NOTICE: This is an unofficial transcript of the Public Company Accounting Oversight Board's March 21, 2012 Public Meeting on Auditor Independence and Audit Firm Rotation.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION
PCAOB RULEMAKING DOCKET MATTER
NO. 37

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PUBLIC MEETING

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WEDNESDAY,
MARCH 21, 2012

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The public meeting convened in the National Association of Home Builders Auditorium, 1201 15th Street, N.W., Washington, D.C. at 8:15 a.m., James R. Doty, PCAOB Chairman, presiding.

THE BOARD:
JAMES R. DOTY, Chairman
LEWIS H. FERGUSON, Board Member
JEANETTE M. FRANZEL, Board Member
JAY D. HANSON, Board Member
STEVEN B. HARRIS, Board Member

PCAOB STAFF:
MARTIN F. BAUMANN, Chief Auditor and Director of Professional Standards
MICHAEL GURBUTT, Associate Chief Auditor
J. GORDON SEYMOUR, General Counsel
JACOB LESSER, Associate General Counsel

OBSERVERS:
BRIAN CROTEAU, U.S. Securities and Exchange Commission
JIM KROEKER, U.S. Securities and Exchange Commission

PANELISTS:
JAMES ALEXANDER, Head of Equity Research, M&G Investment Management
MAX H. BAZERMAN, Jesse Isidor Straus Professor of Business Administration, Harvard Business School
JOHN H. BIGGS, former Chairman and Chief Executive Officer, TIAA-CREF
JOHN C. BOGLE, founder and former Chief Executive, The Vanguard Group
THE HONORABLE CHARLES A. BOWSHER, former U.S. Comptroller General
THE HONORABLE RICHARD C. BREEDEN, Chairman and Chief Executive Officer, Breeden Capital Management, LLC; former Chairman, U.S. Securities and Exchange Commission
STEVEN E. BULLER, Managing Director, BlackRock, Inc.
THEODORE BUNTING, JR., Senior Vice President, Chief Accounting Officer, Entergy Corporation (a member of the Edison Electric Institute)
STEPHEN CHIPMAN, Chief Executive Officer, Grant Thornton LLP
PETER CLAPMAN, Chairman and President, Governance for Owners USA, Inc.

EDWARD J. DURKIN, Director, Corporate Affairs, United Brotherhood of Carpenters
JOE ECHEVARRIA, Chief Executive Officer, Deloitte LLP
STEPHEN R. HOWE, Jr., Americas Managing Partner and Managing Partner of the U.S. firm, Ernst & Young LLP
GREG JENKINS, Professor of Accounting and Information Systems and the William S. Gay Faculty Fellow, Virginia Polytechnic Institute and State University
RICHARD L. KAPLAN, Peer and Sarah Pedersen Professor of Law, University of Illinois at Urbana-Champaign

PANELISTS (Continued):

THE HONORABLE ARTHUR LEVITT, Senior Advisor to The Carlyle Group, Goldman Sachs Group, Inc., and Promontory Financial Group; former Chairman, U.S. Securities and Exchange Commission

DON A. MOORE, Associate Professor of Management of Organizations, Haas School of Business, University of California at Berkeley

ROBERT E. MORITZ, Chairman and Senior Partner, PricewaterhouseCoopers LLP

THE HONORABLE HARVEY L. PITT, Chief Executive Officer, Kalorama Partners LLC; former Chairman, U.S. Securities and Exchange Commission

VALARIE L. SHEPPARD, Senior Vice President and Comptroller, The Proctor & Gamble Company

DAMON A. SILVERS, Director of Policy and Special Counsel, AFL-CIO

JOHN B. VEIHMEYER, Chairman and Chief Executive Officer, KPMG LLP

THE HONORABLE PAUL A. VOLCKER, former Chairman of the Federal Reserve; former Chairman of the Economic Recovery Advisory Board

DARREN WELLS, Executive Vice President and Chief Financial Officer, The Goodyear Tire & Rubber Company

C-O-N-T-E-N-T-S

C-O-N-T-E-N-T-S

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

(8:13 a.m.)

CHAIRMAN DOTY: I want to welcome everyone, to the Public Company Accounting Oversight Board's first public meeting on the Board's Concept Release on ways to enhance auditor independence. The discussions we undertake today will raise important questions for our financial markets and the protection of investors.

Investors need reliable financial reporting in order that they or their intermediaries can fairly evaluate a potential investment as well as management's stewardship of the companies in which they have purchased interests.

These investor protection considerations form the expressed purposes for which Congress created the Public Company Accounting Oversight Board. The Sarbanes-Oxley Act requires that the PCAOB in furtherance of investor protection establish standards that foster auditor independence.

The linchpin of investor confidence is the independent audit of a public company's financial statements. The statutory franchise to conduct these audits has been accorded to the accounting profession.

To perform their role properly, to assure that reported financial and economic successes are not illusory, auditors must approach their jobs with independence, objectivity, and skepticism. They cannot allow themselves to be caught up in their audit clients' business goals.

It is the rare case, the rare case, in which an auditor knowingly compromises his or her integrity. But well-intentioned auditors, as with other people, sometimes fail to recognize and guard against their own unconscious biases.

We are nearly ten years from the adoption of Sarbanes-Oxley. With that experience, we have embarked on an in-depth examination of an issue that continues to trouble many of the most thoughtful supporters of the audit profession: the subtle and not so subtle influences on the auditor's mindset and the implication for the integrity of the audit.

In August 2011, the PCAOB issued a Concept Release, seeking public comment on a variety of questions about how to improve auditor independence, objectivity, and professional skepticism. Our discussion today will supplement the written comments we have received on the Concept Release.

The discussion will focus on ways to insulate the audit process from the pressure to maintain a long-term relationship with the audit client, pressure that could affect how an auditor approaches tough decisions on an audit.

Many people are troubled by reports of audits that span decades, even a century. These are the engagements that no partner wants to be the one to lose. At the same time, we should be concerned about the relatively new audit that the auditor may hope to turn into a long-term engagement.

The panelists who are speaking to us over these two days include some of the most authoritative and experienced voices to address the subject of audit quality, auditor independence, and the challenges to both. These panelists have different perspectives and divergent views on rotation of audit firms and a range of related subjects.

In issuing the Concept Release, I recognize that fixed term limits would significantly alter the status quo. The idea is not popular among audit firms and companies. The Concept Release did not raise it lightly and was candid about the challenges of implementing mandatory term limits.

I have no predetermined outcome in mind other than that the debate be robust. If there are better alternatives to accomplish the goal of improving independence, we should hear them.

We will hear honest debate about whether term limits will enhance auditor independence, objectivity, and skepticism and about potential collateral drawbacks that could result from rotation. To that end, the meetings today and tomorrow include a wide variety of perspectives. This is not a contest to judge the loudest voice.

I want to acknowledge and thank the many speakers scheduled for the next two days for setting aside time and in many cases traveling significant distance to be here. Your participation is critical to helping us fill the scope of opinion for our examination.

I hope to hold similar meetings in other cities around the country. I look forward to each of those meetings informing this important debate.

And now I want to recognize my

colleagues for a brief comment as well. Mr. Harris?

MEMBER HARRIS: Mr. Chairman, I will be brief. I commend you for initiating these public hearings and for making the enhancement of auditor independence, objectivity, and professional skepticism a top priority of the Board. Having such a distinguished group of experts to talk about these issues is testament to the importance of this topic to financial markets, capital formation, and to investor protection.

The drafters of the Sarbanes-Oxley recognized that independence is the bedrock upon which audit quality is built and included several reforms designed to enhance independence. For example, among other things, the responsibility for selecting and overseeing external auditors was taken from management of listed companies and given to audit committees, auditors were banned from providing numerous non-audit services to their audit clients, and audit firms were forced to rotate lead engagement partners every five years.

However, even with these important reforms, the inspection findings of the Board as well as those of our international counterparts indicate that more needs to be done. In addition to the findings of our PCAOB inspectors, regulators in, for example, Australia, Canada, Germany, the Netherlands, Singapore, and the United Kingdom have cited deficiencies in professional skepticism as a cause of persistent problems at audit firms.

And, just as we in the United States are considering ways to improve auditor independence, objectivity, and professional skepticism, so are many of our international counterparts. Investor groups and leaders of the profession alike recognize that the status quo is not an option.

The Board has received over six hundred comment letters in response to our

Concept Release. In addition to mandatory rotation, suggestions have included, for example, mandatory re-tendering, audit-only firms, enhancing auditor training, joint audits, strengthening audit committees, enhancing independent standards, and more targeted PCAOB inspections. Some assert that as long as auditors are paid by their clients, independence issues will continue to surface.

We have a responsibility to explore all options and carefully consider the intended and unintended consequences of each option, including the costs of each.

It is a particular pleasure to welcome Chairman Volcker, Chuck Bowsher, and Richard Breeden and later Damon Silvers, Harvey Pitt, John Biggs, Rod Hills, and Arthur Levitt. 2012 marks the tenth anniversary of the passage of the Sarbanes-Oxley Act, and it was ten years ago last month that each of you testified before the Senate Banking Committee and provided such valuable input to the

Committee.

I look forward to hearing your comments and suggestions as well as the remarks of all of those who participate in these roundtables over the next two days.

Thank you, Mr. Chairman.

CHAIRMAN DOTY: Mr. Ferguson? Thank you.

MEMBER FERGUSON: We are grateful to the many distinguished individuals who have been willing to share their time with us today to give us their views on what is an important issue to us. (Microphone On) We are grateful to the many individuals who have decided to come here and spend two days with us talking to us about what for us is a very important topic, namely auditor independence and how it contributes to the kinds of public company audits that I think we all share the view that we need.

This board member at least approaches the issue of auditor independence and its relation to the question of auditor compensation and audit firm tenure as a curious skeptic. Despite the many, many rules we have that try to create a structure of independence, at least the PCAOB inspection program over the last few years has revealed a number of audit deficiencies that are repeated year after year and that appear to stem from an absence of auditor skepticism. The question is, where does this absence of skepticism come from? Is it related to the structure of auditor compensation and is it related to the absence of audit firm tenure limitation?

So I hope that we can address a number of questions today. First of all, does such a relationship exist? Secondly, even if it were the case, what would the costs of a mandatory audit firm rotation regime be? What would it cost for a new auditor to learn a complex business? What would the costs be in terms of the time of the client's management that would be diverted from the core business? What human capital costs would be involved, particularly where large audit clients are located in places where the only significant audit firm office is the client's longstanding auditor?

Would audit deficiencies, in fact, increase in the early years of a new auditor's tenure as it learned the client's business? Would any increase in independence outweigh whatever these costs are? These are the questions on which we seek your views.

Another area of inquiry that deserves focus is whether the auditor independence and its correlative, auditor skepticism, is even related to the structure of auditor compensation or auditor tenure. In other words, are we barking up the wrong tree? But if so, what are your suggestions for improving what the Board's inspection program reveals to be serious deficiencies in auditor skepticism that seem to underlie many audit failures.

I hope that participants in this meeting will also discuss whether audit committees are able effectively to monitor auditor independence and to counteract whatever force the existing auditor compensation and tenure models exert in undermining independence. Do participants believe that audit committees, to the extent one can generalize in this way, even perceive a problem? If so, do they possess the technical skills or have access to the technical skills to ask the right questions?

Any rule that would overthrow longstanding and well-accepted practices that are not obviously wrong bears a heavy burden of proof, but the board is faced with stubborn and persistent issues of audit deficiency that raise serious and fundamental questions about how the current independent audit model for public companies works. On these issues, we seek your wisdom.

CHAIRMAN DOTY: Mr. Hanson?

MEMBER HANSON: I would like to join Chairman Doty and my fellow Board members in thanking today's panelists and welcoming them to this event and everybody listening, whether in person or over the internet, especially the busy lives of the panelists. It's really important and remarkable that we have them here today. Your experience and insight are invaluable as we consider the important but difficult issues of auditor independence, objectivity, and skepticism.

I noted back in August of last year, when the Board issued the Concept Release on auditor independence, that my main goal for the Concept Release was to provide a vehicle to gather information and spark discussion about whether the board should do more to enhance auditor independence, objectivity, and skepticism and if so, what steps the board should take. Today's event continues that effort.

Based on the number of comment letters we received, over 620, this clearly is a topic in which many people have an interest. The comment letters demonstrate strong support for the board to consider the issue of auditor independence, objectivity, and skepticism, although mandatory auditor rotation as an approach to enhance independence had significantly less support.

I am pleased that we received substantial input from investors through members of the audit committees given their important role in ensuring the independence of auditors. Investors lie at the core of our mandate. So I am particularly sensitive to their views and look forward to learning more about their varying perspectives.

The audit committee comment letters expressed virtually unanimous opposition to mandatory firm rotation, and I think it is important that we understand why. So I anticipate that we will get into that today.

I am also interested in understanding the factors considered by those audit committees who have voluntarily established periodic auditor rotation. I would like to hear from them and others whether making auditor rotation mandatory, rather than leaving it as a voluntary option for audit committees, would provide any additional benefits. At the same time, I am concerned about comments suggesting that the board's actions could undermine the role of the audit committees, making them less effective.

Feedback on rotation from investors other than audit committees was more mixed. I hope to hear more about how we might be able to accomplish our goal of enhancing auditor independence, objectivity, and skepticism without causing negative unintended consequences, such as unreasonable costs or a decrease in audit quality.

Audit firms and financial statement preparers also provided extensive comments, in some cases highlighting what they believe are significant downsides to mandatory auditor rotation. Auditors and preparers have extensive hands-on experience with audits, and they provide a valuable perspective. Yet, firms are not unanimous in their opposition to mandatory rotation, so hopefully we can explore the reasons for their varying views.

Finally, we have heard from a number of academics who have attempted to look at the related issues empirically, and several well-regarded university professors are joining us today. I look forward to hearing about their research, and I am always eager to hear about the steps that learning institutions can take to prepare students for their important roles in the capital markets.

I anticipate that the questions we pose to the panelists today will range far and wide and should foster a good debate. Themes to explore from my chair include defining the problems that we are trying to solve, including by trying to better understand the extent to which our panelists believe auditors currently lack independence, objectivity, and skepticism and what evidence we should consider in support of such views; the role and effectiveness of audit committees in ensuring auditor independence; auditor behavior since the enactment of the Sarbanes-Oxley Act, including actions firms have taken and are continuing to take to enhance auditor independence, objectivity, and skepticism, and the effectiveness of those measures; and, most importantly, I would like to hear what other alternatives people have to talk to us about related to a mandatory auditor rotation.

So let me end by thanking the staff of the Office of the Chief Auditor, including Marty Baumann and Michael Gurbutt sitting here up front with us, as well as the staff of the SEC that worked very hard with us on coming up with this Concept Release. We have many frequent discussions with them. And I look forward to the event.

CHAIRMAN DOTY: Ms. Franzel?

MEMBER FRANZEL: Thank you, Chairman Doty, for calling these public meetings to discuss ways to improve auditor independence, objectivity, and professional skepticism.

I am so pleased that the board will be receiving input over the next two days from so many distinguished panelists representing a wide range of stakeholders. I want to thank all of the panelists, their staff, and their constituencies for taking the time and effort to assist us in exploring these important issues.

I am personally committed to exploring the broad range of issues that impact auditor independence, objectivity, and professional skepticism and advancing the board's efforts to forge a path for improved audits that help ensure investor protection and audit quality.

Clearly an independent, high-quality, and reliable audit function is fundamental to investor protection and the public interest. Auditor independence is the cornerstone of informative, accurate, and independent audit reports. This is a complex and difficult topic because the concept of auditor independence challenges personal behavior and ethics of auditors as well as ingrained business models and business interests.

But we need to deal with these difficult topics, the results from PCAOB inspections are troubling. PCAOB inspections continue to find serious audit deficiencies where auditors do not conduct basic testing procedures required by the standards in areas that are material and that impact investors.

The potential causes for these

problems are complex and vary in nature across cases. We need to continue to analyze the causes of why auditors issue clean opinions in cases when the audit work is incomplete or not properly conducted.

When financial statement information is contradicted by other available evidence or when audit conclusions on material issues are based on management's views without independent verification, unfortunately, the Board has seen too many examples where auditors go ahead and issue clean opinions without fully or properly completing the audit work in important areas that impact investors.

The methods for improving auditor independence and audit quality won't be easy or simple. There will not be one single silver bullet. Accordingly, the Board has set a broad agenda looking at a variety of issues that could help improve auditor independence and audit quality.

It is my hope that the ongoing

discussions on these issues will lend insights into the multiple, interrelated factors that influence the behavior of auditors and audit firms.

The bottom line here is that we must come up with a package of solutions that will be solid and effective in protecting investors and the public interest. This will involve looking beyond the status quo.

At the same time, we need to analyze the potential costs and benefits of various actions as well as the risks associated with unintended consequences so that in the end, we are effective in protecting the interests of investors and furthering the public interests.

I look forward to working with my fellow board members, the staff of the PCAOB and the SEC, and our stakeholders on these important issues. I welcome the input of the panelists over the next two days.

CHAIRMAN DOTY: Thank you,

Jeanette.

We are, as always, grateful for the support we get from the SEC and the staff we have here today Jim Kroeker and Brian Croteau from the staff. They will be questioners at times, and we are grateful for their interest in this project. Only a panel of the distinction of the one we have in front of us, could have gotten this many people out this early in Washington, D.C. I think.

But before us we have the honorable Paul A. Volcker, former Chairman of the Federal Reserve Bank and a former Chairman of President Obama's Economic Recovery Advisory Board, who is widely credited, of course, with ending high levels of inflation seen in the United States in the 1970s and '80s, whose career stretches back decades to the Treasury and the Federal Reserve Bank of New York, where he was the President from '75 to '79.

The honorable Charles A. Bowsher,

Chuck Bowsher, is former U.S. Comptroller General of the General Accounting Office. Appointed by President Reagan in 1981, he had a 25-year career in public accountancy. He served as Assistant Secretary of the Navy. He is currently a member of the Research Advisory Council of Glass Lewis and serves on many, many boards, including -- he is a public member of the NASD Board of Directors and of the FINRA Board. And he is a member of our Advisory Board at the Public Company Accounting Oversight Board.

The honorable Richard C. Breeden was Chairman of the United States Securities and Exchange Commission from 1989 to 1993. He now heads Breeden Capital Management, LLC and serves as a director and has served as a director of a number of American public companies and has been Chairman of the Board of H&R Block from November 2007 to April 2011.

So these gentlemen bring a wealth of experience. And we would like to begin by asking Mr. Volcker to address us all. Thank you.

MR. VOLCKER: Well, thank you, Mr. Chairman and members of the Board. I appreciate the invitation to appear here.

You are dealing with a very important issue of auditing integrity. You made clear that the concerns go well beyond the question of auditor rotation, which is the centerpiece of this particular hearing. But auditor rotation is a significant element in how we proceed.

I have a chance to read the written statements of Chuck Bowsher and John Biggs and John Bogle and found myself in substantial agreement with those I thought convincing arguments in terms of auditor rotation. And I won't take the time to repeat all of that argument.

Let me say that it is obvious we are all aware of lapses in auditor performance in recent years that get widely reported.

Those have continued beyond Sarbanes-Oxley and the appointment of this Board.

Most impressive to me is not what we read about in the papers but the careful reviews that the Board has made and the staff has made of auditing performance and the number of occasions where you have pointed out indications of divided loyalties or inattention contrary to the professional discipline and ingrained skepticism that we should expect of auditors.

And I do understand, as I guess Board Member Harris mentioned, that these concerns extend to a number of other European countries, in particular, who are in the process of reviewing this issue.

My own experience is embedded in a maybe rather unfortunate period when I was deeply involved in Arthur Andersen and could observe its sad demise. Here you had a firm that historically was considered the strongest, most disciplined of auditing firms.

That discipline and integrity I have to say was not displayed in the days preceding my involvement in Arthur Andersen. And that, directly or indirectly, led to the ending of that firm. It was simply a failure of internal management controls, compensation practices that rewarded retaining clients and success in attracting new business, rather than the exposure of inadequate financial reporting, constant tension between auditing partners and consultants in terms of the existence and profitability of the firm. So we had a once-leading firm that became the victim of a succession of auditing failures.

Let me say I have also seen many different perspectives that may be relevant of professional auditors at their best. I at one point was chairman of a committee to look into allegations of Swiss banks misusing the funds of Holocaust victims and also a committee looking into corruption in the U.N. Oil-for-Food Program. In both those cases, we were heavily relying upon professional auditors in pursuing the problem.

I must say I think both of those investigations were successful, but perhaps not so coincidentally, those audits, while indirectly funded by the institutions investigated, had the sole responsibility to those in charge of the investigation, not to those paying the bills. And that may have released a certain amount of constructive energy.

As a corporate director, I also observed one important instance where a succession of problems led to a change in auditors. And ensuing auditors, certainly in reviewing the earlier evidence, found a lot of weaknesses in the auditing process by a firm that had been long involved in that company.

So, although that experience does suggest to me the importance of requiring auditor rotation, it does seem to me that regular audits should not become a sort of long-term annuity for the accounting firm paid for by the company being audited, rather than being responsive to the true client: the investment public.

I know there is a natural reluctance to risk interrupting the relationship, the long-term, perhaps rather cozy relationship, of the employing committee or executive offices or companies. The idea of friction between the auditor and the company raised deserving questions for both the auditing company and the company being audited. So the possibility can't be dismissed that judgments may be influenced, consciously or not, by the potential for consulting relationships extending over a period of time.

I do think the sense that work may be subsequently reviewed by another auditing firm can be a powerful incentive to maintain professional discipline. I understand why it makes an auditing firm perhaps uneasy to know that its term as auditor may be up and another firm is going to come and look over the work, but I think that is a useful point of uneasiness.

I also would suggest that perhaps a senior auditing partner should sign the auditor report, a little different subject, to add a bit to the sense of personal as well as firm responsibility in the auditing.

I know the red light is on. I know there are some downsides in terms of cost. I think we can discuss that a bit in the subsequent discussion. I know Mr. Bowsher and Mr. Breeden will refer to it. So let me stop at the moment.

CHAIRMAN DOTY: You will be called on again, Mr. Volcker. Thank you.

Mr. Bowsher?

MR. BOWSHER: Thank you very much. It is a pleasure to be here. And I think this is such an important issue, the issue of audit independence and the interface of the professional audit firm and their client.

You have to start with the idea that there is an inherent conflict of interest when the big corporate clients are paying the audit fees. And I think that is true of rating agencies, too, as well as the audit profession. Therefore, you must decide on how best to strengthen the audit independence. And I think audit rotation is one of the main issues.

I believe the Sarbanes-Oxley legislation, Mr. Chairman, that you and Steve Harris especially talked about, has been a big success in strengthening and improving the audit independence in the vast majority of the small and medium-sized client situations. However, I think many people believe that in the 2008 financial crisis, there were far too many incidents where the audit firms did not insist on full disclosure of risks and material weaknesses of their biggest clients. And all too many of the financial statements did not fairly present the financial position of the client.

I list a number of companies, starting with Lehman Brothers and Bear Stearns at that. The biggest financial institutions and some of our biggest companies, General Electric, General Motors, would be in that category as far as I am concerned.

So I believe it is very timely and somewhat long overdue that the SEC and the PCAOB consider additional issues that would further strengthen auditor independence in addition to the ones enacted in the SOX legislation. And I believe the most important change and improvement would result from the requirement of an audit firm rotation for the biggest clients of the Big Four firms.

I believe the comment memorandum that John Biggs, retired Chairman and CEO of TIAA-CREF, submitted to the PCAOB last November is really an excellent paper on the history of the audit firm rotation issue and why the events of the last ten years, since SOX was passed, clearly showed the need for requiring that public companies periodically rotate their audit firms.

Now, there are two main benefits of firm rotation. And they were featured in the Cohen Commission report back in 1978. First, since the tenure of the independent auditor would be limited, the auditor's incentive for resisting pressure -- and "pressure" is a very key word here -- from management would be increased. Second, a new independent auditor would bring a fresh viewpoint.

At the same time, there are many issues and arguments against rotations, but I think there are three big ones. One is the increased cost. The second one is steep learning curve for the new auditing firm, which might lead to an audit failure; and too much disruption for the auditing firms. Let me address each of those.

I believe that it would be wise on the cost issue to limit the adoption of the audit firm rotation at the beginning here to somewhere between 25 and 40 very large companies. This selection should include all the major financial institutions and certainly any firm that is designated as "Too Big To Fail" by the FDIC. Also, I think the selection should include some of the biggest industry leaders, such as General Motors and General Electric. In addition, it would be prudent, of course, to include any large companies that appear to have significant audit and accounting problems.

If rotation is limited to the very large companies, the cost issue really is moot. The cost of an audit for the very largest companies is a very, very small percent of their overall cost structure.

The second issue is the steep learning curve issue, which I have always been somewhat suspicious of, but it can be addressed I think very well by requiring a dual audit by the two firms in the last year of the audit term. If it's the 10th year, that would be the year. And those large companies can easily afford this. In addition, by requiring each firm during that tenth year to submit an independent report to the Board of Directors, the investors, make it public, the PCAOB, and the SEC on the overall condition of the financial statements and the systems and controls of their client.

This would result in what John Biggs called in his November paper a "real-time" peer review. His paper goes on to state "The outgoing auditor would want the work papers to be complete and of high quality with all problems clearly resolved. The new firm would review them, and could either challenge the results or start with fresh eyes."

Now let me just digress for a minute. When I was with Arthur Andersen from

1956 into the '70s, it was led by Leonard Spacek. And, as Paul said, it was the great firm. It was the best firm. I'm prejudiced, but let me tell you Leonard Spacek knew how to handle tough clients. And he knew how to build a great firm. And we were a small firm, though. So we lost a lot of clients every year to Pricewaterhouse and the big English firm, as we call it. And the English firm is in New York. And so he always wanted to make sure there were no problems. And when he heard of a merger and acquisition taking place that would remove one of our clients to one of the big New York firms, he always made sure that he put another couple of partners on there to do an independent review, you might say. He didn't want any problems to come back like that.

When I came out of the job as Comptroller General, I went onto several Boards, as you pointed out, Mr. Chairman. One was American Express Bank. And Dan Akerson, the current CEO of General Motors, a new CEO of General Motors, he was the Chairman of the Audit Committee for the corporation. And I was Chairman of the Audit Committee for the bank.

And, of course, when SOX came in, why, we worked together quite a bit. And one of the things I urged on them, that we would have two big firms working for us, one that did the audit and one that did everything else, internal audit reviews, tax work, everything else. And he bought into that.

Later, after I left, he actually rotated off the first audit firm to the second audit firm. And he told me just the other day when I saw him that, you know, there were some problems, there were some difficulties but nothing that was hard to handle. And he said now that he's at General Motors -- and I think he said they have had the same auditors for 90 years was his term. He is a supporter he said of the overall idea of rotation. And he wished us well. Let me put it that way.

The third issue now in this whole thing is, would it be too disruptive for the auditing firms and all the big auditing firm managers? They don't want this because it is easier if you have the annuities from your past. And especially if they are 20, 30, 40, 50-year clients with big fees, why it is much easier to manage the firm.

But I think the independent look is more important. And I have never been convinced that when I was Comptroller General of this it's too disruptive. When we did the Yellow Book, which was the standards for the states and large cities and municipalities, we included a requirement for the auditors to be rotated every five years. And that is what has been happening for the last 20-plus years.

It also should be noted, as you mentioned, that the European Commission is considering the audit firms will be required to rotate after a maximum engagement period of six years with some exceptions, as they say.

So I say that, you know, at the beginning, if you were just limiting this to 40 companies or some number like that and stagger the rotation over 10 years, the result would be the big firms would be losing maybe 1 or 2 firms each year and maybe picking up 1 or 2 firms.

In each year now, they all lose more than that from mergers, sales, and acquisitions of clients. So, of course, we go back to 2002, when Arthur Andersen went down, for the very reasons that Paul pointed out, unfortunately. Why, hundreds had to rotate off and go to other firms. And there were problems, no question, but it was also successfully accomplished.

So, just in conclusion, I would just like to say as the last Chairman of the POB, I strongly recommended to the Congress ten years ago the creation of the PCAOB because of the POB's inability at that time to oversee the big firms and the AICPA.

I salute the current leadership of the PCAOB for taking on these major issues now on your agenda. And I said at the beginning the rotation issue is number one. We have debated it for 30 years. I think the last ten years have provided more than enough evidence that it should be adopted.

CHAIRMAN DOTY: Thank you, Mr. Bowsher.

Mr. Breeden?

MR. BREEDEN: Chairman Doty, Commissioners, and staff of the PCAOB, it is a great honor for me to be here and participate in this discussion of auditor independence, objectivity, and professional skepticism. In fact, I consider myself a lifelong skeptic on a variety of topics. And, therefore, it is a pleasure to discuss that issue, in particular.

Having served together with Chairman Doty during my time as Chairman of the SEC, it is immensely gratifying to me to see the PCAOB under his most thoughtful leadership. And just as important is the outstanding group of commissioners and superb staff that have been assembled at the PCAOB. And, although I would defer to Steve Harris on this point, from my perspective, I think the PCAOB has already exceeded the hopes of those who helped create the agency. And, yet, I am sure that the best is yet to come.

I don't have a specific yes or no answer on the issue of mandatory rotation of audit firms. Rather than either supporting or opposing mandatory rotation this morning, I would like to offer a few observations based on my practical experience. And, as the Chairman noted, those include serving as monitor of KPMG under its deferred prosecution agreement with the Justice Department following tax shelter frauds, a three-year stint as a senior partner of Coopers & Lybrand, overseeing the restructuring of

WorldCom and the restatement of its financial statements, the largest restatement ever undertaken, serving as the director of more than a dozen companies, and investing several billions of dollars in 65 different companies in the U.S. and Europe.

And in those experiences -- and in the course of that, I have been through probably a dozen accounting firm transitions of companies where I was a director or investor or had oversight responsibilities. Those experiences leave me believing, pretty much as I did when the SOX was being considered, that mandatory rotation would benefit some companies and it would probably harm others. And I am not able to tell the actual proportions of those two eventualities. So let me highlight a couple of concerns that may be helpful in your thinking as you address these issues.

First is the issue what I think of as the elephant in the room. And that is the issue of concentration in the accounting profession. Over the years, when I first started worrying about these topics, we had a Big Eight. Then it was a Big Six. And then it was a Big Five, and now it's a Big Four. And if I hadn't been successful saving KPMG, unlike my friend Mr. Volcker's inability to save Arthur Andersen, we would have been down to Big Three. And that would have been a disaster.

But for companies and their audit committees, the lack of competitive firms, competitive choices significantly limits their practical options. For many reasons, Ford is reluctant to have the auditor of General Motors as their auditor. Whether it is a direct competitor, whether it is a potential hostile acquirer, whether it is a firm that's on the opposite side doing litigation work in a massive litigation, there are many reasons why members of an audit committee might see some of the other of the Big Four as unattractive potential and as not viable as potential audit firms.

So this is a serious issue. And I think if we were dealing in a world of eight major accounting firms, mandatory rotation would be a much easier topic than a world in which there may only be one viable firm, particularly in the large companies that Chuck was talking about.

By the way, I agree with Chuck's suggestion that if you are going to do this, the large companies is the place to start.

Another issue is the question of independence and the economically inherent issue of the fees. And for a very large global company, it is not at all unheard of for the audit fee to be up in the tens of millions of dollars.

I think back ten years ago. Enron's audit fee was in the 20 to 25 million-dollar range. As a purely financial matter, the $25 million audit fee in perpetuity with a discount rate of 5 percent has a present value, that audit relationship, of somewhere around $500 million or a half-billion dollars.

So the ten or so largest audit relationships of any of the Big Four firms could have an aggregate present value of several billion dollars assuming continued incumbency. That's an immense sum for any professional firm, and it helps explain why the issue of auditors trying to please the largest clients continues to arise, notwithstanding how many inspections the PCAOB performs.

The largest audits support the audit firm's core existence, and they pay the pensions of the partners. That is something that every audit partner understands, whether you tell them that explicitly or not.

To some, that is a reason to force rotation in hopes that that will break that conflict and the immense influence of the fees. For various reasons, though, I'm not sure that improved objectivity would be the result.

If the mandatory rotation period is reasonably long, such as 10 or 12 years, then the partners of the incumbent firm would still be afraid of losing the audit in the early years of that tenure. The guy who loses the audit in year two or three of a ten-year period is going to be just as disadvantaged internally in the firm as a person who might lose it in later years without rotation.

Even as the time for rotation got close as you got into year seven, eight, or nine, the incumbent firm would be highly preoccupied trying to find replacement clients to replace those that it was losing. And they would want the management of the firm they are losing to be singing their praises to other firms that might be considering swapping if Ford and GM are going to swap their auditors.

So I am not convinced that lack of

objectivity would suddenly result from rotation. Ultimately, rotation would replace one set of somewhat conflicted audit partners with another set of partners with exactly the same issue. One group of people would lose their relationship, and another group of people would step right into their shoes. Theoretically the new firm would know it was going to lose the client down the road, but, again, it would be six or seven years before that was a realistic discipline.

Thus, you would have some degree of musical chairs among audit firms. And I really doubt that objectivity levels would rise that much as a result.

I would like to before I stop here for the red light mention a word, say a word, about the PCAOB inspection program and how critically important that is.

When I was monitor of KPMG, I had the occasion to look at some of those reports and consider several very significant issues that came to light as a result of them. And I think to the extent that rotation is not something that you move forward with immediately, that the inspection program is developing far better empirical evidence about the scale and scope of problems and how to address them than we ever had before and better than any of the opinions many people may have. So I hope that that can be enhanced as you go forward.

My own suggestion for a possible middle course, is to instead of having mandatory rotation if you conclude that's not viable, would be to use a U.K. or European system of comply or explain and that the PCAOB could set a ten year expectation and in year seven or eight be sure that it does an inspection of the large audit client.

If that inspection comes back showing unacceptable levels of problems for objectivity and independence, then there should be no option for renewing the audit, but if the firm got a clean opinion, if the inspection report showed that they were doing a good job, then that would in my view allow you to comfortably allow the audit committee to then make a judgment. So you would have, in essence, a rebuttable presumption of a loss of independence at the end of ten years. But if they had acceptable inspections, if they did a reproposal and considered the alternatives, and if the audit committee then, being fully aware of the situation voted to continue the incumbency, I would allow that option.

Thank you very much.

CHAIRMAN DOTY: Thank you, Mr. Breeden.

We have about 25 minutes for questions and dialogue with this distinguished panel. And I think we should go in reverse military order. So, Jeanette, the floor is yours.

MEMBER FRANZEL: Thanks, Mr.

Chairman.

Mr. Bowsher, you talked about the need to start this rotation with the largest firms first because of the increased risk in those firms and those audits. We've also got the concentration issue. Can you speak a little bit more about the risks you see with the big audits and how concentration might play into the more immediate proposal that you are making to start with the big firms and the big audits?

MR. BOWSHER: Yes, I would be pleased to do that. There is no question you have concentration, both in the audit firm -- and I wish we had the Big Eight, instead of the Big Four, as Richard pointed out, but we are saddled with that situation. And a lot of the industry -- and we have big four banks now that really dominate the whole issue. So this is not a perfect situation by any stretch of the imagination.

But I do believe that if you

rotated the auditors, I do believe the decision-making in the audit firms is more than one audit partner, the engagement partner. I think if it's done right, like Spacek used to do it, you do it with a team.

And you also have a compensation that the partners that are losing or have to give up the client, they don't suffer any compensation or even that office, as we used to have one worldwide partnership pool at Arthur Andersen, not when they went down but for the many, many years there. And so when they could give up the Keating big S&L in Phoenix, the Phoenix office, the Phoenix partners, none of them lost anything. And a big firm can share losses. These firms are huge, multibillion-dollar operations today. They can be more independent than they have ever been before, but they don't operate that way with their biggest clients.

So I think the problem really lies in the biggest clients. And I think, although

Richard points out some problems because of the limited number of firms, I think it's doable.

And I have been on several Board audit committees where we did rotate and we actually enhanced the role of the audit committee. I know some people think that it does not enhance. It does because you really then starting to interview the other firms. You are really figuring out what are the problems that we might be having to transfer over, anything like that. It really gets the audit committee into the whole issue.

So I think it's very doable. It's not perfect.

CHAIRMAN DOTY: Mr. Hanson?

MEMBER HANSON: Thanks.

For any of the panelists, I appreciate your experience over many, many years. And you bring a wealth of experience. And we're really benefitted from your presence. But I would like to hear some of

your thoughts on your observations of what is
happening with the audit committees in their
oversight of the auditors post-implementation
of SOX and also your observations about
auditors and how they might have changed after
the Sarbanes-Oxley Act was implemented.

CHAIRMAN DOTY: Mr. Volcker, do
you want to start them off again?

MR. VOLCKER: Start with me
because I am at an age where I have a lot of
experience with being a member of Board of
directors since Sarbanes-Oxley. So I'll leave
it to my colleagues up here, but I must say I
was concerned at the reports that the Board
itself has put out about auditing, a lack of
diligence I suppose is a way to put it since
Sarbanes-Oxley.

I am surprised to see that those
comments could be so obvious in a way and so
incriminating so many years after
Sarbanes-Oxley has passed.

MR. BREEDEN: I know as a member

of an audit committee, I would dearly love to be able to read the inspection reports that are today kept confidential. And I think that is robbing the directors who have responsibility on audit committees of vital information to help them evaluate the conduct and tenure of their audit firms.

