special purpose entities, to build your -- build a -- information concerning them.

Have this person who's highly trained in this area to look at the audit, step back, and say wait a second, what is it that this -- does this audit show any of these items? And if so, to be able to see how they were dealt with. And so that's something that I think is important.

Now, the other area -- remember I talked about mining, getting the information, bubbling it up, getting it up to the top.

The second area now is what -- how does the accountant handle this? The accountant now knows -- let's assume my system works -- he now knows what the problems are. And now we get back to, I guess it was Turner's point, what I used to call the exception list that the accountants have at the end of the audit; and to take up and sort of getting into negotiation with the company.

And here we have the same problem we were talking about today: Does the accountant have the fortitude to be able to stand up to the company and tell them that with respect to these items, they've got to be dealt with right?

I remember I had one case where an old fellow named Bluhdorn -- I don't know if that name means anything to anybody anymore -- but he had an asset on Gulf & Western. It was $28 million. In those days, millions meant something, in a company that was kaput, so he came up with a scheme.

The company invested in sugar plantations. He went around and was buying sugar plantations. What he would do, he would give them cash and some of the kaput company, and say okay, I'll pay 5 million plus I'll give you 2 million of this kaput company.

And so he was able through this way of buying a number of these, to take off completely the bad asset, and then went into the sugar plantations where nobody would even know about it. In any event as property went up in value, it would mask what they were doing.

And I remember calling in the head of the audit firm, because we were ready to take action, and the fellow was quite candid. He said to me, Stan, he said let me tell you something. At the end of the audit we had five items. We sat down with management, and you know what? We won on four of them, 80 percent. He said that's not a bad percentage. Therefore, we had to give them this one.

You know, I had to tell him that 80 percent might be good in certain things but it isn't good in accounting.

Therefore, how do you get the profession and the accounting firm to stand up and say look, no, we're not going to go for it, we are going to go for the 100 percent.

We saw today where we were talking about this business of the foreign auditor; and -- you know -- it's common for people to be worrying about other people's concerns; and I've learned through my many, many years that once you compromise your principles and say well, it might not be that bad, it is a prescription for disaster. It happened with the SEC in the Madoff case. It happens all the time.

So how do you inspire or get the accounting profession -- this is, to me I think is a core issue -- that once they have to make a decision that's tough on their client for them, to say yes, that they're going to go through with it. That I think is really the core issue. The mining can be taken care of, as I told you about the combination.

But the real problem is once they know about it -- this is not something they don't know about -- but once they know about it, to carry

through and tell the client no, they cannot do what they want to do. I don't know how you get, other than by getting people like the PCAOB, when they find it, to be able to say folks, you're going to get -- it is going to cost you.

And I think that's where we have got to do it.

That's my sermon for the day.

Charlie, what do you think?

(Some laughter.)

MR. NIEMEIER: You're my hero, Stanley.

MR. HARRIS: Kelvin, I think you mentioned in your priorities a modified forensic, either the concept of a modified forensic and then I think you indicated that was in a report, The Global Capital Markets and the Global Economy: A Vision For the CEOs of the International Audit Networks issued in November of 2006 for consideration.

Do you want to spend a minute or two and review some of your thoughts on that as well?

MR. BLAKE: Sure. I mentioned some type of modified forensic audit where there's been known fraud.

Perhaps the PCAOB and the other auditing agencies should impose some type of forensic audit requirement where it requires to go beyond the routine financial statement audit and require more in-depth analysis of the transactions.

One of the things I suggested based upon my background as a compliance auditor is when I do audits and I go and do the audits and notice some of the examiners from other states, they may want to focus on looking at a set -- 10 percent of the transactions, 10 percent of the customer files, and they think they can take that and project it on to the hundred percent of what the transactions would be.

But I think that's -- that low threshold is extremely too low, and I think we should require the audit firms to look at more than say 5 or 10 percent of the transactions and project it on to the overall population.

