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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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THURSDAY  
JUNE 28, 2012

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The Public Meeting convened at the Hilton San Francisco Financial District, 750 Kearny Street, San Francisco, California, at 8:00 a.m., Jim Doty, PCAOB Chairman, presiding.

THE BOARD

JAMES R. DOTY, Chairman  
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JANICE HESTER AMEY, Portfolio Manager, Corporate Governance, California State Teachers' Retirement System (CalSTRS)

ANDREW D. BAILEY, JR., Professor Emeritus, University of Illinois at Urbana-Champaign; former Deputy Chief Accountant, US Securities and Exchange Commission

WILLIAM H. BARIBAULT, Trustee and Independent Director, American Funds; Chairman, Oakwood Enterprises, Inc.

JAMES D. COX, Brainerd Currie Professor of Law, Duke University

WILLIAM D. CVENGROS, Trustee and Independent Director, Janus Funds

CHARLES R. DROTT, Independent Consultant

ROGER DUNBAR, Chairman of the Board and Audit Committee, Silicon Valley Bank

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DAVID FOLLETT, Chief Practice Officer, Moss Adams LLP

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C. BRIAN FOX, Founder, Confirmation.com

DAVID GERALD, Founder, President and Chief Executive Officer, Securities Investors Association Singapore

KENNETH A. GOLDMAN, Senior Vice President and Chief Financial Officer, Fortinet, Inc.

CONRAD HEWITT, Director, Bank of the West; former Chief Accountant, US Securities Exchange Commission

BONNIE HILL, Co-Founder, Icon Blue, Inc.; President, B. Hill Enterprises LLC; Director, The Home Depot, Inc., Yum! Brands, Inc, AK Steel Corporation and California Water Services Group

ERIC KELLER, Chief Operating Officer, Kleiner Perkins Caufield & Byers

KOICHIRO KURAMOCHI, Deputy Chief Accountant, Corporate Accounting and Disclosure Division, Financial Services Agency - Japan

MIKE KWATINETZ, General Partner, Azure Capital Partners

RICHARD D. LEVY, Executive Vice President and Controller, Wells Fargo & Company

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

2 (8:18 a.m.)

3 CHAIRMAN DOTY: Well, welcome, everybody, to the  
4 Public Company Accounting Oversight Board's second public  
5 meeting on the Board's Concept Release on ways to enhance  
6 auditor independence. A couple of logistical matters.  
7 Our practice here has been to take a break occasionally,  
8 and I have the intention of providing for 10 or 15-minute  
9 breaks before the third and fifth panel this morning, and  
10 again, at appropriate intervals, the same intervals this  
11 afternoon. So we will have breaks. Our methodology has  
12 been to move through the statements of panelists and then  
13 to open the floor for questions and engagement by the  
14 Board. And we will begin the session this morning with  
15 some brief opening statements by Board members that will  
16 lend a little context to where we are in this process.

17 It's the second meeting on our Concept Release,  
18 but it's the first meeting that the PCAOB is held on the  
19 west coast of this type. This meeting will give us the  
20 opportunity to benefit from important perspectives with  
21 investors, financial statement preparers, academicians,  
22 and firm professionals and regulators who participate in

1 our financial markets. We have venture capitalists,  
2 audit committee chairs and CFOs on today's panels, and  
3 we're eager to hear from all of them.

4           The Concept Release that we issued last August  
5 was intended to begin the discussion of auditor  
6 independence and the factors that can jeopardize the  
7 fundamental investor protection -- that fundamental  
8 investor protection of auditor independence. This round-  
9 table is the next step in that journey.

10           The PCAOB benefits from the diverse range of  
11 views that have been gathered through the comment  
12 letters, the round-tables and the public discussions.  
13 And this public meeting is an extension of that  
14 interaction. We are honored today to have the  
15 participation of former SEC Chairman, Harold Williams.  
16 We're going to benefit from the wisdom that he has  
17 accumulated over a long and distinguished career  
18 protecting investors and promoting strong public  
19 disclosure.

20           We're also deeply grateful for the time spent by  
21 the many other speakers who are scheduled here today, in  
22 preparing and participating -- preparing for and

1 participating in this open meeting. We have had  
2 statements submitted by the Black Economic Council, the  
3 NACD, the National Association of Corporate Directors,  
4 has a strong interest in this program and in this  
5 outreach. And while we have not been able to include  
6 everyone on the panel today in the space of the day, we  
7 look forward to doing so in the future.