I must say I share Paul's dismay at it's been ten years since Sarbanes-Oxley and the continued occurrence of the same problems over and over again that are documented in your inspection reports. I can see why you are considering proposals that would go of the nature of mandatory rotation to say, "Well, we have got to find a way to break through whatever is the -- barrier that is" -- it should be a simple thing for firms to understand that if you are going to sign an opinion, that you need to have some reasonable basis in your work papers for doing so and particularly where the particular issue might be highly material. And I don't have an explanation for that.

I think people have become more process-driven subsequent to the enactment of SOX, but I don't know that the inherent judgment and wisdom of decisions has actually gotten significantly better.

I might also as a footnote just say, having been through a number of switchovers -- at H&R Block, we had an independence issue with KPMG. There was an incumbent and replaced them with Deloitte. And I've been through transitions at WorldCom and other companies. And I think often, putting aside the fact that if you did mandatory rotation, I would invest in interstate moving companies because of the thousands of people that are going to be moving around the country, switching accounting firms can often -- you know, people talk about the risk of problems. It can be a hugely beneficial thing.

You get a reexamination of every

possible accounting judgment, every possible estimate that is material when a new audit firm comes in. And that delivers some real benefits.

MR. BOWSHER: Well, as I said in my opening statement, I really think SOX has been a big success for everybody practically except the very biggest companies.

And when I see the audit committees in the big banks and the big broker-dealers not doing their job -- and I have interviewed some of those people since the crisis. And it's amazing to me that they admit that they just didn't understand some of those financial instruments that were being created: the mortgage-backed securities, the CDs, all the derivatives, and everything like that. And, of course, I can understand that.

I'll always remember one time Judge Sporkin said, you know, when he was the general counsel of the CIA, if they wanted to hide something, they complicated it. And

Michael Lewis in his first book that he ever wrote said that's what was happening on Wall Street. They were complicating all of those things and hoping the regulators wouldn't understand it. And, of course, sometimes it's hard for the audit committees.

But the audit committees have a right to seek counsel from specialists and everything like that. So I think our problem basically lies with these very big companies.

You know, another problem we seldom ever talk about, when we were on the POB at the end, we had two or three new members. One was Norm Augustine. And he was of course the distinguished former head of Lockheed Martin. And I knew him when we were both at the Pentagon. He's a really brilliant and capable guy.

And he said to us, "Can you give me a list of all of the audit busts that we've had in the last ten years that came to the POB? So we gave him a list of about 15.

And when he looked at the list, he said, "Well, you know, I'm not an auditor. I'm not an accountant. But I can tell you what comes off this paper. And that is the arrogant, strong-willed CEOs of these companies." And so that is one of the big issues, too, that the audit committees have to deal with.

I think when AIG got into trouble, you know, the audit committees very wisely went over and saw some lawyers. And the lawyers explained what their responsibilities were. And they did the right thing there.

But in the past I think when you're dealing with the Sandy Weills and a few others of these guys, it's not an easy job. And that's why the auditing firms have to mobilize themselves so that they can make tough decisions when they go to see the client and say, "You've got to make these kinds of adjustments. You are not fairly presenting." That's what you've got to do.

But I think the audit committees, by and large, have improved immensely. I really do. But I can't defend them in those big banks and big broker-dealers and some of those other big companies because I don't think they did do their job.

MEMBER HANSON: Yes.

CHAIRMAN DOTY: Mr. Ferguson? Lewis?

MEMBER FERGUSON: Yes. I would like to get your views on the human capital costs of a mandatory rotation regime. And by that I mean -- Richard, you mentioned the moving companies that would probably be some of the great beneficiaries of this, but the examples I think of are a company like John Deere in Moline, Illinois or Berkshire Hathaway in Omaha. And there are many others where a very large corporation is headquartered in a town that probably only can support the one audit firm.

Are we simply going to have

hundreds of people changing team hats if we had mandatory rotation? I mean, the Ernst and Young hat would be switched for a Deloitte hat or a Pricewaterhouse hat? And if so, would that really achieve the kinds of changes and fresh view that we want? And how great would these costs be?

MR. BREEDEN: I think they would be meaningful, pretty significant. There would probably be some level of, as you suggest, at lower levels staff accountants, even up through young managers, of the firm that is rotating away. The new firm coming in might hire large numbers of the former staff who helped perform the audit. And that would certainly undercut some of the benefits that are held out from rotation, although you would certainly have a change in the partners.

Among all the Big Four, it certainly was my experience at Coopers and I suspect it was Chuck's at Andersen that the engagement partners are used to moving around the world. They frequently have to rotate off accounts. And if they move from Pfizer to Citicorp, a movement that's local, but if they rotate onto a different account on the other side of the country, they accept the fact that the profession entails frequent family moves.

So I don't know. You may make that more frequent, but it's not something brand new certainly for the more senior leaders in the firm.

In that respect, I think auditing is different than law firms and investment banks, where people may be able to go through their entire career working out of one city, admittedly doing a lot of commuting. But I think the audit profession moving around the country is much more common.

CHAIRMAN DOTY: Mr. Bowsher?

MR. BOWSHER: One of the things when Spacek ran Andersen was that we didn't have near as many offices as other firms. And you never would put an office in a small town where we had a big client because you didn't think the firm or the people working in it could be audit independent.

When I became head of the GAO, I closed down all the audit sites in the cabinet office buildings and in the small towns, where we had a big, let's say, IRS service center and the guys went over there and did the same work year after year after year. I think that if you went to rotation, there would be some firms that might have to close some of these smaller offices.

When I was on a big steel company Board, when they ran into trouble, they had a small office in Fort Wayne, Indiana. And I remember Wally saying to them, "You ought to close that Fort Wayne, Indiana office and work out of Chicago" because I think it does color people's independence if they think they're going to lose a client.

And so I think rotation would be more -- they can handle rotation better because they know it's coming up, but I also believe that this is always a problem, but it is not a big problem that should stand in the way of moving to rotation myself. Yes.

CHAIRMAN DOTY: Mr. Harris?

MEMBER HARRIS: I think throughout the next two days, we are going to hear the issue of cost-benefit analysis come up. And how would you all weigh the benefits versus the cost? And how would you deal with the argument that we ought to get empirical data for the benefits that would come out of auditor rotation?

MR. VOLCKER: The mantra of cost-benefit is it sounds good. It's applicable to many operations of government or business. I don't think it's particularly applicable in this particular case because the costs are identifiable. They may look large in terms of a change, but the cost is not measurable and could be enormous.

What we're worried about is a

breakdown in the auditing process that leads to damage to the firm, may lead to the end of the firm, may lead to enormous reputational problems, which you can't equate in any normal cost-benefit analysis.

You have got a continuing stream of relatively small cost with the risk of a huge catastrophe for the company. I don't think that is susceptible to normal cost-benefit. I don't think you can go around and say, "You know, it's worth three basis points to the investment firms over time" or whatever. It doesn't work.

MR. BREEDEN: You know, I think this is an excellent question and really goes to what I have struggled with, both at the original time this topic was considered a decade ago. And now I come at it slightly differently from Paul. I wonder how do you quantify whether mandatory rotation would indeed be successful. It's great.

If we knew for a fact that

changing the legal rules or forcing rotation would suddenly cause auditors to be more professional, verify opinions more frequently, be more skeptical, be more objective, great. I think everybody would support it.

The question is can rules, ultimately, that you might enact cause individuals -- these are subjective qualities. Is somebody too trusting? Are they sufficiently wary? Are they alert to signs of problems? And rules won't necessarily change that. So I'm not sure.

There's a leap of faith involved in buying into the idea that rotation will, in fact, mean that a given audit partner suddenly does a better job, as opposed to that given audit partner, instead of failing at this company, will fail at this company over there. And if all it does is move around a badly performing partner or team, then the benefits may not occur to offset the costs.

So it is a very difficult issue.

It will be a very difficult one to litigate, I suspect, if challenged under the statutes requiring cost-benefit analysis.

I do, parenthetically, think that the costs are in some respect overstated. I've tried to think back in the dozen or so times where I have seen audit firms -- now, these were all voluntary cases where we reproposed on an audit committee and picked somebody new. But in every single case, the fee was the same or lower, not higher.

And I think the competition on the part of if the auditor of Ford is rotating off, if PwC is losing that 100-year joint venture to a mandatory rotation rule, then the competition among the three who might get it will be immense. And there will be a lot of cost-cutting.

So I think both on the cost side and on the benefit side, it is going to be a tricky issue for the economists and others to really document.

MR. BOWSHER: It is difficult to do a good cost-benefit on practically any issue. And this one I think is -- just as my panel members were pointing out some of the problems. I do believe strongly that if you do a cost-benefit, you have to really go back a few years and look at the costs and look at the benefits in the past because you are then dealing with real costs.

Most cost-benefits are what I always call economic projections, rather than cost-benefit analysis because they're always looking forward and they get the economists to always build in more assumptions and data. And sometimes they do it on a modeling thing and everything like that. And then it comes out and looks great, but the truth of the matter is if you don't look back, sometimes you are kidding yourself.

And if you look back in the last ten years here and figured out what the cost was of these big meltdowns of the big banks, the big broker-dealers, and General Motors and Chrysler and General Electric's problems and things like that, AIG, why, you would soon see that the cost of the audit or rotation, any additional cost, would be very, very small compared to those costs.

And then I think what would be good for the PCAOB to do is what you are doing right now. And that is look every ten years at whatever you decide to do now. And so it's SOX plus what you decide to do now ten years and see what the costs would be.

So it's good I think to try to do some, but I think lots of times cost-benefits are not done well at all. And so you've got to be careful.

I always love to tell the story -- I was Secretary in the Navy. The Air Force started walking around the Hill in the Congress with a study pointing out that land-based air was cheaper than sea-based air. And the Chief of Naval Operations showed it to me. And he said, "What do you think of this?"

And I said, "Well, let's look back." And when I did a special study and we came up with the fact that we lost a lot of the air bases that we built in Spain and places like that, and it turned out the sea base there with the carriers was really more cost-effective.

Now, I always try to point out that Ken Lay was a young naval officer who was on my staff. And he worked on that cost-benefit analysis. I've had more than one Air Force general say he would like to have a recount. But, anyway, I think you have to be very careful.

I think also I really agree with Richard on the costs are overstated generally on this because when we were with Arthur Andersen and we would get a new client, we would eat the first-time costs. And we were a small partnership, and we could afford that.

And I think when I have been on

these audit committees 20-30 years later, we don't get big bids of cost increases. So I think that you're coming in and especially if you have that overlap that I am recommending. It would seem to me that that would be an extra cost, the overlap. But I think that is really good to get that in there.

But I believe that the idea that the future costs -- and you've got to always remember, just like on 404, the better the accounting systems and the closing processes of your company and your client are, the cheaper the audit should be. In other words -- and that is what is happening now. The audit fees are going down.

A lot of people think it is because of pressure. I don't know what's causing it myself, but I would guess that one of the reasons is when you walked in today, the accounting systems and the financial reports are in much better shape than they were ten years ago because of Sarbanes.

CHAIRMAN DOTY: We have less then five minutes. Military order -- and this means kind of a rough calculation of the Chairman between length of service and biological age, but I want to be sure that we have covered everyone else.

I do think it would be useful, Chairman Volcker, if you told us whether the conflict inherent in the fee, the fee structure, can and should be addressed by something short of looking at other solutions.

In Europe now, they are talking about a third party payor, having an insurance firm, having someone else pay the audit, select the auditor. Moving away from the inherent conflict of the fee, are we on the right track trying to come up with some combination of arrangements and standards of the kind that you are talking about that the panel has talked about and that we will hear from today? And do we have a chance of avoiding the third party payor? Can the conflict be solved within the current structure?

MR. VOLCKER: I don't see how it can be solved within the current structure. You're asking, can you change that payment system? I would think that would be fundamentally important if you could do it, if you have a better system.

I don't think we devised just how to do this without some kind of a -- I don't know how you would do it. Would some government agency say, "This is who your auditor is going to be, and this is how you are going to get paid"? I think that's more -- if you could deal with that payment problem, it's more important than auditor rotation, in my view. Auditor rotation is a way of getting around the existing problem.

If you could face it more directly, God bless you but I don't know how.

CHAIRMAN DOTY: And how do other panelists feel about the alternatives?

Richard and Chuck?

MR. BREEDEN: I think trying to have any system where you socialize payments through government agencies or something would be an unmitigated disaster. I think audit committees feel a real responsibility for policing the audit costs. And changing that would hurt shareholders.

I guess if we are starting with a clean slate, what I would do to address the conflict issue would be to say that the ultimate authority for picking -- I would copy what the Nordic countries do and say that for selection of the auditor as well as for selection of members of the audit committee and maybe the entire Board but at least the audit committee, I would let a committee of either the five or the ten largest shareholders meet in advance of the AGM and make those decisions, instead of the Board, as currently constituted.

That way you would have the people

who are ultimately both paying the fee and shouldering the risk of what it breaks down, be it the people who say, you know, "I am not comfortable with this audit committee. I want to see some changes. I'm not comfortable with that 50-year tenure of that auditor. I'm going to force some changes," rather than the current system that resists shareholder involvement.

But they are ultimately paying the bills. Why not put more responsibility on them for deciding.

CHAIRMAN DOTY: Chuck, briefly?

MR. BOWSHER: I agree, Richard. I wouldn't turn it over to a government agency.

I think, actually, I am kind of an optimist in life. You have to keep improving whatever process you have. The SEC made the decision in the 1930s under Joe Kennedy and the original team that they would rely on the private sector auditing profession.

I think on balance, it has done a

good job over the years, but there are times when they don't do an adequate job. And I think what you are doing right now is terrific. Look at it and see how you can improve it. So I think that is what you want to do. You want to come up with how we can make it more independent.

I think what we did in SOX, making the audit committee more independent and making there be a financial expert, making the CFO and the CEO certify, all of that has really worked quite well. But then the big firms, for some reason, especially in the financial area -- even when you think about like General Electric's problem, which to a great extent, was in their financial arm.

So these things I think any improvement you come up with, whatever mix you finally decide on I would hope would work and would improve. And ten years later or five years later, we ought to take another look.

CHAIRMAN DOTY: Let me say this

again. These three gentlemen sitting before us have a rather remarkable record of having been right about a great many very difficult questions of financial policy and regulation over a very long time. I exclude you, Richard, from that, but we are in awe of the wisdom and the perspective you bring to this exercise. We are grateful for your time. Thank you again.

MR. VOLCKER: Could I have one --

CHAIRMAN DOTY: Yes, sir?

MR. VOLCKER: One comment, Mr. Chairman.

CHAIRMAN DOTY: Yes, sir.

MR. VOLCKER: I don't want to let this business about storing for the big companies go by without some comment. They obviously are a big problem. You've got a big problem with concentration in the auditing industry. You do not have a problem with concentration with small firms and small auditors. There is lots of competition there.

And it is very easy to make a change.

I had forgotten when I said earlier, I'm no longer a director. I am a director of a small company that happens to be right in the midst of changing auditors. And they do it because they wanted to get a different perspective, not because it's a problem.

CHAIRMAN DOTY: Thank you, Chairmen. Thank you all. Thank you.

Next panel -- and I will introduce them as they make their way forward.

We have people now who have invested serious money and who have spent a lot of time looking at these issues in governance. James Alexander is the head of Equity Research at M&G Investment Management, a subsidiary of Prudential PLC. He's been at M&G for ten years specializing in the financial sector, particularly bank analysis.

Prior to M&G, he was ten years in equity research at a number of investment banks in London. He has a B.Sc. in economics from the LSE, London School of Economics, followed by a M.Sc. and a Ph.D. in economic history at that institution, at London School of Economics.

Peter Clapman. Peter Clapman is the Chairman and the President of Governance for Owners USA. He was the Senior Vice President and Chief Investment Council for TIAA-CREF until his retirement in 2005. He is a member of Stanford Law School Institutional Investors' Forum, teaches at directors' and fiduciary colleges.

He is on the advisory Boards of the Yale Milstein Center for Corporate Governance, programs at Delaware. He was appointed by the New York State Comptroller to the Pension Fund Task Force in 2008. He is an independent Chairman of the AARP Mutual Funds Board of Trustees and a member of the Risk Metrics ISS Governance Leadership Council. Peter has a long and distinguished career in governance.

Ed Durkin is the Director of Corporate Affairs of the United Brotherhood of Carpenters. He coordinates government and investment activities of the carpenters' U.S. and Canadian pension funds with assets of 40 billion, with a b.

He has been a leader in efforts to further auditor independence, option expensing, majority voting, and director elections through that medium. He is a former Co-chair and a Board member of the Council of Institutional Investors.

If Damon Silvers is in the building or joins us, he will be welcome at the table. But first I think we should begin and proceed.

Mr. Alexander, thank you. Please proceed.

MR. ALEXANDER: Thank you very much for inviting me.

I'm not so used to these

proceedings, coming from London. I should emphasize these are my personal views and not those of my company, either M&G or Prudential. I have discussed them with some of my colleagues. I am a very humble user of company accounts, especially in the presence of such a distinguished roster of panelists and Board members.

I think myself and most of my colleagues are in favor of auditor rotation. We think it is a good idea in principle. I think it has some problems with the size of the companies, the size of the auditors. I think there are conflicts of interest. I think we also need to just keep in mind the value of audits and how valuable they are, not how lacking in value they are. And also I would like to say a word about the financial company audits, in particular, which is kind of my area of specialty.

I think while we think rotation of auditors is a good idea, a very good idea in theory, it may not be that particularly important. Trust in management is the most important thing for investors. And I think we shouldn't lose sight of that when we are talking to company management, we're not thinking about the audit. We're thinking about do we think that management know what they're talking about, are they competent. It's not always the case. Are they good? Are they entrepreneurs? Those are the sort of questions that we think about as investors. The audit is not at the top of our minds at that time.

I think Boards should be responsible for our auditor rotation. And I hear what some of the earlier speakers said about Boards not always being as engaged or understanding of the audits or the audit process.

And I think one slightly sad thing is that you end up with people on audit committees who are former auditors. And so you can just perpetuate a culture of auditors know best.

I think we certainly would agree with the U.K. view that Boards should do more to explain their choice of auditors and their reasons for not rotating, so comply or explain when they don't rotate.

But I think there are some very serious practical problems with the lack of choice in auditors, especially for the bigger companies.

The concentration has been pointed out. There are only four auditors around that most Boards feel comfortable with. And that really is a serious, serious lack of choice. I think that's a consequence of gigantism, if you like, where we get bigger and bigger companies needing bigger and bigger auditors.

It's probably a consequence of globalization, which is a good thing in many ways. I don't want to knock it. It's a good thing that promotes economic efficiency and trade and everything. But it does lead to some very, very large companies that are very, very complex to analyze or very complex to manage, very complex to analyze and very, very hard to audit as well.

Smaller companies just have no chance when you have got a global company of being able to manage a global audit. And if there are lots of subsidiaries around the world, that becomes even more of a complex situation. So there are some real challenges for them to audit and analyze a big company.

With smaller companies, after talking to them and looking at their accounts and auditing them, you can get to think you know them quite well, but with the bigger companies, this is a real issue.

I think it's an agency problem. It's an agency problem that is more acute in giant companies as they become so much bigger than individual investors, these three, four hundred billion market cap companies out there. They are almost too big to invest in it with any real confidence. I think that is an issue. They have become too powerful. And the managers can become too powerful.

So I think where do we end up? With giant companies requiring giant auditors or do we just have to have giant investors? Everyone has to be a Blackrock? Is that where we end up? And I'm not sure that would be a great place to end up, even though Blackrock is obviously very good at what they do.

It's almost like an arms race that you end up by following this path of size in everything. It's a real challenge.

I think also just on the conflict of interest issue, I did look at some audit companies before I came, just the latest accounts. And I was surprised, actually, by this drift to earning fees from non-audit sources. And that up to 70 percent, 75 percent of revenues are from non-audit sources at the big audit companies. And I think that is a bit surprising. I know that it's good.

In most cases, they don't earn those fees from their audit clients, they earn them from non-audit clients. But I still think there's an issue as the non-audit fees grow so quickly relative to audit fees that this is going to become even more of an issue for these firms. And I think it becomes more challenging for them to manage those conflicts.

In particular, where audit firms don't maybe get captured by the firms that are paying them but they get captured by the industry, where you've only got four big companies in an industry or big banks in an industry, they will be earning audit fees from one firm earning non-audit fees from two of the other big firms and the fourth firm, they can't really work for because of conflicts of interest. So if you do have auditor rotation, you kind of wonder who is going to turn up to the pitch. So that's quite an issue.

I see the red light has come on. I just want to say two quick things. One is about the value of audits. I think they're not very expensive relative to the revenues. I think that has been made clear. So you've got to wonder what value they really have when they're so low-cost. I think that's got to be an issue.

But also you have got to remember I think that, although auditing is a very, very good thing in some sense, economic sense, firms are audited by their competitors. And weaknesses in those big firms appear as competitive opportunities for their competitors. And that is what is exploited. Scandals happen when those weaknesses are covered up by accounting issues. And I think that is the issue that blows up every now and again. But, generally speaking, firms are audited or reviewed by their competitors who find out their weaknesses.

And last I would just like to say

something about financial company audits. This is an area where I do quite a lot of work trying to understand banks. They are incredibly complex. I think they're a decent-sized investor. I'm lucky to be a specialist in the banking sector. But it's still incredibly difficult to work out exactly what is going on in a bank as an investor on the outside.

And I think in some sense audits don't matter for banks. What really matters is the regulatory process. The regulator's yea or nay is the key decision for a bank, not necessarily or even the going concern of an auditor.

I think you can end up in many cases with what the Japanese or what investors called zombie banks in Japan, where the banks aren't really going concerns but there is a sort of public nod and a wink to let these banks carry on between the bank and the regulator. And everyone knows they're not really taking the write downs they should on their assets. So they're not really going concerns, but, you know, we just have to live with that. And that compromise and conflict I think is an issue for a lot of companies, especially banks.

CHAIRMAN DOTY: Peter Clapman?

MR. CLAPMAN: To start, I must commend the PCAOB for raising the issue of audit firm rotation as a means to strengthen and enhance auditor independence. And my position is straightforward. I support periodic audit firm rotation as the best policy with this goal of increasing audit firm independence as the best policy and periodic audit firm re-bidding, bringing in other audit firms to bid for the assignment at periodic intervals, as the next best policy.

But I do think that unless the PCAOB takes the regulatory action to require something in this area, the status quo, which encourages audit firm for life or forever, whichever comes first, will continue. And investor concerns about audit firm independence will persist.

I am speaking on behalf of Governance for Owners USA, the parent of which is a British investment manager that promotes investor engagement with our portfolio companies.

I have looked at these issues from a global perspective for many years -- and auditor rotation is now a global issue -- for a long time, having been a former Chairman of the International Corporate Governance Network. I am also speaking on the basis of my past personal experience as the Chief Investment Counsel for TIAA-CREF, which is the largest investment pension system in the world. I also managed the TIAA-CREF corporate governance program.

Auditor independence has always been an important issue to my organizations and me professionally. At TIAA-CREF, I participated in three auditor rotations at intervals between eight and ten years. The results were better audits, similar costs, and none of the dire consequences being argued by many of the commentators against the PCAOB Concept Release.

Additionally, as a major investor, TI-CREF asked a number of major companies to voluntarily adopt a policy of auditor rotation. And we had no takers. My clear sense was that these companies refused to even consider periodic audit firm change.

A clear theme emerges from this experience and any fair reading of the bulk of comment letters from the corporate community. The vast majority of companies will not seriously consider voluntary adoption of rotation because they have come to think that it is an act of folly to change audit firms. These companies have argued the familiar dogma that costs will inevitably go up substantially and that initial audits will suffer in quality. This familiar dogma, however, in my view is based on faulty assumptions.

Why would audit quality decline with a change of audit firms? This contention supposes that good audit committees, the outgoing auditor, and the incoming auditor are professionally incapable of developing the appropriate transition, a supposition I reject.

To the contrary, my own experience indicates that better audits will result as the outgoing firm is aware that another quality firm might take a fresh look at some of the prior decisions and when fresh looks actually do take place, better audits result.

Significant cost increases, another claim against audit firm rotation. I do not see this occurring because competitive forces will encourage cost competition. Audit firms will want to win new assignments, which they can anticipate will last for a number of years. And with competition, they can be expected to bid wisely and win the assignment. Investors, of course, will look at costs as justified if auditor independence is enhanced.

Another charge against the PCAOB initiative is that it would intrude upon the authority of company Boards and audit committees. To that, I observe that few, if any, of the now generally accepted governance reforms were adopted without some regulatory or legislative intervention. Regrettably, most governance reforms have rarely occurred otherwise.

For example, take the current important audit committee practices, now widely accepted as positive. It took the SEC initiative under Chairman Levitt to require that audit committee members should have financial literacy and that committees should include a financial expert. It took Sarbanes-Oxley to eliminate the conflict when audit firms provided substantial consulting services to companies they audited.

These and other reforms instructing companies as to who may serve on their audit committees and how companies receive consulting services were far more intrusive into company affairs than a requirement that audit committees must choose different audit firms at periodic intervals while leaving the discretion as to which audit firm to the committee.

In conclusion, my experience both as a company executive and as a corporate governance professional leads to a clear conclusion. The time is right for the PCAOB to implement the appropriate policy of audit firm rotation or if that is too big a bite, compulsory audit firm re-bidding, again leaving the ultimate decision to the audit committee but to promote change in order to promote greater auditor independence, a key issue for many investors.

And unless the PCAOB takes action along these lines, the system will remain largely unchanged. And that would be regrettable.

We all need to recognize a practical reality and examples abound that our corporate governance system often will need an external impetus to adopt governance reforms later understood to be the right steps to take. In retrospect, these were perhaps intrusions, but they were appropriate intrusions. Auditor rotation through action by the PCAOB is the right step to be taken now.

CHAIRMAN DOTY: Thank you, Peter.

Ed Durkin?

MR. DURKIN: On behalf of the United Brotherhood of Carpenters and Joiners of America, I would like to thank you and the members of the PCAO Board for the opportunity to participate in this public hearing.

Carpenter members in the United States and Canada participate in over 100 pension funds with assets of $40 billion. Our members' retirement security is dependent upon the integrity of the nation's securities markets with accurate and reliable data, financial reporting, the foundation on which those markets operate. For these reasons, we commend the Board for its clear focus on the issue of auditor independence.

Our pension funds have engaged hundreds of companies over the past decade with auditor independence and financial statement integrity issues.

In 2002, prior to Sarbanes-Oxley, new corporate auditor fee disclosures enabled us to challenge corporations on their use of audit firms to provide non-audit services. Strong shareholder support allowed us to negotiate limits on non-audit fees and secure corporate commitments to institute fee pre-approval processes.

In subsequent proxy seasons, shareholder initiatives forced hundreds of companies to retreat from plans to eliminate shareholder auditor ratification votes and buttress FASB's successful stock option expense and rulemaking.

This past fall, carpenter funds submitted shareholder proposals to several dozen large cap companies, requesting that they establish an audit firm rotation policy. The corporate reaction to the proposal was mixed. Some disliked it while others really disliked it.

Several companies quickly sought no action relief from the Securities and Exchange Commission to exclude the proposal from their proxy materials. The SEC staff agreed with corporate assertions that the auditor rotation proposal presented an ordinary business matter not appropriate for a shareholder vote.

Our request for full Commission reconsideration of the decision was rejected by the SEC staff. In recent weeks, we have submitted new auditor independence report proposals to a number of companies with long audit firm relationships.

The proposed independence report entails proxy disclosure on aspects of the audit firm engagement, including Board and audit committee efforts to protect auditor independence. Again, several companies have chosen to seek no action relief from the SEC with a decision on those requests pending.

Despite the challenges to the rotation and the report proposals, a majority of the companies have chosen to engage in constructive dialogue on the auditor independence issue. Corporate discussion participants have included audit committee members, CFOs, controllers, general counsels, and corporate secretaries.

While these corporate representatives express confidence in their policies and practices to protect auditor independence, many acknowledge shortcomings in current disclosure practices regarding the issue.

The ongoing give and take has been productive. For example, Citigroup's recent proxy statement, issued I think on March 8th, contains new audit committee report disclosures, including information on KPMG's tenure as Citigroup's independent auditor; the factors, including tenure, involved in the committee's decision to recommend shareholder ratification of KPMG; the details of an assessment of KPMG prepared by management, including a fee assessment; and a statement that the audit committee has concluded that the retention of KPMG to be in the best interest of Citigroup and its investors. And in recent days, several companies have agreed to expand their proxy auditor independence disclosure in response to withdrawal of the report proposal.

The new disclosure in the auditor ratification vote narrative will state that the audit committee is directly responsible for the appointment, compensation, retention, and oversight of the independent external auditor; two, the date of the beginning of the audit firm's tenure as independent auditor; three, that the audit committee is responsible for fee negotiations with the audit firm; four, that the audit committee periodically considers whether there should be a regular rotation of the independent audit firm; five, that the audit firm and its chair are directly involved in the selection of the new lead engagement partner; and, six, that the Board of directors and its independent audit committee believe that the selection of the company's independent auditor is in the best interest of the company and its investors.

We believe these commitments to new auditor independence disclosure represent a solid step forward. Enhanced independent proxy disclosure that informs investors and promotes internal practices and processes to protect auditor independence is essential.

Improved shareholder disclosure will transform the routine auditor ratification vote into a meaningful exercise of shareholder voting rights.

Further, expanded disclosure will facilitate and inform use of shareholder majority voting rights in director elections. This shareholder empowerment will focus Boards and their audit committees on protecting auditor independence. Achieving improved and uniform auditor independence proxy disclosure through shareholder private auditing actions will be difficult and time-consuming.

We urge the Board as part of its ongoing efforts to protect auditor independence to consider new proxy statement auditor independence disclosure requirements. We believe such an initiative would represent the next best step in auditor independence reform.

Thank you, Mr. Chairman.

CHAIRMAN DOTY: We have been

joined by Damon Silvers, Director of Policy and Special Counsel for the AFL-CIO. Damon was Deputy Chair of the Congressional Oversight Panel for the Troubled Asset Relief Program. He served on the Treasury Department's Advisory Committee on the Audit Profession. He was a clerk for Justice William T. Allen. And he serves on the Investment Advisory Committees of the Securities and Exchange Commission and the PCAOB.

Welcome, Damon.

MR. SILVERS: Thank you, Mr. Chairman. And thank you for the opportunity to testify -- I guess it's not testify -- speak before the Board today.

As you noted, I served as Chair of the Competition Subcommittee of the Treasury's Task Force on the Future of the Auditing Profession. And in that context, we reviewed the fundamental issues involving competitiveness in the auditing profession and the fact that, as has been mentioned by my fellow panelists, from the perspective of larger public companies, there are effectively four audit firms functioning in the United States today, which presents fundamental problems in terms of both fee competition and the role of competition among audit firms to foster auditor independence.

We found through that process on behalf of the Treasury Department that there are fundamental structural obstacles to expanding the number of audit firms capable of doing an audit of a large public company and that any path to having a larger number of firms is very much a long-term path. That fact overshadows I think the PCAOB's consideration of steps that need to be taken at this stage to increase auditor independence.

The primary initiative that is in front of the Board today, the question of mandatory firm rotation has been a matter of widespread public debate intermittently, intermittently widespread since the Enron and WorldCom scandals and the bursting of the dot-com bubble in 2001 and 2002.

Firm rotation was contemplated as part of the Sarbanes-Oxley Act but was ultimately not included in the act. Instead, there really was an approach that promoted two distinct ideas. One was this primary role, as my other panelists have mentioned, of the audit committee of the Board as a means of quasi-independent oversight. That is my term, "quasi-independent" of the auditor.

The notion is that the audit committee is distinct from management and is even in a certain respect distinct from the rest of the Board in the levels of independence required of the audit committee and in the requirement that there be a financial expert. This was enhanced by the requirement of partner rotation.

I think that if you look at these

two measures over the least ten years, while we have not had similar evaporations of mega cap companies, such as Enron and WorldCom, in the context of audit failure, in the last ten years, we have had something rather more insidious and longer-term occur that argues, I think fairly strongly, for additional protections for auditor independence and the encouragement of the appropriate professional skepticism that this Board, in particular you, Mr. Chairman, have highlighted as the appropriate stance of the independent auditor.

Part of the reason why I believe that this sort of long-term deterioration has occurred and the relevance of independent auditing can be identified by little things, like the fact that over this last ten-year period, while they have auditor rotation, while we have had audit partner rotation, we have not had the audit partner sign the letter from the auditor, creating a situation where there is an appearance of accountability at the partner level but at a level of accountability that is rather hard for investors and the public to enforce. As my colleague Ed Durkin mentioned, absent disclosure, it's rather difficult to get much of anything done.

The upshot here is that when the financial crisis of 2008 occurred, it became quite clear. And my fellow panelists have discussed this as well. It became quite clear that there was a diminished relevance of audited financial statements to the functioning of the financial markets. This was I think rather obvious in that we had in 2007 and into 2008 audited financial statements from major firms that suggested that those firms were healthy and those firms very quickly thereafter sought public support to avoid systemically catastrophic bankruptcy.

Following those events, at numerous meetings of the standing advisory group of the PCAOB, it was impossible for any member of the auditing profession to answer basic questions about how this could have happened, but when those questions were posed at that body, the result was deafening silence. And I mean questions as simple as "What is the nature, in relation to the going concern rules, of a company which but for government support, which is not guaranteed as a matter of contractor law, would fail?"

No auditor was prepared to answer that question in a public setting. This suggests to me a profound problem of auditor independence.

Now, last fall, just to show that these problems were not temporary in relationship to the financial crisis of 2008, last fall, we saw during a period when there were jitters about Europe that the credit default swap spread for major banks and publicly traded financial institutions in U.S. markets went to levels in some cases exceeding those that were in play in the markets in the

Fall of 2008.

This occurred while again our audited financial statements for these very same firms suggested that not only were they healthy but that they were healthier than they had been in years. It appeared, though, that the markets for their debt just simply didn't see it that way.

Now, I believe that the diminishing relevance of audited financial statements and of the audit process itself has contributed to the legislative environment we have today, where key protections that were mentioned by my fellow panelists are now under legislative assault this morning as we meet down the street on Capitol Hill in the form of the so-called JOBS Act.

Now, as my fellow panelist Ed Durkin mentioned, there are some obstacles today to investors taking up the next step in auditor independence, which would be firm rotation on a private ordering basis. In that context, it is the view of the AFL-CIO that it would be appropriate for this body, the Public Company Accounting Oversight Board, to move in the direction that, frankly, many independent commentators on this matter urged on Congress in 2002, which is to move from partner rotation to firm rotation.

Thank you very much.

CHAIRMAN DOTY: Thank you, Damon.

We have about 25 minutes for questions. And I'll begin with Mr. Harris.

MEMBER HARRIS: Mr. Alexander, I wish you would explain a little bit the British requirement for comply or explain for not rotating. I'm not familiar with how that works. I think you mentioned it.

And then also if you could talk a little bit about the role of relevancy of the audit and value of the audit? Both you mentioned that, and Mr. Silvers mentioned that. How do we make the audit more relevant and valuable?

But, first of all, if you could talk about the comply or explain for not rotating requirement in the U.K.

MR. ALEXANDER: I am not an actual expert on that area, but it's a principle I think that is adopted quite widely in U.K. corporate governance that there are codes, voluntary codes, of corporate governance for a whole variety of areas when it comes to U.K. companies. And the rules are laid down voluntarily, but the Boards have to either comply with the rules that are laid down or explain why they are not. That is basically -- it's pretty much as it sounds: comply or explain. So rotate your auditors or explain why you're not. It's the same sort of principle.

I think maybe you've gotten some -- Citigroup, I think, was adopting this year in that proxy. It's the same sort of principle, just better disclose -- better explanation of why you have adopted something that maybe people think isn't in the public interest but you do it anyway because there are good reasons for it. So it's comply or explain is the basic principle.

I'm not sure it brings about a lot of change, but I think it at least fosters debate from the Boards that perhaps people didn't think was happening. And puts Board members and non-executive members on, the spot a bit more than they otherwise would have been if they say they talked about it, then you assume they have talked about it. And there should be some paperwork on that and should be some discussion of that. So that's where you get to. So that might help move things in the right direction.

What was the other issue? The -

MEMBER HARRIS: Damon raised the issue, Mr. Silvers raised the issue, about -- I think your exact words audits don't matter for banks. And then Mr. Silvers raised the issue of the relevance of audits and how do we enhance the relevance of the audits and why the problem with respect to the possible diminished relevance of audits, as you just articulated.

MR. ALEXANDER: Yes. I think it is around the "Too Big To Fail" issue, the large, systemically important financial institutions, not just banks. Notice that two or three nonbanks were in the latest Fed's stress test. Large, systemically important financial institutions are too big to fail. And, therefore, when they get into difficulties, they have to find some other solution for them other than bankruptcy because that is so difficult and so complex.

And so I think then the markets assume there are problems. And you can see there are problems. And everyone, most market participants know it. But nothing really can be done of that because these institutions are too big.

I think maybe we've got that in

some other areas, not just in financials but financials tends to be the core one because they're so complex and so linked to each other in so many ways, these large financial companies, that it becomes very, very difficult.

It's a problem of size, I think. To make the audit more relevant and more important, it's very, very challenging. It was interesting. When you were talking about, it was raised a question of maybe having some independent body to appoint the auditor and not the Board and some independent person pay for it, it was immediately assumed it would be the government in some way or other that would do it.

And to a certain extent, we have already got that when it comes to financial institutions with the intrusive and all-enveloping regulation that financials have from the SEC and the FDIC and the whole enormous structures of the regulations, not just in the U.S. but in the U.K. and in most other countries. There's an awful lot of audit-type work being done by regulators and by official bodies already. So the audit has been moved a bit to one side, I think.