If you require the audit firm to look at more, a higher percentage of the population, you may

have a better chance of detecting any irregularities.

MR. TURNER: Thank you, Steve.

I did want to make a couple comments. I have to run to the airport in a couple minutes.

I think Tony is absolutely correct in that we spend all week long auditing the numbers but only look at disclosures at 4:30 in the afternoon. That has certainly typically been my experience, and I think he raises a very good point.

The professional standards do require the auditors to go get evidence, substantial evidence for the footnotes, but they tend to do it at the last moment, ask a client to give them some schedule that will tie-out to the footnote, and boom, they're done.

Actually, probably some more guidance would be helpful; but more than anything, would be some good strict enforcement. If out of your inspections and out of your enforcement program you took a hard look at these, and actually took enforcement actions against some firms that had failed to do -- gather the evidence they needed for the footnotes, I think that would be excellent.

I know you're hamstrung now because of the private nature of your enforcement actions. Fortunately, Stanley had -- and those of us at the SEC -- had a much more public enforcement regime. We made 102Es a public process during Dan's stint as general counsel, much to his credit. I honestly think you absolutely need to go get legislation and get a change here in order to be able to make your enforcement actions public.

Keeping them private has proven just to engender the accounting firms to fight you all the way through. I think, one, that dramatically needs to be changed. As an investor I would like to see that happen, so we get timely enforcement.

I think if you took a couple of enforcement actions against a couple firms on disclosures, and your inspection process came out with -- I think -- came out with a 4020 report that said here in general are some shortcomings we have seen from the inspections, I think the combination of those things would be very helpful.

As far as expanding the auditor's role, I

have been a fan of having the auditor go ahead and give a report on MD&As. Quite some time ago there was a standard the profession floated. Actually, I think about the same time Dan was the general counsel as well. Nothing has happened with that. I think having an auditor report providing some assurance around what is in that MD&A report and the completeness of that report to us, about the trends and what's going on with operations, would be of tremendous help.

On the forensic angle I do chair the audit committee of a public entity where we do engage the auditor and pay extra to have a forensic accountant come in each year and do work for us.

We design that each year around the particulars; and I sit down with that person and say here is what I want you to do for us, but we do have a forensic piece of it. I think it is very good in that it keeps people on their toes and has been good in framing the mindset of the auditors, the regular auditors, if you will.

I think as the O'Malley panel recommended, building some type of that forensic expertise and notion into the regular audit would be very beneficial. I've done it and find it to be very helpful and good, and I found that it has in some instances done a very good job then of informing the audit staff of some things they haven't focused on and subsequently did. I'd be a big supporter of doing that.

MR. HARRIS: Thank you. Joe, before we go to you -- I don't know, Meredith, I know you have to take off for a plane shortly as well. We can go to Joe but if you have comments you'd like to make before you clear out of here, certainly take the opportunity.

MR. WILLIAMS: Thank you, Mr. Chairman. I apologize for having to leave earlier. I have an engagement with some of those 463,000 members tomorrow morning in western Colorado.

I'm a strong supporter of the forensic approach. I think it is a different mindset. I think it does a wonderful job of keeping the entity on its toes, just knowing a different look will be

taken on a regular basis.

Going back to my rotation pitch, I would suggest that it not be the same forensic accounting firm each year. I see them probably working -- whether they work separate and then report directly to the company, the audit committee, or if they're an adjunct to the regular audit effort, just to have that presence I think is the most important thing.

Thank you.

MR. HARRIS: Since we've heard it before, I'd like to get the response from the Judge, Kelvin, and you in terms of the cost and how we deal with that.

Judge, we raised it with you. I'd like all three of you to respond to that.

JUDGE SPORKIN: This has come up in connection with Foreign Corrupt Practices Act matters.

My discussion with my clients, other than the accounting firm, is since I think they all have been faced with FCPA issues, they think it is terrific. They think it is much cheaper than having

to go through a Siemens -- what -- $1 billion investigation. And so the cost really hasn't been an issue there.