8 I would not predict the outcome of the debate,  
9 but I expect that we will all benefit from a robust  
10 debate on approaches to improving independence,  
11 objectivity and professional skepticism. Most of all,  
12 I want to thank the dedicated PCAOB staff, many of whom  
13 you see before you, and whose efforts have made this  
14 meeting possible, our Office of the Chief Auditor, our  
15 General Counsel's Office, and the entire staff who are  
16 around the premises today. And we are, as always,  
17 grateful for the participation of the Securities and  
18 Exchange Commission, and the Deputy Chief Accountant,  
19 Brian Croteau.

20 With that, I'd like to turn this over to my  
21 colleagues for a statement. Board Member Ferguson?  
22 Thank you.

1           MEMBER FERGUSON: I just want to say how much we  
2 appreciate your coming here and taking time out of your  
3 busy schedules to help us with this. These are difficult  
4 and complex issues that we're considering. And the more  
5 widely we consult, and the more -- the greater the  
6 breadth of views we hear, the more we are informed in  
7 terms of both thinking about them and taking action, if  
8 that's appropriate. So I simply want to say thank you  
9 very much for coming here.

10           CHAIRMAN DOTY: Mr. Hanson?

11           MEMBER HANSON: I also want to thank all the  
12 panelists and say good morning to all of you. We heard  
13 good discussion in March from a wide variety of  
14 constituents and certainly no consensus, but lots of good  
15 debate we had there, and good viewpoints.

16           I'm very interested to hear the viewpoints of all  
17 the panelists on things, in addition to mandatory firm  
18 rotation. The thing that we seem to hear the most about  
19 is the references to audit committees and what audit  
20 committees could and should be doing to discharge their  
21 responsibilities under Sarbanes-Oxley Act. And we've  
22 heard some -- from some very prominent audit committee

1 members about the things they are doing. And I'm looking  
2 very much forward it hearing from some prominent audit  
3 committee members today as well.

4 One of the things that is a common theme coming  
5 from, from a wide variety of constituents is what more  
6 we could do at the PCAOB to provide audit committees more  
7 information about what we do and what we see broadly, as  
8 well as on individual audits that we inspect. And we've  
9 had some firm representatives advocate that -- that being  
10 able to provide audit committees the direct information  
11 about what we saw in the audit of the company that  
12 they're responsible for would be helpful. We've had many  
13 audit committee members say that. Some of the folks here  
14 today have included that in their statement.

15 And even in Chairman Doty's recent testimony  
16 before Congress, Congressman Waters asked specifically  
17 if that's something that would need legislation, and  
18 something that we would advocate. And so I personally  
19 think that we should have more discussion on that to see  
20 if it is something that would be of a benefit to the  
21 audit committee to help them discharge their  
22 responsibility so that we can raise the level of all

1 audit committees to what we observe as some of the best  
2 practices.

3           So with that, I will turn it over to Mr. Harris.

4           MEMBER HARRIS: Well, thank you, Jay. Thank you,  
5 Mr. Chairman. And in my opinion, there is no more  
6 important issue confronting the Board than ensuring the  
7 independence, objectivity and professional skepticism of  
8 auditors as they conduct their audits. Both our own  
9 PCAOB inspection reports and those of many of our  
10 international counterparts recognize that more must be  
11 done in this area. Whether the answer is mandatory  
12 rotation, re-tendering, greater transparency of audit  
13 tenure, as Jay indicated, enhanced independent audit  
14 committees, or any of the other recommendations that  
15 resulted from our first round-table discussion, or any  
16 of those that may be offered today, I believe that all  
17 alternatives must be thoroughly considered to further  
18 shareholder trust in the quality of the audit.

19           I believe that the public policy-making process  
20 is best serve by hearing from all interested parties in  
21 open deliberative processes such as we are conducting  
22 today. And while some of the recommendations we have

1 heard so far are within the SEC's jurisdiction, not ours,  
2 I believe the record we are creating may serve as a  
3 potentially valuable tool for their consideration as  
4 well. I join my colleagues here in looking forward to  
5 an illuminating and robust discussion of the many  
6 implications of our Concept Release on auditor  
7 independence. Thank you, Mr. Chairman.

8 CHAIRMAN DOTY: Board Member Franzel?

9 MEMBER FRANZEL: I also want to thank all the  
10 panelists and the staff and their constituencies for  
11 taking the time and effort to come here today to discuss  
12 this important topic.

13 Obviously, auditor independence, objectivity and  
14 professional skepticism is a very complex topic. And the  
15 more feedback and input we can get from a wide variety  
16 of stakeholders, the better off all of us will be. The  
17 challenge before all of us is to find the appropriate  
18 path forward to achieve the needed improvements and audit  
19 independence and audit quality. And this is part of that  
20 process.