CHAIRMAN DOTY: Peter?

MR. CLAPMAN: If I could just add to the point about the British system of comply or explain? And that's really the variation that I suggested in my remarks about perhaps having a system of compulsory re-bidding where you could have a general premise that a company will at least review audited tenure at periodic intervals with a more or less presumption that you would rotate auditors, but if a particular company having gone through that process believed that it was just not feasible or impractical, they could explain it in their proxy statement or in some other disclosure document.

Disclosure, as my colleagues have indicated, is currently absent as to why a company has a continued auditor for 25-50 years without explaining anything about auditor tenure. So you could have that as a variant of comply or explain.

CHAIRMAN DOTY: Mr. Ferguson?

MEMBER FERGUSON: I would like to have the panel give us their views on the relationship between auditor concentration and non-auditor services. It specifically arises in this context. One of the things we hear repeatedly is that one of the major problems with a mandatory auditor rotation regime would be that it would be very difficult for many companies to find another auditor because there are only four big audit firms that could do the audits of the kind, large entities.

Oftentimes the other three firms are already providing services for the client. And that would make it very difficult. It's almost like, you know, you're dealing with someone who has created a structure that makes it impossible to change the structure.

The question is, if we had audit-only firms, if firms could only do audits, would that a) help the problem of independence and b) would it potentially in the longer run help the problem of concentration? Because I tend to believe with Damon that the concentration problem is something that is an extraordinarily difficult problem to solve.

It's certainly not going to be solved in the short run and not by this Board. But I would welcome your views on that question or that set of questions.

MR. DURKIN: Over the past couple of months, we have talked and negotiated with about 40 companies on these two resolutions. So we have had these discussions.

And the concentration, just to appreciate that, it's not the three other firms. For instance, Coke won't use the same firm that PepsiCo uses. So, you know, in the defense industry, one defense contractor won't use -- you know, so you're talking about it more limited.

You're talking about the other services. There are very few companies that we found. Legg Mason is one. There are very few companies who have a practice of freeing one of those other firms up, like not having any entanglements so that if they have to, they could rotate to somebody, one of the other Big Three.

We certainly support that practice, limited as it may be. But the concentration is even more limited than the other three in most cases. But the question is, would any one of them be more independent?

When we went after fees 12 years ago, we were concerned. We saw ratios in the fee disclosure of ten to one. It wasn't surprising to see ten to one non-audit to audit fee ratios. The companies 10-12 years ago didn't even know how much they were spending on non-audit fees until the SEC regulation required them to compile it. That was our concern about independence.

Our concern about independence now is just the size and the tenure of these relationships.

You know, it's a point of fact that the companies don't even have to put it in their proxy materials, companies that are now agreeing to this new disclosure. Some of these go back decades. They have talked about it in terms of it being an annuity. So it's just -- forget about the non-audit fees, just the tenure and the size.

Some of our shareholder proposals want the companies that in the last seven years have made close to a half a billion dollars in fees. That alone is a challenge to independence.

MR. SILVERS: In addition to what Ed just said, which I agree with, I think if you look at the arc of public policy around this subject, the intention, beginning with

Sarbanes-Oxley, was to try to move the auditing profession back to an audit-only type of regime.

I think it's quite obvious that the public policy tools that were deployed to achieve that sort of goal -- and I think if you look back in 2001-2002, 2003, you will see many sort of expert documents.

The one that I was involved in, together with my former employer, Chancellor Allen of Delaware, was the American Academy of Arts and Sciences did such a document. It talked about the need to restore professionalism in auditing.

The clear direction was back in the direction of audit only. But what, in fact, happened instead -- and Ed just described to you how it plays out practically -- was that while the use of non-audit services by the firm's actual auditor was constrained, the firms issued prepared -- the operating firms tended to seek those services from other audit firms. And so the net balance between audit and non-audit services within each large audit firm diminished somewhat but not decisively.

The result where essentially preparers of financial statements are locked in, as you described, is not really an acceptable result. And it raises the question of, you know if the interaction between issuer and the four large audit firms is such as to create that locked-in dynamic, then what they have really done collectively is force policy-makers to go back to the question of, you know, is having private audit firms a viable solution and to raise issues that are now 70 years old, going back to the beginning of the securities laws, as to that, we ought to have another model entirely.

My view is that it would be possible through a series of actions. And one of them is mandatory firm rotation. It would be possible through a series of coordinated actions to create a much more friendly environment for the expansion of the number of firms capable of auditing a large firm from the current four.

And this was the conclusion, by the way, of the Treasury Department in a kind of general sense that the Treasury Department's Task Force on the Future of Auditing is that that is an important public policy goal, but it would require some coordination between this body, the Securities and Exchange Commission, and perhaps Congress to really achieve it over time. But, to be blunt, someone has to start.

CHAIRMAN DOTY: Do other panelists have views on that question as well?

MR. CLAPMAN: Well, just very briefly, it's a dilemma that your question raises. Unfortunately, if you take that concern to its extreme, you would basically seem to acknowledge that some firms can have the audit firm for life, which I think would be a policy mistake.

And I think if the PCAOB takes action, the system would adjust. And obviously if you could have audit-only firms, it would be a good thing. I think it would be a difficult thing to achieve. You certainly could have the limits on and you do have the limits on consulting, which I think have dramatically changed the relationship between audit firms and companies they audit.

MR. DURKIN: One quick point. In talking to some companies, they indicate that the other firms, the ones that are not doing the audit now, aren't interested in doing their audit because the engagement on the other fees is too lucrative and too attractive.

CHAIRMAN DOTY: Mr. Hanson?

MEMBER HANSON: A couple-part question that maybe start with an over-arching question and just get down to a granular question wrapped into it.

The over-arching question is -- and I would like your reactions to it -- do you think SOX with a ten-year hindsight now has been effective at giving investors better information and more reliable information?

And, one level down, do you think the PCAOB has been effective at improving audit quality? But then I really wanted to zero in on a couple of the comments that several of you have made about audit committees.

And I think Mr. Silvers mentioned a comment like quasi-independent audit committees. And, really, the acid test question, do you think audit committees today are doing the job that Congress intended with the Sarbanes-Oxley Act? And if not, what things could be done to improve their effectiveness?

MR. CLAPMAN: Somebody has to take a first crack at it. I will try. I am on an audit committee of a public company. And I think audit committees have dramatically increased their effectiveness over this period of time. And I think the PCAOB has been effective in fostering the positive change.

I think we are now, though, in a policy level looking at next steps because some of us believe the results to date are yet not fully effective in terms of auditor independence or, really, taking the concerns of investors into account.

And I think, partly what has happened is that many audit committees, in effect, have been sold a bill of goods for a variety of reasons and probably think that changing audit firms -- I use the term "an act of folly." And I think that is an unfortunate position.

I think they have been led to believe that these dire consequences would occur, that they want to preserve their own authority. As I tried to indicate in my own presentation, and I think your earlier panel reflects this as well, that audits would improve with a change in practice. Costs would not go up.

And this would be a reasonable -- I would put again, underline the word "reasonable" -- intrusion on their authority to pick another audit firm. And it's their choice which firm it would be.

And if it turned out that going through a process, let's say re-bidding or under a rubric of audit firm rotation, that it just could not be done, I'm sure that a system could be worked out with the PCAOB to try to work through the practical consequences of that.

But I think we're really at the next stage of policy-making.

MR. DURKIN: To the question of the Sarbanes-Oxley impact, I think it created good structures. I think we missed the opportunity to have audit firms in the post-Sarbanes-Oxley SEC rulemaking on non-audit fees. I think the industry won there.

What it hasn't done is it took from management these responsibilities and put them in the audit committee. But the audit committee -- if you look at the disclosure documents, the audit committee report is pure boilerplate.

And if you look at the auditor ratification vote that's in the proxy statement, you have a proposed -- you have a hearing here on an issue of auditor rotation. Companies aren't even required to put the auditor up for ratification.

The auditor ratification vote that's in proxy statements now is in there for one reason. It's so that companies can get quorums to hold their meetings. That's the only reason it's there because broker non-votes can actually be registered at the meeting as present. And that allows the company to have a quorum because auditor ratification is the only routine vote left on shareholder proxy statements.

So this issue is being used by companies to make sure they get a quorum for their meeting. Okay? And then the audit committee has this boilerplate. They never take ownership of the powers that I think Sarbanes-Oxley has given them. And that is what we are trying to push with this disclosure.

Tell us how long this relationship has lasted. Tell us why it makes sense to continue with this firm versus rotating. The lead partner -- the shareholders don't know about the lead partner rotation. And we found all kinds of experiences from the firm dictating, the audit firm dictating the new partner, to management dictating who the new partner is, to the audit committee chair being involved. Start explaining that process a little bit.

That audit committee, which was

empowered by Sarbanes-Oxley, needs to take more ownership. And they need to tell the shareholders because now we do have voting rights where we can vote out audit committee members.

There are accountability mechanisms. But the SEC is standing in the way. The SEC staff is standing in the way on the no-action process.

This issue at the SEC technically is considered a routine, ordinary matter, auditor rotation, not suitable for a shareholder vote. Yet, we're having a public hearing here about it and we had 600-plus respondents to your rulemaking to show you how important it is.

CHAIRMAN DOTY: It may not be strategic. It may be in the ordinary course of business, important but not strategic.

Damon?

MR. SILVERS: Well, yes. You have asked an enormous set of questions. I'll try to give you a very compact set of answers.

With respect to the overall effectiveness of Sarbanes-Oxley and the PCAOB, I think the key dynamic to be aware of is what Ed mentioned in one instance, which is the regulatory give and take over the last ten years and the occasional interventions of the Congress have I think not left Sarbanes-Oxley and now I think are not leaving Dodd-Frank more or less what they were intended to be when passed. And so it's hard to assess. It's hard to pull apart where things have been weakened and left unable to do what Congress initially intended and where perhaps the framework wasn't properly constructed in the first place.

That being said, I agree with my fellow panelists that as a general matter, the quality of audit committees has been significantly improved by the independence and expert requirements and by the cultural change that the Sarbanes-Oxley Act signaled.

I think in certain respects, aspects of the Sarbanes-Oxley Act, like the internal controls provisions, actually ended up sort of properly aligning the audit firms and honestly their political power with the interest of the investors and the general public. That was helpful.

The limitations, though, which I embodied in my use of the term "quasi-independent" for the audit committee, the limitations here are structural. Right?

The audit committee is made up of members of the Board. Members of the Board as a practical matter are the outcome of a process that is almost always initiated by management in terms of the selection of those auditors.

There is a profound and justified cultural tendency within the Boards of public companies to want to operate as a team in most circumstances. That renders an audit committee made up of the most independent, well-meaning people with a competent expert, nonetheless fairly closely tied to management. It's unavoidable. And not only is it unavoidable, but the business community literally demands it.

Whenever any change is suggested in the way the Boards are selected, the business community comes in and demands of policy-makers that they do nothing to interrupt the team functioning of the Board. That team functioning of the Board is another way of saying quasi-independent.

Now, where the success of Sarbanes-Oxley stopped, I think, was revealed by the financial crisis. And what it turned out to be was that this structure, partner rotation --

CHAIRMAN DOTY: Separation of audit from non-audit services.

MR. SILVERS: Right, separation of non-audit services. Actually, I was thinking of public partner rotation, audit committee independence, and expert, and separation of non-audit services.

What that structure ended up not being able to properly foster was an ability on the part of the audit committees and the outside auditor in the context of what turned out to be very important major financial institutions to take a skeptical eye to complex financial structures within the firms they were looking at. And the consequences of that failure were very grave.

In the aftermath, it is my view -- and I think this has enormous consequences for our financial system and for our economy; in the aftermath of the events of 2008, an inability of that system to simply tell the truth about the nature of financial institution balance sheets.

And that comes back I think to the limitations of that model I think it has turned out as an empirical model to do fairly well in relationship to essentially the

WorldCom problem. Somebody took a pencil and erased numbers and filled in zeros, right? That problem we have not been faced with in the last ten years.

Complexity. Complexity that adds up to the same thing. A bankrupt firm? Not so good.

I would also mention something that has almost been forgotten in the consequence of the 2008 fiascos, which was the option backdating scandals. Those scandals suggested, again, that this system was not very good at dealing with matters that were of intense interest to executives but might not rise to the level of blowing up the firm, that in those circumstances, this system was not very good at producing really independent audits.

CHAIRMAN DOTY: Jim Alexander, you had a comment before. I want to get to Jeanette.

MR. ALEXANDER: Yes. You guys

have already said everything that needed to say. Just I would just say that I think the scale of the recession you just had in the United States, I think, and the fact that there weren't many financial scandals in the non-financial area, non-financial companies, it does demonstrate something must have improved because recessions always find out the weakest companies and the problems and the scandals.

And, actually, there weren't that many scandals, despite the pretty catastrophic drop in GDP. That was pretty impressive.

I do see on the financial sector complexity. Maybe some of it has leaked out somewhere else into the financial sector and with the systemic risks that have increased, as opposed to idiosyncratic risks. Not that many individual firms go, but when one does have a problem, it does seem to bring down the whole industry.

And that is something that, the

coziness, I think, of having the Big Four audit firms and doing a lot of non-audit fee work for non-audit clients can lead to a group thing that I think has been raised quite -- actually, a group think has been raised quite a lot. And there is a danger that the auditors and the non-audit colleagues get captured by the industry that they are working for. And they will end up thinking the same. And that is when you have problems. So more firms is better.

MEMBER FRANZEL: I am interested in exploring the benefits that you all have seen in live cases where the audit committee is employing a practice such as disclose or explain, you know, on the consideration of audit rotation. Or disclosing a re-bidding process. Or disclosing oversight of auditor independence, so the benefits that you have seen in real cases there.

Also I am very interested in Mr. Clapman's comment or view that audit committees aren't going to get there voluntarily and that there is some type of regulatory intervention needed. And if you all could comment on that as well?

MR. CLAPMAN: Well, if I can take a first crack at it from the point of view that my prior organization, TI-CREF, went through three auditor rotations. This actually went back many, many years, even prior to John Biggs' tenure as CEO of the company.

We didn't disclose it. There were no reasons to disclose it. But to just quickly get to the benefits, what we found was that, as I indicated, we didn't have an increase in costs, that basically audit firms that wanted our audit contract bid on the basis of trying to obtain it. And cost just never was a factor.

In terms of benefits to the audit, what we found -- and this was both anecdotal and I think could be substantiated, is the outgoing auditor I think is a little more careful. The audit firms try to clearly do the best job possible, but knowing that another audit firm of similar quality is going to come in and take a look at some of the decisions that actually took place I think adds a certain impetus to their awareness of the sensitivity of making the correct decision.

And then what we found as well is that the incoming audit firm did take a fresh look at some of the prior decisions. I witnessed these personally as chief investment lawyer of the company. And some of the accounting conclusions were changed. And, in hindsight, I think those changed conclusions were the right thing to have done, not that the prior auditor didn't do a good job, but that a fresh look created a different impetus within the organization.

In terms of voluntary compliance of that, as I say, when I was doing this for

TI-CREF, we went to a number of companies to see whether they would voluntarily change their -- we didn't even call it mandatory auditor rotation. We called it tenure review. And companies simply were unwilling to do that.

And I think if you look at the bulk of comment letters that came in to the PCAOB during this process, you get this repetition of increased costs. There's repetition of poor audits, both of which I think are belied by my own experience. And I think some of the comments in the earlier panel would support the notion that these don't occur and then again, finally, that it's sort of human nature to continue relationships unless you are more or less required to go through a process of reviewing them.

So that's where I come out that unless the PCAOB does something, I think the bulk of companies are just going to simply stay with the status quo and simply not review, even on a voluntary basis, tenure review.

CHAIRMAN DOTY: We are going to have to leave it there. This panel has brought a wonderful perspective to bear, breadth and of linkage of the specific issues raised by the Concept Release with broader issues of disclosure, of governance, of restoring trust with focus on financial institutions.

Jim Alexander's papers on this are riveting. Ed Durkin's comments and Damon's comments and Peter's on what they have seen have been very helpful.

We are going to take a break. The break will be a short break. But the next panel is a panel of one. The next panel is the honorable Harvey Pitt, Harvey L. Pitt. So we will reconvene here promptly at 10:35. Thank you.

(Whereupon, the above-entitled matter went off the record at 10:27 a.m. and resumed at 10:38 a.m.)

CHAIRMAN DOTY: Ladies and gentlemen, I can assert with confidence that there is no subject of important financial services regulation or public policy in the securities or finance area that is not benefitted by spending an hour with Harvey L. Pitt.

Harvey Pitt, of course, was the 26th Chairman of the United States Securities and Exchange Commission. For a quarter of a century, before becoming Chairman, he was a senior corporate partner at the New York law firm of Fried, Frank, Harris, Shriver & Jacobson. He was a founding trustee of the SEC Historical Society. He has been an adjunct Professor of Law at Georgetown, George Washington, Pennsylvania, the Yale School of Law. And he served from 1968 until '78 as the Commission's general counsel, and in that role as a mentor and a guiding spirit for all of us.

A member of the Global Advisory Forum, of the COS Hedge Fund, member of the Regulatory and Compliance Advisory Council of Millennium Management. Serves on the Board of Directors of Paulson and Co. And is the founder and the operator of Kalorama Partners, LLC of which he is the Chief Executive Officer.

Harvey L. Pitt, thank you and welcome

MR. PITT: Thank you, Mr. Chairman, and members of the Board. I'm actually honored and flattered to be asked to offer my personal observations. It is ironic that it was ten years to this precise day that I testified on this subject before the Senate Committee, at which time Mr. Harris was its chief counsel, on what ultimately became Sarbanes-Oxley and on a lot of these issues.

I would like to start by commending the Board on this critical initiative and the thoughtful and transparent manner in which you are proceeding. My written statement outlines my views in some detail, so I would like to take only a few minutes to summarize some of the core concepts I recommend that you consider, and then attempt to respond to any questions that you might have.

Although this hearing is specifically focused on the question of whether to mandate audit firm rotation, that's but one method for trying to achieve the Board's appropriate objective, improving the independence, objectivity and professional skepticism of external auditors with a view toward improving the quality of public company financial statements.

That objective is unassailable and unfortunately never ending. Audited financial statements of public companies are improving, thanks in large part to the efforts of this Board and the SEC. But we continue to see egregious instances of inaccurate, misleading, opaque, imprecise, and doubtful financial reports with disastrous consequences not just for investors, but for capitalism itself and the economic integrity that secures our fundamental political freedoms.

Unfortunately, nothing this Board, the SEC, or the audit profession can do will eliminate all future fraudulent financial statements. But that doesn't mean the Board should abandon its effort. In this context, the perfect is always the enemy of both the good and the sensible. We can and must constantly strive to improve quality controls at all professional audit firms and in my view that was the precise reason this Board was created in 2002.

There are three facets to the task the Board has wisely undertaken. First is the methodology the Board should employ. The second is differentiating between short and longer term solutions. And the third is developing the kind of empirical data that will justify whatever conclusions the Board ultimately thinks it wise to reach.

To me, the starting point is recognizing that firms which do sloppy or improper professional audits should not be allowed to remain in a position of trust and confidence, namely, serving as a public company's outside audit firm.

Conversely, the imposition of what I would call a dead hand switch regulation, preventing the exercise of any human discretion by requiring auditors to be replaced no matter how ably they may be serving, does not seem to me to reflect the thoughtfulness we want to foster vis-a-vis public company financial reporting.

I favor placing burdens on audit committees realistically and skeptically to consider the performance of their company's outside auditors on a regular and periodic basis and to compel them to consider factors that this Board thinks may be lacking in instances where it has observed audit deficiencies.

The ultimate deliverable, in my view, should be an affirmative finding by audit committees that their outside auditors exceed quality control levels set by this Board, if the public company wants to retain the audit firm beyond some specified period.

To do this, the Board and the SEC should assist public company audit committees in developing a systemic methodology for assessing the performance of outside auditors and define the types of circumstances under which outside auditors should be discharged.

I also believe that careful attention will have to be paid to anticipated costs and benefits. Given the speculative nature of those issues of costs and benefits from something not now in effect, I think the utilization of a pilot program, as raised in the Concept Release, would permit the Board to test its theories, assess its proposed response and ensure that the public is well served by whatever mechanisms the Board puts in place. I think it would also allay questions from the judiciary about cost-benefit analysis by providing a predicate for gathering appropriate data.

I'd like to conclude my oral statement by commending the Board again for its thoughtful, disciplined, and transparent approach to an issue that is well deserving of the attention you are giving it. I'm pleased to have been a part of this process and I'll be happy to try to respond to any questions you may wish to pose.

CHAIRMAN DOTY: Thank you, Chairman Pitt. Ms. Franzel.

MEMBER FRANZEL: Thank you, Mr. Chairman.

Mr. Pitt, I'd like to hear a little bit more about two of the main points that you made. First, the systemic methodology that you suggested for audit committees to use in evaluating the performance of auditors. What are some of the criteria and factors that you would envision being in such a methodology?

And then secondly, how would you envision a pilot program to be conducted to sort of test and develop that methodology?

MR. PITT: First, part of the difficulty in anything like this is that an audit committee of a public company, assuming it wants to do the right thing, is confronted only with the knowledge relating to its own company, whereas the PCAOB does quality control reviews and sees these firms in multiple contexts. There needs to be a way, in my view, and I know about the statutory limitations which I think are most unfortunate in a sense, but there needs to be a way for the generic data to be communicated if a firm constantly crops up on the PCAOB's problematic list, but an audit committee doesn't know about that. It makes it difficult for the audit committee to do the right thing even if it wants to do it.

So there needs to a methodology created, and I think you'll need the assistance of the SEC and you may need legislation on that, although I believe that it may be possible to provide generic data instead of specific data, although there might be litigation over that and I'm not sure it's worth your while to spend time on that. But I do think that getting that kind of data out was important.

Second, what are the factors that the Board sees that cause you concern? The Concept Release differentiated in a sense between what it called audit failures and then what it talked about as potentially violative conduct and said the fact that there's an audit failure doesn't mean that the financials were misleading. Which is true, although as I point out in my statement, we should never be satisfied with what I call inadvertent compliance with the law. So the fact that somebody got through this and didn't get burned by their ineptitude or their carelessness or what have you is irrelevant, because that could happen.

The Board can define the types of behaviors, the types of incidents. So even if you don't put out a report, you can put out statistical analyses. You can put out generic descriptions. I think there's a lot of thought, although obviously, I defer to your able staff on how far you can go, but my view would be to assume more.

Your second element, with respect to a pilot program is this: I think that you may not want to try a single pilot program, but you may want to try several pilot programs. The advantage of trying several pilot programs is that I think it will make it difficult for someone to say you have a preordained conclusion as to where you're coming out and you were really just making an effort to delay the ultimate introduction.

So one thing that I would see as a possibility, if you thought about that, is I have recommended the approach that audit committees be required at a set interval to make an affirmative finding that the accounting firm that they want to keep, assuming they want to keep it, exceeds whatever standards this Board articulates. And if you did that, you could start a pilot program. You could try to get volunteers, which would be the best way, and there may be companies that want to volunteer.

At the same time, if you wanted, although this is in an area where I have more concern, if you wanted to get some experience with what would the audit costs rise to for companies that had to replace their auditors on a five-year cycle and what burdens might it provide and what difficulties were encountered in trying to replace the audit firm?

We tend to view the now Big Four

as monolithic. But the fact is they're all very different. And some of them have fabulous skill sets in certain areas and certainly professional skill sets, but perhaps not as fabulous in other areas, so they're not directly interchangeable. This would give you a chance, in essence, to sort of decide what your data is, and having multiple pilots at the same time, in my view, would give you a direct comparison. You could carefully pick the areas that you wanted.

MEMBER HANSON: Thank you for coming today, Mr. Pitt. Your written statement that you submitted has some very intriguing thoughts and I really appreciate those.

I've got a question for you about how your views have evolved since the enactment of Sarbanes-Oxley. I want to frame it with a quote from one of the other letters that we received.

So Charles Rossotti, currently an

independent Board member, former Commissioner of the IRS, he said in his letter, "My views on mandatory auditor rotation have changed since the enactment of the Sarbanes-Oxley Act. When the act was initially being considered, I was surveyed and expressed the view that mandatory auditor rotation was a concept that should be seriously considered in lieu of several other proposals. However, the Act itself as now put in place a very robust set of structures and policies that make it unnecessary to impose the additional costs and risks of mandatory auditor rotation." So that is the view that he expressed.

So I'd just like to hear some of your personal experiences from what you've observed of auditors and your roles in the Board rooms in the last ten years.

MR. PITT: I am privileged now to work with public companies and sort of see how Sarbanes-Oxley operates in real time and in the real world. I think it has created improvements, but I think that fears of liability and tendencies on the part of everyone to devolve into rote approaches means that the Act has not achieved what it should and I think that's why I was very impressed with your Concept Release because it notes that things have gotten better, but there are still too many audit difficulties or deficiencies.

I looked at my testimony from 2002 and my views have not evolved a great deal from what positions I was expressing, at that time for a unanimous Commission, but they have changed in a couple of ways. I get very concerned when people take absolute positions. I think that creates a real problem for regulators and your job is just to exercise your judgment in the best way you know how and not allow people to either parade horribles about the terrible things that would happen or parade sugar plums of all the benefits that might arise and so on.

But I think that, ultimately, mandatory auditor rotation, as most people think of it, and I use the analogy to a dead hand switch, that would never allow the audit committee to exercise real judgment would be an unfortunate solution. And I think ultimately, the cure could turn out to be -- I'm not saying it would -- but could turn out to be worse than the disease, depending, for example, on the amount of time that people were required to rotate off.

But I think if instead what you do is put the onus in the one place where it can most properly be exercised by an independent audit committee, armed with whatever appropriate information this Board and the SEC can give it, and if you spell out, in a sense, what kinds of determinations will permit an accounting firm to remain beyond whatever the period is, I think you can avoid the potential of lip service on the part of some audit committees. I think you can get the benefits of auditor rotation where it's warranted. But if a firm is doing the kind of top-rate job it's doing, then getting rid of them or forcibly rotating them is not ultimately going to benefit the shareholders of the company.

CHAIRMAN DOTY: The five-minute mark. Mr. Ferguson, please, go.

MEMBER FERGUSON: Just a couple of questions. Your suggestion of the audit committee having to sort of determine whether the auditor has exceeded our standards is an intriguing one and I have a couple of questions about that.

First of all, would the standard be, for example, that the auditor -- that the specific audit involved exceeded our standards or that the audit firm's performance as a whole exceeded our standards? And the reason I ask that question is when we look at these reports that we get on audit firms, they vary widely for all the firms. I mean, some of the work is absolutely superb. Some of it is not good. So it's very hard to generalize. So just to focus on that question.

The second question is are audit committees, in fact, equipped to do the kinds of detailed analysis that would really be required? I mean, the analysis that we do when we examine audit quality and whether it meets our standards is oftentimes highly technical, we'll go into -- and requires batteries of very skilled auditors themselves who go in and look at this and examine these things again. I'm not sure that audit committees, at least the ones I'm familiar with, really have that skill. Where would they get them? Would they hire experts? Would they have to hire outside experts? How would you envision this would work?

MR. PITT: First, I think in order to get the best judgment and to improve audit quality overall, I think this Board's mission is much broader than making sure that Pitt Company has good audits. This Board's mission is to make sure all public companies have the best audits we can inspire those in the profession to achieve.

So as a result, I think the audit committee has to take into account information that might show that in certain circumstances their audit committee, although not at their company, may have cut some corners or been professionally less than excellent and so on and take that into account. There's no way that any public company can get that information unless, as I said earlier, this Board and the SEC find a way to create the tools.

And I want to stress here, I'm not suggesting that this Board make the decision on a case-by-case basis, obviously, as to who stays and who goes, although I will say even there, I think if you see something egregious enough, I think you have that ability and you should exercise it.

What I'm really talking about is

giving the audit committee the tools. And that sort of segues into your second question. And I think that audit committees need a lot of help. I think there is some excellent audit committees, but some don't fully comprehend what their job is. And so one thing I suggest in my statement is that this Board ought to delineate the kinds of findings the audit committee will have to have made in order for the company to keep its auditors beyond a set period.

And what you could do, I mean there are so many variables on this, you could say every five years there has to be an affirmative determination. You can have a much more shorter period for this than you would if you were doing a formal rotation where there would be a lot of reasons to allow firms to stay longer. And so I worry. I think if you put people on the test to demonstrate that they're performing and after every five years it may be that the audit committee has to do this every other year. It doesn't get to wait another five years. But it has to make an affirmative finding and the committee has to put its imprimatur on what's going on.

I think with help from this Board and from the SEC and outside advisors, I think there's a real way to get people informed, advised, and functioning well.

MEMBER HARRIS: I realize we're out of time for this. I just want to make one closing statement. It was ten years to the day, as you point out in your testimony, that you wrapped up our ten days of hearings on Sarbanes-Oxley. But the most memorable two days of hearings that I participated in during my 25 years on the Hill, I was first of all 9/11 Superior. I can't resist the temptation. And the second one was September 20th when you testified after the crisis and you were the right person, at the right time, at the right place. I just wanted to thank you for your outstanding service at that time on the other related issue and for your service on Sarbanes-Oxley. I did have questions, but I'll refrain from asking them.

CHAIRMAN DOTY: Thank you, Steve. Thank you, Mr. Pitt. Thank you, Harvey.

MR. PITT: Thank you.

CHAIRMAN DOTY: The next panel, we now move, we're going to move now to preparers and registrants. And as they make their way to the table I will introduce with pleasure Steven Buller.

Steve Buller, a managing director of BlackRock, Inc., as a managing director, he has oversight of accounting policy controls, auditor independence, and over other financial aspects of BlackRock's 3500 investment companies. He's a member of the wholly-owned bank of BlackRock's system and he previously served as their Chief Financial Officer. Prior to joining BlackRock, Mr. Buller spent 30 years at Ernst & Young, LLP where he was the global director of Asset Management Services. And he is also a member of the PCAOB Standing Advisory Board, for which we are very grateful.

Theo Bunting is the senior vice president and Chief Accounting Officer of Entergy Corporation. He has a long and distinguished career, not only with Entergy where he has been at various times the Senior Vice President of Nuclear Operations and of System Energy. He has served in senior capacities in various Entergy subsidiaries. But from 1999 to 2000, he's been the head of various utility operations, a partner with Public Energy Services, Inc., from '97 to '99. Theo Bunting knows the energy industry. He knows the issue or side of that. We're delighted to have him.

Valarie Sheppard is the Senior Vice President and Comptroller of the Proctor & Gamble Company, one of America's crown jewels in our corporate governance system.

Senior Vice President and Comptroller has joined the company -- she joined in 1986. For the previous five years, she held the positions of Manager of Finance and Accounting for Global Household Care, Manager of F & A for Global Fabric and Home Care, and Finance Director for the Northeast Asia Market Development Organization.

Darren Wells. Darren Wells is Executive V.P. and Chief Financial Officer of the Goodyear Tire & Rubber Company, another one of the crown jewels of American corporate life. He was named Executive VP and CFO in October of 2008. He had been the Treasurer. He had also served as the Treasurer of Visteon which is a parts manufacturer which was spun off from Ford Motor Company. He worked -- Mr. Wells worked in Ford's Australian operations from 1998 to 2000, Comptroller of Ford Investment Enterprises and as a Finance Director of Ford Credit Australia.

So we have a distinguished panel

of people who bring a new and different perspective to the whole discussion that we've been having and I'll take the liberty of starting with you, Steve. If you'll begin. Thank you.

MR. BULLER: Thank you. I appreciate the opportunity to participate in this public meeting on auditor independence and audit firm rotation. I'm speaking based upon the input I've received from our firm's analysts, as well as our corporate and investment fund financial statement preparers.

BlackRock manages approximately $3.5 trillion of assets and sponsors approximately 3,500 investment funds, substantially all of which are subject to annual audits. We utilize two of the Big Four audit firms for our SEC attest services and all five, or the five largest accounting firms for advisory services, to give you some perspective.

The PCAOB's Concept Release on

auditor independence and audit firm rotation offered a number of alternatives to enhance auditor independence and objectivity. I will address mandatory rotation momentarily.

We support some of those alternatives, including further restrictions on the scope of non-audit services that may be provided by an audit firm to its SEC-registered clients if those services do not relate to the audit or control environment. We don't object to audit firms performing advisory services which may provide their professionals with business acumen that will enhance their audit skills. However, we have observed that some firms continue to expand their advisory practices into areas that are less aligned with traditional audit and tax practices.

We recommend the PCAOB and SEC consider whether certain non-audit services, including bookkeeping, financial information system design and implementation, appraisal or valuation services, or actuarial services may be preformed for a registrant by a company's independent auditor even when those services will not be subject to audit procedures during the client's financial statement audit.

We also encourage review of other non-audit services to determine whether they should be identified as potential conflicts. For example, personal tax services for company employees, compensation consulting, staff augmentation and project management all may provide the appearance of lack of independence.

So turning to a central aspect of the release, we do not support mandatory rotation. Our corporate audit committee, our analysts, and management are concerned about the restrictions in a company's ability to select the most qualified firm, the loss of institutional knowledge, and the reduced incentive for audit firms to invest in the audit relationship when the time horizon is short. This is particularly when the firm has a large global footprint, like we and I think all firms at the table here today have.

An auditor's effectiveness is lowest at the beginning of a new audit relationship and the learning curve may last for several years. Companies also may be limited in the selection of a new audit firm by a number of factors including industry expertise and employees who are former audit partners in a financial reporting oversight role. So in my case, I'm one of five partners from my former firm who are employed in financial reporting and oversight rules at my firm. And we either have the choice to hire that firm as auditor for SEC work, of either having the firm pay all of this out of our pensions which they have said they would not do, or my firm fire all five of us, which I hope they will not.

As we sponsor investment funds that are part of an investment company complex for SEC auditor independence purposes, every fund is subject to the SEC auditor independence rules even though they may not be an SEC registrant. As a result, mandatory rotation would be a logistical challenge, given our monthly year-end cycles and the need to coordinate auditor selection with about 15 different corporate and fund Boards of directors that all must decide upon the auditor for their specific responsibilities.

As we indicated in our written responses, other alternatives to mandatory rotation include requiring registrants to disclose their policy with respect to periodic tendering of the audit and the date upon which the most recent audit tender occurred, and as previously mentioned, further restricting advisory services.

The PCAOB should continue to emphasize the importance of independence and objectivity through their comprehensive auditor inspection process which we believe is very productive.

Finally, we believe the PCAOB should share as much information as possible for all their inspections -- or from all their inspections with audit committees and provide criteria that should be considered in evaluating auditors, thereby putting the audit committee members in a better position to enhance the audit process and monitor auditor independence.

So overall, we're satisfied that the current audit and professional standards, quality control measures implemented as a result of Sarbanes-Oxley, the PCAOB inspections, and mandatory partner and staff rotation requirements have helped ensure high-quality audits and we applaud the PCAOB's on-going efforts to enhance those standards. Thank you.

CHAIRMAN DOTY: Thank you. Theo, yes. Mr. Bunting.

MR. BUNTING: Thank you. As was

mentioned earlier, my name is Theodore Bunting. I'm Senior Vice President and Chief Accounting Officer for Entergy Corporation. Also today I'm speaking on behalf of the utility industry in general through the Edison Electric Institute which most of us are a member.

I appreciate the opportunity to be here and to provide my point of view on the issue of auditor independence, objectivity, professional skepticism, as well as the current consideration being given to audit firm term limits. At Entergy, we have given a lot of thought to this issue and we certainly devote a significant amount of time and attention to the external audit.

I have the primary management responsibility for working with external auditors and in this role I'm responsible for understanding and working to resolve or correct any significant findings or issues as a result of the audit. My group owns all the financial processing of transactions and the development of accounting conclusions on issues which are the primary areas of focus during the audit as well as the associated external reporting.

I, along with the Chief Financial Officer, have the primary management responsibility to support and answer to the audit committee or the Board which includes providing management's point of view on audit findings and significant accounting issues. It is primarily from this experience and vantage point that I have formed my opinions as it relates to issues being discussed here today.

I would like to start by discussing our approach in preparing financial statements. One key point that I would like to emphasize is that my objective as the Chief Accounting Officer is to make every effort to get it right. And that means preparing and issuing financial statements and maintaining internal controls that comply with all applicable requirements and that meet the needs of our financial statement users. I believe that management of the company has the ultimate responsibility for financial statements and is ultimately responsible to its investors and the SEC.

In my experience, one of the factors that helped to get it right is to undergo a robust audit process by a qualified audit engagement team, a team with the right level of experience focusing on the right things. And experience includes experience with the company and the utility industry.

During my career as Chief Accounting Officer, I've not observed a situation where I felt the external auditor backed off on a material issue because of a concern about client relationships or audit fees.

I do agree that having a good working relationship with the external auditor is important, but for me, that working relationship is important because it fosters communication that helps to avoid surprises in the process and helps our company have an awareness of material issues so that those issues can be addressed in a timely fashion.

But in my opinion, having a good working relationship with the audit firm and having a quality audit are not mutually exclusive and I do not believe that the audit fee is an issue that should affect auditor independence, objectivity and professional skepticism.

This brings me to the issue of proposal of audit firm term limits. Entergy is a large, highly specialized and regulated entity. We file multiple external reports with various regulatory agencies, including the SEC and the Federal Energy Regulatory Commission. We have several utility operating companies which are separately and distinctly regulated by various state and local regulatory bodies.