Remember, you are going to have to do a lot of risk assessment as to what you are going to look for and how you do it. You are not going to go in and do a general forensic one. It shouldn't be that much. I have not yet seen a pushback on the cost. Probably will be there, but we'll have to wait and see.

MR. WILLIAMS: I totally agree with Judge Sporkin. I believe on a risk-reward basis, you can't afford to go in the other direction.

Again, I think it would require a regular assessment of where you want to focus those resources in any given time frame. I think that would change over time as the risks change. Small price to pay.

MR. HARRIS: I guess you are out of here, too. Why don't we go around that way?

MR. TURNER: Just real quickly. I have done this. We made it part of our audit process.

The cost was fairly negligible in

comparison to the audit partner audit fee. It was not that significant to have it done.

The benefits in terms of what they learned and how that informed the audit, improved the audit process in and of itself, including some risk and some things we needed to change, was very helpful to the audit team, as well as to the audit committee and the board, so that was very helpful.

And when you look at the benefit, though, you also have to measure what happens in the market when you find these things; and if we could have avoided even a small fraction of these losses, and headed off some of this stuff, the benefit would have been tremendous.

The one thing that I've seen when you did these forensic audits, we've all talked about how is it that the auditors never saw, management never saw, or the board never set up and said anything about these subprime loans, and things people were engaging, the repo 105 transactions, the one thing I found out is that forensic auditor is the person who walks in the room and says "time out. What are you people thinking?"

That's what that -- my experience has been that's what that forensic person does. And the benefit of having had -- if we had some people in these rooms at a Countrywide, you know, at a Citigroup, at an AIG, standing in there and saying "time out, what are you guys thinking about," the benefit would have been immense to us and the costs would have been a drop in the bucket.

And you know, like I said, we do do it.

MR. HARRIS: Joe. We'll go right around.

MR. CARCELLO: Yeah. And that's where I wanted to go, Steve. And I think -- what I heard, I thought was very good, from Bob was talking about if I heard him right additional audit report involvement with the MD&A, maybe the CD&A, ethics hot line, ERM system, I agree that they're all important and I think auditor attestation on those would be useful. Then I hear the Judge talk about the forensic audit. I think that would be extremely useful.

As I was sitting here, the issue that came to my mind is exactly the issue that you raised.

That is to the extent the auditor is involved in these phases, would the benefits exceed the costs? And so I want to pose a question to Gus and to Anne and -- Gus is with obviously a very large mutual fund complex. Anne is a large pension fund. To a lesser extent, a little different, Pete, Norman representing what -- in my mind a hedge fund and private equity group.

And because if you propose this, here's what's going to happen. Management is going to say no, we don't want to pay the extra fees, but it is not their money. It is in Gus's case my money, my 401(b) and 303(b), but he has to make the decision. There's too many of me.

So how much value does this have for investors and what is -- you know -- what's -- what are you guys willing to pay for? That's the decision. Not what management says. That's really kind of irrelevant.

MR. NACHTWEY: I actually think this dialogue has been great. I expand it beyond the forensic, although I have a healthy respect for what

forensic accounting can do.

Look what we do when we buy a company. In our portfolio we have about 500 entities across 67 different funds. We rely on our investment professionals basically to go in and identify what the risks are, and what we kind of want to peel back layers of the onion on every single company we look at.

We get a matter of weeks if we are in an auction or bidding process. The kind of things we bring in in addition to the forensic side, if we have concerns, are going to be evaluation experts, actuarial experts, oil -- whether it is oil reserves or long term construction contracts or complex manufacturing contracts.

Getting that kind of expertise involved, from our standpoint, the diligence a company you are looking at buying is the same thing that auditors need to be doing to say are the financial statements that all of us are relying upon to make investment decisions reliable?