21 Through extensive input and feedback we've  
22 received to date, many people have expressed support for

1 the Board's efforts in this area of enhancing auditor  
2 independence, objectivity and professional skepticism.  
3 And we've also heard through some of other projects broad  
4 support for the audit itself, and the value that the  
5 audit provides. And so the task before us is to really  
6 continue to find ways to maintain the relevance and  
7 reliability of those audits.

8           It is troubling that our inspections do continue  
9 to find a significant amount of findings. And we  
10 continue to work on that in conjunction with these other  
11 efforts. But coming up with a solution is not going to  
12 be easy or simple, and we must look at all alternatives.

13           Like Jay, I'm very interested in exploring the  
14 audit committee's role and how audit committees can be  
15 made more effective in the three-legged stool model that  
16 has often been discussed with regard to reliable  
17 financial reporting. The feedback that we've gotten is  
18 that when audit committees work properly, they're very  
19 effective, but that all audit committees are not created  
20 equal. And so people often talk of best practices. I'm  
21 interested in consistent practices to help ensure auditor  
22 independence and objectivity and professional skepticism.

1           But achieving this will be difficult because this  
2 really goes beyond the PCAOB. But I believe that it is  
3 our responsibility to explore these issues, because the  
4 audit committee provides part of an ecosystem for a good  
5 reliable audit. So again, I want to thank all of the  
6 panelists who are here today, and I look forward to  
7 hearing your input.

8           CHAIRMAN DOTY: Thank you, Jeanette. Our panels  
9 begin today with the statement and the opportunity to  
10 speak with the former Chairman of the United States  
11 Securities and Exchange Commission, Harold M. Williams.  
12 And as he comes to the table, I will try to synopsise  
13 what are the highlights of a long and very distinguished  
14 career.

15           We have one of the giants and one of the giant  
16 thinkers in the area of financial securities regulation  
17 here. He is the President of Emeritus of the J. Paul  
18 Getty Trust, a charitable trust devoted to the arts and  
19 humanities. He was the chief executive officer and  
20 president from May of '81 until January of '98. And  
21 under that leadership, the programs of the trust were  
22 established, and the Getty Center in Los Angeles was

1 created.

2 He was council to the Law Firm of Skadden, Arps,  
3 Slate, Meagher & Flom. He was chairman of the United  
4 States Securities and Exchange Commission, nominated in  
5 '77 by President Carter.

6 During his tenure he received considerable  
7 attention for his views advocating the necessity of  
8 accountable conduct by the business community,  
9 particularly of boards of directors and the accounting  
10 profession. He was the dean and professor of management  
11 in the Graduate School of Management in the University  
12 of California, Los Angeles, his alma mater. He is a  
13 Harvard Law graduate. He is a veteran of the Korean War,  
14 where he received a bronze star.

15 He is one of the most admired members of the  
16 Securities Bar. I can testify firsthand that we're  
17 deeply honored to have you here. Please proceed,  
18 Chairman Williams.

19 You have to press your mic.

20 MR. WILLIAMS: There we go. I'm sorry. I'll  
21 just repeat. I'm delighted to be here. Thank you for  
22 the opportunity to comment on the Public Company

1 Oversight Board's Concept Release on Auditor Independence  
2 and Audit Firm Rotation and its efforts to enhance the  
3 independence objectivity of professional skepticism of  
4 external auditors, and to express my personal view as to  
5 whether a decision to require the regular rotation of  
6 auditors would significantly further those efforts is  
7 desirable.

8 I want to begin by expressing my respect and  
9 appreciation for the outstanding work of the PCAOB. A  
10 tribute to its committed and thoughtful leadership, its  
11 outstanding board members, and a superb staff. You're  
12 making a significant difference towards assuring auditor  
13 independence and audit quality.

14 I'm impressed by the volume and quality of the  
15 responses you've received to your Concept Release.  
16 Rather than offering a comprehensive statement, I will  
17 focus my comments as a response to specific recurring  
18 arguments and will be happy to expand on them as you  
19 wish.

20 I recognize that many audit committees have been  
21 much more active and proactive in their discharging their  
22 responsibilities under Sarbanes-Oxley. Certainly, both

1 the written and oral testimony before this body pays high  
2 tribute. I do not believe, however, that the audit  
3 committee is capable of addressing the issues of lack of  
4 professional skepticism by its lack of independence  
5 addressed by the Concept Release.

6 In reviewing the audit failures identified by the  
7 Board in its Concept Release, I'm left with the question,  
8 "Would a diligent -- vigilant audit committee discharging  
9 its responsibilities under Sarbanes-Oxley have discovered  
10 the lack of skepticism, bias, and lack of independence  
11 identified in the PCAOB audits?" And my belief is no,  
12 not likely, not systemically.