The utility industry is a complex industry and we are a complex company. These complexities can be difficult to comprehend and require significant time to understand. In our circumstances, a mandatory change in audit firm would result not only in a disruption to our business from a resource perspective to execute that change, but more importantly be disruptive from a risk perspective because of significant loss of auditor knowledge. This requirement seems particularly counterintuitive to us in a situation where we have a qualified audit firm with very good technical accounting ability and significant industry experience and, more importantly, specific company experience.

My point is simple. The implementation of audit firm term limits could, in fact, have the opposite of its intended effect because a great deal of insight by the audit firm will be lost in those types of required transitions. In addition, when we initiate certain transactions, those transactions may take years to execute. A required audit firm change in the midst of a large transaction would not only disrupt normal business, but could be an impediment to the completion of the transaction, which certainly would not be beneficial to our investors.

I've read some of the findings of the PCAOB inspections and understand that there is a concern about the level of audit quality. In my opinion, a more robust discussion surrounding the PCAOB's findings and what may be the root cause of those findings may provide additional insight.

I also believe a broader discussion about whether audits are sufficiently risk-based would be extremely valuable. Given the compressed filing time lines and growing compliance requirements, we have concerns as to whether the pressure to complete the audit is allowing sufficient time to be spent on high-risk areas in the financial statements. We also support performing an evaluation of existing compliance requirements at the audit committee and management level and whether some of these compliance requirements can be expanded and/or focused more narrowly on riskier areas and areas involving a high degree of judgment.

In closing, I do believe this is an extremely important issue and want to support the PCAOB's efforts in whatever way that we can. Again, I appreciate the opportunity to speak with you on this issue.

CHAIRMAN DOTY: Thank you. Valarie Sheppard.

MS. SHEPPARD: Thank you very much for the opportunity to provide Proctor & Gamble's view on the PCAOB's Concept Release on auditor independence and audit firm rotation.

We really appreciate and support

the Board's effort to improve the overall quality of the audits by looking for ways to enhance auditor independence. However, we do not believe auditor rotation will accomplish those goals. To the contrary, we actually believe there's risk that the overall audit quality could erode and result in higher costs and significant disruption for our internal resources.

Finally, we believe the disruption and added costs are more significant for larger companies.

So let me give you a little bit of background on our company. P&G is a multi-national consumer goods company with over $80 billion in annual sales in approximately 180 countries. The company's brands include household names such as Pampers, Tide, Pantene, Gillette, Crest, Olay and many more. We have on-the-ground operations in approximately 80 countries operating through 500 legal entities and employing around

130,000 employees. The sales, supply chain, personnel, and financing needs of a company of our size and footprint requires a complex legal entity structure, business model, accounting and systems infrastructure which involve both internally and externally-sourced systems and personnel.

We directly employ 7,000 staff in our finance and accounting function. The structure of the independent audit team must mirror our company structure in terms of global footprint and relative size and complexity. The independent audit team for P&G is composed of over 900 audit and tax professionals in 75 countries including 170 partners and 200 managers.

The audit team includes professionals with a number of specialties including tax, treasury, actuaries, valuation experts, technology experts and, of course, general audit and controls professionals.

Because of the overall size and

complexity of our business, the overall design and execution of the audit is very complex. Therefore, the auditors must have an extensive understanding of our business model, legal entity structure, internal control systems and accounting processes. This institutional knowledge enables the audit firm to more thoroughly assess risk, review trends, and design and execute the most efficient and effective audit procedures.

The requisite level of knowledge cannot be effectively gained over a period of a few years. It is built over a much longer period of time. We believe mandatory rotation of the audit firm would result in a loss of institutional knowledge of our company's operations. This would lead to less effective planning and execution of the audit.

It's important to note that audit complexity considerations are even more pronounced in large multi-national companies like P&G than they might be in smaller domestic or regional companies due to the existence of much more complex environments in terms of legal, regulatory, tax, and other considerations.

Accordingly, we believe mandatory rotation of the larger or only the largest companies would be relatively more disruptive and carry higher risks to audit quality than for smaller companies.

Another concern with the mandatory audit rotation is that there are real costs and disruption impacts. In the Concept Release, the GAO report estimated initial audit fees would go up by more than 20 percent, about 20 percent. We believe this estimate is a little bit low. In a mandatory rotation environment, we'd be forced to discontinue our relationship with one of the firms in order to guarantee we had AN independent firm to which to rotate to.

We employ all the Big Four accounting firms. One is an independent auditor and the other three through various consulting capacities. Requiring us to rotate auditors on a regular basis would have a detrimental impact on our ability to source our non-audit consulting needs. At a minimum, we would need to effectively decide on our auditors one or two rotations out to ensure the new auditors are independent at the time of rotation. This would effectively lock us into our next auditor and eliminate any notion of a competitive bidding process, likely resulting in higher fees.

There's also the costs of the firm to get our personnel in the -- the firm's personnel in the appropriate global locations. For larger companies with significant operations in remote locations, a significant portion of the audit staff is dedicated virtually year-round to our audit. The mandatory rotation would have dramatic consequences to those offices and carry significant risk to the incoming audit firm in staffing up to service our account.

Internal resources to P&G would also be required to train new auditors and that would be significant. Importantly, this investment by company personnel reduces the amount of time we would have available for on-going control stewardship and other business-building priorities.

In summary, while we agree with the Board regarding the importance of auditor independence, we're not supportive of the PCAOB moving forward with development of the rotational proposal, including consideration of the length of rotation period, the size of the company, or the industry. We feel mandatory rotation would not result in an improvement in auditor independence, objectivity or professional skepticism. In fact, in our situation, we believe it would decrease the audit quality and it would also significantly increase both audit fees and internal costs.

We really appreciate the opportunity to share our views on this very important matter. Thank you.

CHAIRMAN DOTY: Thank you. And Darren Wells.

MR. WELLS: Good morning. I think in my remarks you'll hear some things that are similar to what Valarie and Theo have laid out. I do think that we'd like to add to those some thoughts that we had in terms of actions that could be taken to further address the issue that's given rise to the hearings.

As Chairman Doty said, I am Darren Wells. I'm Executive Vice President and Chief Financial Officer of the Goodyear Tire and Rubber Company. Goodyear is a multi-national company with $23 billion in net sales, operating 53 manufacturing facilities in 22 countries. Goodyear develops, manufacturers, markets, and distributes tires in almost every country around the world. We appreciate the opportunity to comment on the topic of auditor independence and audit firm rotation.

To open, let me share with you a summary of Goodyear's views on PCAOB's 2011 proposal. While we agree that auditor independence, objectivity and professional skepticism are critical to the success of an audit, and periodically reviewing the audit approach from a fresh perspective provides value. We are not convinced of the correlation between the length of an audit firm's tenure with a company and a failure of the auditor to approach an audit with the required independence, objectivity and professional skepticism.

We do not support the proposal for mandatory audit firm rotation, nor are we convinced that these will achieve the PCAOB's desired improvement in these areas. We believe that the current processes for audit firm selection, partner rotation, and quality control within the audit firms, while not perfect, support auditor independence and objectivity, while also providing a fresh perspective to audit engagement and promoting professional skepticism.

These processes include the role of the independent audit committee in its oversight of a company's independent audit firm, annual shareholder ratification of the appointment of the independent audit firm, mandatory rotation of audit engagement partners and engagement quality review partners every five years, the role of the national office review system by audit firms in reviewing and challenging a company's accounting for significant transactions, and lastly, the PCAOB's inspections of the operations and audit procedures conducted by the public accounting firms.

We also point out that there are significant drawbacks and limitations to the proposal for mandatory audit firm rotation. First, as my colleagues on the panel have said, there are a limited number of firms who have the global footprint sufficient to meet the needs for audit and non-audit services of large multi-national companies. For example, under a mandatory audit firm rotation requirement there would currently be only one of the Big Four audit firms remaining that would be able and be permitted to provide us with audit services, thereby effectively eliminating a competitive bidding process.

Higher costs, not just in additional audit fees, but also increased internal staff work, which would relate not only to the company's consolidated financial statements, but also to nearly 100 statutory audits required annually for our subsidiaries, for the time needed to gain the understanding of the tire industry, our business, and the multiple IT platforms that are used worldwide, and to perform the testing needed to rely on system-based and process-level internal controls to execute an effective integrated audit.

These additional fees and internal costs would be recurring at each rotation period with no guarantee that significant incremental costs and time incurred by companies as a result of mandatory audit firm rotation would result in the PCAOB's desired result which is the benefit of increased objectivity, independence and professional skepticism.

Conversely, we are concerned that mandatory audit firm rotation would actually decrease audit quality as the new audit firm would not initially have the appropriate understanding of company-specific risks, processes, and IT systems to plan and perform a high-quality, risk-based audit.

While we do not support the proposal for mandatory audit firm rotation as a means to increase or to achieve increased auditor independence, we're supportive of the PCAOB's desire to identify alternatives to achieve the same goal. Some alternatives that we think could be beneficial and should be explored further include more timely inspection of audits, forced audit firm rotation in the event of an audit failure, and mandatory audit firm communication to the audit committee regarding alternative accounting considerations for significant transactions.

In order for audits to be effective and conducted with independence, objectivity and professional skepticism that is required to benefit the company's financial statement users, both the company's management and auditors must willingly hold themselves to the highest professional standards. No amount of regulation, including mandatory audit firm rotation, can legislate or persuade those who do not currently adhere to these high professional standards to adopt such an approach.

To impose the significant costs and inefficiencies that are part of mandatory audit firm rotation on all public companies in an attempt to force the minority which do not adhere to a high level of professional standards to do so is punitive and unlikely to achieve the PCAOB's desired result. Thank you.

CHAIRMAN DOTY: Thank you, all. You're the first panel representing the group of people who engage the auditors. And you heard Chairman Pitt say that our job is to try to be sure that all of the American companies get the best audits.

I'm going to start with a question for all of you and to hear your response. And I would simply say this is extremely valuable, so if these questions are somewhat more probing of the way in which audit firm management works, I hope you will take them as being sincere attempts to get information and not to pushback or to reject your rejection of audit firm rotation.

But it sounds, from where I sit,

it sounds as if perhaps if one took an approach that eschewed what Harvey Pitt called a deck hand switch, if in fact, there was not a one size fits all approach to audit rotation. If in fact the consideration of whether independence of an auditor had been impaired by tenure or by the inattention of an audit committee were based upon some record which we had compiled, and if it turned out that, in fact, the non-audit services of an issuer may not require a Big Four firm to perform those audit services. If in fact, we could give more information to the audit committee publicly than we can now give under the statutory restraints on the use of our information so that you knew more about what our inspection results meant. If in fact, we adopt our reproposed standard on audit committee communications which, in fact, is going to enhance the communications that auditors are supposed to give the audit committee. If we adopt the standard on related parties which require auditors to be more explicit with audit committees about where dangerous transactions may exist in the related-party area. If we take a somewhat holistic approach, instead of a one size fits all mandatory term rotation, how does that affect your attitude and your issuers and your funding sources toward the concept and the Concept Release?

Steve, do you want to begin and take a crack? Let others formulate?

MR. BULLER: Sure. Well, first of all, it's a more positive step and it probably is responsive to individual situations that, for example, if there were a series of audit failures, or if there were known instances of the failure to adhere to auditor independence requirements, and if in reviewing certain firms you found that with respect to those engagements they had failed to properly identify a specialized industry expert as an independent reviewer as well as the coordinating partner on key engagements, those are probably all indications of where it may be appropriate to require an auditor rotation.

I think there are things that can be done in addition to those though that you may have mentioned. One is the part of the PCAOB's inspection process. The one thing which they had been striving to do, I know, is to enhance the level and quality of documentation that shows the critical objectivity in evaluating audit situations. And I think that is very important because it also allows the independent reviewer and the firm to better assess the level of objectivity that is exercised at the local level, the individual audit level. I think those would probably be my general comments to start.

MR. BUNTING: I guess we will just proceed down the row. I echo Steve's comment, initial comment in terms of it being a positive step in the right direction. I also believe that any information, additional information that can be brought to the audit committee in its assessment of the performance of the audit firm can only help. I also believe bringing that information on a timely basis, obviously, would help.

I do believe though the decision to make the change has to be one that rests with the audit committee of the company and it has to make that decision, I think, in a diligent manner considering all the various aspects of the information as well as tangential issues. The one thing -- a couple things that still would concern me in that construct that you laid out, Mr. Chairman, is the fact that in the utility business today there's probably two firms probably do the abundance of the audits in the industry and there's a reason for that. And it's because of their level of expertise, the knowledge, and the ability of the firms' staffs. And we, as a company, generally use the non-audit firm to do a lot of the non-audit services because of that same reason.

And so again, I believe it would be a step in a positive direction. I think it puts the focus back where I think the focus should be which is with the audit committee and their role in terms of making that choice, in terms of having a determinative position as to whether or not the auditors are exhibiting a level of independence, thus appropriate at a level of skepticism. But I would still have some concern as to how it might impact some of your non-audit services relative to -- if you had to make a change, how would you transition that change given the fact that you're engaging probably the other firm that would most likely be capable to do the work in non-audit services.

MS. SHEPPARD: I also agree with the comments from the previous panelists as well. And I think the emphasis on making the audit committee more responsible for managing the relationship with the auditors is right on point. And I think anything that improves the communication with the audit committee and the independent auditors is also on point.

So the items you talked about around increasing communication to the audit committee is important as well as making sure key findings that occur with the PCAOB are shared with the audit committee. I think that's important as well. There are a few other things that we also think might help one of which is having the audit committee on some periodic basis review and assess the quality of the audit firm, so we are supportive of that. Over time, we think that's a healthy change. And as well as some things like limiting an audit firm's ability to pay for entertainment costs of a client would be another example of things that could be done. That's policy within our company today, so it wouldn't be a change for us, but it could be something that would both help the appearance of independence, as well as in fact independence. So we do think that there are some measures that can be taken in the spirit of continuous improvement versus kind of what we would see as mandatory rotation having some negative connotations to it and unintended consequences.

MR. WELLS: I won't reiterate what some of the other panelists have said, but I think first of all, the holistic approach makes an enormous amount of sense. There are a number of different factors that have to be taken into account in any situation like this. And I will echo the comments that have been made about the empowerment of audit committees and maybe expand on that a bit because I think the critical thing for audit committees is they do have full information and not only about the relationship the company maintains with the audit firm which we provide today and is an area that our audit committee is very focused on, but also the specifics of the reviews that the PCAOB has done of the firm that audits us. And ideally, it would be information about reviews that the PCAOB has conducted of our audit.

Now the thing that would make it most helpful in many ways for the audit committee would be if that audit could take place at more or less real time with the preparation of the financial statements because that timeliness is of a lot of value. The audit committee is in a better position to take action, to ask questions, to become involved if, in fact, the information that they're reviewing is timely. It's something that's going on now or has gone on in the recent past.

We have an example of a similar situation in that the IRS now conducts a real time audit of Goodyear's tax returns and it's something that has improved the efficiency enormously and has led to better quality returns so by the time our returns are filed the audit has already been conducted. I think something like that for the PCAOB could be very helpful because not only would the audit committee be hearing the result of the audit of the financial statements, but they'd also be getting information about what level of quality the firm was applying as it conducted the audit.

CHAIRMAN DOTY: Steve Harris.

MEMBER HARRIS: Mr. Buller, why do you think that the periodic tendering of the audit is important and what would be your time frame that you would envision?

MR. BULLER: I am not sure I said I would support periodic tendering or time frame. What I think would be useful is having the audit committee provide internal criteria as to the time lines that they may use in assessing the auditor and perhaps if they so desire having a policy that they will periodically go out for tender. I don't think we would suggest necessarily there should be a specific time line for a tendering.

MEMBER FERGUSON: Yes, I'd like to probe a little bit some of the underlying assumptions of a couple of things you said. First of all, let me raise the question of long-term institutional knowledge. And I fully understand how for companies as complex and the companies all of you operate institutional knowledge is very important and leads to efficiency.

On the other hand, it seems to me that long-term tenure also potentially causes the auditor to develop an identification with and a deference to the client. Isn't it almost always the case that too much familiarity prevents fresh thinking? That's why lots of institutions in the society we require changes of leadership, changes in leadership at the top to get fresh thinking. You don't have that when your auditor has been your auditor for 100 years, it seems to me. That's the first question.

The second question is and this is a question that you raised, Mr. Wells, that part of the limitation or the problem with auditor tendering would be that you could only find one other audit firm presumably because of independence problems, you were raising, from non-audit services. Is that a problem with rotation or is it a problem with non-audit services? What if we only had audit-only firms? Wouldn't that solve that problem?

MR. WELLS: Maybe I'll address the second question first and then come back to the question of the impact of long-term tenure of an audit firm on the level of review.

Yes, I think the practicality is what we're -- what we would be focused on in the case of mandatory rotation, so if there was a separate system, if there were more firms available who had the global resource and reach to provide the services that a company like Goodyear requires, then in that hypothetical certainly it would be easier.

Finding firms that are willing and able to make an investment at the level that would be required either for non-audit services or for audit services seems to be the challenge because the number of countries we operate in, the number of locations that have to be reviewed is very significant and the level of integration and consistency across all of those reviews is critical. So in other words, it doesn't work to have multiple firms trying to communicate with each other using different processes. It's very important that we have something that's integrated in order to meet reporting timing requirements. So I think that's how I would respond to the second question.

Although I would respond to the first question as well. And I understand that there are firms, including the one that I work for, that have long-standing relationships with their auditors. However, in the ten years that I've been an officer of the

Goodyear Tire and Rubber Company, I've had three different partners that have reviewed our financial statements and three different review partners that have reviewed their work. And during that time I've had the opportunity to have numerous accounting treatments and transactions reviewed by a variety of experts at the national office of our auditor. My impression and clearly the evidence is that those discussions were -- had a high level of independent thought, a high level of objectivity, and a significant amount of debate.

I look at the evidence of our discussions and would say that there is no evidence that I've seen of any deference to management. And in fact, there is a high level of evidence that the different individuals that are involved and responsible for the audit all bring with them their very own perspective. So the firm is not a uniform perspective. The individuals themselves take their professional credibility very seriously and I'm sure they take the protection of their firms very seriously, but each of them has behaved as if their professional credibility was on the line and that that was first and foremost in their mind as we had discussions on the preparation of our financial statements.

CHAIRMAN DOTY: Jay Hanson.

MS. SHEPPARD: Is it okay if I answer as well?

CHAIRMAN DOTY: Valerie, I'm sorry -- Yes.

MS. SHEPPARD: Just to the first question around long audit tenure, of course, at Proctor & Gamble we have that situation and we don't really see a correlation between audit tenure and independence. And it's for many of the same reasons that have already been mentioned. Since Sarbanes-Oxley was enacted, we've had three lead audit partners. We've also had three audit committee chairs and two CFOs, two comptrollers. So the individuals do rotate and I think the roles that were put in place to have that rotation within the firm are very helpful. Also, of the key managers at the firm, they rotate as well every seven years.

So we are all, of course, focused on getting it right, the consequences of not getting it right are severe, and so we find that our auditor is challenging us as we work through issues with staff. We find that there is good communication between the auditor and the audit committee as well.

Not too much more to add to the second question. I think it was covered very well. It's not just the audit service issue. It's just the practical nature of trying to find the ability to every ten years get that firm up and ready to be able to manage an audit for large companies.

MR. BUNTING: Do you mind if I also respond and I'll only take a quick second, but I'd like to maybe pose a corollary to you as it relates to our industry. We are very highly regulated industry with tremendous oversight. And I think oversight is the key word. And that oversight tends to keep complacency out of the process. And my view is with appropriate oversight and some of the things we've talked about previously in terms of the audit committee, audit committee engagement, communication, my view is that oversight process will help remove the complacency along with some of the specific points others on the panel have made.

CHAIRMAN DOTY: Very good. Thank you. Jay?

MEMBER HANSON: Two questions and I ask one of them of Valarie specifically since I think Proctor & Gamble is the largest company represented at the table. And then a second question, I'll let the rest of you answer.

The question for Valarie, I'll

just pose first and that's some have suggested and Chuck Bowsher this morning suggested that this transition effort and the additional costs and the disruption that it's really overblown, that it's not that big of a deal. When Andersen failed, many companies got a new auditor and the world didn't end. So I want you to react to that question of a little more color around the things that you put in your letter which were very helpful with the actual data about the number of people on the ground.

For the rest of you, I want to quote something that Richard Kaplan who is on this afternoon said in his letter and these aren't the exact words, but effectively that long-term client relationships are too important to be jeopardized by one difficult partner. And so the question for you is if you could just share some of your experiences with the partner rotation process and whether the new partner on one end is kind of rubber stamped with what's gone on by everybody in the firm before versus on the other hand, the fresh set of eyes, that the rotation really envisions. So just a little comment on your experience with the partner rotation process.

Valarie, being the devil's advocate is what you're saying is way overblown? How do you react to that?

MS. SHEPPARD: Well, I think the numbers do speak for themselves in that, as I mentioned, we have over 900 audit professionals that are touching the audit of the Proctor & Gamble company. So if you just think about the need to even if you were just to spend a day onboarding them and it would take more time than that, it would be significant, just for them to learn the acronyms we use in our company could take some time.

So that is real and so to that question I would say look at the facts. And I think the facts support it. But I would say the more important thing relative to this question about rotation is not just the cost and disruption. That's important. But what concerns us even more is that the audit quality could be diminished. And so our concern is if we don't do a good enough job and spend all that time and effort bringing them up to speed and trying to remember that that would be every single person touching the audit would have to be brought up to speed versus today when we have rotation that occurs at different times, it's much more manageable, then the real concern is if whether the audit quality will be there or not, whether they'll be able to spot trends. And so that is a bigger concern. The cost and disruption, I can assure you, is quite real for us.

MR. WELLS: I guess addressing the question of partner rotation, I think the thing that's most prominent in my mind, partner rotation is that while clearly their efforts to ensure that the incoming partner is well educated and understands the acronyms and the industry dynamics and the specifics around the company's audit and there's some information sharing from the prior partner to the new partner, what struck me is that in the case of our most recent rotation, the new partner focused his attention on a variety of new issues and, in fact, did bring a very fresh perspective. And the fact that he had worked in other industries that were different than his predecessor and with companies that were different than his predecessor caused his questioning and his interrogation to take a different form.

So while there were some of the same issues challenged, he also found a number of additional issues to challenge. So that experience leaves me with the feeling and in a lot of ways in my position a very comforting feeling that he's come in with a fresh set of eyes and is looking for new issues and other things that we need to be considering.

MR. BUNTING: I would like to follow up. I think Darren's point is very good. I had a similar thought as well. What I would add to that is generally partners have different strengths and so generally people focus, as most do, in areas where their strengths are. And so I think when you get that rotation you will see somewhat of a different focus in areas that maybe were not focused on as much. I'm not saying that we're not audited well, but maybe not focused on as much just because of the change in the individual and the change in the skill set.

I also think what happens when you see that change occur is the new partner obviously wants to ensure that there's a level of comfort that he has relative to what has been done as it might affect what is going to take place going forward. I mean many transactions and many issues play out over a period of time. And so it's really important that you have a really good understanding and strong insight on what has been done and you can get comfortable with that as you think about issues that you have to address as you go forward.

MR. BULLER: Maybe just one last quick comment. I don't mean to infer that large companies have better audits than small companies, but in large companies you do have multiple partners and senior level people who are involved in the engagement. And they tend to, I shouldn't say travel in packs, but they certainly tend to have a large group that are part of the decision-making process. So even while you also have a rotation within that group of partners, you also have a body of partners who are involved with different, as Theodore said, different levels of expertise that provide the decision making that I think that's fairly important, including people who over time from the national office of those firms and the national accounting areas in particular, understand your issues and have the ability to benchmark that against what other firms are doing and providing you more meaningful and timely advice during the audit.

CHAIRMAN DOTY: All big firms bring that advantage to a big client.

MEMBER FRANZEL: We've had a lot of discussions about some of the factors and methods that you all have seen put in place that you believe impact auditor independence, so I'm just asking for a very quick wrap up, summary, laundry list here.

In your experience, what are the most important factors or processes that you've experienced with the audit committee and the auditor that really make you believe that it's an independent audit?

MR. WELLS: So I will start. I think first is the direct relationship between the auditor and the audit committee and the relationship there takes place not only during scheduled meetings, but also and particularly with the audit committee chairman outside and in between meetings. And there's an enormous amount of information sharing and communication that takes place without any of us present. Clearly, there's a high level of ownership there by the audit committee of the relationship.

The second thing is the opportunities that exist when we are reviewing financial statements or significant transactions, opportunities for the representatives of our audit firm to meet privately with the audit committee. I think those two processes are critical.

MS. SHEPPARD: I agree with those two processes for sure. I think the other key one is the mandatory rotation of lead partners every five years and other significant partners every seven years is also very critical.

MR. BUNTING: I would agree with both of those as well and to emphasize the transparency of the relationship between the auditors and the audit committee. Our auditors have opportunities to meet with audit committee when they desire a meeting. And those meetings do not include management and so there is a very strong relationship between the audit committee and our auditors and I think that's important.

The rotations I also think are helpful, but I think one of the things that I view as being very supportive to the process that I take comfort in in terms of having an audit firm that fundamentally is doing the right thing is the level of engagement that I have with that audit firm. We don't always agree. And to be able to debate an issue and we have had situations where their position was the position that the company went with even though I think at times we felt like we had a strong position relative to what we thought was the appropriate interpretation. But from the audit committee's perspective, they had a level of comfort with the auditor's position and that was the direction we headed. So it's the process of the strong engagement and then the oversight that weighs that engagement and determines what is and takes some role in making that determination.

I would also say the fact that again, we approach our audit not from the standpoint of making our decisions relative so much to how it will play out with the auditors, but what we view as our ultimate regulator, which is the SEC.

CHAIRMAN DOTY: Steve?

MR. BULLER: The only point I'd add is I think what gives me a great deal of comfort is critical challenge. And that's the critical challenge that the audit committee gives the auditors and also the auditors in turn give management. There are difficult decisions.

CHAIRMAN DOTY: I think our chief auditor, Martin Baumann, may have a question.

MR. BAUMANN: Thank you, Mr. Chairman. This is a question, I guess, for Valarie, but anybody could follow on. Putting aside the fact that other firms may have performed non-audit services for you, so just taking that out of the equation for the time being, if you were to put your audit out for competitive bid, it would be likely that the other three firms would all propose for your audit. And if the other firms said they had a managed transition, they understand the risks of a large organization, the engagement partner they're putting on this job has audited jobs with a thousand-person staff in 80 countries and is an industry expert in your particular industry, and the nature of the rest of the team they'll put together in each of the countries understands the type of business you're in and has audited a multi-national of this type, and they say we believe we can do this audit with very high quality and we believe we'll do it without any transition problems. What would you think? Would the firm not be really understanding the situation? Would they be naive to say that or what would your perspective be of the firms who said that, that they didn't get it?

MS. SHEPPARD: I understand the question and I do think that if we were to bid out, if you will, that you're right, that the other firms would all say that they could handle the audit. And they would say they could manage the transition. And so I understand the question. What I would say though is that we feel that there are a number of other safeguards in place to create a very independent relationship with our auditor and so as we would look at that, we would have to weigh, our audit committee would have to weigh the loss of the institutional knowledge and therefore the issue with audit quality for the first few years as the audit firm tried to ramp up. Because while those other firms do have and service other multi-national companies, I think that you would find that every single large company has -- if you just took and looked at technology. We use SAP.

Many other companies use SAP. Ours is customized. And it's a very P&G-specific solution that's come up and grown over time.

We've had acquisitions that have come in with the Gillette acquisition and those systems and processes have been different and as we've melded those together our firm, as well as many other large companies, don't tend to have standard kinds of systems and processes.

And so while again the concern then is the loss of the ability to know and be able to do quality audits in that first two or three years of getting up to speed, maybe longer, frankly, and getting up to speed on our particular unique situation. And that's why we feel that it shouldn't be mandatory and it shouldn't be on a clock, so to speak. It should be the responsibility of the audit committee to look at and review the quality of other firms and to assure that we have the best audit firm we have.

So I'm not saying that might not ever happen, I'm just saying that saying it on a clock every ten years mandatory rotation would not be a way to achieve what I think the right goal of the Board is which is to improve audit quality and improve independence. And we just see this as something that would work counter to that.

CHAIRMAN DOTY: We are at the noon hour. We're on schedule. This panel has been remarkably beneficial and fruitful for all of us. It's been a real pleasure to have you here. I hope it's been a pleasure for you. You got a trick question from Lewis, but you got a soft ball from Jay, so I think you all ought to be happy about that.

(Laughter.)

We may have the opportunity to discuss these very same subjects again in another forum with this same group because you all do bring to the table an extraordinary combination of what represents American business and American corporate life. It's been a pleasure to have you.

After lunch, we will have another very distinguished panel. We will hear from John Biggs, Jack Bogle, and the Honorable Arthur Levitt, former Chairman of the SEC. That should get you all back here on time because we will begin promptly at one. Thank you. We'll break.

(Whereupon, the above-entitled matter went off the record at 12:02 p.m. and resumed at 12:58 p.m.)

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

(12:58 p.m.)

CHAIRMAN DOTY: This is an important panel. If it's not the most important panel of the day, it may be the most important panel of the two days. And we need to start on time. Chairman Levitt has got a 2:00 hard deadline.

We have here three of the pundits and senior statesmen of the financial regulatory area who have been, along with Paul Volcker and Chuck Bowsher, been right about different subjects more times than any of us can think. And they are here doing us a great honor and giving us a great privilege of hearing from them on this subject.

John Biggs is the former Chairman and Chief Executive officer of course of TIAA-CREF. He began his professional career with General American Life in 1958. He was Vice Chancellor for Administration and Finance at the Washington University in St. Louis, the

CEO of Centerre Trust Company in St. Louis, a trustee of the Danforth Foundation of Washington University, and has had an amazing impact, a huge impact on corporate finance and corporate governance and regulation.

John Bogle, John C. "Jack" Bogle is the founder and former CEO of The Vanguard Group, created Vanguard in '74. He was CEO until '96. He was appointed by then Chairman Arthur Levitt to the Independent Standards Board. He has served as the director of many companies. He is a best-selling author. He is finishing his book by Friday, he says. We've got to get him out of here, because he has until Friday to finish his last book, The Clash of the Cultures: Investment Versus Speculation.

The Honorable Arthur Levitt, Senior Advisor of The Carlyle Group and of Goldman Sachs and Promontory Financial of course was the former Chairman of the United States Securities and Exchange Commission. He was its 25th chairman.

Before joining the Commission, he owned and operated Roll Call. He served as Chairman of the American Stock Exchange. He was 16 years on Wall Street. He serves on the Boards of Bloomberg, CCBN, he is on the Board of Overseers of Teachers Annuity, and the College Retirement and Equity Funds.

So we are, gentlemen, in your debt for being here, and welcome. Mr. Biggs, do you want to begin?

MR. BIGGS: This is a topic I have been interested in for many years, first testifying on it in the 1990s, and thinking about it and working on it since then. And I think this may be the time for a decision to be made.

I think it is a pernicious idea, that it is okay to enter into perpetual relationships between the auditor and the audited firms, creating an intolerable incentive to the audit firm not to take any action that might diminish the value to the firm for that perpetuity.

Accounting firms understand the present value of a growing stream of fees extended out indefinitely. If the growth rate exceeds the discount rate, the value is infinite. That has been a trap for many stock analysts over the years, where they thought that the growth would be perpetual. But I'd like to talk about two personal experiences I have had that involve this issue.

First is when I became a director, a member of the Audit Committee of JPMorgan Chase, it was about a year before we had to pay out over $4.4 billion in settlement costs, which were due in part, not entirely, to audit failures of the two companies. In my considered opinion, those audit failures would likely not -- would not have occurred had auditor rotation been required for the firms.

When I joined the JPMorgan Chase Board in 2003, Bill Harris, its CEO then, asked me to take a personal look at the adequacy of their underwriting of Enron and WorldCom bonds in the years before they failed. I did so. I didn't know much about bond underwriting before that time, but I learned a lot in the process, studying the -- working with the lawyers and the bankers on what they had done and what they relied upon.

What I found was that the underwriting process met and exceeded the standard for a bond underwriting -- for bond underwriters at that time, which I would have expected from JPMorgan.

I read other countries' judicial opinions, and they confirmed that view. The issue that led to the underwriting failure, in virtually everyone's opinion, was their reliance on one of the Big Five accounting firms' audit opinions. In both cases, the firms -- the auditing firms had been auditing the companies for many years.

These were not examples of a

failed audit by an auditor recently appointed to the job. In each case, the audit firm fees were enormous, and the companies were growing rapidly. In the case of Enron, the total fees were $51 million a year, with double-digit growth projected out. To the auditing firm, the present value of those fees appeared to be worth probably a billion dollars. How could a firm be called "independent" when such values were at stake? How could the local senior partner step up to oppose a determined management when his firm had so much at stake?

The simple institution of required rotation would have slashed the value of that perpetuity to human terms, still valuable for several years but not obscenely valuable as a perpetuity.

The firm would know that if it did the right thing it would only lose those fees for a few years, and there has been plenty of evidence in the autopsies that have been written about that -- the Enron collapse that members of that firm did know what they should have done.

It seems preposterous to me that there are opponents of rotation who think the benefits of rotation do not offset the small cost. Four billion is a lot of benefit. Not all of that could be accounted -- it's not necessarily true that we would have gotten all of that with auditor rotation, but in my opinion it was very likely.

But that was just JPMorgan's loss. Citicorp had similar losses, and then there were further shareholders and employers who lost many billions of dollars in that process. Given the company's business failure, probably those losses would have eventually been incurred, but with a decent audit the bondholders might have been protected.

My second personal experience, which I believe is relevant to your consideration, is the excellent experience we had at TIAA-CREF where we had a rotation policy in effect for almost 50 years. During my 13 years as President, and later as Chairman and CEO, we made two rotations of our audit firms. They were on a seven-year cycle, which I replaced for an earlier five-year cycle that had been adopted in the 1950s.

We moved from Ernst & Young to Deloitte, and then seven years later back to Ernst & Young. After that they moved to PricewaterhouseCoopers, and I think they -- and that was the change after they left from Ernst & Young.

The rotation process was done on a tightly planned basis, with primary emphasis on the quality of the auditors and their backup experts within their firms. We did not negotiate a fee until after the appointment decision was final.

I can assure you that there was nothing like a 20 percent increase in fees in the first year, and that the trivial cost of our own process was well worth the money for the rejuvenation that it provided for our audit relationship with new people, fresh outlook. And Peter Clapman testified this morning there were changes, which we thought were in the right direction that the new auditors found.

I have always taken the auditor relationship very seriously. I expect the senior audit professional to meet with me quarterly, and our conversations were open and challenging. For most of such relationships, I received significant information about what was going on in my company, but the auditor knew I took the independence relation very seriously.

I cite one experience which the representative of Procter & Gamble mentioned this morning that should be part of the independence culture and companies. I learned that our CFO at TI-CREF, who was an avid golfer, had enjoyed an occasional golf outing at the club of, and at the expense of, the audit firm. We then adopted a policy that excluded any acceptance of entertainment by the audit firm by any of the staff of the company.

I learned later -- and I have commented on this -- that Jamie Dimon had adopted that policy at Bank One about the time I had done so at TIAA-CREF. And he brought that then to JPMorgan, one of the other wonderful things about that acquisition.

The auditors picked by the company, paid for by the company, and perhaps unreasonably is expected to be independent and effectively working only for investors. Our investors were mostly college professors and higher education employees, since TIAA-CREF is nonprofit.

I testified in the 1990s several times about our experience. And later, as a member of the Public Oversight Board, I urged rotation in my testimony before the Sarbanes Senate Committee.

I was disappointed by the failure to include rotation in SOX, but understood that many other limitations included in the law advanced significantly the cause of independence. I thought we had made enormous progress in showing the way to a culture of independence, for example, by the assignment of hiring of the auditor to the Audit Committee, the hard-wired prohibition of using the audit relationship for the purpose of getting other business from the client, the creation of a federal regulator after all -- the PCAOB -- for the auditing profession, and then the five-year statutory requirement for the rotation of the senior audit partner.

Subsequently, I sensed in my own Board experience real progress and acknowledge the independence issue, and in many cases the need for rotation. Although I disagreed with the conclusion -- the broad conclusion and the process of the GAO study that was required by SOX, I did agree heartily with the final conclusion that it was too early, after just two years, to impose firm rotation.

I thought the 20 percent cost number was very high from my own experience, where we had seen actual cost reductions after the rotation. But that has now been quoted so often, so everyone believes it, although I think it was hedged properly in the document. We certainly saw no such increases.

I also thought the final conclusion that the subject should be reviewed after a few years of PCAOB inspections was a good one. Now that that has happened, and the finding seems clear that the professional skepticism that arises from true independence is missing in too many cases.

Rotation, I believe, will help significantly in making it clear to auditors and to companies that independence is essential.

I also mentioned in my written documents at some length what -- I see this as a real-time peer reviews. I thought the peer reviews which were done under the POB supervision were useful, although not as strong as they might have been. I think having them in real time, as between the two audit firms, going over the papers would be very powerful and very effective just on an ongoing basis.

I don't believe there is a greater danger of a failed audit after rotation, and I can talk more about that if there is further questions. There are other ideas that you could include without going to full rotation. I think disclosure of the audit tenure in the proxy statement would make a lot of Audit Committee chairmen very uneasy, and that would be, in my opinion, a good thing.