The challenges -- and I think most of the

accounting firms have maintained at one point or another resources in all of those areas. I think where most of them are today, forensic accounting, and valuation is almost standard table stakes, because you have got to have those experts and probably actuarial.

But the issue is getting the clients to pay for it because that's again one of our big challenges. We didn't spend a lot of time talking about that. At the end of the day the clients pay for the audits. How do we make sure that's -- if it is part of the audit standard where every accounting firm has to do it, so there is no optionality. If I want to go look at -- geez, firm X is going to foist all these experts on me but firm Y is going to say I don't need to use them in the audit, I think we -- again something that this group could possibly help with or the PCAOB could help with is taking the optionality out of the audit.

Second is how do you maintain the capability. That's more of a business issue. You need world class people facing off. You don't want to have a young capital markets guy at one of -- a guy or gal at one of the accounting firms going up against Fab whatever his name is at Goldman Sachs, without the same level of talent, energy, experience. And how can they maintain that inside the Big Four if they are just audit support? Allowing them to be in the business commercially helps them to maintain the expertise.

Last but not least, we talked a lot about disclosures for companies in financial statements. Maybe there should be some disclosure around the experts used in an audit, so that we as investors or users of the financial statement, if we're looking at an insurance company and there are no actuaries involved or an oil company and there are no engineers involved to understand oil reserves, you might scratch your head a little bit. Just some thoughts.

MR. HARRIS: Gus.

MR. SAUTER: That is Gus Sauter. Joe asked the question what do we think as investors of other people's money about the costs of requiring forensic accounting?

And number one, I'm going to say I'm probably at odds with the rest of the people around the table, perhaps because I don't know what the costs of forensic accounting would be. Lynn said it is really not much. I think Judge Sporkin pointed out you wouldn't just blindly do it across the board; you would measure risks and apply it accordingly.

Costs do matter at the end of the day. It is not just the level of the costs but the total value over time of those costs as well.

So if we're talking about really what could be hundreds of millions of dollars of additional costs of accounting, that could be billions of dollars worth of value when you assign a PE ratio to it.

Nevertheless, it has been pointed out if you catch one bad actor, that could pay for that.

So on the one hand, I ask the question does it need to be an independent forensic accounting or something we require inside of a normal audit?

Audit firms perhaps should have this capability themselves. It is not -- forensic

accountants aren't super accountants, why wouldn't this be something that the accounting firm could do?

So I come at this from two different directions, saying there certainly can be some benefit to it, particularly when you catch the bad actor; but I am concerned about costs and I do raise the question about what the form should be. Is it truly an independent forensic accountant? Could it be -- should it be required of auditors in general?

MR. CARCELLO: Can I follow up with Gus? Some of the Big Four -- they probably all do, but I know specifically on at least some of them they actually have very complex algorithms as they plan the arrangement. Financial characteristics, governance characteristics, a whole bunch of things you could probably think through.

They've essentially back-tested these algorithms against restatements, and they assign loadings out of a regression on the factors and come up with a risk score. So it is essentially a risk model. And if the risk score is above a certain cut, this particular firm requires involvement by forensic

auditors.

But that's a voluntary decision. Would it make sense from an investor perspective at least -- you know -- from your point of view, maybe not to go to a blanket forensic requirement, but to say if risk is assessed as high -- and you have to be careful with language -- but if risk is assessed as high, then that's a requirement on the audit?

Then the cost is more targeted to where the risk is higher.

JUDGE SPORKIN: Let me mention what my model is and where we're testing it. My model is every firm has a forensic component. The problem is when I went in there, I found out that that forensic component was doing work with third-party companies, not with their own clients. So the answer is yes, you use your own, the accounting firm under my model would use its own forensics so there is a synergy and everything else there.

You know, you don't have to be a genius to figure out that if you're doing business in China or in some other foreign country where you have a high risk of bribery, that right away tells you that you have to do something. Any company that's doing business in those countries, that's doing so like a horse with blinders. And not worrying about this, you know, it is a no-brainer. How can they just walk in and say well, we're not going to consider any of this?

So it's -- to me, it became obvious, this kind of thing as to how you have to put these things -- these two together. It is no genius here. You put them together because you see, you know that -- all you have to do is talk to an accountant. He's talking about materiality. He doesn't want to look at that thing, it is not material. You talk to your forensic and he's interested in the low hanging fruit. He's interested in looking at that.

So that's it. But you should use the same accounting firm to cut down on costs. There is no reason it has to be independent. I think it would be too disruptive and there would be too many -- already there are some disagreements we're finding in connection with my analysis of the pilot program that

we're using.

There is some contention there, but that can be worked out.

MR. HARRISON: First on the resource question, I think the Judge is absolutely right. Joe, the -- in my experience, the Big Four firms certainly have a talented pool of auditors and accountants with forensic backgrounds. Most of them reside in the advisory practice. As the Judge said, they're providing those services but perhaps to non-audit clients. But I think the resources are certainly there. It would be a question of allocation, how to build that into the model.

With regard to your question, Joe, about how much -- what's the value or how much would investors be willing to pay, I'm going to answer it like a lawyer, not like an investor.

My answer is the lawyer's typical answer. It depends. It depends on what we're getting, what incremental comfort or assurance we're getting from the additional effort, I think.

Tony in his opening comments made

reference to the expansion of scope of areas or resources in an audit process in an effort to achieve some validation of things.

I think when you start down the path to validation or verification, I've often wondered if we were going to go back to square one and design the auditing process or profession all over again, would we find or get to a point where there is sort of a fundamental mismatch between what auditors are selling and what issuers want to buy. Is it more like assurance?

If so, what does that tell you about the business model, about pricing, about risk, about liability, all these issues?

There are a lot of big macro issues here that I think your subject touches upon in terms of what it is that we hope and expect, and I think sometimes perhaps wrongly assume, that the audit process is delivering to us.

If we could really get it, it would be something presumably that you would be willing to pay more.

MR. BECKER: Just a couple of brief observations. Just a reminder, we had a conversation about a fraud center or "some lessons" learned assessment earlier today. And it would seem to me if you had a more robust one, it could help supplement and assist the risk assessment process of what you did with your forensic audits, and help bring a better identification of where you wanted to allocate those resources.

With respect to the cost issue, I concur with the "it depends." If it is just another check list of items that are an added expense across the board, I don't think it provides much value added. If it is the kind of sensitive assessment of risks on a targeted basis, and you can assure me that Judge Sporkin is doing that on each menu item, then I think it will provide value added.

That would be, the trade-off is whether it became a more mechanical process rather than a well textured assessment of individual risks.

Third, I think it was Peter who mentioned earlier, one of the things I'm most concerned about, apart from forensic, is whether we maintain the expertise and talent within the audit function.

So for me, independence, other issues, what migrates into advisory are interesting questions and we use various prophylactics and rules to do that, but what I worry about structurally is if we siphon off all the key talent into those foundations then how do we maintain the talent in the audit function, in the audit process.

While I don't want to denigrate the importance of the Foreign Corrupt Practices Act in maintaining the integrity of our payment structure, valuation issues, getting a good assessment of the quality of earnings, is critically important going forward in trying to assess the financial reports of companies. And even more so, I would say, in some instances -- without trying to sound sacrilegious -- than running to ground their particular payments in a jurisdiction -- which we should do. But knowing how they are assessing those risks and having the right talent doing that strikes me as critical to this exercise.

MR. HARRIS: In the information that we circulated, we indicated that we wanted everybody to have the opportunity to express their top priority before we left. We're closing in on 5:00. We have got 20 minutes more. I do want to finish on time.

There were three areas that have been brought up that weren't covered. Brandon Becker and Bob, you mentioned executive compensation in the context of audits. Investor education, the expectations gap, Kelvin, you mentioned that. Bonnie Hill, you mentioned it and Meredith is gone so we'll save time there.