I think that Chuck Bowsher this morning proposed auditing the large firms. I would wonder if possibly whenever the total fees of the firm exceed $5 million a year, or some number, that might be a time that you could require rotation, because the present value of that on a perpetual basis would be such an extraordinary number.

I think we all want to improve the quality of audits, and I think this particular action is one of -- it's not a silver bullet, but it would be at the top of my list of ways to improve quality.

Thank you.

CHAIRMAN DOTY: Thank you, John.

Jack Bogle.

MR. BOGLE: Good morning. Good afternoon, I should say, gentlemen. And first of all, I hope it is not gratuitous to say that I, for one, as an outsider applaud the increasing activism of the PCAOB, and hope you will get even tougher and tougher, because we have a lot of problems in this area. They are not coming -- going to come to solution easily.

I have been a business man sort of all my career, but I have had in fact a lot of personal involvement in the accounting area. Most recently, I served as a member -- one of four independent members -- of the Independent Standards Board, appointed by SEC Chairman Arthur Levitt, and we work for the four CEOs of the major accounting firms to try and develop the whole idea of independence.

I have one little anecdote that I think I'd like to tell you about that, and that is I got a little bit tired of hearing these accountants, these CEOs of the accounting firms, say they would never do anything wrong because they had reputation risk. And I finally looked at them and I said, "Well, you know, it's interesting to think about reputation risk. How many clients would you have if you got a reputation for being the toughest, most unyielding, sternest accounting firm in the country that refused one iota of compromise between Generally Accepted Accounting Principles in their spirit and the letter, how long would you get along in your business?"

They didn't seem to have a very good answer for that. Obviously, they are very much tied into all of these accounting firms, tied into the firms that they supervise, and that is just the risk of the present system.

I should say that after hearing the testimony from the previous four witnesses before you this morning, if "witness" is the right word, I kind of came to an odd conclusion. They make an unbelievably powerful case that auditors should never be rotated. Never. I mean, I would have said 20 years would be -- I don't think it is going to change the world, by the way, but I think every 10 or 20 years. Seems like "never" is a word that one should, well, never use.

And so I am willing almost to concede, then, that because the interlinkage of these two giant mega-lists, the giant corporation, the giant auditing firm, that in fact that would be a very, very difficult thing to do. And if we decide not to do it, I wonder if they have thought about the consequences of that, because the system is not working. And if rotation is not the answer, what is?

Well, one thing that occurred to me as I worked in the group headed by Paul Volcker and Chuck Bowsher, in fact, back at the time of the demise of Arthur Andersen, and we had put together a little bit of a -- kind of a group of people, like myself and them, who prepared to act as independent directors of Arthur Andersen, to have an independent Board.

And the Justice Department rejected that, but I couldn't help thinking about the idea that if the CPA firms, the CPA industry business profession has a public purpose -- and it clearly does have a public purpose -- why does it have private governance? You know, we do exactly that in our government-sponsored enterprises -- Fannie Mae and Freddie Mac -- and that doesn't seem to be working out so well. So we maybe ought to be thinking about the very governance of these firms.

And then I want to mention that I think it was Board Member Hanson mentioned -- advanced this a little bit this morning -- that -- here we are -- are audit committees -- was that your question, sir? Were audit committees equipped to do the job? I think they are not.

I have served on audit committees, actually served as Chairman of the Audit Committee of Instanet, a small technology market trading firm. And I was Chairman of the Audit Committee during Sarbanes-Oxley Rule 404. I worked with the accountants. I had the total confidence of the board, and we got it all done, and I thought it was a good rule, if somewhat expensive.

But if the audit committees aren't

working -- and I have seen on both sides of the table, both as a CEO and as an audit member -- what is to be done?

Well, there are not a lot of easy things to do. The Chairman is going to be appointed by the management. They have responsibility, but not enough knowledge. Perhaps the Audit Committee should retain its own independent staff members or consultant to assure that the significant issues surrounding the corporation's financial statements will receive a full hearing.

I have an uneasy feeling that corporate managements may not warm to that issue. But there we are; they may have to warm to it. That's one of the things that we might be able to work on a little bit.

The other thing that occurs to me is there is a lot of -- with all due respect to everybody in the room, a lot of minutia in accounting. You know, let's make sure that the liabilities in Turkey are exactly right and the books balance over there, and there are hundreds and hundreds of these decisions.

And everything has got to be cleared and approved and go through this process. But somewhere along the line judgment has gotten lost in this morassing process. And I see to this day it is better but it is nowhere near solved. I see short-term decisions being made by managements who are inevitably only there for a short term, or almost inevitably, but don't change the corporation's financial statements over the long run. That's a very difficult thing to do.

But if you start writing off things more rapidly, or put a high return in your pension plan -- I will come back to that in a second -- you know, you're gonna improve the short-term picture of the company in favor of the existing management, and you will meet your earnings guidance. You will please Wall Street.

Pleasing Wall Street should not be part of the accounting profession's mandate -- my opinion, deeply held. These issues are everywhere, and I outline them on the last -- these kinds of issues -- or Chairman Levitt did -- about seven or eight or maybe 10 years ago, a wonderful job up in New York of laying out all of these things, like cookie jar reserves, that whole litany, you had, sir.

And there is a lot of fussing around that goes on above this detailed level where everything has to tie in, work out, about managing earnings. We call it financial engineering, and we are going to get to those earnings by hook or by crook.

And I have always found it quite amazing that companies, corporations that are in the volatile businesses all over the world, are able to tell you early in the year what they expect their earnings to be. Remarkable, truly remarkable. But there is a lot of accounting -- for want of a better word -- I'm sorry to be so blunt, but I guess I'm known for that, and I can't help it, but there is a lot of finagling going on to get there.

And I will give you, before I close, my favorite, and that is pension fund assumed returns. I don't think auditors audit them. I don't know how you would audit them. But American corporations are today assuming an eight percent return on their pension plans in the years ahead.

I state to you unequivocally they are not going to get an eight percent return. With a two percent Treasury bond? You've got to be kidding me. How are they going to do that? It's impossible. The math doesn't work out.

In my new book -- thanks for the mention, Mr. Chairman -- I have a little analysis of what you have to do to get the eight percent, and you wouldn't believe what it will take. But in any event, they are not going to get there, but from an accounting standpoint shouldn't the accountants -- you know, this is an accounting number that we are given here.

And shouldn't the accountants, at least if the corporation is projecting eight percent, shouldn't they at least say, "If the return turns out to be -- let's be fair, if it turns out to be 10 percent, here is how much money we will have extra.

"And if it turns out to be six percent, here is how much we will have to put into the" -- you know, it seems like the tiniest thing in the world, but a lot of numbers that should be touched are not, and a lot of numbers it doesn't really matter whether they are touched, are touched, and I don't think that is in the interest of full disclosure.

So I don't think there is enough independence. I think it is difficult to change auditors. But we've got to change something, and the sooner the better.

CHAIRMAN DOTY: Thank you.

Chairman Levitt.

MR. LEVITT: I am honored to be before this group -- a group that was spawned at a time of great national crisis, and one of the few agencies in America today that is really the investors' protectors.

What Steve Harris did in terms of the Sarbanes-Oxley bill, what you, Mr. Chairman, did during your years of service at the Commission, what all of you have done in public life, is really a model for really superb public service.

When we talk about auditor rotation, I think we have to recognize the fact that auditing is not a mathematic formula where the answers will always come out precisely the same. Professional judgment figures into the results, and, therefore, investors deserve the perspectives of different professionals every so often, particularly when an auditor's independence can be reasonably called into question.

Listening today and hearing the major criticism about auditor rotation is the damage to institutional memory among the audit teams. I think it fair to say that most of the billable work of the audit is done by front line professional staff who themselves rotate from audit firm to audit firm. And the real continuity is among the partners and managers who oversee the work.

So the concern about lost institutional memory strikes me as being, at best, misplaced. And as much as auditor rotation would help the cause of investor confidence and transparency, there is now, in my judgment, a much greater threat on the horizon. It's the so-called JOBS Act.

I focus my concern in particular on proposed rule changes that would lower reporting standards for post-IPO companies. My experience, both as a regulator and as chairman of a public exchange, and as a member of 20 different public Boards, was that any time basic reporting standards are weakened, investor protections and market transparency are weakened as well.

As Chairman of the American Stock Exchange, floor brokers endeavored to persuade me to lower the listing standard, so that they could trade many more companies. For them, it was about increasing the overall volume of potential business. The problem was the kind of listings we would attract. I had to consider the overall reputation of the institution.

The AMEX had previously dealt with significant challenges, reputational challenges. We had by then recovered from that damage, but I don't want to repeat the mistakes that got us there. We held the line; I'm glad that we did.

My fear is that in the current debate we are experiencing IPO envy. One doesn't measure the strength of a national economy by the number of public company listings, nor do investors care very much whether they lose money on a large public company or a small public company, and watering down the rigorous requirements for public listings is merely good for the economy, the investment bankers, the early stage investors, and some high-level employees at the IPO firms.

There would be very little public policy benefit measurable either in GDP or jobs created or public prosperity. I would urge the PCAOB to resist the legislation. A decline in regulatory standards always is followed by damage to public investors.

I know this is somewhat off topic, but I believe this bill goes to the heart of what created this remarkably important organization. The issues that you are dealing with are enormously important, and anything that stands in the way of your efforts and investor protection, which is really what you were created for, I think is to be fought with every possible vigor we can muster.

So I commend you for your boldness in taking on an issue where you are likely to be opposed so vigorously by most segments of the business community.

There is not much glory in what you are doing, nor do I consider the job of listening to a lot of us pontificate hour after hour wasn't what you really signed on for. But you are doing really God's work, to use a terribly overused expression.

(Laughter.)

I would be glad to answer your questions. Thank you very much.

CHAIRMAN DOTY: Well, thank you all. And given the importance of this panel, the first question goes to our newest Board member, Jeanette Franzel.

MEMBER FRANZEL: Thank you, Mr. Chairman. I want to take advantage of the tremendous amount of distinguished experience that this panel has. And it is clear that you are all strongly in favor of change and some pretty significant change.

And so I want to ask all of you, from a public policy standpoint, the systemic risks that you think might be introduced right now by the current business model and way of doing business, this morning we heard that very large companies need very large auditors, and that because of the concentration it is very difficult to rotate, and if not impossible.

But in the pre-Sarbanes-Oxley days, and the days after, we were referring to those times as a crisis of confidence, where there was just tremendously devastating results from the systemic risk that had been embedded in the business models and how auditors were doing business.

I would like your perspectives on where we are today in the systemic risk area.

MR. BIGGS: I would like to

comment on that. Systemic risk in the last collapse, the panic of 2008, was I think much greater than earlier when the Enron and WorldCom collapses occurred.

What has interested me in this is how silent the auditors were throughout this period. Where were the auditors for Lehman Brothers, AIG? They are all in this room, I'm afraid, and I know that there were very difficult issues for them. But they were part -- they played a role in a systemic failure of our financial institutions.

They were there. Could they have done something better? I would think so. They probably look back on it and they know better than I will ever know what their roles were and what they would have done differently.

But I think the importance of the audit relationships is incredibly important in heading off systemic problems. And if the auditors feel that that is a role for them, to warn companies when they are getting into a dangerous area, I think they play a very positive role in reducing systemic risk.

What I'm afraid is they didn't play that role. They don't appear to me to have played that role in the major financial institutions that broke down during 2008 and '09.

MR. LEVITT: Well, the problems of 2008 and '09 have lots of parentage to it. It wasn't a failure of the auditors. It was a failure of managers and a failure of rating agencies, a failure of investors. There were a whole -- certainly a failure of oversight, failure of regulatory bodies.

I wouldn't cite the accountants as being generators of systemic failure. I think that the accountants today, their leadership today, in my judgment, is far better than it has ever been in my memory. And I believe that is a function of having fought these battles and dealing with the issues of conflicts of interest.

And, realistically, you are not going to eliminate conflicts of interest, either in this arena or in any commercial arena. There are buyers and sellers, and there are inevitable tensions that arise in transactions between those buyers and sellers. And I think we have to approach how we deal with conflict, and how we deal with transparency, and what kind of public confidence this spawns.

And, again, an environment where auditors change from time to time has a better feel to it, has a better smell to it, than an environment where the auditor has worked with the same client year after year after year. There is nothing inherently dishonorable about that act, but it doesn't feel quite as good.

And I think that perception is so important in these relationships to more specifically address the question of systemic risk. The audit firms are critical in this regard. Do I think that by changing auditors you will necessarily have greater attention paid to those things which bring about systemic problems? I wouldn't say that. That's not one of the arguments that I would make.

MR. BOGLE: Let me add, if I may, to me the biggest systemic risk is the constant focus on short-term earnings, and very strong, still to this day, which has companies take their eye off the long-term ball. This can be documented time and time again and written up in academic journals.

It is really quite clear there, and, you know, the way CEOs can get their big bonuses, for example, is to slash the way they operate the company -- fire people, maybe very good, loyal people, and do all kinds of economies, cut out R&D, do things that cut to the heart of corporate value, which is, to be very clear, where all of the value in the stock market is created. The stock market is nothing but a conduit.

And so the risk comes less in the stock market, I think. It is going to go up and down in its own funny way, and it will be doing that forever. But it comes to how we actually operate our corporations themselves.

We had two of the gatekeepers, as I call them in my new book -- one more little plug, Mr. Chairman, I hope that's all right -- that we haven't talked about here, and one has to wonder where they are or were. One is the Wall Street security analysts. We still have I think 85 percent or 90 percent of the recommendations are to buy and not to sell. I mean, really? What sense can one make out of that?

There is a very lack of in-depth analysis. There is now. There used to be some good analysts at Wall Street firms, excellent, who looked into the accounting side of firms. I know of none anymore, and they have sort of vanished because it doesn't seem to work.

We had a survey of these firms -- Chairman Allen and I of the Independent Standards Board -- interviewed some of the best firms on Wall Street and asked them, "How are you satisfied about the state of accounting in America today?" And they said, "It's wonderful." This was a year before Enron, a year before WorldCom, a year before Adelphia, a year before whatever the next one is. I can't remember them all.

But they just did nothing, but that is not the worst. The worst is the sad state of ownership. The owners aren't looking after their own interests.

As everybody must know now, if only because I say it every time I get a chance, 72 percent of all the stock of all of the American corporations are held by money managers, institutional money managers. And 50 percent, or I guess it's 46 percent -- I think I may have an error in here, I think I said 52 percent -- it's 46 percent I believe -- are owned by just the 25 largest managers alone, an incredible concentration of power.

What did they do? What do they do? They've got their own security analysts, not biased like the Wall Street analysts. I see nothing. I see almost no voting. The patterns vary, but no one steps up to the plate. As far as I know, there has never been a proxy proposal made by any large institutional money manager in a corporate proxy. It seems incredible.

Someone asked me in the break -- that's because of index funds. They're the problem. Well, look, index funds may be the problem -- I'll grant that -- but they are the ultimate salvation, because think about it this way. The old Wall Street rule so-called was, "If you don't like the management, sell the stock."

Well, the index fund has a different rule, has to have a different rule.

"If you don't like the management, fix the management." They just don't do that. They don't follow up on that obvious premise.

So we have to awaken them. Perhaps some kind of government action should take place -- I hope we will get a federal standard of fiduciary duty -- to bring them back into the game. And because if the owners aren't going to look after their own interests, I don't know who is.

I will say very quickly -- I don't want to take too much time here, which I have taken already -- but the idea of the accountants reporting to the shareholders may sound like a funny thing to you. But I have heard time and again, when the Scotts sent all that money over in the late 1800s to build our railroad system, they sent their own accountants over. Of course they did. They had their own money at stake. But that linkage is lost in our present system, and we need to bring it back.

CHAIRMAN DOTY: That was true in the 17th century, in New Amsterdam.

Jay? Mr. Jay Hanson?

MEMBER HANSON: Two questions. And one I will ask of Mr. Biggs just specifically, but then a broader question for all of you. The broader question is, this Concept Release that we put out -- and this hearing today is about auditor independence, objectivity, and professional skepticism. And we have talked a lot about mandatory rotation. I understand your views on that.

But my question is, what other things should we be considering in addition to that? Because I think a lot of people acknowledge that even if we do mandatory rotation, it is not a silver bullet. There are still lots of other environmental factors. So I would really like to hear your thoughts on what other things we should be considering as well.

But, Mr. Biggs, just a very

specific question. You shared with us your experience with auditor rotation at TIAA-CREF, and I understand you are also either currently, or have been in the last 10 years, on several audit committees of very large organizations.

And do those large companies that you have been on the audit committee for, do they have a mandatory audit rotation program in place that the audit committee has requested? And if not, maybe -- just share some color on what your thoughts have been about rotating the auditors on those companies.

MR. BIGGS: They do not have a policy. We have had discussions of it. In the case of JPMorgan Chase, it happened because when we did the merger with Bank One we had two audit firms, and we had to pick one. So it was one of the two existing firms. So in a sense, it was not a rotation, but in another sense it was, because they own half the company. At Boeing, we have not done it; we have talked about it.

What it comes up time -- when the time comes up to consider the new senior partner, unless you really have a good fit -- and it happened that we did have an excellent fit there -- we stayed with the firm. But if that had not existed, I think that would have been a natural time to rotate. And I think the audit committee probably would have wanted to look at least and see what was available.

In that case, the natural rotation time is when the senior partner rotates. So I recommended a ten-year system, so the second senior partner rotation you would do that. And I think that is the time when you ought to think about it.

But we had special problems. The company was the only company in the United States that uses program accounting, which involves very complex accounting underlying principles. And having somebody who was trained and knew that, had learned it at Boeing, made it an ideal change. And the firm did a very good job of bringing that person along, the audit firm did.

MR. BOGLE: Yes. I would add -- Chairman Breeden mentioned this this morning, and it is along the lines of what I had mentioned a little bit earlier. You mentioned the Norway system. I'm not expert on the Norway system, but apparently they pretty much require 10 large investors to be participating in the analysis of financial statements and the analysis of whether the auditors are doing a proper job and doing the right thing. I think that is a good start.

Right here we have this big problem of -- and these conflicts are everywhere; this one happens to be quite a parallel. But one of the problems we face in the field of institutional investment management is that we're managing money for all of those clients out there, and we own those stocks in our portfolios.

And as I have said many, many times -- too many perhaps -- there are only two kinds of clients we don't want to offend in the money management business -- actual and potential. And that, believe me, is a lot of clients. And in a way, the accountants are facing that same problem themselves. You know, they don't want to offend their actual clients, but they also don't want to offend anybody who might think of hiring them in the aftermath of a firing.

So we have an interlock system, almost a gridlock system. But I think to the extent we can work toward an idea of having the audit committee strengthened, perhaps with its own -- as I mentioned, but with its own staff or consultants -- management will not like that -- and having the shareholders stand up for their own rights.

And, actually, even as important as having the shareholders stand up for their own rights is to exercise the responsibilities of corporate governance. It is going to take a long time coming, but it is going to come.

MR. LEVITT: I would encourage you to have meetings similar to this in different parts of the country, and giving greater visibility to your efforts to oversee the profession, to nurture competition, encourage smaller firms to be part of this process, and to continue your visibility as monitors of the profession. That doesn't mean punishers of the profession, because I think the profession has many really sound people.

But you've got to be certain that sound procedures are followed, that your inspection program is given every possible encouragement possible, and that you be vigorous in terms of your overall inspection activities.

MEMBER FERGUSON: The question that I would like to ask and get all of your views on, if I could, is whether -- and we hear this from particularly preparers. Preparers say, "Look, the Sarbanes-Oxley Act in 2002 gave the oversight of audit firms to the audit committee," and that system is working very, very well now.

And what we don't want to do is put a bunch of rules in place that in fact end up limiting the power of the audit committee. And I would like to get your views on, in fact, are audit committees doing what they need to do?

Are they capable of providing the kind of detailed and in-depth oversight of the audit firms that I think we would all like to see? And are they capable of exercising the kinds of judgments that really protect investors? And if not, what would your suggestions be to fix that?

MR. LEVITT: I think that today's audit committees are vastly superior to any that preceded them. But there is no such thing as the perfect audit committee, and some are better than others.

I think this goes beyond that, though. This is -- I don't believe that an energetic, experienced audit committee would take exception to the notion of auditor rotation. I was an advisor to a very large publicly owned company that had endured its own public embarrassments that considered the possibility of rotating auditors.

And this committee -- committee of a number of people had pretty much decided to make that rotation, but didn't do so because the staff felt uncomfortable about it. And this special committee decided that the staff's views were more important, and I can understand that.

I think that we can't afford to dilute the impact of the audit committee, but I honestly do not believe that auditor rotation -- we are talking about a 10-, 15-, 20-year period -- would have any impact whatsoever on audit committee morale.

MR. BOGLE: I would just like to say, I mean, I know you are dealing with a small part of a big issue, and this is beyond the providence of your Board to deal with. But it seems to me it begins with something like corporate governance itself. I happen to be a believer that the Chairman of the Board should be different than the Chief Executive.

My friend John Biggs disagrees with me, and I quickly say he is almost always right, and I am almost always wrong. But I think it is something that ought to be pursued. And when you think about it in the context of what we are talking about today, then it would be that chairmen who appointed the audit committee, not the president of the company. It would give you more independence.

It is hard when -- for any committee of outside directors, which comes in probably six times a year and meets for six or eight hours -- and, yes, they say they do a lot of homework in between, and I am sure they do -- but how can they contend with management with all of the facts? We have to balance somehow the responsibilities of our corporations to the public rather than to the management, to the stockholders rather than the management, I put it even more acutely.

MR. BIGGS: Yes, I would comment briefly. I think most of the large company audit committees are taking this responsibility very seriously. And I agree with Arthur's comment that there is a huge difference between audit committees today -- of the companies I have been involved with -- and 10, 15, 20 years ago.

However, there are some 17,000 companies out there. And when you get down into the ranks, I think then you may not find people getting the message. The audit committee should take that role. And CEOs really don't much like the idea that the audit committee is going to make this decision, and perhaps independently of the CEO.

I think the NACD, the National Association of Corporate Directors, is really doing God's work on getting out to all of the directors in all of the major cities around the country, and to the extent that PCAOB could support them. But this is a theme that I hear all the time at their meetings is now the audit committee has got a new responsibility, and how are they doing it?

And people get up and testify what they have done, what others have done. And I think that is -- I always think that is incredibly powerful and helpful. And to the extent you can participate or encourage that in corporate governance, I think that could be helpful.

MEMBER HARRIS: I have now learned to couple questions into one from Lew and Jay, who asked multiple questions in one round. So let me put a couple together and ask a couple into one, and answer them as you see fit.

But number one is, earlier

panelists have suggested that mandatory rotation is too costly, too disruptive, anti-competitive, and not feasible with respect to the largest companies. You touched upon that, John, but if you could expand upon that. That's one part of a tripartite question.

Separately and unrelated, I would like to get the idea -- the answer from all you, who do you believe is the primary client of the auditor? Is it the investor, or is it management?

And the third is, with respect to auditing and accounting, why do some of you believe that the system is not working?

MR. BIGGS: Well, let me comment on the cost issue. Clearly, there is some additional cost when a new firm comes in. But it seems to me the firms deal with that. They are not going to come in and immediately increase the fees by the amount of that extra cost, but they get it worked out over time, and that they see an audit relationship as being -- they see it as a ten-year relationship.

Even if the 20 percent number were right, that would only be a two percent increase in fees smoothed out over time, and that is in the noise of audit fees. I mean, I think having pushed on audit fees, trying to get them lower always, and the Board's situations, a two percent change is hardly noticeable.

So I don't -- and I think 20 percent is way too high, because I think the firm -- the major firms can come in, you know, the senior people can find their way pretty quickly. I mean, proper rotation is they have full access to everything that the previous audit firm did, and all of the issues are surfaced immediately. They don't have to spend a lot of money to find those. They are there, and then they can take those up with the company.

So I think the cost issue needs to

be considered in a cost-benefit. But the benefits of avoiding one bad error that causes huge losses is so enormous that I don't find that the cost-benefit analysis -- but I'm sorry that some academic didn't take the wonderful opportunity to do a test when they took all of those Arthur Andersen forced rotations that occurred.

Did anybody go out and really look at, well, what did that cost the firms? What happened to fees, the Arthur Andersen fees, and the new fees? I suspect -- a priori on that is they would have found very little in the way of increased costs and increased fees to the companies.

Unfortunately -- or fortunately, rather, for the audit firms, Sarbanes-Oxley came across -- came along about that time, and fees in the firms skyrocketed to help companies comply with Sarbanes-Oxley.

So I think the cost-benefit analysis could be done differently. It seems to me rather than ask the audit firms what do they think it is, when they know that it is going to be used possibly in a contested environment, about whether this is a useful change, it doesn't get there.

What you need is some kind of actual study of rotation -- firms that have rotated their auditors, and go in and get information from the audit firm and the company when that occurs. And I think firms would be willing to provide that data, so it is another study for the GAO or for -- I'm not sure if PCAOB could engage in that.

MR. BOGLE: Let me just add to that that, you know, all of -- I think cost kind of is the last refuge of the scoundrel, and we fall back on that to justify everything else. And here is a company paying its CEO $25 million a year. Somebody remarked on what the total capital cost of that was in a decade, but it is a lot of money.

And they talk about maybe a

million dollar cost in this rotation thing, if any, because an audit firm eager enough for the business is probably going to find a way to eat that cost, and it would be zero. So cost is going to be overexaggerated.

The same thing is true in our business. We complain about accounting fees, regulatory costs -- this is the mutual fund business -- but we never complain about our management fees. They are always wonderful, and they are 100 times what these numbers all put together were. So, you know, cost is kind of in the eye of the calculator.

And let me say this about cost-benefit. I think maybe the worst thing that Congress has done -- I know that is a tough standard, but the worst thing they have done is require a cost-benefit analysis, because we all know intuitively -- our common sense doesn't mislead us -- cost is so easy to measure, and benefit so difficult to measure.

Benefits, in a lot of ways, can't

be quantified. What would the benefit be if we had a purely independent accounting system, if the auditors were truly independent? Nobody can tell you that, but your common sense isn't going to let you down. It is priceless. So how do you measure the easily priced versus the priceless? And you can give me that answer in your next meeting.

MR. LEVITT: I think what Steve was asking, essentially, was: who do the auditors -- who are their customers? Who do they report to? And I think it is obviously the client. But in terms of their reputations, in terms of their claims for independence and professionalism, investors are their major concern.

Now, the balance between those two sometimes becomes skewed, and in my judgment it is your job, along with the SEC, to see to it that that balance is maintained in a way that favors investors rather than corporate interests, which would be viewed as conflict situations.

CHAIRMAN DOTY: Gentlemen, we are going to get Arthur Levitt on the way at 2:00. This would be something that we would love to extend, and we may have to call you back again. This may not be the last time we call on you to do something like this. But it has been a wonderful panel. You have -- as always, you have delivered great wisdom and great stimulus to your auditors, and we thank you all.

Good afternoon. Safe travels to all of you.

MR. BOGLE: Good luck, ladies and gentlemen.

CHAIRMAN DOTY: One of the simulating things about this job and this place is that you learn that there are entire areas of academic discipline that you didn't know existed. And you begin to realize that they have a lot to offer aging students and scholars, such as the ones you see here in front of you.

We have with us Max Bazerman. Max is the Jesse Isidor Straus Professor of Business Administration at the Harvard Law School. His research and his area of specialization focuses on decisionmaking, negotiation, ethics. He is the author, co-author, or co-editor of 19 books and over 200 research articles and chapters.

In addition to being the Straus Professor at the Harvard Business School, he is formally affiliated with the Kennedy School of Government, the Psychology Department, and the Program on Negotiation at Harvard.

He has been consistently named one of the top 40 authors, speakers, and teachers of management by Executive Excellence. I have found his works riveting.

His co-author for some of these works, Don Moore, is the Associate Professor of Management of Organizations, Haas School of Business, University of Berkeley. He studies human overconfidence, including when people think they are better than they actually are, when people think they are better than others, and when people are too sure they know the truth.

He received a Ph.D. from Northwestern University and his B.A. from Carlton College.

Welcome to both of you, and please proceed.

MR. BAZERMAN: Thank you very much. It is an honor to be here. A couple of comments before I begin. First, I am not a professor at the Harvard Law School. After what I say, they may want to deny any association.

CHAIRMAN DOTY: You don't have to deny that. You don't have to deny that.

MR. BAZERMAN: Okay. So I probably should clear that up in case the Dean of the Law School was concerned.

And, second, I want to make a

statement about conflict of interest, because we are -- this whole process is about professionals potentially having a conflict of interest. And in the process of people providing comments, in the process of people providing testimony, one of the challenges for the committee is to deal with the fact that people may also have financial conflicts of interest as they provide their opinions to you.

And I take that concern very seriously. I want to clarify that I did substantial work for the major auditing accounting tax firms up through the mid-1990s. I haven't had any connection to them since 1997, for reasons that will become apparent in a little bit.

I believe I have no direct conflict of interest with anything I am going to say before your committee today. And if by chance what I say leads to any consulting work that I receive any financial compensation for, I don't plan on keeping it. I will donate that, because I don't want my comments to be potentially affected by any financial conflict of interest.

Fifteen years ago, in 1997, when I first published a paper on auditor independence, the AICPA's code of conduct required that auditors, quote, "shall be free of conflict of interest," unquote. In 1984, Chief Justice Warren Burger argued that auditors were required to, quote, "maintain total independence from the client at all times," unquote.

Yet in our 1997 paper, Kimberly Morgan, George Loewenstein, and I argued that the massive conflicts of interest that existed in the structure of the auditing industry created a situation where we were undoubtedly failing the directive of Chief Justice Burger. Quite simply, auditors were not independent in 1997, and I am going to argue auditors are not independent today.

Even a decade after we made this argument to the SEC in front of Chairman Levitt in 2000, after the collapse of Enron and Arthur Andersen, after the ineffective compromises created by Sarbanes-Oxley, after the financial crises where we don't know what would have happened if we actually had auditor independence in this country, our conclusion remains the same. We don't have auditor independence in this country.

The problem is more than the issue of integrity. Mr. Bogle spoke about reputation risks and the limit. But we argue that the problem is far broader. The problem that we believe that confronts this industry is that human beings, when they have a desire to see data in a particular way, they are no longer capable of objectivity.

If you ask people how good they are at -- to assess their own driving skills, to assess the intelligence of their children, or to assess their ability to pick the right stocks, we know that people are incapable of objectively assessing when they have a self-interest in seeing the data a particular way. And we argue that this is a fundamental concern that fundamentally affects virtually all auditors as a result of the structures that exist today.

So while corruption may be the problem of the few, we are arguing that the lack of perfect rationality is a problem of the many and should be a fundamental challenge that we are concerned with in this hearing.

Experiments going back as long as more than 50 years ago have shown the power of self-serving biases, to see data as we would like them to be. In one famous study by Linda Babcock, George Loewenstein, Samuel Issacharoff and Colin Camerer, they had participants in the study play the role of lawyers for a plaintiff and a defendant where both sides had access to the exact same facts.

The participants in the study were

soon interrupted after a fairly small number of minutes of interaction. After they were interrupted, they were simply asked the question: what is your estimate of what an unbiased panel of experts would judge this case to be worth?

And the interesting result is that even when you motivate people to provide you the right answers, plaintiffs believe that the case is worth more than twice what defendants believe it is worth on average. After a small number of minutes playing in a role, people are no longer capable of objectivity to actually assess what the facts of the case look like.

My own work with Don Moore to my right, and Lloyd Tanlu, shows that actual auditors will be more likely to conclude that the accounting behind a firm's financial reports complies with Generally Accepted Accounting Principles if they are working as the firm's auditor than if they are not.

What I find particularly intriguing about the arguments that I am presenting is that when we first started presenting these arguments in the early part of the millennium to different academic audiences, we got shockingly strong differences in responses.

When we presented this work to academic psychologists, academic research psychologists, the typical response is: do you have anything new to tell us? They basically said, "Long ago we learned that people with self-interest are no longer capable of objectivity, and that their bias occurs in a systematic direction."

And the answer is: we didn't have anything new to tell them. We were replicating a result that had existed in psychology for more than 50 years and had been applied in numerous applied contexts. And we were simply bringing it to one more arena.

At the same time, when we

presented this information to the accounting world, the response was disdain. Quite simply, the lead audit firms did not want to hear the message. The accounting academic profession viewed it as a threat. And more broadly, anybody connected to accounting wanted little to hear about this argument, because it upset the way business was currently being done.

We would argue that our current institutions prevent auditor independence from occurring for very predictable reasons. And I believe I am answering prior questions by Mr. Hanson and Mr. Ferguson. We believe that we can identify the structural characteristics that keep us from having independent auditing in this country.

Audit firms have incentives to avoid being fired and incentives to be rehired. Audit firms profit greatly from selling non-audit services to their audit clients, and individual auditors often end up taking jobs with client firms. These structural characteristics, we believe, define a condition where independence does not exist in our auditing institutions today.

So what needs to be done? Auditors should be hired under fixed contracts that stipulate the true rotation of both individual auditors and the firm will occur. During that time period -- specified time period, the client should not be able to fire the audit firm. In addition, the client should not be allowed to rehire the auditor at the end of that contract.

When a client changes auditors, audit firms, the personnel working on that audit for Audit Firm A should not be able to move with the job to Audit Firm B, which often does occur in actual audit rotation situations where the client decides to rotate the audit firm. Sometimes the actual people doing the work remain the same.

Auditors should not be allowed to

provide non-audit services, and the auditing personnel for a particular client should be barred from working for that client for a specified number of time periods.

The basic concept here is very simple. The auditor should not have an incentive to please the client. And without solving that problem, we simply don't have auditor independence in this country.

Opponents of auditor reform have provided a number of arguments having to do with cost-benefit analyses, in terms of the costs of the transition, the argument that we need more research.

To be quite honest, that hasn't changed one drop in the last 12 years since I have appeared before the SEC. We will always be able to benefit from more research. I am an academic. I think funding research is a lovely thing.

But that said, I think we actually have enough data, we have enough reason that we should be taking action based on what we currently know, rather than using a variety of delay tactics that we saw the tobacco industry use to delay reform for decades, and we see climate deniers using in the same way. Audit firms should not be in that category.

I would like to ask you to think about two options, about how one might go about creating auditor independence. Option one would be to start from scratch and have a system where auditors are prohibited from establishing durable, long-term cooperative relationships with their clients, from providing non-audit services to their clients, and from taking jobs with their clients. That is option one.

Option two is: start by creating a variety of incentives that lead auditors to want to please their clients at all costs, and then try to create a complex set of legislative and professional incentives to counteract the corrupting influences that we have by allowing all of the incentives to exist to begin with.

Now, when I ask any manager this question, option one is obvious over option two. And what is striking is that we continually decide to go with option two, to treat the status quo as a place that we are going to start from and create what ends up being fairly small reforms one step at a time as many years go by.

I believe, if we want to take auditor independence seriously, we need to think about what would that actually look like.

The auditing industry has avoided responding to the obvious arguments that my colleagues and I have been making as far back as our 1997 article and the 2000 hearings by the SEC. The auditing industry has spent tens of millions of dollars to block the creation of auditor independence in the United States.

Only recently, the academic

accounting audience has begun to take the issue more seriously. And after being boycotted by my academic colleagues for over a decade, I was recently invited to be the keynote speaker at the Management Accounting Section of the American Accounting Association.

I think it is time for policymakers to move in the same direction. And I want to end my comments by encouraging you to take the bold steps necessary not just to think through, is auditor rotation a good idea or not, but to ask: what would we need to do if we actually wanted to have independence in our auditing system in this country?

Thank you very much.

CHAIRMAN DOTY: Thank you.

Mr. Moore, Don Moore.

MR. MOORE: Thanks for the opportunity to be a part of this process. It is an honor to be able to present to you today. Allow me to express my own personal appreciation for the patience and endurance on display by the five of you over these two days of panel discussions.

I also wish to declare that I have no direct financial stake in the issues before the Board.

I speak to you as a research psychologist who works in a business school. And from the perspective of auditor psychology, the question before you is easy and obvious. Of course, the current system undermines auditor independence. Indeed, the very notion that the current system facilitates truly independent audits is laughably implausible.

These claims are not controversial among psychologists. Indeed, there is such an obvious application of the basic psychological principles that we have known for quite some time that psychologists find this whole debate entirely uninteresting.

Understanding the fact that long,

enduring relationships between firms and their auditors represents a conflict of interest that compromises auditor independence is easy, the real question is whether the PCAOB will have the courage to act to reduce this conflict of interest and increase auditor independence.

There are some critics of reform who have argued that we must pay attention to the whole patient and the cost-benefit ratio of the proposed treatment. While this logic sounds reasonable, I believe it is problematic in this instance. The auditing profession exists because it promises independence.

Without independence, outside auditors become redundant, with inside auditors raising questions about whether outside auditors perform a useful service at all and whether it makes sense to require firms to pay for audits that are in effect redundant with their own internal accounting reports.

If the PCAOB is the doctor treating the ills that have befallen auditor independence, there are some who would invoke the Hippocratic Oath, first "Do no harm." The underlying assumption there is that the perfect regulatory scheme is one whose implementation creates no costs, only benefits.

In a system with as many constituents and as many parts as the current auditing system in the United States, it is unlikely that there is any change that would not harm somebody in some small way. But there is no single patient to be treated by the PCAOB.

There are many constituencies that would be affected by this rule change, and there are some individuals and organizations whose lives would be disrupted by this change. But refusing chemotherapy to a cancer patient because their hair follicles will suffer is a mistake.

We have heard howls of protest from frightened hair follicles in the comments already submitted, and you are getting more at these panel discussions. Those organizations and individuals who are most likely to have their work disrupted by the reforms are considering -- have mobilized to present to you the costs that a change would impose on them. They will lobby and cajole. They will fulminate and portend disaster is you act to reform the system.

And those who would benefit from the change are, by and large, absent. I would like to remind us of those people, those organizations, and those institutions. The hair follicles might not prefer chemotherapy, even if it is in the interest of the rest of the person.

To say that we should not increase auditor independence because it is costly to do so is, in my opinion, like saying that the cancer patient should not undergo chemotherapy because it might be bad for their hair. I have little sympathy for those complaints about hair.

To settle for partial auditor independence only when it requires minimal change from the highly problematic status quo is akin to taking out just the easy part of a malignant tumor. Partial solutions violate the promise of independence on which the auditing profession is based.

The benefits of a system that delivered true auditor independence would be enormous. Equity markets depend on the truthful and reliable public disclosure of information about public companies, indeed that is the fundamental premise on which our equity markets are based.

As the Nobel Prize winning work of George Akerlof has shown, markets break down when the key information is held only by insiders. This is because others become reluctant to trade, rightfully fearing that they could be cheated by those insiders. There are of course high-profile examples of big public companies in which this precisely has occurred.

Insiders have been able to cheat outside investors, leaving companies that collapsed when the truth finally emerged. And the complicity of the firm's auditors makes it so much easier for public companies to get away with hiding the true state of their finances.

If reforming our system would reduce the probability of another Enron or another WorldCom, even by a little bit, we should be willing to endure costly and disruptive change to do it.

The problem we have here today is that the enumerable market participants who would benefit from this reform are not here to speak for themselves. They do not yet know about the potential cases of audit fraud at the companies whose stocks they own, and so they have not yet calculated how much they would benefit from avoiding the resulting bankruptcies, because the benefits of greater auditor independence would be so widespread, those with an interest in seeing it occur find their members and their voices too diffuse to organize action.

They do not have enough spokespeople or lobbying organizations. Investors represent just a tiny minority of the comments submitted to the PCAOB, and they are far more favorable regarding the benefits of auditor rotation then are audit firms and their clients.

The public really only starts to pay attention when high-profile accounting scandals raise their outrage enough to lead them to take action. It is only then, with public esteem for our business leaders falling to a new low, that the public expresses its will loudly enough for lawmakers to be able to hear it above the coordinated concert of voices coming from those concentrated industries, like the accounting firms that are resisting change.

It was this sort of public outrage that enabled passage of Sarbanes-Oxley, which is an important piece of legislation, even if it left the task of auditor reform unfinished.

One reason why it is unfinished is that in the long intervals during which the investing public is not really paying close attention concentrated industries work with regulators to soften the edges around legal constraints, to find new ways to make money, and to work around regulations.

Indeed, it happens too often that these concentrated industries are savvy enough to cap to the regulators whose job it is to supervise them.

What you all are considering is something remarkable. You are considering a meaningful and useful reform without the angry demands of an outraged public fresh from some new scandal. You are wise enough to anticipate the potential scandals and take action now to reduce their future probability.

Allow me to commend you for it and to wish you courage. It will take courage for you to act to treat the cancer of conflict of interest in auditing.

I would be happy to try to answer any questions you might have.

CHAIRMAN DOTY: Thank you. Before I let some of my colleagues have at you, I thought I would ask you a couple of contextual questions. First, do I understand correctly that you would agree or argue that even if we take the approach that Max Bazerman says, or something else that -- some of the other approaches that have been tendered today, whatever we do in the area of addressing the fundamental conflict of interest of the fee structure, that we will not exclude the issue of bias.

We will only counterweight it.

That we cannot exclude it completely, that we will counterweight it at best. Is that your conclusion as behavioral scientists?

MR. BAZERMAN: Yes, is the simple answer. But I would say that we could make tremendous progress, and the way to make tremendous progress is to ask, what would a system look like that would take away the incentives of the auditor to please the client?

Now, we can take this to an extreme and ask, "Well, what happens if they have lunch together? Is that relationship going to bias the audit?" Probably not, but when I worked for the Department of Justice or the FTC, and it is time to go out for lunch, I notice that they don't pay for me.

I think that that is just great. It may be overkill, but better to have overkill than to allow conflict of interest based on relationship and favors to seep into the process.

CHAIRMAN DOTY: Well, John Biggs, for example, and Bowsher pointed to some of the phenomena that tend to coalescence in this area, such as, for example, if you couple long tenure with population of the issuer client's financial reporting staff with alumni of the accounting firm, if you then have with that a large volume of non-audit work, admittedly under the permissible areas of non-audit work, the sort of thing that was -- we talked about earlier, that also increased the percentage of non-audit service to audit service and the revenue, when you see an emerging pattern like that, as behavioral scientists you would say that could be an area around which behavioral analysis could operate without the requirement of econometrics, or without other data to support it.

MR. BAZERMAN: That is correct. I believe you have plenty of data to act currently without additional research.

CHAIRMAN DOTY: And you have

removed -- I think -- if I understand your analysis correctly, what you have done by talking about the escalation of commitment and some of the other aspects of behavioral bias here, you have removed issues of intention or competence.

In other words, you don't think that all auditors are bad people. You don't consider that in fact -- that they are lacking some judgmental or ethical quality or even competence quality that other professionals have. You are just saying we all have this bias.

MR. BAZERMAN: We are accusing auditors of being human.

CHAIRMAN DOTY: Human, that's it. That's what I -- and I'm now going to let Ferguson have at, and we'll move down the line. Lewis?

MEMBER FERGUSON: First, I just noticed, Professor Moore, when you told us or congratulated us on being brave for taking on a big issue in the absence of public outrage, I mean, I think a lot of people might say it's foolhardy to do that without the wind in our sails from public outrage. But there you are.

I guess I'd like to ask a question of both of you having to do with -- if we start with the notion that people are inevitably biased by the sort of structure in which they operate, and in this particular example the way I put it in another paper was people are very reluctant to bite the hand that feeds them.

Even if we put all of the safeguards that you had mentioned, Professor Bazerman, in your paper, including fixed terms, you can't fire, you can't do things like that, as long as the firm is being paid by the client, isn't that bias still going to be there? Isn't the very fact that the payment is being done by the person being audited going to influence the mindset of the auditor? Or do you think that these other structures will overcome that biasing factor?

MR. BAZERMAN: I don't think that where the check is coming from is important. I think the question is whether the check depends -- whether the future checks depend on what the auditor says or decides. That is a critical issue, and that is why I did sneak in -- it is not just auditor rotation that I am for, but I am also for a provision after the PCAOB decides whether it is five or seven or 10 or 12 years. And I am really -- I don't think that I am the right person to tell you how long the period should be.

But I think that it is critical to solve the problem that you are addressing that there is a no fire provision. So when you hire that person for X years, they are your auditor for X years. And, by the way, after that X years, they won't be your auditor for the following X years.

And since they are not providing you non-audit services, they are going to look a little bit more like the tax collector rather than your business partner. And when I hear the term "partner" used to refer to your audit firm, I find that really scary. So I want to eliminate any notion of partnership. I want to eliminate any notion that the auditor has a financial incentive to please.

I don't think that you -- this goes back to Chairman Doty's question. I don't think you can make it perfect. These are human beings. They are going to interact. It might be that Mr. Harris seems like a nice guy, and I have been working with him over the last two years, so I simply trust him more. That would be a human interaction. And if it turned out he wasn't as trustworthy as my intuition suggested, I might be more accepting of the data that he gives me.

So I am not arguing we can make it perfect, but I think we can solve 98 percent of the problem with a very, very small number of rules.

MEMBER FERGUSON: But doesn't the no fire rule have its own set of problems?

MR. BAZERMAN: Absolutely. For me the question isn't, should we be at the system we have now or in this alternative system? The question is, do we want to have an independent auditor function in this country or not?

If the answer is no, there is other strategies instead. If the answer is yes, we have to identify, what are the basic ingredients that you would need for an auditor to be independent? And part of the answer is having no financial incentive to please the client.

MR. MOORE: And at the risk of repeating myself, to go with the answer, no, we're okay with the corrupted status quo, raises questions about what purpose independent auditors serve.

MEMBER HANSON: A couple of questions. The system that we are in, there is obviously a world of compromises to get where we are at today, as you point out. And one of the things that the Sarbanes-Oxley Act acknowledged was that audit committees could do more in legislating their expertise and the relationship.

And hearing Mr. Biggs a few minutes ago talk about his experience on the Audit Committee of Boeing, obviously, a large company, very few auditors with a skill set around -- as he described, around the ability to audit the program accounting, and his thoughtful considerations that he described of why he, as an Audit Committee member, decided to continue with a long-term auditor.

I am just curious as to your reactions as to whether you think audit committees should even have a role in this. If John Biggs' expertise in deciding to keep the auditor at Boeing should be disregarded, and any auditor, regardless of their expertise, should be able to pick it up in some period of time and do the job.

MR. MOORE: So I think Philip Tetlock's work on accountability has a lot to say on that question, that knowing the interest and preferences of your audience play a powerful role in determining the way you think about the answer that you give them, and your own motivations in formulating that answer.

The Audit Committee of the Board of Directors represents the owners of the company and not its managers. Being directly accountable to that Board of Directors and its Audit Committee represents a substantial improvement in terms of the accountability that the auditors feel.

MR. BAZERMAN: I agree that there are positive things about Sarbanes-Oxley, and I think the Audit Committee is one those -- an improvement over an inappropriate starting point for discussion from my perspective. Okay?

And when I think back to the creation of Sarbanes-Oxley, by reading Chairman Levitt's book and by reading The New York Times, The Washington Post, pretty carefully during that time period, I mean, it is important that we realize why we are here today on the auditor rotation question.

There was an enormous amount of lobbying by four firms in order to change what auditor rotation said in the final bill. Okay? Up until days before, best estimates from the media at least was that auditor rotation meant firm rotation. And there were four firms that did a great job in changing that to their own benefit.

Of course, there had to be some compromises. There was a public outrage that Don spoke about during that time period. And so for me the Audit Committee is a good thing in comparison to a status quo that shouldn't be the basis of comparison. And it is very weak in comparison to what the ingredients would look like in a true independent audit system.

MEMBER FRANZEL: So let me try to interpret what you are saying. If we were to find the tools to remove some of these structural impediments to independence, and knowing it is not going to be perfect because we are dealing with humans -- in addition, there are an awful lot of other pressures during the course of an audit that we are not even talking about.

But assuming that we are able to fix some of those impediments, all of these problems still exist, because of the human beings doing the audit. Am I interpreting you correctly?

MR. BAZERMAN: No, I don't think so.

MEMBER FRANZEL: That some of these would counteract it appropriately?

MR. BAZERMAN: I think that 98 percent of the bias that we are talking about

-- we are talking about the human side rather than the corrupt side -- I think 98 percent of it is created by the incentives that auditors across levels have in pleasing the client.

If we eliminate those incentives, I think we are going to have a small amount of remaining bias. But we are talking about a trivial amount in comparison to the current state.

MEMBER FRANZEL: Let me just add some of the other pressures, then, that happen during the course of an audit. You know, there are complex technical issues with a range of possible answers, potential disagreement among the team or even with the client, deadlines, heavy workloads, and then deadlines as they approach and get closer. So that is how an audit works.

Under a scenario where some of the structural impediments are fixed or removed or counteracted, how do these types of pressures impact auditor independence?

MR. MOORE: So the complexity of the technical issues to which you make reference opens room for ambiguity where human judgment can allow smart people to come to different interpretations of the same evidence.

And that is where our self-interest and our human preference can affect the way we interpret evidence, and the evidence is quite -- the psychological research evidence is quite clear that we are very good at interpreting ambiguous evidence in ways that it is consistent with our own self-interest.

One of the ways in which people justify decisions to protect themselves produces escalation of commitment to a previously selected course of action. And that is high on the list of the problems into which auditors are likely to get themselves when they make a judgment call in one year that then gets a little worse the next year, but they feel like to reverse themselves on the call they made the year before would be to be inconsistent.

And so they wind up escalating their commitment to allowing the client to push the envelope a little further. The rotation of the audit firm helps that problem substantially.

MEMBER HARRIS: What facts or examples would you point to that the system is not working? And, granted, your behavioral analysis with respect to the need for independence in the conflicts, but what are the underlying, as I say, facts or examples that point to you that the system is not working the way it should?

And then, once again, dealing with the issue of the cost-benefit analysis, how would you measure the benefits of changing the current system versus the cost.

MR. MOORE: So it is a little bit hard to know where to begin on problems.

There is evidence consistent with the notion that long-term relationships between auditors and their clients color the way that they see their role and the way they interpret information, everything from auditors referring to themselves as partners to differences of opinion in the interpretation of accounting from internal auditors to the inspectors of the PCAOB and other organizations.

The Concept Release, which I found very impressive, insightful, honest, and thorough, goes into some detail on the discrepancies that your organization has found with the way that audits have been conducted in the past.

On the other hand, we don't have the other condition -- the condition in which we could compare those same audit reports with the alternative world that we are imagining. And so we will forever be hamstrung in our ability to answer that question.

MR. BAZERMAN: But I will try anyhow.

(Laughter.)

So we have an enormous number of important cases of companies engaging in egregious behavior, where the audit firm was held to be partially culpable. Those audit firms can either decide to come forward and say, "Yes, we were corrupt, we did that intentionally" -- and I think that that is not the best guess of what happened.

My best guess of what happened -- and it is the only other viable explanation for how they could get it wrong so often -- is that because of the incentives that we have been talking about, honest people with reasonable talent simply didn't notice.

If we think about Bernie Madoff's funds, I think that the evidence is pretty clear he was a bad guy. He was in the intentional corruption category. But I think the more interesting category is, who are all of those other people who were supposed to have noticed that those returns weren't possible?

I don't think we want to go after the auditor. It turns out it is a fairly small auditor in that case, but there were lots of other feeder funds who were also audited. And the auditors didn't notice that anything was wrong. Again, it's possible that they were just truly corrupt, but I think a far more likely explanation is that they had an incentive to not notice, and that they didn't notice.

I find the book about the financial collapse by Gretchen Morgenson to be a phenomenal read. And she talks not just about auditors but all of the gatekeepers who just didn't notice.

And what is unique about auditors, what makes them different from all of the other gatekeepers, is that is their whole business. Auditors are in the business of noticing when something is wrong. If they are not going to notice when something is wrong, it is unclear why we pay for this function to exist in society.

And we clearly know that the auditors didn't see massive problems at a variety of the major organizations that were central to the financial collapse. Once again, the auditors can come forward and say, "That was intentional, and we were corrupt," okay, but I don't think that that is the most likely case.

I think the much more likely case is that they have an incentive to not notice. And as a result, they didn't notice lots and lots of things that they should have noticed, and they may well have noticed if we could rerun those conditions under a true independent auditor system in this country.

Thank you for the question.

CHAIRMAN DOTY: I want to -- I am not -- I don't often have the chance to throw a thought problem to a Harvard and a Berkeley professor. And you may have thought this through, but you may not. I just want to leave it with you.

First, as to your analogy of the tax collector, there are in this room those who would say to you, as a behavioral matter, the auditor really is -- of course is not supposed to be an advocate, but he is not a prosecutor. The tax collector has the job of collecting money for the fisc.

So that really what you are doing is trying to hit a much finer slice of behavior here, that in fact the objectivity that you are striving for is one which is much more difficult than the IRS agent has. And it is much more difficult than the policeman, the cop on the beat has. And so you need to think about how refined your concepts need to be to get there.

And the second thing is, the no fire rule -- and this really gets down into the weeds -- but people who are talking about this tend to view the no fire rule as incompatible with non-audit services.

In other words, I think you are saying they should do no audit services, because the possibility for bartering -- the conflict for bartering for the audit services is there. But also, as a behavioral matter, there is concern that the no fire rule is going to lead to back scratching, especially if you think about an industry where, as we heard today, there may be two audit firms that can audit the particular industry. So that I will scratch your back if you will scratch mine.

I am going to be out in 10 years, or I am going to be out in three years, and, therefore, you know, make sure that -- I will be back. In other words, if I am the departing auditor, I will be back in five years. So isn't there a behavioral concern with back scratching and tradeoffs in the non-audit service area?

MR. MOORE: That sounds like a completely valid concern, that if anything it is worse under the current system.

CHAIRMAN DOTY: Well, that is a good academic answer.

(Laughter.)

I think, if it is all right, I'm going to save a little bit time here. Lewis, do you have --

MEMBER FERGUSON: One more.

CHAIRMAN DOTY: One more. Yes, shoot.

MEMBER FERGUSON: If we were to adopt -- you know, start from the beginning again, theoretically, or if one were to do that and put in a no fire rule, with or without any limitations on other audit services, this is a radical change if that were to be the case.

What would your idea of an appropriate tenure be? Because clearly what you don't want to do is put people in the situation where they can't be fired for years and years and years and years.

And that would lead to runaway auditors, and the auditor in fact making the financial decisions for the company, which I think is a great concern here, too, to keep the auditor in his proper place as providing attest services and not taking over the financial management.

So what, in your model, is a reasonable time period?

MR. BAZERMAN: So I am going to -- I am going to give a non-answer, but I will try to be informative in my non-answer.

The first thing, you can imagine on the no fire that people are concerned, well, what if my auditor is truly incompetent? Well, that could be something that you have to bring to the PCAOB. So no fire without bringing it to the PCAOB for review. Okay? And if the PCAOB says you can fire mid-term, so be it. I don't think that that destroys anything that we said earlier.

In terms of the number of years, my reaction is if you have the other pieces in place, so that we are creating a true, independent audit system in this country, I am -- Don may have an opinion -- I am relatively agnostic.

And this is where I would actually defer to what ideally the investment community, with people who have served on Boards, who have some experience in the auditing industry, could help inform what the optimal number of years would be to basically solve the fact that we don't want too many transitions. On the other hand, we do want to see some rotation.

So I am shockingly -- for an opinionated guy, I am shockingly open on what that number of years should be. But I would argue that the process should be created by the PCAOB to figure out that answer from people who don't have a vested interest in manipulating what that answer is.

MR. MOORE: As a tenured faculty member, I am well aware of the problems and incentives -- problematic incentives created by no fire rules. But I think --

MR. BAZERMAN: There are benefits if you are on the other side.

MR. MOORE: Indeed. The situation that university faculty face is also dramatically different from one that we are imagining in which there would be a fixed term, as in your university can't fire you for a specific period of time, and then you have to go look for another job that retains many of the incentives to stay productive and to keep doing your job well.

CHAIRMAN DOTY: I think we can save a bit of time here, provide for a break, get ready for the next panel.

This has been, to say the least, stimulating. I have an idea it is not the last occasion we will have to talk about all of this. We thank you for coming this distance and for sparring with us and for indulging us in this kind of analysis. I think it is very helpful.

MR. BAZERMAN: Thank you for listening to us and talking with us.

CHAIRMAN DOTY: Thank you. We have two panels coming up. And I think that since Richard Kaplan is sitting here, and I think -- is Jenkins here? Is he back here anywhere? We could begin the panel -- let's begin the next panel promptly at 10 minutes of 3:00.

We'll take a break. That gives us a 10-minute break. The panel begins at 10 of 3:00, and that means we will have the leaders of the five firms on at least by 4:00, which is what we want to do.

Thank you both.

(Whereupon, the above-entitled matter went off the record at 2:40 p.m. and resumed at 2:54 p.m.)

CHAIRMAN DOTY: Ladies and gentlemen, we have two distinguished academicians with us. Greg Jenkins is the professor of accounting and information systems and the William S. Gay faculty fellow at Virginia Polytechnic Institute and State University. He is also the co-author of Comprehensive Assurance and Systems Tool, it's an integrated practice set, and he's the author of a book, The Enron Collapse.

He's widely published, and he routinely receives outstanding teacher awards, and he has published some articles on this very issue of auditor independence which are, to say the least, stimulating and interesting articles. And I think we'll get into that this afternoon.

Richard L. Kaplan, Dick Kaplan, is the Peer and Sarah Pedersen Professor of Law at the University of Illinois at Urbana Champaign. He graduated with honors from

Indiana, highest honors from Indiana, earned his law degree from Yale. He practiced law in Houston for a brief period of time with the current chairman of the Public Company Accounting Oversight Board, did not find his career blighted by that. Got out early, went on to better things, to the University of Illinois.

He's an internationally recognized expert on U.S. taxation and tax policy, and has lectured on these areas in three continents, testified before Congress, and has written course books on income taxation and international taxation. Notwithstanding that, he has, as his presentation will explain, considerable experience on the inside in the audit profession, and for that reason brings a unique perspective to bear.

Gentlemen. Greg, the floor is yours.

MR. JENKINS: Thank you very much. Chairman Doty, members of the Board and others, it is my privilege to speak with you today. I would like to begin by noting that I currently serve on a team of academics selected by the auditing section of the American Accounting Association to synthesize academic literature and other data relevant to the Board's consideration of mandatory firm rotation. My team provided your Board a draft of this report in December of this past year.

My remarks this afternoon are my own, and are not intended to represent the views of my synthesis team members, the American Accounting Association, certainly, or the auditing section.

Auditor independence has been the subject of research, a significant body of research, over the years. I would like to just briefly describe to you what this body of research reveals about several relevant issues: the influence of client economic importance, the provision of non-audit services to audit clients, rotation, and certainly tenure; all of those and their effect on auditor independence. I will then conclude my remarks by sharing some data related to audit firm tenure for the year 2010.

Turning now to economic importance, concerns related to economic importance are based, certainly, on the notion that auditors become so economically dependent on clients that they may, in fact, be willing to compromise audit quality to maintain those relationships. U.S.-based research -- and that's important for me to note -- U.S.-based research does not reveal an empirical basis for these concerns.

There is, however, some non-U.S.-based research which does find a positive association between client importance and impaired independence. The differences in the findings of the U.S.- and non-U.S.-based studies appear to stem from two things. One, regulatory environments in the other countries, and corporate governance practices.

For example, one non-U.S.-based study examined data from New Zealand, admittedly quite a different environment, but nonetheless a country with a self-regulated accounting profession that operates in a weaker corporate governance environment. Companies there are not required to establish particular oversight mechanisms, such as audit committees, and there is no ban at all on the provision of non-audit services to audit clients.

A second example relates to China, where findings of impaired independence are limited to a period of time there where there was a very weak legal environment and very little regulatory oversight. Following a period of substantial legal and regulatory reform in the early 2000s in China, the evidence of impaired independence goes away.

Given the current legal and regulatory environment in our own country, it seems unlikely that these findings translate to the United States.

Turning now to the influence of non-audit services, as with the matter of economic importance, numerous studies have examined the influence of an audit firm providing non-audit services to their audit clients. These studies have investigated the impact of non-audit services on earnings management, perceptions of auditor independence, financial statement re-statements, and the issuance of modified audit opinions, such as going concern opinions.

The overwhelming majority of these studies, again, find no evidence to indicate that the provision of non-audit services to their clients, to their audit clients, leads to impaired independence. An exception to this overall observation is the finding by some studies that the provision of non-audit services does, in fact, lead to a perceived loss of independence. However, a more recent study that examines both pre- and post-SOX data suggests that even that perceived loss of independence may now have simply gone away.

Some have expressed concerns that audit firms are earning significant amounts by providing greater levels of non-audit services to their audit clients. An analysis of the audit and non-audit services fees paid by the Fortune 500 from 2002 through 2010 is not consistent with this assertion, however. The level and mix of fees, following the initial years of implementing Section 404 requirements, have been quite stable.

In fact, audit fees have averaged 8.9 million dollars, and non-audit service fees have averaged 2.4 million dollars since 2007, so they have been quite flat for the last four or five years. The non-audit service fees, 2.4 million dollars, result almost entirely from audit-related and tax services activities.

Now turning to certainly a very

relevant issue, rotation and tenure. The academic findings on rotation are mixed, with no clear picture as to whether or not rotation is beneficial. Adding to this lack of clarity is the increasing realization that the association between tenure and audit quality is rather complex. The relationship appears to depend on various factors, such as the length of term limits, which there was quite a bit of discussion on earlier, audit complexity, industry specialization, and lastly the legal liability environment.

I would like to now turn to some preliminary data related to auditor tenure in the United States for public companies for 2010, the most recent whole year for which vendor-provided data are, in fact, available to academics.

The average tenure of an auditor of a public company in the United States at the end of 2010 was 9.8 years. Tenure is relatively similar for Deloitte, Ernst &

Young, and KPMG, with an average overall tenure of 10.4 years. PwC has the longest average tenure, of 12.1 years. The 16 next largest firms have a combined average tenure of 4.7 years, so there's a marked difference there.

Tenures also differ substantially across industries. For example, companies in the financial, pharmaceutical, and computer industries are audited by firms with the shortest average tenure, of 8.1, 8.3, and 8.9 years, respectively. Companies, on the other hand, in the durable manufacturing, chemicals, and food industries are audited by firms with the longest average tenures, of 12.2, 14.3, and 14.9 years. I bring these data to your attention because they indicate the possibility of differential effects of firm rotation requirements across industries.

There may also be differential effects on the very largest audit firms as well. An analysis of the client portfolios of these firms reveals varying degrees of industry concentration at the end of 2010. For example, KPMG audits the greatest number of companies in the financial industry, while PwC audits the largest proportion of the industry based on market capitalization.

Take another example. Ernst & Young audits 40 percent of the companies in the pharmaceutical industry, yet again PwC audits almost 50 percent of the industry based on market capitalization. Other industries, such as retail and utilities, are mostly dominated by Ernst & Young and Deloitte, both in terms of the number of clients as well as the market capitalization.

Industry concentrations such as this reflects the market's endorsement of the industry specialization of these firms. Indeed, this endorsement is supported by fairly strong academic evidence. Research indicates that industry specialization is closely associated with improved financial reporting quality, improved disclosure quality, fewer financial statement frauds, and fewer re-statements.

In sum, mandatory firm rotation may have significant unintended negative consequences for companies that require specialist auditors, if they are required to retain an audit firm that possesses less industry specialization than their former audit firm.

I thank you for the opportunity to speak with you today, and I hope my remarks have been helpful. I look forward to answering your questions.

CHAIRMAN DOTY: Thank you. Richard?

MR. KAPLAN: Chairman Doty, Board Members Harris, Ferguson, Hanson, and Franzel, thank you very much for inviting me to present this discussion this afternoon. I have taught accounting for lawyers for many years, but the main reason I'm here today is because in 2004

I published an article about the Sarbanes-Oxley provisions dealing with auditor independence.

That article was entitled "The Mother of All Conflicts: Auditors and Their Clients." It began with the essential dichotomy set out by the Supreme Court in the Arthur Young decision that described the role of auditing firms as "a public watchdog." That position, however, conflicts with the very obvious reality that this public watchdog is hired, paid for, and possibly fired by the very companies that it's supposed to be watching.

That essential problem of auditor independence, however, is compounded when the auditor-client relationship goes on for many years, or even decades. Over that period of time, the auditors begin to identify with the client. They brag about the client to their own recruits. They substitute trust for skepticism. In short, they find that long-term relationships are the antithesis of auditor independence.

To this reality, the Sarbanes-Oxley response was to rotate the engagement and reviewing partners. That approach is simply inadequate. A moment's reflection as to the realities of what the context is will make this clear.

Although the big accounting firms have thousands of partners and multitudes of clients, an individual partner, such as David Duncan at Arthur Andersen, will typically have relatively few clients, and as a result is under tremendous pressure to, at least, maintain those clients. Anyone who loses a major client is going to have serious consequences. Anyone who loses two is basically committing professional suicide.

As a consequence, the partner that is rotated out is typically someone who has been the subject of respect in the office, perhaps even veneration, who has no doubt been the mentor to many of the younger partners, quite possibly including one of the partners who's being rotated in as a new engagement partner.

In that context, how likely is it that this new partner is going to challenge the decisions and judgments made by her predecessor, who has probably in fact promoted her very career? It is far better, in this context, to change accounting firms. Then you would be aligning the interests of accounting firms with that of the investing public. Then you have accounting firms with a professional incentive to question the judgments of the past, to ferret out the disputes, to have no intellectual investment to what was done before.

They have never met SALY -- that's SALY, same as last year. They weren't here last year, therefore they're going to take a look at everything afresh. In fact, the most comprehensive audits are the first-year audits, when new auditors come in. Because they don't know where the issues are, they look at everything. The more frequently we can have first-year audits, the better in terms of having independent assessment of what is going on.

There is no doubt that having auditor rotation would accelerate and have more frequent first-year comprehensive audits. There's been a lot of discussion about higher fees. The prior panel, I thought, dealt very effectively with that. If we're going to have audits at all, the question is what are we getting? That is, frequent turnover would enhance the value of those audits, giving credibility to them. And a cost/benefit analysis must also examine the benefit of those frequent audits, not just their cost.

More importantly, once accounting firms realize that they also have a chance to audit some of these companies that have had the same auditor for decades, that these relationships are not fixed in stone and are not locked up, there will be an incentive to develop the kind of industry-specific expertise that has heretofore been cabined in only a few firms. As a result, we will have more accounting firms being able to compete, more accounting firms to provide that expertise. And as a consequence, it is quite likely that fees would actually go down.

I would be pleased to answer whatever questions you have, and thank you very much.

CHAIRMAN DOTY: Thank you both. Jeanette?

MEMBER FRANZEL: Mr. Jenkins, I'd be interested in hearing more detail behind the statement that you made that the academic results of research is mixed when looking at audit firm tenure and the evidence of impairment. And Mr. Kaplan, I'd be interested in hearing your views on that.

MR. JENKINS: The challenge with

this particular literature is that we do not have history with mandatory firm rotation. Spain did require mandatory firm rotation at one point in time, and just prior to the mandatory rotation taking effect the Spanish government eliminated that rotation.

Now, interestingly enough, the study that was done around that timeframe of approximately seven years in Spain actually found no difference in terms of the nature of the audit report that was issued for firms where there was firm rotation and those where there was no firm rotation. So I can give you that one example, but again we don't have a lot of history with firm rotation.

Now, in terms of partner rotation and the idea that a fresh set of eyes is a good thing, that's intuitively appealing to me. And I think it's intuitively appealing to many people. However, what the research tends to show is that it's in the first two to three years -- the first three years, I'll say it this way -- the first three years where is the greatest risk of a mis-statement not getting captured.

Now, interestingly, the research that addresses that particular point says there is one very important attribute of the new auditor in that first three years that seems to mitigate the mis-statement not getting captured, and that is is the auditor, the new auditor, an industry specialist? And the way specialist has been defined in the accounting academic literature really is based on industry concentration. Admittedly, perhaps, not the best measure, but that is the way it's been measured. And again, it's that industry specialization that seems to catch those mis-statements. But that's really kind of the broad strokes of what we know about that.

MR. KAPLAN: Thank you, Board Member Franzel, for that question. There's no doubt that auditor rotation is not a silver bullet. What we're trying to do, however, is to make it as effective as possible. That is, there's no getting away from the fact that it's still the client firm that is hiring these people, that is negotiating the pay, that is going to be firing them, that may contract for other services.

But when you have the big collapses -- not the minor re-statements, but the big collapses of Enron, WorldCom, World Strategy, and all the rest, Adelphi -- these were long-term auditors. These were not instances where they did not have the expertise.

Accounting is really not as difficult as it's frequently portrayed. As a friend of mine describes, we're not talking here about rocket surgery. There are four sources of accounting failures: assets are overstated, liabilities are hidden, revenues are accelerated prematurely, expenses are deferred. That's it.

All of the audit failures are a variation on those themes, and most of the times the accountants have seen what's going on and have chosen not to report it. So their incompetence is really not an issue. It's their willingness to go along. It's their willingness to say "Well, the problem wasn't that bad last year. It was not material." And so as a consequence, the real issue that would be informative on your question is "How many audit problems have we missed?"

That is, as long as the company is doing well, we really don't know whether the audit is all that good, because the only times we find out is when the company collapses. That's when we go around and see, why was this not disclosed? And so the issue will be, is it more likely that this issue will be confronted and a different assessment made by a new auditor? And that's where auditor rotation tends to have its biggest benefit.

MEMBER HANSON: The paper, Greg,

that you mentioned, that was submitted to the Board in December is helpful as a good survey. And I'm just curious: you'd mentioned that there's not a lot of data out there on mandatory firm rotation schemes, but are you aware of any studies that support the conclusion that mandatory firm rotation actually increases audit quality? I guess either one of you.

MR. KAPLAN: Well, I'll go first. Audit quality is very difficult to measure, just to kind of reprise my prior point. That is, there are a number of audit failures that people don't notice because the company is doing very well.

So it's only when the end of the road is reached that then we ask. And so you could say that you don't need audits at all if a company is going to be making tons of profit and is going to be doing well. The purpose of the audit is to provide assurance that the financial statements are at least some degree of accurate.

And so what we regard as an audit failure is when we have incontrovertible evidence that it has failed. What we don't know is when things are going along smoothly for the company, the audits have not necessarily been effective, but it doesn't matter because the company is doing well and no one's complaining.

So it's an issue about how we define audit failures. The ones we see are the ones where the company itself has failed.

MR. JENKINS: I would say that I'm not aware of any studies that link rotation in that fashion. There has been -- because we don't have the situation where we can actually assess firm rotation, there have been attempts to address that issue through tenure, trying to determine whether or not there's a relationship between audit tenure and audit quality.

And unfortunately, as I said, the

research is mixed. It indeed is. There are some studies that suggest that tenure is positively associated with quality, so the longer the auditor's around, the higher the quality, the higher the financial reporting quality, less earnings management, and the like. Other studies suggest it's the opposite. Some studies find no relationship at all.

Kind of an intriguing point is that there are some studies that are relatively recent that seem to suggest that there's a particular sweet spot of tenure in terms of when the audit quality is at its peak. And there are just a couple of studies, so I don't want to overstate this point, but to address or answer your specific question, the sweet spot seems to be somewhere between 14 and 16 years, based on the studies that have been published. Well, one published and one working paper.

However, there's an important

point that one of those studies makes, and that is, there must be a very strict legal liability environment in place. Meaning litigation cost, litigation risk, is very high, in order for that sweet spot to be really that 14 to 16 years.

MR. KAPLAN: If I can come back to that, remember that the singular form of the word data is anecdote. And so if we take another look back at the Arthur Andersen instance with Enron, there you had an instance where the partner in charge had a question about the fair accounting treatment, and so he referred it to the partners in the Chicago office and asked what their assessment was. And they came back, as a fresh set of eyes, still within the same accounting firm, but they had not been on this audit in years past, and said that specific treatment would not fly.

The partner in charge, however, overruled that assessment of their own in-firm experts -- so much for this role of industry-specific expertise -- and then went ahead. And an outside accounting firm, a different firm, would not have had the kind of client pressures that the Arthur Andersen partner felt to maintain that client, and no doubt would have made a different call.

So that's the kind of thing, that what we are talking about is that auditor rotation can bring a new set of eyes with no reason to ratify prior judgments when the client could say "Well, why are you objecting to it now? Last year we did this, although it was smaller." A new firm would come in and say "This does not fly."

MEMBER FERGUSON: I am curious about the statistic you cited, Professor Jenkins, having to do with the average tenure of the big four firms being 10.5 years, and the average tenure of the next 16 firms being 4.1 years.

What explains that? Is that a

question of concentration? Is that a result of concentration, where there are many more firms as you get down to smaller firms who are of roughly equivalent size? What explains this vast difference in tenure depending on the size of the audit firm?

MR. JENKINS: I'm not sure that there is a satisfactory explanation that's been put forth in the literature for why we might see such a difference in tenure. I might surmise that companies that are audited by the larger firms may grow up, in some fashion, with those firms.

As those companies grow, as they experience growth and change, they have the ability to reach out to their firm and receive differing levels of expertise, insights, and so forth, whereas in many cases smaller audit firms, after a certain point in time, a company may outgrow the expertise and also the reach, the physical reach and resources -- the capacity, even -- of some of the smaller firms.

I would mention an interesting study that is very, very recent, and that is this idea of concentration, industry concentration. And the study actually finds that concentration itself is not a problem when there is adequate competition. And adequate competition in the case of this particular paper is defined as simply other firms being actively pursuing clients. It's when the clients really have nowhere else to turn that, these particular authors suggest, you get into a problematic situation where the auditor is not able, at that point, to be as independent, if you will.

MEMBER FERGUSON: But we heard this morning, repeatedly, that one of the problems with mandatory rotation is because of particularly the provision of non-audit services, that there are independent problems, and in fact for many very large companies there isn't an option, or at most one other option. How does that square with what you just said?

MR. JENKINS: Well, the idea that you have a situation where a company is reaching out to a, quote, "specialist auditor," and they have received or are receiving non-audit services from a number of other firms, perhaps including one or two or several, all of the other big firms, it really eliminates choice. I mean, that is a very real situation.

The study that I'm referring to not only looks at the United States, but over 40 other countries. And so the reality is, in some cases, there is not a lot of choice, because of industry specialization, because at a particular point in time a company is receiving various non-audit services from other firms, such that those firms are not currently independent.

MEMBER FERGUSON: But if there's no choice, there can be no competition. Isn't that correct?

MR. JENKINS: That is true.

MR. KAPLAN: Mr. Ferguson, if I could weigh in on that, just briefly? I saw the same reference in the Wall Street Journal article on Tuesday, and my reaction to that was "Then you should not be using those accounting firms for non-audit services." That is, you could hire actuaries. You could hire other consultants.

There are other firms in the marketplace that provide these other services, with one exception, and that's auditing. The only service that can be done by accounting firms exclusively is auditing. That should be their primary focus, and these other services are ancillary, even when they're done by non-auditing firms.