On inspections, Barbara has gone, too.

But Bonnie Hill, you mentioned that and Mike also is gone. I think we're going to be in good shape in getting out of here at the allotted time. We would have in any event.

On executive compensation, Bob, Brandon, you both mentioned that. If you want to make comments on it we would appreciate it.

MR. BECKER: Briefly the point we tried to make in our written statement -- and I will turn it

over quickly to Bob -- we are going through a lot of gymnastics to try to rope in executive compensation, in particular with clawbacks, multi-year payouts, payouts in stock.

Those may or may not be relevant to the underlying issues of a company management; and we certainly have encouraged say, on pay and other investor guidance.

But they all strike me at one level as highlighting the fact that we don't trust the earnings that we are reporting, because we haven't been able to build in an effective assessment of tail risk when we make a judgment about complicated financial instruments in many regards.

To the extent we can improve some of our quality of earnings assessments so that we have greater confidence we are not going to get these surprises because we haven't valued the instruments correctly in the first place, I think it would help assess and remediate some of the issues that we've identified, in terms of trying to deal with the fact that right now, we think it is such a soft number we

don't know whether two years, four years, six years from now the instrument as it goes through its earning life cycle is just going to explode on us.

MR. TAROLA: Steve from my perspective, just taking compensation discussion analysis, there's three major components. There's the measure of the compensation which frankly has some complicated formulas involved in it, whether it is the current value of a pension right or a -- or the value of equity type compensation.

Secondly, there's the philosophy discussion, and I guess thirdly, it's how it affects the business of the issuer.

How -- whether or not it is really driving the behaviors that the board thinks it should be driving.

But that's to me just one aspect of a company's disclosure of their story that could be subject to audit that currently isn't.

I try to put myself in the shoes of the board and looking for the auditor to help validate what the board does on behalf of the shareholder, so that the shareholder gets the benefit of an independent look. The board gets the benefit of an auditor's independent look.

And it is across the board, across the entire story of the enterprise, not just the balance sheet.

MR. HARRIS: What is the auditor looking for in terms of executive compensation?

MR. TAROLA: Where I sit on the audit committee of a public company, we ask the internal auditor to check all the calcs for one thing. We ask the comp committee to make sure that the philosophy is well articulated.

And as -- and then the audit committee itself takes on the -- I guess the task of assessing whether or not it's being deployed in a way that promotes what the philosophy is intended to promote -- right behaviors, strategic objectives -- and it does so effectively.

So it is a combination of risk assessment, pure calculating -- pure rechecking calcs and then making sure that it's doing what it ought to do.

MR. HARRIS: Tony? Gus.

MR. SONDHI: Steve, I was going to say in response to your question to Bob, one of the things that I have found in my analysis of compensation is that when the compensation exceeds -- for a particular company, top management exceeds their peers and so on, I find that it is worth taking a look at their financial reporting choices, and I find problems and issues.

And one of my classic examples is one of the biggest companies in this country, they were reporting the gain on sale of patents as a reduction of their SG&A, and it was partly because their CEO's compensation was tied to a reduction in SG&A expenses.

So these are the kinds of things you can find, these relationships when you look for -- and I think that's one of the things I would ask when an auditor -- it is good for them to check the calculations, but I can check most calculations on my own without any help from anybody.

MR. HARRIS: Gus? Bonnie.

MR. SAUTER: Thank you, Steve.

We deal directly with companies that we own. We talk with them on a constant basis, send them a letter and tell then what we expect them to do with regard to executive compensation. We want to know what incentives they have aligned and whether or not those incentives are aligned with best value for us.

We let them know if we don't like their compensation incentives we will vote against all the members of the comp committee. We want to know the magnitude of the compensation. Certainly, you talk about a CEO that supposedly added $500 million worth of value to a company and is therefore deserving of a hundred million -- quite frankly we find that a little difficult that somebody else could not have added 450 million. Maybe 50 million would have been just fine. There is a maximum level where we think compensation gets to be too high.