The point is that if there is a problem with competition, then maybe you should not be using accounting firms for these other services. You should hire actuaries, consultants, law firms, Baker Botts, somebody else to do that. There is only one thing, only one source for auditing, and that's auditing firms.

If they are not interested in providing that service -- and this has been an interesting point that was raised in the earlier panel, that is, this identification with the client, this partnering. When did this happen? Well, it's hard to pin this exact point down, but at one point, in fact, accounting firms took great pride in their independence, in their willingness to tell some client to take to the road.

Then there was this opening up of advertising, advertising professional services, raising two issues: what are you going to brag about? Namely, that we are the sternest ones around. And who is your audience? It's not the investors. It's managers. And so the focus in all those instances is, once you start advertising, you need to advertise what you're going to be doing.

And at that point, the accounting firm faced a real issue: where do we treat auditing services? Is it our main reason, or is it just a loss leader? Is it just a reason to get the foot in the door so that we can sell high-margin other services that do not have the kind of commodification that auditing services have become?

If we're interested in having independent auditors, that should be their primary focus, and perhaps some of these non-audit services that they're providing, which disqualify them from being auditor possibilities, should be discontinued by them in favor of other companies that do not have auditing as part of their portfolio.

MEMBER HARRIS: So we've heard different views with respect to how audit rotation will impact competition. Some believe fervently that it will diminish competition. Others believe that it will increase competition. I'd like to get the views of each of you on that issue.

And then I'm led to believe that certain sectors are quite heavily concentrated. Commercial banking, I gather only two firms audit 70 percent. Energy, only two firms audit 72 percent. Telecommunications, two firms audit 89 percent. Utilities, two firms audit 91 percent. How do we promote competition in these sectors? And what would the impact be with respect to audit rotation, pro or con?

MR. KAPLAN: As I suggested, one of the reasons that that concentration that you pointed out has existed is because the auditors knew that they had a potential annuity here. That is, that there was never an endpoint in sight, that therefore they could develop that kind of expertise because they would have a long-term payoff, and it also meant that they could ignore other kinds of accounting, other sectors of the business world, and just focus on utilities, on telecommunications, on financial services, and be known as that one.

If the client firms have to rotate, then the other firms will say "Maybe we should learn something about normalization of utility costs, because now we actually have a chance of auditing Georgia Power." It will not be locked up with whoever's been doing that for the last seven decades, and as a consequence there will be this effort to develop expertise and provide a bid, because now they know that, whatever else has happened, that company has to switch auditors after five years, or whatever, and therefore we have as good a chance as everyone else. We're not going to be competing against a firm that has been there for five decades and has developed all these social and financial relationships.

Once that expertise is developed,

there may be other firms that will grow, and the firms beyond the big four will develop that expertise, and you will see more competition for all of these audits because they'll all be in play. And the flip-side of those statistics that you quite correctly pointed out is that all of those companies are basically hands-off. There's no point learning anything about them, because they are going to stay with the present auditors and there's no reason to develop any countervailing expertise.

Once that link is broken, once that lock-in is stopped, then companies will respond, and we will see more auditing firms become eligible to be part of this auditing pool. And with competition comes lower fees, I'm told.

MR. JENKINS: To the extent that an audit firm is interested in pursuing providing audit services to a company, if they do not have the expertise in-house, it would seem a fairly logical step for them to go hire people that do have the expertise. Either develop that expertise in-house in some fashion, or simply over time hire individuals that do have the expertise.

And so to me, that's a logical response to this idea of "Well, I want to audit a particular company. Perhaps they've been locked in for some extended period of time, but I think I can provide some services to that company, and so I'm going to prepare to do that."

Well, one of the curious issues to me is this: if we have rotation, what does that mean for the individuals who have been working for the accounting firm, the auditing firm, that have been doing the audit? If, for example, just taking the large firms in alphabetical order, if the company is required to rotate from Deloitte to Ernst & Young, what's to stop some of the employees who have been employed with Deloitte for some period of time by migrating to Ernst & Young?

Would a rotation requirement essentially eliminate the possibility that audit professionals could change jobs? Or would there be some level that would not be allowed to change? So perhaps partners would not be allowed to go from one firm to another firm, or maybe senior managers?

And so without there being some mechanism in place to ensure that you don't have a movement of talent, a movement of the expertise in some sense, you could potentially have a situation where rotation occurs but it's not clear that the people doing the audit necessarily are really new people.

In fact, speaking of anecdotes, I have a colleague who spent a significant amount of time in a southern state -- not necessary to name it -- but he talked about a particular large city in this state that had a requirement that the audit firm rotate every three years. And there was kind of this almost running joke in this city that the job rotated back and forth between two firms, and one of the firms would simply hire the people from the other firm to do the work.

So there was rotation -- there was a different signing firm -- but the personnel doing the work were effectively the same people. So to me rotation also has to consider, are you going to allow people to move or not move? And what level will you limit that at?

CHAIRMAN DOTY: Well, we do see and take consideration of a number of the implementation issues involved with rotation. You're going to have to do that. On the other hand, firms do have -- major firms have different approaches to the audit. They have different procedures, they have different manuals, they have different processes, different training. They have different reviewing partners. The kind of partners you're talking about would be subject to a different engagement quality review.

So I'm not sure the Board would ever prohibit people moving. I think in invoking and defining independence standards, we would want to have a look at all of the practical implementation aspects of it. But you do -- I think in your work, you do acknowledge that there is a correlation between the perception of independence, of enhanced independence, and rotation. I think.

And the question would be, isn't that a starting point whereby we ought seriously to consider what could be done by way of enhancing independence, consistent with addressing this kind of practical consideration, implementation consideration, but that we have to consider the effects on perception. Isn't that just as important to the credibility of the audit and the survival of the profession as independence in fact?

MR. JENKINS: I would agree with your assertion that there is an association with the perception of independence when there is a rotation. However, I'm not sure which is more important, independence in fact or independence in appearance. I don't know the answer to that question. I think if you ask people, you'll get different answers, just like you're getting kind of different perspectives on rotation.

Clearly, you have to be independent in fact for there to be quality there. You need to be independent in appearance for people to believe there is a high level of audit quality. So I would say that. But let me also say this: there's really no one definition of independence that's been accepted.

And people tend to have this intuition about what independence is. There seems to be this notion that independence is a dichotomous state: you're independent, you're not independent. And I'm not convinced that that's the right notion, that perhaps independence is on a continuum. You can be more or less independent. And so it seems as though we approach it from the perspective of you are or you aren't.

CHAIRMAN DOTY: That is an interesting comment, Greg Jenkins. Because of course the legal consequence is, you're either independent or you're not. You are pointing to an area where I wanted to ask you about anyway, and that's the extent to which either of you or both of you think that independence in fact comes to rest in the mind of the auditor.

I mean, at the end of the day, aren't we left with the duty, as a regulatory body, of trying to make reasonable conjectures about how we think standards and rules and existing arrangements in the industry might affect the mind of the auditor? Do we have anything better to work with than our pragmatic experience of what we see regarding the mind of the auditor?

MR. JENKINS: Let me -- that's a good question.

CHAIRMAN DOTY: Well, it may be a bad question.

MR. JENKINS: I think there is some sense that independence is, indeed, in the mind of the auditor: "Am I independent or am I not?" But as your previous panelists suggested, it's not clear that you would necessarily even know whether or not you were really independent. You would know whether or not you were independent, perhaps, in terms of referencing some set of rules. But are you independent in fact? Well, you know, maybe there's some debate about that. Or perhaps there's not debate. It's hard for you to know, exactly, whether you are independent.

You know, I'm reminded, as we think about this, of the way the accounting profession viewed independence many, many years ago, in the early part of the 1900s, which was -- independence wasn't even defined.

And the notion at that point was this: if I have to define independence for you, you don't know what it is. And in fact, the way the profession viewed independence was "It's each of our individual responsibility, as a CPA, to find individuals who are not -- just in their being -- independent, and get them out of the profession." And the feeling was, you simply cannot define it.

And clearly, we've gone a long way from that in terms of trying to structure, create rules and structure rules to try to define situations where there are conflicts of interest, and so consequently maybe a loss of independence.

CHAIRMAN DOTY: Well, we tend to deal with the miscreants, the people who shouldn't be in auditing, on an individual, specific basis, as a Board. That seems to be consistent with accountability. It seems to be what social norms want now.

But what I was really trying to

tease out of you, or get you to think about is if, as Arthur Levitt says, there's just something that feels better about a company that has changed its auditors every 10 or 15 years, or at least has disclosed why it didn't, isn't that the perception issue?

And doesn't that suggest that in the current milieu, in which there is a lot being written and said about the crisis in auditing and the confidence in auditing, and the confidence in the audit opinion, shouldn't we be preeminently concerned with perception, even if it means not necessarily having the ability to define independence in any given case, or to demonstrate a lack of independence, to tie it to any data base?

MEMBER FERGUSON: Isn't it also possible that the reason that there's a difference in the perception and the reality of independence with respect to audit tenure is, in fact, the perception is a recognition by a lot of people of the kinds of psychological realities that the previous panel talked about? That, in our human experience, long relationships tend to lead to identification, that you become identified -- the two parties that have been related a long time become psychologically identified. And that's what people looking at this, from a perceptual standpoint, intuitively understand, and that's why you get it.

Is that possible?

MR. KAPLAN: It's certainly possible. Of course, part of the perception gets you into the expectations gap. That is, ordinary investors typically see the audit certificate as akin to the Good Housekeeping Seal of Approval. They think this means that, at a minimum, all of the money is there, the company will not go bankrupt if you invest in it based on what's going on. And they're not interested in the fine points of Generally Accepted Accounting Principles, or that. They think that this shows that it's an independent check of management, sort of "What is independence? Well, it means that you're not a full-time employee of the company. Otherwise, we'd just use the internal audit staff."

The Supreme Court's description of the role of the independent auditor as being "to elevate the interests of the public" sets up a certain anomaly. The public does not hire, fire, or pay for these auditors. If that were the case, we'd have the Securities and Exchange Commission send out a team of auditors, like the Internal Revenue Service does. It says "These are independent auditors. They work for the public. They are not going to be having any connection with the company."

We're already indulging in a bit of, shall we say, make-believe, thinking that companies who are going to be hiring, firing, and paying for auditors are going to be doing so looking for the sternest, the most objective ones. No, they're going to be looking for people with whom they can get along, who have good chemistry and so forth.

And what that means is that independence is, as Greg indicated, a bit of a continuum. But what we're trying to do is maximize not just the perception of independence, but the reality. The fact of the matter is, the current system has neither one, when we have major companies imploding and people having their 401(k) become a 201(k).

You can ask any of them what they think independence means, and they'd basically say "I didn't think we were investing in companies that had no there there." As a consequence, it's helpful to get someone who will look back and say "Why have you always done it this way before?" And so if the accounting firm says "Well, this special-purpose entity" -- and this is, again, not a hypo, going back to Arthur Andersen -- "need not be consolidated. Those liabilities can be kept off the balance sheet as long as you don't own more than 97 percent."

That doesn't pass the giggle test, and yet it went through the accounting firm year after year. Maybe some other accounting firm would have come in and said "Are you kidding me? Of course you've got to show these liabilities." And so I would suggest that independence in fact, of course, is more important. But unless we are going to radically change the system even more than the paradigmatic shift of this proposal, it's probably off the table.

CHAIRMAN DOTY: Are there any other questions from Board members?

MEMBER HANSON: I just want to conclude with one last question. The other -- and I've asked this of the other panelists, too. Our Concept Release was about auditor independence, objectivity, and professional skepticism, and mandatory rotation is but one item that we can consider. And I'm curious to hear about other things that you think we should be thinking about. Because it's been acknowledged by many of the panelists that this is not a silver bullet. This isn't going to fix everything. What other things should we be thinking about with respect to improvements to independence, objectivity, and skepticism?

MR. JENKINS: One of the things that occurs to me is this notion that it would be quite helpful for there to be a bit more sunshine around audit failures. More specifics: what went wrong, how did it go wrong, what could have been done to prevent it? Were people simply incompetent? Were people thinking "Well, I'm going to lose a lot of money here," or "This may be my second client loss," and that's, as Mr. Kaplan said, professional suicide. But really do -- taking this idea almost of what physicians do when there's been a medical error.

When there's an audit error -- an audit failure, as the term is being used here -- what is the lesson? What's the takeaway? Now, I recognize that the Board puts out 4010 reports, kind of these observations, trends and so forth that you see. But really being able to have, in much greater, much finer detail, "This is the failure. This is how it happened. These are the circumstances. Here's how to fix it," I think that that would be something that would be quite helpful.

CHAIRMAN DOTY: If the identity of the issuers in Part 1 and the backup conclusions that we might make in Part 2 of our report on quality control things that we thought should be fixed in the firm, if those were made available on real-time basis, you think that would do a lot for the problems that we face?

MR. KAPLAN: It certainly would, but we shouldn't think that that will be the complete answer. Because the history of the development of auditing standards, for example, is basically closing the barn door after the proverbial horse has left.

That is, at one time auditors did not do counts of physical inventory. That changed. Why? Did the accounting profession sit around and think "Well, we ought to physically observe the inventory?" No. There was an audit failure, a company went belly-up. This is McKesson & Robbins. And so they said "From now on, every single inventory will be physically observed."

Then there were issues about accounts receivable, and they were not completely there. So another company collapsed, and they said we should circularize and make sure that the big ones are there. And so there has always been this chasing the last problem, and the real issue is what's going to be on the horizon for the next special purpose entity, the next derivative, the next item?

It's certainly a good idea to say that they didn't follow the procedures, if that was the case. But usually it's not a matter of incompetence, it's a matter of a novelty, a novel situation or financial instrument being created, one that might have favorable tax consequences, that is treated not as debt for tax purposes, or is treated as debt for tax purposes but doesn't have to be shown on the balance sheet for financial accounting purposes. This is a major part of the intellectual activity.

And so then there is this game of leapfrog with the regulator. "Well, I don't see anything here that forbids it." I think there's a reason why the Concept Release specifically included at the end "professional skepticism." It should not be reliant simply on "Where is it written that you may not do this?" It's a matter of instilling professional judgment, instilling professional pride.

In fact, I would prefer if the audit fees did go up, rather than using the audit as a loss leader, so that people took pride in the idea of catching these disasters before they circulate throughout the financial system and cause people to withdraw from equity markets entirely.

CHAIRMAN DOTY: I think the chief auditor may have a question.

MR. BAUMANN: I do. Thank you, Mr. Chairman.

Professor Jenkins, just a couple of questions. One, when you talked about the average tenure of clients at the various different firms, I wondered if you had done any work on stratifying tenure by size, and how that might be differentiated. And then I have one more question.

MR. JENKINS: I cannot tell you -- I can't take the deciles, all the public companies, break them into tenths, and tell you what the average tenures are as I sit here now. I can tell you, if you want to meet afterwards, I'd be happy to provide that to the Board.

But I can tell you, when you look at the public companies for the United States by market cap, taking each percentile of the market, you could basically just draw a straight upwards-sloping line and what you would see, on average, is that tenure increases with time. So the bigger the companies, the longer the tenure.

MR. BAUMANN: Good. Thanks. And then, with respect to the comment you made earlier -- and I think we appreciate very much the work you did on the synthesis, and it's very valuable work for us. So thank you for doing that. But there is a fundamental problem with respect to that, and I think you've pointed it out, in terms of that research, in that even the comment that there's potentially greater risk in years one, two, and three of an audit, that's in a voluntary rotation environment. So therefore the real problem with research in this area is, we don't have experience and research in a mandatory environment. Correct?

MR. JENKINS: That is correct, absolutely.

MR. BAUMANN: And that's a limitation, too, to the studies.

MR. JENKINS: Absolutely, it is. It is.

MR. BAUMANN: Thanks.

CHAIRMAN DOTY: And I think, Steven, you had one?

MEMBER HARRIS: Yes. Professor Jenkins, I think you recommended that maybe we do a little bit more with respect to getting the specifics around audit failures and some of the lessons learned, and I think the CAQ has done some work in terms of the fraud center looking at issues related to that. What is your vision behind that, and what exactly do you think the PCAOB ought to do in the area of either doing a forensic study, or setting up some kind of a division within the PCAOB? What do you have in mind?

MR. JENKINS: I don't necessarily assume that the PCAOB should do this, but rather I think that there should be some mechanism -- and perhaps it could be done through the CAQ. It could be done through the PCAOB, or perhaps some other mechanism, whereby the firms share the best approaches to addressing audit failures.

They all have the same standards to follow, right? They all use the same auditing standards. And while their methodologies may be different, and their procedures might be different, fundamentally, at the end of the day, an audit's an audit. You confirm accounts receivable, you send out letters of inquiry, you have conversations with the client. You do a lot of very similar things.

And so my feeling is, would it be

useful if there would be some standing body that would allow firms to come together and, in a very -- in a legally safe environment, have a very frank conversation about an audit failure, and then talk about what could have been done differently, so that those lessons are then shared with other firms, other auditors, so that we don't have those problems?

I guess my feeling is, kind of going back to "we respond after the barn door's open," I agree with that. But at the same time, to draw an analogy here, when there's a plane crash, there is an investigation, and there are steps taken to try to prevent a crash like that from ever happening again.

There will be other crashes. There will be other audit failures. But my question -- or my suggestion -- is, let's take additional steps to try to learn from those failures, other than just saying, "Well, it looks like the auditors weren't independent. They were making too much money, and they really didn't want to question the client."

Maybe it is that simple in some cases, but I'm not sure, given all the people I know who are audit partners, I'm not sure that it is that simple. I think these are men and women who really do want to do the very best job they can. So I would like to see more open communication about problems when they do occur.

MEMBER HARRIS: I think that may very well be a good idea. I think there may be an issue with respect to the firms sharing proprietary information amongst themselves, so whether that's something that we would want to consider, I think, is an open question. Thank you.

CHAIRMAN DOTY: We have run out of time. We thank you both. It's been a wonderful discussion. We have benefitted from it. We will next have the heads of the largest accounting firms. We will allow ourselves five minutes, and we will start promptly at 4:00.

(Whereupon, the above-entitled meeting went off the record at 3:52 p.m., and resumed at 4:00 p.m.)

CHAIRMAN DOTY: By prior agreement with this distinguished panel, I have agreed not to go through the credentials that each of them has -- each of them has extensive credentials -- but to identify them for who they are and whom they represent.

John Veihmeyer is the CEO of KPMG U.S. Robert Moritz, PricewaterhouseCoopers. Stephen Howe, Ernst & Young. Joe Echevarria, Deloitte & Touche. And Stephen Chipman, Grant Thornton, LLP.

So we have the five heads of the five largest audit firms here, and would like to turn it over to you to begin your statements. We know from your submitted comment letters generally where you are on this issue, but I think it would be very useful for the audience to hear it. Stephen, do you want to begin this?

MR. CHIPMAN: Thank you, Mr. Chairman. Good afternoon. As you kindly introduced me, I'm fortunate to be the CEO of Grant Thornton in the United States. We are part of a global organization that has 30,000 people operating in over 100 countries, and we share the same global values, audit methodologies, and commitment to audit quality across all of those countries. In fact, I am proud to have had the opportunity to have lived and worked in Europe, China, and the United States as part of my career with Grant Thornton.

So I am pleased to be able to address you today on this very important topic of auditor independence and audit firm rotation from the perspective of a firm that focuses on serving dynamic organizations. These organizations include a specific focus on growth-oriented public companies, a core segment of the U.S. economy.

Auditor independence, objectivity, and skepticism are the foundation for trust in business and are critical to the investor's ability to rely on the auditing profession and their role in the U.S. capital markets. As such, the continuous enhancement of these elements is an important effort and we absolutely support it.

We believe that the vast majority of auditors want to do what is right. They undertake their professional responsibilities with great seriousness. However, we also believe that audit firm tenure over a period of many decades can create, at a minimum, the perception of a decreased level of auditor objectivity. As ours is a profession that is based on trust, it is important to remain vigilant in our demonstration of that core value.

In circumstances of extreme

tenure, mandatory firm rotation could be a component of a potential solution to this perceived loss of auditor objectivity, although there is no empirical evidence in our view to suggest that rotation would improve audit quality, and its potential negative consequences may well be very significant. Specifically, adopting mandatory firm rotation will have an effect on the overall cost, conduct, and timing of an audit.

We believe that the costs will be disproportionately higher for smaller public companies, such as those in the Russell 2000, for example, and in addition we believe that in the initial years of implementation, that this would be the most significant challenge, while any improvements in audit quality, should they occur, would not be seen in the short term, and unfortunately may not be measurable or identifiable at all.

We are also concerned that, if not appropriately implemented, mandatory rotation would accelerate a trend of large audits gravitating to a small group of firms, and therefore a change in audit appointment patterns will further negatively affect audit firm concentration.

So, respectfully, we caution the Board not to assume that mandatory firm rotation can address all of the audit quality concerns identified by your Concept Release. As the release indicates, there are many factors that can unfavorably impact audit quality. We have seen instances where two seasoned and well-informed professionals may well reach different judgments about the sufficiency and appropriateness of audit evidence, or even the range of acceptability of a particular accounting estimate.

We suggest that the ongoing efforts to improve audit quality -- evaluating existing standards, drilling down on audit deficiencies, and firm quality control enhancements -- should continue to play a significant part in informing the Board in its decision on whether and how to implement a rotation system. Clearly, professional skepticism and related judgments are qualities that can be influenced by factors unrelated to audit tenure. They could include competency of individuals, training, performance of the audit professionals, as well as the audit firms' quality control systems and tone at the top.

We also echo concerns expressed by certain audit committee members that a mandatory firm requirement will impact their governance responsibilities and activities. Given the audit committee's current role to appoint and approve all services, compensate and oversee the audit firm, it's important to consider the likely diminishment of the relevance of the audit committee's role in the financial reporting process. We are concerned that a direct offshoot of mandatory firm rotation could lead to less audit committee interaction at precisely the time when we believe more would be warranted.

As we wrestle with these important issues, and particularly the issues of auditor independence, objectivity, and skepticism, I believe it is important for us to acknowledge that the issue of pay model, where organizations hire and compensate the professionals who audit their financial statements lies at the very heart of this debate and discussion.

Many bright minds have debated and researched this issue for decades. We've certainly done so at Grant Thornton, and we've invested a significant amount of time looking at different solutions that could help with some of these inherent conflicts. We've considered options that would ensure the right highly qualified professionals are engaged, incented, and held accountable for providing reasonable assurance about the completeness and accuracy of financial information.

We've concluded, like many before us, that any option that takes the retention and compensation of the auditor out of the hands of those responsible professionals -- professionals who are in the best position to know the organization, the needs of the entity, and the auditors' skills and competencies -- would likely diminish audit quality, perhaps significantly, and in doing so harm investors.

So I call attention to these challenges to stress the importance of effective regulation and oversight, as well as the commitment from regulators and the profession to continue to work together and collaborate on improving independence, objectivity, and skepticism.

CHAIRMAN DOTY: Thank you, Mr. Chipman. Mr. Echevarria of Deloitte.

MR. ECHEVARRIA: I want to first thank Jim and the Board for putting this new emphasis on independence, objectivity, and professional skepticism. The Concept Release was clearly a catalyst to encourage new ideas and new thinking in ways to improve the vital role that auditors serve for the public interest.

It's clear that independence, objectivity, and professional skepticism are indispensable attributes that are fundamental to the public trust. They're also foundational to a culture of professionalism. But auditing and audit quality goes beyond those, as identified in the Concept Release. It requires expertise. It requires experience. It requires deep knowledge and understanding of the companies being audited. And I believe those attributes could be adversely affected through any arbitrary term limits that might be put in place.

As you know, the papers that we submitted, both in December and in March, we went through great detail to make sure we looked at every piece of evidence we could find, every piece of public research. Which, by the way, did include your previous panelists. They were all included. And we wanted to do that because we wanted to make sure we made an informed decision about our views on this subject.

So what did we conclude? We concluded foundationally that the system is sound. It's not perfect. It can be improved. But it's still sound, and I believe it's still the best system in the world. We didn't find any real correlation between tenure and issues. We did note that re-statements and litigation related to accounting matters have both declined in excess of 50 percent, so as a consequence we concluded that the great work that was done in putting the Sarbanes-Oxley framework in place did, in fact, enhance financial reporting, and did improve audit quality.

So we believe what's required now, and what the next step should be, is to build on that Sarbanes framework. And we would start by looking at the interactions between audit committees and auditors. We would look at the communications between auditors and audit committees. We would look at introducing a concept of the PCAOB actually engaging audit committees directly.

And why do we say that? Primarily because under the rules today, it's the audit committee who represent investors. It's the audit committee who is tasked with engaging, compensating, and overseeing the audit firms. That's essentially what their charge is today, and that's why our focus is there.

As to mandatory audit firm rotation in general, the evidence on experience would suggest it's generally not favorable. As to what we should do next, we think the Board should consider the over 600 comment letters that have been submitted, what you've heard today, what you undoubtedly will hear tomorrow, and take a balanced view of all that. And we would start with, again, the interactions between audit committees and auditors; yourselves and audit committees, and their transparency with investors.

We would also suggest that the good work that's already being done in terms of the role of the auditor and the audit report, which the PCAOB currently has underway, should continue. We believe that you should consider a study more broadly involving all the stakeholders to deal with the overall impacts of audit quality, not just independence, objectivity and professional skepticism.

We also believe that it would be wise to look at those countries who have attempted rotation, or are attempting it now. Look at what the consequences were, both intended and unintended.

And lastly, as Board Member Harris has heard me say on numerous occasions, we believe that status quo is not an option.

Deloitte is committed to working with the Board and this very important initiative, and equally important, to helping the profession transform, ultimately with the goal of improving audit quality and enhancing investor protection.

I am often asked -- and I have been with the firm for 34 years as an auditor -- I am often asked "What is it that you stand for?" I've thought about that question quite deeply, and I think the answer's quite simple. We stand for nothing any different than what America stands for. America builds great ideas, and then works tirelessly to make them better. That's what we stand for.

So thank you for the time this afternoon, and I'll turn it over to the next panelist.

CHAIRMAN DOTY: Thank you. Mr. Howe, Ernst & Young.

MR. HOWE: Thank you, Mr. Chairman, and good afternoon to you, other members of the Board, staff, and SEC observers. I too am pleased to be here for today's discussion, which is important.

The PCAOB's Concept Release raised a number of questions, and today's discussion certainly adds to the record established through the extensive comment period. We at Ernst & Young are sincerely interested in exploring any and all constructive ways to further strengthen audit quality. We believe any ideas pursued to further auditor independence, objectivity and skepticism must lead to an increase, not a decrease, in audit quality. And as you know, we do not see mandatory firm rotation meeting this important objective.

We also believe evidence in support of such a policy is lacking. We examined results of our PCAOB inspection reports and our own internal inspection activity and did not find correlation between the findings and auditor tenure. And we understand that's consistent with the PCAOB's own preliminary analysis of inspection results.

My written statement and our comment letter, along with close to 600 others, cite things like disruption, costs, and harm to corporate governance and audit quality, and these should provide the Board with substantial input on the possible negative effects of mandatory firm rotation. I'm not going to belabor any of those points in these opening remarks.

Ernst & Young audits more than 1,000 public companies. Excellent audit work is being performed by many thousands of our auditors. Our world is increasingly complex and global, and we know we must continuously improve. We do truly embrace the opportunity to continue to engage with the Board, with the SEC, investors, and audit committees to further improve audit quality. I believe our interests in this regard our totally aligned, and I look forward to openly sharing and absorbing suggestions to continue to improve our focus on independence, objectivity and skepticism.

At this meeting, some have or will express support for mandatory firm rotation. In some cases, this support is consistent with views predating the Sarbanes-Oxley act of 2002. I think it's very important to recognize that much was changed by that act, and much has in fact improved since that time 10 years ago. Audit firms, audit committees, and the PCAOB itself, born of that act, have indeed all contributed to these improvements.

Obviously, though, we cannot be content to stop there. We have put forward ideas that go further and build on the progress made by the Sarbanes-Oxley changes. These ideas seek to foster even stronger alignment among auditors, audit committees, independent oversight authorities and shareholders.

I think that alignment is critically important to our ability, as a profession, to make continued improvements to audit quality. Of the opportunities we outline, some the PCAOB can perform on its own. Some would benefit from the SEC's involvement. Most, if not all, require action by the firms. We are committed to further actions.

It is my hope that the Board will focus on our collective ongoing actions, and such suggestions to further improvements. I believe an extended debate over mandatory firm rotation could be counterproductive, not just here in the U.S. but around the world. We endorse a continued commitment to ongoing actions, and we offer additional measures.

First and foremost, I believe Ernst & Young, and the profession, must continue its commitment to invest in the necessary tools and resources to execute audits in a high quality manner, and we accept accountability for that. Further measures we support include the following:

Increasing communication and transparency among auditors, audit committees and shareholders, as well as between audit committees and the PCAOB itself.

Developing and sharing among audit committees the leading practices that promote auditor skepticism. In so doing, we should build on, not undermine, the foundational reforms which SOX put in place.

Analyzing the true root causes of audit deficiencies. This important work by the Board and audit firms can help us collectively address what really needs to be done based on grounded analysis, not theory.

Carefully reviewing the Board's important recent and planned auditing standards to assess their impact on audit quality and the effectiveness of firms' implementation.

Engagement by the PCAOB and the

SEC, and capital markets' regulators outside the U.S., to enhance corporate governance globally, particularly with respect to the composition, expertise, and responsibilities of independent audit committees.

And empowering the PCAOB to recommend firm rotation to an audit committee in situations where it has been demonstrated, through the enforcement process, that professional skepticism or objectivity was significantly lacking in the audit of that issuer.

At present, we believe the foundation for audit quality is very strong. Progress has been made. More is ongoing and needed. Collectively continuing these efforts and embracing further approaches offers a positive way forward.

I thank you for the opportunity to participate with my colleagues today.

CHAIRMAN DOTY: Thank you. Mr. Moritz, PwC.

MR. MORITZ: I know we've been here, and it's been a long day. I thank you for inviting me to this important discussion, and I also want to thank the Board and the many other panelists that spoke earlier, as well as those that will be with us tomorrow, for their interest, perspectives, and investment of time.

While I have the microphone, I also want to thank one other group, and that is my fellow partners at PwC and the audit teams. I know firsthand the tremendous work our teams do, and the dedication they bring to serving the capital markets and the investor groups that rely on their work. I see it each and every day.

One of the ironies of this profession is that the public rarely sees or hears anything when an audit is done well. But even though the benefits and the workings of a well-done audit are often quiet to the public, the reality is a lot of great work goes on behind the scenes. Our audit teams make the tough calls that need to be made. In fact, in a recent quality and value survey of randomly selected PwC partners and staff, 92 percent of them -- 92 percent -- reported that in the last two years, they had to have a difficult conversation about an accounting judgment, suggested different or improved financial disclosures, or identified a potential weakness in the financial reporting controls that needed attention.

I recognize entirely, beauty is in the eye of the beholder. I recognize we need to do more, and we're not always perfect in what we do. But we strive to be. Making the tough calls, improving quality continuously, and striving for that excellence, is at the core of the culture at PwC.

The path by which we improve auditors' independence, objectivity, and skepticism is the subject of today's meeting, and in dealing with such important topics I hope that we can all agree on the need to be open to different points of view, analyze and explore the pros and cons, costs and benefits, as well as these potential unintended consequences that were talked about earlier. But before moving forward, we have to actually take stock of where we are today, because what was hopefully noted was there has been tremendous progress over the last 10 years through the enactment of Sarbanes-Oxley, and some of the examples we have talked about today precede that enactment.

Many have said there have been great enhancements in financial reporting and audit quality, both of which go hand in hand in serving the needs of the investing public. Over the last 10 years, we have been on a journey that has led to significant enhancements in reporting requirements, better execution of auditing standards by the profession, clearer accountability of audit committees in overseeing the financial reporting process, and greater effectiveness of the inspection and standards process.

Changes over that time -- including substantially limiting non-audit services, moving the oversight of the audit firms to the audit committees, and mandating external oversight by the PCAOB -- are, in fact, working. Yes, more needs to be done, but they are, in fact, working.

And I humbly admit we, PwC and the profession entirely, have more work to do. So let's continue on that journey of improvement. But continuing on this journey requires us to focus on four topics: importance of independence, objectivity and skepticism, and the performance of the profession overall. Audit quality is top of mind. Independence, objectivity and skepticism is, of course, the foundation of how auditors must approach their work, but there are many other aspects of audit quality. Having the right expertise, in the right industries or for the right complex, technical areas are a key must and an absolute, and audit firms must have a tremendous network, here in the U.S. and around the world, to bring, in fact, the right expertise, day in and day out.

A second factor is the profession's ability to keep pace with the evolving needs of the capital markets, and the needs of investors. It's important that all of us continually assess the auditors' work product to ensure we're meeting the needs of the stakeholders we serve. I applaud and support the potential changes to the auditor's report that have been proposed by the Board, more specifically use of matters of emphasis paragraphs as we think about that audit product. But to me, again, it's another step forward with hopefully many more steps to come on that journey.

Third, transparency is a third critical factor. If we are to sustain the confidence of our stakeholders in what we do each and every day, including the perception of independence, we must, as a profession, be much more transparent in how we think about things like audit quality, the areas in which we can improve, the investments needed to be made, and measuring and reporting the progress made to date.

And finally, the factor of governance. Our firm, the profession, and the many other stakeholders in the supply chain of corporate reporting must make sure the right governance mechanisms are in place to ensure we're delivering quality audits to the investing public. While our discussions today focus specifically on independence, objectivity and skepticism, I hope that we can actually step back and spend equal time around these broader topics.

Mandatory firm rotation, re-tendering or other considerations, which for some sound like a compelling way to quickly improve the perception of independence and objectivity, in my mind will result in perhaps stepping off of that journey of continuous improvement. Mandating when companies make key governance decisions, whether through mandatory firm re-tendering or rotation, in my mind, is a blunt instrument. Harvey Pitt talked earlier about that dead man's hand, which I think will, in fact, undermine good corporate governance.

I thought I'd wrap up with five summary comments. We truly believe the profession has improved over the last several years in the area of audit quality. And yes, more continuous improvement is needed, something we are invested in and committed to accomplish. But these improvements cannot just be limited to the issues of independence, objectivity and skepticism, but rather should include the other areas of focus I mentioned earlier.

Second, expanding auditor reporting that will benefit investors is what we support in addition to the other topics on the table today. We support what the Board has proposed and the efforts they have underway. We would encourage you to enact them as quickly as possible, because, again, we want to work together to move that ball forward and take additional steps.

Three, there needs to be better engagement and more robust communication among auditors, audit committees and investors. In this regard, we believe audit committees serve as the best governing mechanisms, but audit committees can continually improve their game as well, by actually focusing on the selection of the firm, the audit partner, his or her ability to actually be skeptical. And they need to communicate that work clearly, each and every day, to the investing public.

Four, audit firms need to be more transparent in what they do. We cannot increase that trust in us, and overcome the perception issues that we have, without in fact being more transparent. For example, suggesting and performing a transparency report, or suggesting key performance indicators, or what drives quality, is something we believe in.

And finally, we want to make sure we do not rush to judgment in trying to solve the problems that may not exist to the magnitude some assume, or react to a personal view on what is perceived to be "why not?" fixes. We support today changes that enhance quality, and not ones that risk even the potential of a reduction of audit quality.

As I leave the microphone, I ask one thing of this group today. We want, hope, and honestly expect to be part of future discussions in working with you towards enhancements of the auditor's role in serving what I think is our aligned goal of serving the investing community. We have points of view to bring to the debate. We do believe status quo is not the option. And we sit in front of various stakeholders.

The question was raised earlier today, what do we brag about? We brag about the tough calls we've made and the role that we play each and every day to serve the investing public. Thank you very much for your time.

CHAIRMAN DOTY: Thank you. Mr. Veihmeyer, KPMG.

MR. VEIHMEYER: Thank you, Mr. Chairman, and good afternoon. You know, in the Board's August 2011 Concept Release, the Board asked for comments on ways auditor independence, objectivity, and professional skepticism could be enhanced. I'm here today with the other members of the profession to discuss that important and shared goal.

But first, I want to put that goal into context, because it is just one part of the Board's and the accounting profession's shared mission to continuously improve audit quality. As an auditor, I realize that the audit itself can't remain relevant to the capital markets unless it provides value. And as a professions regulator, the Board very much understands that as well, and it's released several proposals in the last year that go directly to enhancing the relevancy of the audit, such as the Concept Release on expanding the auditors' reporting model and proposals relating to enhancing the transparency of the audit, concepts and proposals that KPMG in large part supports.

But most important to maintaining or enhancing the relevance of the audit is to ensure that it is done well, that it is thorough, sound, and objective. And like you, we understand that enhancing the auditor's objectivity and skepticism improves audit quality.

I believe that audit quality at KPMG has improved since the passage of Sarbanes-Oxley and the creation of the Board. But we have to continue to monitor our work for areas of improvement, attempt to identify the root causes of deficiencies noted, and remediate issues as quickly as possible when they are identified.

But looking back across the results of our quality reviews, as well as the Board's inspections, we believe that when audit quality deficiencies do occur they are historically attributable to one or a combination of several things, including primarily methodology, training, time pressures, and professional performance. And we have found that voluntary attrition often creates challenges to the professional performance of the remaining team members.

Now, at KPMG, we've done a lot to try and address those root causes, including professional performance. However, as the Board makes clear in its Concept Release, professional performance is more than the proficient application of technical audit principles. A quality audit also requires approaching ones job with the requisite independence, objectivity and skepticism, and applying professional skepticism is about making tough choices.

At that critical point when the auditor is faced with a decision about whether to keep pushing, either pushing back on management's representation or pushing forward for more audit evidence, what forces are motivating the auditor to keep at it? And what forces are there that may be pushing in the opposite direction? And the question we're faced with today is how do we increase those forces that contribute to that skeptical mindset?

Now, the Board's Concept Release spent some time analyzing the appropriateness of reducing one possible negative force by suggesting that there are pressures that come from a desire to maintain a long relationship with the client that might best be removed. But at KPMG, we don't find a nexus between audit tenure and insufficient skepticism, and we see significant disadvantages to term limits.

One of those disadvantages is a kind of culture that a constant stream of re-tendering would likely create. Many on the Board have publicly commented on what is seen as a potentially adverse increasing sales culture at the accounting firms, but in my view such a culture is far more likely to exist in a system of mandatory firm rotation, where every year a significant percentage of a firm's audit engagements will be lost and will have to be replaced. In this respect, mandatory firm rotation would certainly increase those forces that the Board is concerned could detract from a skeptical mindset.

Another disadvantage to mandatory firm rotation is the long-term effect it could have on attracting and retaining quality talent in the profession. I spend a lot of my time focusing on retaining and attracting quality people at KPMG, and I have a sincere concern that mandatory firm rotation will make that considerably more difficult.

And with the disadvantages of mandatory rotation in mind, we look for other ways to address this issue of skepticism, independence and objectivity, principally by looking for ways that we can increase those forces that encourage the auditor to keep pushing forward at those critical decision-making moments. Many such powerful forces already exist, such as the auditor's interest in his or her own professional reputation, career progression, and compensation, our internal quality review programs, independent regulatory oversight, and the oversight of the independent audit committee. These forces can be strengthened and complemented, and we have set forth a number of proposals to that effect in our comment letter.

These suggestions, a number of

which have been implemented by some audit committees, largely reflect our overarching guiding principle, that SOX got it right when it recognized that the audit committee is in the best position to evaluate the auditor and to represent the shareholders' interests as it relates to audit quality.

The discussion of how to enhance auditor skepticism is an important one, and I'm proud to be part of this conversation today. But whatever is done to address this issue as we go forward, it's our responsibility collectively to ensure that we don't harm audit quality. And from my perspective, one of the most important ingredients to performing high-quality audits is the caliber of the talent performing the audit. So as we consider ways to continuously improve audit quality, I would urge us to evaluate any proposals from the standpoint of whether they will contribute to or detract from our ability as a profession to attract and retain the highest quality people.

Thank you for inviting me to participate today, and I look forward to our dialogue.

CHAIRMAN DOTY: Thank you, John. Jeanette Franzel.

MEMBER FRANZEL: Thank you, Mr. Chairman. I appreciate the comments made by the firms that we need to continually improve, and that remediation is also needed. I want to ask a question -- I want to have you each focus on two things in your responses.

First, you have a lot of interaction with audit committees. Where do you see opportunities for strengthened governance and really oversight of the audit on the part of the audit committees, and what have you seen that is working well?

And secondly, to what extent are audit committees actually evaluating auditor performance on a regular basis, and what does that look like?

CHAIRMAN DOTY: Stephen, do you want to start and carry it down the table?

MR. CHIPMAN: Thank you. We have certainly seen a significant increase in the capability and performance of audit committees in the post-Sarbanes-Oxley era. In terms of areas for improvement, we still see audit committees that perhaps have less knowledge of the audit process than we would like.

One suggestion that we have in our comment letter is perhaps that audit committees could have an audit expert that had a broader and deeper knowledge of the external audit process. We also would suggest that perhaps some form of training or continuing education for audit committees in the oversight, appointment and evaluation of auditors would be valuable.

And another area where we certainly see room for improvement for audit committees is in the appointment patterns. And I referenced this in my remarks. We often see audit committees certainly going through a more robust selection process than perhaps in the pre-Sarbanes era, but we often find them weighted in their judgment towards, perhaps, the size of a potential audit firm, or the strength of that brand in the market, and not always perhaps doing sufficient due diligence around the nature of the industry expertise, the alignment of the skills and capabilities of the engagement teams, and the other factors that would ensure a high quality external audit.

MR. ECHEVARRIA: And I will build on Stephen's comments without repeating them. So I, too, have seen improvement post-Sarbanes in what audit committees actually do and how they conduct themselves. Having said that, you have to recognize that the diversity of audit committees is as great as the diversity of companies. That is, you have audit committees at very large companies, and you have audit committees at very small public companies, and so how they behave around this whole process will likely be different. So step one for me, Jeanette, would be just that concept itself. Create some consistency and best practice. It's not always the same.

The second is that audit committees, just like us, are pivoting from the notion of accounting to the notion of auditing, keeping in mind that most of the dialogue was about accounting, not how we, in fact, go about auditing matters. And I think that's the next pivot point where audit committees are getting quite good, and better. And Steve's suggestion -- and ours -- about getting some audit expertise into that, besides financial literacy, would be positive.

And I think lastly, the whole notion about the extent to which they evaluate the performance of the auditor -- it's quite extensive in some companies. Not a lot of that is communicated, and perhaps communicating a lot of what audit committees already do through some shareholder/investor material would be helpful.

I do think it's a journey, and I think if you looked at audit committees today versus audit committees pre-Sarbanes, significantly different to the positive.

MR. HOWE: I would agree with several comments made already that audit committees have strengthened, I think significantly, since Sarbanes-Oxley was enacted in 2002. Even heard Arthur Levitt earlier, I think, use the word "dramatically" so in terms of their improvement.

I still believe that they're inconsistent. I think we all see that, and I think we, the firms and the profession, and you, the PCAOB -- together I think we can help audit committees continue on that journey. I think they have strengthened their expertise. I think they are taking on greater responsibility to represent the shareholders and to take responsibility for overseeing the audit, the auditors, and their hiring or firing.

Some of the things I would recommend in terms of sharing best practices, I think evaluating performance every year is what the best audit committees do. And frankly, I don't think we assume our retention on more than a one-year basis with those audit committees.

Secondly, I think audit committee chairs not only running the meetings, as they do well, but interacting with the engagement partner one-to-one between meetings, I think, has been a best practice we've seen as well. And I would also add that the partner rotation process is one that helps the audit committees strengthen their overall understanding of the entire team. When key partners, engagement partners, engagement quality reviewers are rotating, we get out ahead of that with the audit committees and they try and understand what the capabilities they need, how the fit is with the rest of the team. And I see some audit committees doing that exceptionally well.

MR. MORITZ: I think over the last ten years we've seen a continuation of improvements in the audit committees themselves, the meetings that we have on a formal basis as well as the informal interaction. Those conversations, debates and challenges are rich, robust. And when I look to your question, I think there are many improvements that have been made that we do not give investing public insight to. As a result, I do think we can be more transparent, both about what auditors do, what audit committees do, in those meetings.

So you asked a specific question around evaluating of the auditors, and I can think of the last three or four times that we went through partner rotation, at which the questions that were asked of me were A) do they have the right skill sets, industry knowledge and the like? But equally important, do they have a proven track record of challenging, challenging what's been done by management, challenging our practices, challenging each and every day what we do? And do they have that proven track record, and can I understand examples of where it has come to life?

Those, to me, are some of the best practices that need to now be done more consistently. So I go to the conversations that were had earlier today, and I think there were a number of suggestions that came through: the concept of more disclosure around the tenure relationship, the conversation around comply or explain in terms of what audit committees really do. And I would not say "do that every X number of years," but rather leave in the audit committee's hands the responsibility of annually asking that question and annually telling the investing community what it's done.

We're dealing with two challenges right now. One is the actual issue of independence and the behavioral issues associated with that, which I am somewhat skeptical of. And second is the perception issue. And the perception issue, in my mind, only gets overcome not by mandatory rotation, because I think it will still continue, but in fact more information so people can trust what is being done to some level of extent.

So I actually believe that we've got to do much more ourselves, provide better information alike from you and us, as well as make sure the audit committees do their part in this mix, also.

MR. VEIHMEYER: I would agree with the comments of my colleagues. The only additional thoughts I think I would add are, I think if the investing public, and many people who have concerns which are giving rise to some of the perception questions that are being asked as part of this proposal process, could actually participate in, witness, observe the rigor that takes place not only in the audit committees -- and this is, I think, Jeanette to your question -- one of the significant improvements that I've seen since Sarbanes-Oxley is the amount of rigor that takes place outside of audit committees, between audit committee meetings, particularly between the audit committee chair and the firm.

The amount of rigor, time, effort and focus that goes into those processes, I think, would allay many of the perceptual concerns that exist out there. There are, as some of the other firms have summarized, as we have certainly included in our comment letter, some recommendations around "How do we continue to enhance this?"

I think we put it on the auditor to look for ways to continue to provide greater communication with the audit committee, specifically with respect to this issue of skepticism and helping the audit committee understand what is the nature of that dynamic that I talked about earlier, that critical juncture in the audit when the partner and the staff have to decide "Am I going further, or do I have enough?"

I think one of the recommendations we included in our letter was greater communication and conversation required between the committee and the auditor around those highest-risk audit processes and conclusions that you reached, and what was the quality, extent, and nature of the evidence that you saw that led you to that conclusion?

So more rigor around the specifics that led you to the conclusion, I think, would shine a brighter spotlight in the nature of that relationship between the committee and the auditor, on those key moments in the audit when, upon inspection, we may have situations where, to the Board and from an internal inspection standpoint, we would wish the auditor pushed a little bit further, asked one more question, or went and found one more source of objective evidence. And I think that could be helpful as well.

CHAIRMAN DOTY: Jay Hanson?

MEMBER HANSON: A couple of you mentioned the challenges of the most difficult calls that sometimes need to be made. And we've all been in those spots where you have a pit in your stomach about the call. And I'm thinking also about the partner rotation requirements of Sarbanes-Oxley and bringing in a fresh set of eyes as a way to avoid the same partner looking at the same facts and not challenging.

On the panel right before this, Professor Richard Kaplan in his written submission had a comment, effectively, that said "Long-term client relationships are far too important to be jeopardized by a single difficult partner."

And so this is a question around

what tone do you set individually, as the CEOs of your organizations, and then how does it get supported throughout the organization, to back up those partners -- and any employee -- that says "You know, I don't agree with what this really important client that we've had for many years is doing, and I think we have to confront it." And that partner's being a difficult partner to the client, so what are you doing to set the tone about that and support that through the organization?

And then I also want to pair that with the flip side of the question, which Professor Kaplan also referenced the Enron situation, where the national office had reviewed a complex situation, given their conclusion about the proper accounting, and the engagement partner was allowed to overrule the national office. So effectively this question goes two ways: what are you doing in your firms to make sure that the national office experts that rule on the accounting or the auditing actually get implemented?

How about we start with John this time?

MR. VEIHMEYER: Thank you, Jay. I appreciate that. I thought I was going to get to go last on every topic here. Is this because I'm the shortest, or my name begins with V? I wasn't sure what order we were going in.

MEMBER HANSON: I was just being kind.

MR. VEIHMEYER: You know, I think your question is probably one of the most fundamental and important, Jay, around the tone that we set. I think you do that in a lot of little ways every day in your interactions with your partners, and you do it in some big ways in terms of decisions you make around compensation strategies and other very broad issues that have far-reaching, I think, cultural implications through your firm.

And is your compensation system, for example, more aligned to rewarding long-term contributions of a partner to the firm, as opposed to short-term hits or wins, or whatever you might want to reward on the flip side? Is it largely -- for an audit partner, is there a large incentive or variable component, or again do you have a compensation program which takes into account over a period of years the aggregate performance of a partner, and not what may be happening in his or her portfolio in a given year?

So I think there are some very broad structural issues that are important, but the ones that really get, I think, repeated throughout the firm are the interactions you have and the situations that arise that typically spread like wildfire through the firm when we have a tough situation.

And certainly in my role I'm probably benefitted from the fact that I spent the bulk of my career as a professional practice partner in our audit practice, as an SEC reviewing partner. So that's what I've spent my career doing. But I certainly believe a big part of my role now is, when we have difficult situations with our clients, that I am there side by side with our partner, supporting that partner in those discussions. Not just behind the scenes, saying "Head into the line and do it full force," but making sure that that partner feels like he or she has the entire weight of the firm behind them as they go into very difficult discussions with the clients.

So the decisions you make in individual cases like that, I think, send a very strong message. And it's one of the most important roles we fulfill as CEOs of our firms, I think, to set that proper tone.

MR. MORITZ: Jay, it's a great question, of which I would focus on five or six different areas. Number one, the tone at the top has to be set in terms of what is a priority for the individual firm, our partners and the like, and exemplify that through communications, which I send out every two weeks -- examples including where we've actually walked away from a client or made a tough call -- and the storytelling that has to happen in every office you go to, not just with the partners, but with the entire staff, so they understand the importance of this.

Second, you have to put the policies and procedures in place to reinforce that and ensure that the compensation mechanisms to try to incent the right behaviors and overcome the perceptions and the biases that might be there, based upon the earlier panel conversations, have been, to the best of our abilities, overcome. And if not, put the appropriate checks and balances in place to yet again try to overcome whatever, in fact, may be there.

Third, you need to put the right

support in place. This is a very difficult job of which, yes, there is tremendous amount of second guessing. So you need support to deal with the complexity of what's the right accounting and what's the right auditing that needs to be done, and that's where, in fact, investments are being made. You go back to our quality report that we issued in August in terms of additional investments to provide that support.

And you actually then go to the issue of exemplifying in terms of what's important, through the areas of what was important in terms of what people got compensated for. And again, bringing that to life with real, live examples, and let that word spread virally across the whole firm in terms of management and the tone at the top, in fact, supports this.

I want to come back to, though, two things that were said earlier today. Number one, there was a presumption that, quote unquote, "An audit partner will actually never risk losing a client, and they don't want to be that person." And I will tell you that the world has changed dramatically over the last ten years for the reasons I talked about in my opening comments.

And in fact, the name of that partner will be long forgotten and replaced, in fact, instead by the name of the partner that got it wrong, and the fact that they implicated the brand of the firm and -- which is very important in terms of what happened over the last ten years -- and that there were regulatory issues now that we are a regulated profession. And there is a specific accountability that is much more evident than ever before, that is yet another incentive to get it right.

So there are many checks and balances. And I think John Bogle earlier this morning talked about that reputation risk not being enough, and I would say it's not enough.

In fact, it has changed. It is well beyond that today.

The last point I would make is that, as you go back, one of the things that we have tried to do -- and I exemplified it with the survey that we just talked about -- is make sure that we're doing all we can to test that those messages are getting through, and to make sure that what we are saying at the top is 1) actually understood by those underneath, and it's actually coming to life in behaviors.

And that's why we ended up piloting this survey that I just talked about, in terms of asking people to prioritize, what's most important in this firm? Asking them how is it they can do their jobs better, and what other support we can give? Because the world we live in is a tremendously complex world, and changing each and every day, and our challenge is actually to stay relevant to the teams, to make sure they do the quality jobs in being independent and skeptical, and have all the tools and techniques necessary to do the job at hand in serving the investing public. So there's a multiple amount of angles to play this, of which we have to do more each and every day.

MEMBER HANSON: Before we go on to Steve -- and John, I let you off the hook on this question -- the question of the line partner overruling the national office, like we saw in the Enron situation.

MR. VEIHMEYER: I think we have very specific protocols in our firm, and the engagement partner has primary responsibility for audit decision and accounting conclusions reached on an audit engagement. Having said that, we have certain matters which, if they arise on an audit, require mandatory consultation with our national office. And we encourage a culture and an atmosphere of consultation in the firm, that these are firm decisions and there is a significant network, and our national office is certainly a critical component of that, supporting an individual audit partner as he or she is making difficult decisions on their clients.

We have very specific protocols in place in terms of consultation. Once you consult with our national office, the process that occurs and evolves once you initiate that initial consultation -- it is, in 99 percent of the cases, a very collaborative working through a set of facts to get to an answer, so I don't want to imply at all that those consultations often or typically arise in differing points of view and someone has to decide who has the ultimate call.

But when that occurs, if in fact at the end of a consultation process the individual engagement partner has a different point of view than our national office, then there is an escalation procedure within our firm to resolve that and we come to a firm conclusion. It is not acceptable, and our partners understand that they do not have the ability to arbitrarily override or ignore the input and conclusion of our national office.

MR. MORITZ: With all due respect to Mr. Kaplan, the world has dramatically changed since Andersen and Enron. Someone earlier today said, actually, the original auspices of the Sarbanes-Oxley Act was actually to increase, quote unquote, "the independence, objectivity, and the skepticism of the firm, and the only thing that was done was identifying a five-year rotation period for that audit partner." And I would respectfully disagree with that.

We changed the audit reporting requirements. We changed the rotation of auditors. We actually changed scope of services. And yes, we put a regulatory oversight Board and you all on top of us, which as a result required us to change our policies and procedures that John just talked about. So again, when you look at that issue of the national office, I would say all of us -- and I can't speak for the other four panelists today or those that will be speaking tomorrow -- have significantly changed our processes, procedures, and the expectations of our partners, and the teams, and the national office, for getting it right.

And then you should hold us accountable, in fact, if that's not the case and if it's not happening, which you obviously do in your inspection process and thinking about what's there in the tone of the firm, tone at the top of the firm, changes to policies and procedures, and suggestions that you all make to us as an independent third party looking at our policies and procedures.

MR. HOWE: I will try to be additive and not repetitive. They've made some good points, and it's a good question. I'd also commend the PCAOB, because you do believe in tone at the top and tone throughout the organization. And the investor public ought to understand that you hold us accountable for that, and that's the right thing.

I believe it does start at the top. I believe it's my responsibility to make sure our Board discussions are appropriately focused on tone and cascading that through the organization. But a lot of that happens through our partners on their teams, and I wish many of them were here today to speak to you. They do believe in it.

At Ernst & Young, we operate in accordance with a common set of values around the world as well. I heard Stephen mention that for Grant Thornton, words like courage, integrity, and doing the right thing are part of our values, and any one of our 150 thousand people-plus could recite them, and that's important too.

We also believe in sharing. At our most recent assurance partners meeting, where Chairman Doty came and addressed the group of 1,000, that same day partners were sharing stories. Just like this. Difficult decisions, how the firm supported them through those issues, how we constantly are focused on getting to the right answers. That's very important, that sharing.

And with respect to the technical questions, I think as we sit here today I would tell you that, over the last couple of months, this has been happening over and over. I'm sure all of us have been involved in these discussions, but where it is really happening is through our top technical teams, with those teams serving companies we audit. And they are working through these issues.

At Ernst & Young, we too have structure to enable that appropriately, and we very much endorse a culture of consultation, for two reasons, really. One is, no one of us is as smart as all of us. But secondly, with more than one involved, we're always focused on getting to the right answer and doing the right thing. Again, so I think you'd feel good about what's been happening in the busiest of our seasons these last couple of months.

MR. ECHEVARRIA: Again, I'll be additive to what was said. To the second question you asked, Jay, that one I think is a bit simpler. We all have, I believe, similar processes. There really is no way, theoretically, for someone in the line to just disregard the conclusion of the national office. But what are the safeguards? Well, the safeguards are, once you initiate that consultation, you must see it all the way through, conclusion to issuance. So we would have good instincts and knowledge about whether or not those decisions actually manifested themselves in the opinions and the reports of those financial statements appropriately. So that has been said, but I know that it's fundamental to what we all do.

As to your first question, there no longer is, in my view, a partner, one person, that's making that decision. It becomes more of a team making the decision. I think Valarie from Proctor & Gamble talked about the number of partners that serve an account. So in the large, complex ones, it's never one person anymore. It's a broad team. We put advisory partners there, who are very senior partners, to help the LCSPs engage. I serve in that capacity, basically so that we stand up to the right issue, and I think Steve talked about it, the values, and I think we all have the same values.

I can give you a personal experience, though. Nothing's better than what really happens to one of you. You know, I was one of those partners in my professional life that lost a client that the firm had for 45 years. And I sit here today. So it's not the end.

(Laughter.)

MR. ECHEVARRIA: For the record, I didn't say that.

(Laughter.)

MR. ECHEVARRIA: So it's not the end in the firm. It's a longer run. It's more than that. And we really do believe in sustained relationships in terms of who we serve and the committees that we represent.

MR. CHIPMAN: Thank you. Setting the appropriate tone for the organization is my single most important responsibility, I believe. And as part of that, it's important that you create what I would describe as a safe environment, a safe environment where audit partners and teams can do the right thing, make the tough calls, and know that they are safe and embraced.

We put a lot of emphasis on tone. If you go into our training room in Chicago you will see the portrait of my predecessor with his quote about "Without quality, we have nothing," and I refer to that regularly. But what's really important is, how do you translate tone into behavior?

And this actually leads into your second question, Jay, about the interaction and oversight of the national office. Because we have two mantras, if you like, that we use to try and move tone to behavior. One is "Consult early and often," and two is "Don't go it alone." And we pound those mantras, not to become just sayings, but to drive the behavior, which I think we've successfully done, of a very collaborative and consultative level of engagement between our audit teams and our national office. And I think that has led to a much more effective oversight and involvement in a very positive and constructive way for our national office, and we do share all the same protocols that have been already talked about.

The last comment I would make on this point is that we do celebrate and highlight when people do the right thing. And I think that's very important. We also will highlight and make very visible when tough decisions were made at the top of the organization. Early on in my tenure as CEO, I had to make a very tough call over the retention of a significant audit client, and we chose to exit that relationship. We made sure that everybody knew that I had made that decision, and the reasons why, without, obviously, breaching any confidentiality.

CHAIRMAN DOTY: Lewis Ferguson.

MEMBER FERGUSON: I think the one comment that probably every single commenter today would have agreed with is that communications between auditors and audit committees are absolutely vital, and strengthening those has been one of the things that Sarbanes-Oxley did, but that we really need to keep doing.

And with regard to that, I want to ask you a question, or maybe a sort of complex of questions, about how you help audit committees understand whether they should, when they're making their retention decisions, whether they should retain you. How do you help them evaluate what you've done? Presumably the audit committee is familiar with the work of the particular audit they're doing, but there's a lot of other work involved in your firm, showing its capabilities, its strengths, and its weaknesses.

And specifically, I want to ask you about the PCAOB inspection reports, which are documents that are the views of the regulator on your firm. I think we would all agree that Part 1 of those inspections isn't particularly useful. We're constrained in terms of what we can say. Part 2 of the report provides a lot of information. We are constrained from giving that out. The SEC is constrained from giving that out. And with full deference to understanding the remediation time you have and the possibility of waivers of privilege that are concerns with respect to that, do you share that document, which you could share? Do you think it would be useful to share it? Do you think it would provide useful information to audit committees? And if you don't share it, why don't you?

MR. MORITZ: I am happy to start. I would say that the PwC organizations here in the States, and hopefully around the world, do it in two ways. Number one, by hosting a series of audit committee forums and interacting with those Board of directors and audit committee personnel and explaining A) the world that we live in, 2) the challenges in front of us, and 3) how, collectively, we can work together to make sure we overcome those challenges.

So there's a broader educational aspect to what we do, and there's a broader responsibility to make sure that, again, those that sit in front of us are well-informed in terms of the challenges ahead. I'll go specifically to what we did this past year.

Again, I'll go back to the quality report that we issued. Within that, we identified what we thought were six or seven areas where we, PwC, believed we needed to make improvements. We came up with those based upon the combination of our own inspections process findings, your inspection process findings, and then our root cause analysis of, in fact, what needed to be done.

And then what we tried to do was talk to individual audit committees, and asking our partners to do that, and then broader, at audit committee large forums, in public areas, around what it is we're doing, why it is we're doing it, and in fact, here is the information you need to think about, quote unquote, "the performance of PwC."

I think in that regard, it is now starting to get more information in the hands of those, Lew, that have to make the decisions around, quote unquote, "the appointment or retention of an auditor," and that's why I go to the fact that we can do more in terms of more disclosures, specifically around Part 2 disclosures, around that. But again, I think in some reform we've started to do that.

Second is, again, the translation, is hopefully the fact that we engage audit committees to talk about the robust conversation we had, so the investors are seeing it, hearing it, feeling it in a different way, and thereby enhancing, quote unquote, the level of trust in the auditors, hereby enhancing the level of trust in the role of the audit committee representing those investors, and actually up in the game so we can actually deal with both fact around independence, objectivity and skepticism, as well as quality, but also the perceptions that are there.

So those would be the two examples I would point to.

MR. ECHEVARRIA: I'd be happy to go next, Lew. At Deloitte, I would say it's been an evolution. If you went back to the first time those reports were received, back in the early 2000s, and you go to the most recent ones, I think we've moved from a place of having very macro, summary conversations about what might be in Part 2. We did a transparency report, and we spent a few pages about what might be in Part 2. And in the last audit cycle -- it might be two -- we actually sat and took them through the real details of what's in Part 2 over a time horizon. Here are the issues that continue. Here are the ones that we believe have been successfully remediated. Here are the challenges that we're having.

We map that up against our root cause and what we see, to decide which ones we think are longer-term in nature and which ones are more finite and acute. And we get pretty detailed. We start now with the -- we have the benefit of having the Part 1s published. I personally, this last busy season, went around to about 25 different audit committees and had individual conversations about the contents of Part 2s for all of the years that were in existence.

I think the challenge is putting it in context for audit committees. Again, this is an auditing concept, and they're still focused on accounting and the outcomes of accounting. And so pivoting around that becomes difficult at times, but I think it's getting better. I do think the advent of what you've done has created more interest. I do think they have more interest in how we are viewed by you, and I think that's pushed us in a position of to be more responsive in terms of communicating. So we actually do now -- we're working on the next busy season, on how to make this more systemic.

You know, when you have an army of 1,000 partners communicating, and you're not in the room with all the 1,000 partners during the communication, you've got to put something in a framework that they can effectively do on a consistent basis, and I would say that's our next challenge, at least at the firm.

MR. HOWE: I can see we're better when we go in a straight line, but I'll jump in here.

(Laughter.)

MR. HOWE: I would say this. I think audit committees, first of all, are more interested in asking those questions about our relationship with you, our regulator, and I think that's appropriate and that's good for the profession. We do not share Part 2 report in its entirety, but we very much do talk about the issues.

We also talk about the process. You have implemented new processes in the last year, and we're talking about that with companies we audit and audit committees, talking about how you've introduced this letter asking for us for a 60 day plan to address those issues. We talk about the Board meetings that we have with you, which are very granular. We let our clients know that, and we talk to them about the dialogue we have, and some of the issues that we're dealing with.

So I think this is moving in a direction of much more open dialogue, and they need to understand the level of seriousness with which we're taking your comments, and the level of seriousness with which we're implementing actions to make sure that we're on side with our regulator. That's what they need to hear, and that's the conversations we're having.

MR. VEIHMEYER: Lew, we do not share the full report with our clients. Having said that, I think -- and I probably echo Joe's comments earlier in terms of the evolution that has occurred, and I would say those conversations are much more rigorous in the last year and a half, two years, than they had been in earlier years, without question, including Part 2 in terms of the nature of the items there, what issues we are remediating from a firm-wide standpoint, and what that means to the company we may be having this discussion with.

So I think the discussion is taking place. I will say, though, there are varying degrees of interest among audit committees in terms of how detailed they would like to get. One of the recommendations we included in our comment letter response was to try and drive more consistency and best practice around the type of communications that should take place between the auditor and the audit committee in all cases, as opposed to leaving that to kind of particular practices in any particular audit committee or company setting.

And again, I think most audit committees are most concerned with anything in the inspection report that would be relevant to their audit. And so, for example, if we are -- if I'm having this discussion, which I do regularly, with an audit committee that is not in the financial services industry, they are much less interested in any of the things, either in Part 1 or Part 2, that may relate specifically to the audit issues uniquely found in our financial services practice, and vice versa.

So I think it's a targeted discussion of the things that we believe, and the committee has demonstrated and expressed an interest in being briefed and informed on, that are relevant to the audit for that particular company.

MR. CHIPMAN: I won't repeat the comments that have already been made, except to say that we do not share the entire letter, but in order to provide, as Joe mentioned, a more systemic approach to communication around this particular set of matters, we have a standard slide deck that we provide our audit teams to use for audit committee communications. We obviously expect those to get tailored.

We now include in that standard slide deck several slides, one that would allow them to -- and actually, they would have to communicate, based on our own internal process, any inspection findings in Part 1 that were specific to that particular audit client. And then secondly, there are slides that deal with the results of our inspection process as a whole, whether it be Part 1 or Part 2, the feedback that we've got through that process, what we're working on, how we're working on those matters to remediate and improve our systems of quality control, and engage them in a conversation.

And I would agree with the comment that has been made, there are differing degrees of interest from audit committees, and we have to guard against differing degrees of presentation from our partners. So we try to alleviate that issue by having senior partners, members of senior leadership and others, attending those audit committee meetings to help guide those conversations to ensure that they're robust and appropriate, and that the audit committees are getting the full extent of the feedback that they need to evaluate our performance on the audit, and also our performance as a firm.

CHAIRMAN DOTY: Steve Harris.

MEMBER HARRIS: First of all, I want to commend you for your working with us to expand the audit report, and also with respect to enhancing the transparency of the audit, both of which are important to, I know, a number of investors.

A great deal of attention has been paid to communications between the auditors and the audit committee, but I think that investors want more, and I think they want more through the audit report. And I know that you're picking up that message and working with us on that with respect to giving them more of an idea in terms of what the significant risks are that you're detecting. I think that they're concerned, also, with respect to issues, as you're aware, of going concern during the financial crisis, how we work on the going concerns. So I very much appreciate your acknowledgment of those issues as legitimate issues that we can all work on together.

I think I know pretty much your reaction to virtually all the recommendations that we heard in the panel earlier, so I'm not wanting to go through them all. But let me just ask you about one, and that is that Chairman Pitt recommended that independent audit committees be required to consider, and document their consideration, whether the performance of auditors over a prescribed period of time -- say five years -- affirmatively warrants the reappointment of or dictates the movement away from the accounting firm that currently audits the particular company's financial statements.

And I was going to ask him to what extent that's totally within the jurisdiction and realm of the Securities and Exchange Commission, what's in the realm of the PCAOB? I think those issues are of interest to us at the PCAOB, and he's a very imaginative and creative person and so I was sorry that the Chairman ran out of time and I wasn't able to ask him that directly. But with respect to that recommendation, what would be your response to that?

MR. VEIHMEYER: We are obviously anxious to all answer this question, Stephen. You know, with respect to enhanced communication between the audit committee and stakeholders around conclusions they've reached with respect to reassessing the auditor, I think personally we are very supportive of looking for ways to enhance that communication. Because, as we said earlier, my view is, it's a fairly rigorous process that is undertaken, and it would provide some greater confidence in the marketplace if there was greater visibility into that.

My view is that should not be an episodic requirement, as opposed to an ongoing requirement. I think, consistent with some of the comments that were made by my colleagues earlier, irrespective of how many years we have been serving as the auditor for a particular company, I think we very much -- and the vast majority of the audit committees that represent those companies believe that this is a continual process.

There is a formal process every five years tied to, as Bob described earlier, rotating an engagement partner that leads to some unique conversations about the relationship, but I think our best audit committees recognize that on an annual basis they should be applying all of that rigor to understanding how that audit firm is performing, and whether or not that audit firm is still meeting the best interests of the company.

So my concern with tying that recommendation to some episodic timetable is, it seems to me to run counter to, I think, the culture that we would try and create in the committee-auditor relationship of that it's a continual and ongoing process.

MR. HOWE: I would agree. As John said, looking at the area for more communication is a good, I think, conversation for all of us to be having. I also would be concerned about a specific period, such as that suggested by Chairman Pitt. And the reason really is, I think it can become close to mandatory re-tendering. If a company was required to disclose every five, seven, ten years lots of specifics about a process, I think the question would be asked "Why didn't they go through an actual process?"

And so I see it as a slippery slope towards mandatory re-tendering, and I think it's important that we also have the debate about that. We believe mandatory re-tendering has many of the same shortcomings and risks to audit quality, as does mandatory firm rotation. And in particular, I would point out the risk of our people being involved in perpetual marketing, is a term I've used.

I've watched this happen in some markets, most recently in Brazil. And frankly, with all the important audit work we have to do, we just don't want tens and hundreds and thousands of auditors engaged in pursuit activity for tender processes, as opposed to audit activity. And so that I see as the biggest risk, and I think companies should focus on what they're doing annually to assess that audit relationship.

MR. ECHEVARRIA: Without, again, adding to the comments that were made, I do agree with Steve -- Steve, to your point, and Steve, to your conclusion on that point --

that if we're talking about documenting that which the audit committee does annually now, I think that's a good thing. Because audit committees, right now, annually reach that conclusion. And they go through quite a rigorous process to get there.

So I'd be in favor of that. I believe we'd be in favor of that approach, because it already takes place. And if putting it in the sunshine makes it better -- one of your Board members always reminds me that sunshine is the best antiseptic -- and if you put it in the sunshine and make it better, we would be an advocate for that.

If it just got picked at some arbitrary format that made it feel like it was something different, I don't know if it would accomplish the same objective. Because right now, audit committees do that on an annual basis, and putting that in documentation, I don't see why that should be a problem. I see that as a benefit, Steve.

MR. CHIPMAN: Steve, I, as I said earlier, would be very supportive -- and our firm is very supportive of a more robust selection process and increasing and improving the transparency and communication around that. We would encourage that that includes in that transparency and communication a recognition by the audit committee that they have reviewed all appropriate choices, and it's our indication that at times they are overlooking other or additional choices which could be relevant and appropriate for conducting their audit in a high-quality manner.

That choice, that competition, we believe, will lead to higher quality. And a more robust, transparent improved communication process around audit committee selections, we believe, would lead to that enhancement in choice, and therefore quality.

MR. MORITZ: Steve, one other point I'd like to make. First, yes, I'd be supportive of what Harvey provided. Second, to the point that was made, I think it's an annual as opposed to a time-determined assessment. Three, I think by doing so takes best practice to consistent practice, and I think Joe said earlier there is an inconsistency amongst audit committees, their performance, and the reporting on that performance.

And I will say that, over the last two and a half years of being in my role, I walked in with the hope that different stakeholders in the corporate reporting supply chain would volunteer to do things differently. And through the conversations that we've had around the role of the auditor, as we've looked beyond what you all have proposed in terms of what should change -- not only for what the auditor does, but what corporate governance mechanism change, or what the preparer community needs to change -- it is clear that it is very hard to get people to do so on a voluntary basis with the litigation environment that we have in the States, which is much different than the rest of the world.

So to the most important part to your question, would you actually require this by law or some other practice? I would say yes. I think we actually now have to start to do that. I know that is not ideal, in a scenario where you hope for the best, but I think actually going to rulemaking in this regard, in terms of taking that journey from where we were in Sarbanes in terms of the specific accountability, and then refining it for another step on the journey, is the right thing to do.

CHAIRMAN DOTY: We are winding down. And I would say that I think one would have to agree that Sarbanes-Oxley has changed something fundamentally. As one who was around when Arthur Levitt was proposing the original separation of non-audit services from audit services, I reflect on how different the quality of this discussion is, and how different the interaction of the major firms with the regulator is. And I think that's something that, I would hope, we can all be proud of.

One hears, I think, what one wants to hear, but what I think I heard in the course of this discussion were some extraordinary steps or breakthroughs that you all are coming forward with, they largely relate to the building on what we have, which is advocated in your various comment letters, but they go beyond it.

I think, first of all, in the building area I thought I heard substantial support for our re-proposed communication with audit committees release, for doing something with the audit reporting model that would make the audit reporting model more relevant, that would get to some of the disclosure issues that relate to estimates and significant accounting policies.

I thought I heard out of that come, clearly, some indication that strengthening audit committees by making them better and wiser and smarter about what could go wrong in related party transactions would also be something you all would look favorably on.

But then I was really struck by the notion that there should be greater transparency in the key performance indicators. That in other words, you all would, as a series of businesses with a business to run and commercial decisions to make, you would start building morale and building your attraction to recruits, and your retention policies, by showing the public more of what you did by way of key performance indicators, to assure that they're going to get a better audit, and to assure that the incentives are aligned within the firm.

I think this is an extraordinary -- that's the kind of thing Jack Welch used to talk about. And then the notion that the PCAOB should engage the audit committee directly, that more should be laid down institutionally by ourselves and the SEC to facilitate that in a structured and disciplined way, I thought that was an extraordinary thing that came out of the last hour.

A recommendation by the PCAOB to the audit committees should be made when we found things that indicated a lapse of quality tied to tenure. If that happened, we should be communicating that directly. And that presumably carries with it some governance and some disclosure issues. Whether it's something we do, or would do, or could do, it's a grave responsibility that we have in all cases.

But that is groundbreaking. I guess, time having expired, me having run out of time, I want to thank on behalf of the Board, thank all of you for a stimulating session. We will go forward tomorrow. We will hear more of all of these issues. But I think that this certainly ranks as one of the most extraordinary exchanges in a public meeting that could have been put forward at this time, and we thank you. You've made it happen.

(Applause.)

CHAIRMAN DOTY: Applause? Nobody gets applause. Regulators and accounting firms don't get applause.

(Whereupon, the above-entitled proceeding went off the record at 5:27 p.m.)

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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Auditor Independence

Before: Public Company Accounting Oversight Board

Date: 03-21-12

Place: Washington, DC

was duly recorded and accurately transcribed under my direction; further, that said transcript is a true and accurate record of the proceedings.

Neal R Gross

Court Reporter