Nevertheless we are not supporters of say on pay. Honestly, we think it is one of those questions that it is almost like asking have you

stopped beating your spouse? And you almost can't answer it without -- with some degree of objectivity, that most people are going to say, no, I don't like compensation. Well, it is supposedly nonbinding at least at this point in time. I don't know if it is at some point in time, but I think a lot of people just aren't able to say whether or not pay levels are appropriate, and yet have the ability to vote on it. So I must say we are not in favor of say on pay.

Steve, you asked what is the auditor's responsibility for this. Is this just -- it's information that's required in the financial statements. I think one thing the auditor could divulge is the incentive. So are the incentives really truly aligned with the investor; and a comment on that from the auditor, I think would be helpful to individual investors.

MR. HARRIS: Bonnie?

MS. HILL: Bonnie Hill.

A couple of things as it relates to compensation. One is there's a tendency to look at just the upper level of compensation when you're

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looking at risk. There are levels of compensation throughout the organization, places where there could be a real risk of fraud. We would look for the auditors to help identify those, as a matter of fact put those down as questions for them when they go through the organization. Do you see any areas in which a particular employee or group of employees have the ability to put the company at risk? And they may not be the highest paid.

So that becomes important.

I'm with Gus on the say on pay part. One, the compensation committees spend countless hours sorting through compensation. It is not very easy as you know when you look at the proxies and try to decipher all of the various charts. We, I am in favor of shareholders having a conversation with the compensation committee or the company prior to having to make that kind of vote.

So if they've been following it, and the year before they saw something they didn't like, I would encourage that they have that discussion with the company, because a straight up or down vote does

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absolutely nothing. I've had some shareholder groups say it gives us an opportunity to have dialogue with the company. Well, you have access to the company and should have that dialogue in advance.

The shareholders own the company and the board reports to the shareholders for the most part. In that regard I would rather see dialogue on compensation prior to a straight up or down vote.

MR. HARRIS: Anne?

MS. SIMPSON: Anne Simpson, CALPERS.

I'm concerned about overstretching the auditor by suggesting they start looking at compensation.

The board has a job here. Just harking back to what was said earlier, that we need to look at this whole series of checks and balances and roles and relationships in its totality. So this is why it matters that we have majority voting so that you can vote no, not just I withhold on compensation committee members. That really matters.

Proxy access really matters.

And staggered boards are a problem.

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Because of those barriers to the board being accountable, we're hunting around for these ways, like say on pay, invented in the U.K. as bit of a feather duster to tickle public opinion with. It doesn't get to the heart of the problem.

I think there are few circumstances where you need individual detailed discussion. The big picture stuff is clear. You need money at risk, you need performance measures which fit with the strategy in the life cycle of the industry.

And just benchmarking yourself to what everyone else is doing is often a problem, because they are all Lake Woebegone, all "above average" chief executives and before you know it you have sectors where it is beyond control.

I agree with what Bonnie said. For the auditor's role it is about tying it into risk management and their appraisal and responsibilities in that department. Let's not try to load the auditors up with everything. That's what the board is there to do.

MR. HARRIS: Mike?

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MR. HEAD: This is Mike Head.

I mirror a lot. I think table stakes is making sure the disclosures in the proxy are accurate and reliable. That's a combination of internal auditors and external auditing. From an audit role point of view, I think there are some venues that, other than what's been mentioned that I've heard, is -- and I think Tony, you were starting to get at it -- is use of company assets and T&E reimbursement and other things that are benefits that -- executive officers' use of corporate planes.

The straight-up proxy compensation and what you can tie to contracts, I think the corporate governance and holding the board accountable, a comp committee is the right way to go, and the auditor is just making sure that process is in place, and the risk management governance. But where I think the value of the audit efforts is in these -- the Tyco stuff, the misuse and -- and not in accordance with the policies that the company and the board have said. So the auditors are in a better position to say whether they are seeing in the financial statements are aligned with corporate policies that the governance structure has approved and that the structure is adequate, versus trying to make -- do decisions for the board and the board comp committee.

And I think there is going to be more opportunities for misuse of classification and use of company assets than the governance structure itself.

MR. HARRIS: Turning to the two remaining issues just very, very quickly. On inspections, Barbara Roper, you indicated that the PCAOB should develop a robust and formalized system for analyzing inspections findings and using that analysis to inform other board activities. And then Bonnie, you mentioned that as well.

And you thought we should do a better job focusing our inspections on significant issues and risks.

I think Mike, we have already touched on your point with respect to inspection. But I was wondering whether both of you or Bonnie wanted to say anything on that issue.

Barbara, do you --

MS. ROPER: We talked about this at the last Standing Advisory Group meeting. It is my understanding the board is working on ways to use the information from inspections effectively to inform the standards setting process.

It is something that we've talked about as an issue within SAG for a number of years, that the information comes -- that comes from inspections has the potential to really be meaningful in terms of helping to identify problem areas and areas where there may be changes that are needed to the standards, the audit standards.

I think it flows together well with the notion of a fraud center which, as you know, is something I very strongly support, that the PCAOB just should think about how to formalize that process, make sure there's a clear formal process for how the information that comes out of those procedures then informs the standards setting process, and the other things that the board does.

MR. HARRIS: And then Kelvin, you mentioned -- and this probably is a conversation

which is so large that we might want to save it for another time -- but in a snippet you mentioned investor education and the expectation gap. Do you want to briefly comment on your concerns there?

MR. BLAKE: Sure. Kelvin Blake.

I don't know to what extent the PCAOB currently reaches out to investors, but I do suggest that perhaps they can start an investor education program where they're making investors aware of the audit process, both the benefits and the limitations of the audit process. And perhaps in an effort to narrow the expectation gap that now exists.

I also recommend perhaps encouraging senior level members of the accounting profession to meet more often with investor groups so that the investor groups can explain what their expectations are from the audit process and -- you know -- how to improve audit transparency, what effects investors think the new accounting standards may have on -- you know -- their decisions; and any other relevant issues.

MR. HARRIS: Well, before concluding, I'd

like to point out that yesterday the board announced that the PCAOB is seeking nominations for its Standing Advisory Group, and a copy of our press release is in your packet.

As I think most of you know, this Standing Advisory Group is an integral part of the PCAOB standard setting process.

It would be extremely helpful if members of this group could help identify potential candidates by either nominating them yourself or asking the candidates to submit a nomination form which can be found on our website. Or you can feel free to contact Marty Baumann directly with respect to that.

In conclusion, because it is very close to 5:00, I want to give Dan the last remarks, and other board members if they care to make any. I think what we'll do in terms of follow-up is prepare a generic summary of today's meeting which we'll distribute to all of the group members.

I think we'll get back to each of the panels for any possible follow-up issues prior to our next meeting.

I think it has been an extremely productive day and all the panels that have made recommendations -- I'm not sure how realistic or feasible it will be; but I talked to a couple of folks during the break, and there may be follow-up items, which we will want to discuss with each panel and then get a work product out of you, if it makes sense.

So we will summarize, get back in touch.

I want to thank very much all of you for your participation. I want to particularly thank Joanne Hindman who put this together, both substantively and administratively.

(Applause.)

MR. HARRIS: Joanne, you did a terrific job. I want to thank Jennifer Stokes. Bob, you've been out of sight, out of mind; but you have been very helpful. Thank you very much.

We appreciate very much all of your participation.

I don't know whether any of the board

members want to make final comments.

CHAIRMAN GOELZER: I'll just join you in saying thank you to everybody for your participation. You've given us a lot to think about, and I look forward to the next meeting of this group.

MR. HARRIS: Thank you.

(At 4:58 p.m., the meeting was adjourned.)

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