13 If the relationship between management and  
14 managers is harmonious, let alone cozy, how is the audit  
15 committee to effectively probe behind it? What questions  
16 could it ask? What consultants could it employ to get  
17 behind the harmonious responses you would receive from  
18 the management and the auditor that would have surfaced  
19 the conditions and failures identified in the Board  
20 audits? Now, if there are instances where the audit  
21 committee has been successful in this regard, it would  
22 be instructive if they could be made public.

1           How else to address the problem head on and not  
2 just at the margin? Short of or as part of making  
3 mandatory rotation effective, I recommend the Board be  
4 empowered to publicly release the results of its  
5 investigations and proceedings and direct rotation of  
6 auditors where the investigation finds the absence of  
7 independence, objectivity and professional skepticism.

8           Rotation could also be called for on other audits  
9 involving one or more of the same senior audit committee  
10 members. Of course, action against the partner in charge  
11 of the audit committee would have a meaningful impact.  
12 Rotation might also be called for in industries which  
13 appear to have a higher incidence of failure. The Board  
14 might consider responding to an audit committee request  
15 for an inspection, but be careful about being overwhelmed  
16 by requests.

17           I also recommend that the Board be enabled to  
18 re-examine what constitutes audit-related consulting, and  
19 define it more narrowly than the SEC has done.

20           Now, I support mandatory rotation, but I'm not  
21 saying whether it will produce the desired results. We  
22 start by addressing recurrent concerns raised about

1 mandatory rotations. There may be but not necessarily  
2 would be costs associated with the rotation. I believe  
3 the concern is exaggerated. And to the extent that there  
4 are costs, I believe they would be justified.

5 I do not believe that the quality of the audit  
6 needs to deteriorate for the first year or two of the new  
7 auditor's work. And the concern that audit quality might  
8 deteriorate in the last several years of the departing  
9 auditor's engagement casts serious doubt on confidence  
10 in the professionalism, and suggests a more serious  
11 problem that I trust is not warranted. To what extent  
12 have these concerns manifest themselves in voluntary  
13 rotations? And for reasons I've already stated, I do not  
14 believe that such a requirement would reduce the  
15 authority and the role of audit committees.

16 Now, the uncertainty about whether mandatory  
17 rotation would produce the desired result is due to the  
18 international oligopoly of the big four accounting firms.  
19 Auditing is a profession run as a business. As a  
20 business, oligopolies generally, recognizing they're very  
21 comfortable in secure straits, are not inclined to rock  
22 the boat in relation to each other. Status quo, rather

1 than competition, is the name of the game.

2           Would the auditing business, behave any  
3 differently? What would it take for an auditor coming  
4 in to embarrass the one it's replacing. Certainly public  
5 policy would not look favorably at anything that  
6 jeopardizes the existence or even the reputation of one  
7 of the big four. On the other hand, mandatory rotation,  
8 would, I believe, provide incentive to middle-sized firms  
9 to develop their capabilities to serve larger clients.  
10 This, in turn, if successful, would enlarge and  
11 destabilize the oligopoly. If mandatory rotation is  
12 undertaken, I recommend that it begin on a limited basis  
13 so that the Board and the firms could learn from the  
14 experience.

15           I close with a caution to the profession, that  
16 what underlies this entire inquiry is the concern of many  
17 that its basic product, the reason that it has a  
18 statutory mandate is suspect. If the profession doesn't  
19 see a problem, and/or cannot be proactive in effectively  
20 addressing it, then perhaps the business model of the  
21 client-auditor relationship has to be changed.

22           And I'll be happy to respond to questions.

1           CHAIRMAN DOTY: Thank you, Chairman Williams.  
2 Board Member Franzel.

3           MEMBER FRANZEL: Thank you, Chairman. Mr.  
4 Williams, I would like to highlight a very insightful  
5 comment that you made. And I think it is something that  
6 we need to all focus on. And that is your caution to the  
7 profession that what underlies this entire inquiry is the  
8 concern of many that its basic product is suspect. And  
9 I think that lends just a tremendous amount of insight  
10 into the complexity of the problems that we're trying to  
11 solve, and of course, at PCAOB we're doing a tremendous  
12 amount of work on the inspection side also trying to get  
13 at this.

14           But it really illustrates that we need to look at  
15 all the parties involved, and the responsibilities that  
16 each party needs to take. And if those parties don't  
17 take appropriate responsibility, then what would the  
18 consequences be. So I just wanted to highlight that  
19 statement.

20           I'd like to ask you for a little more elaboration  
21 on another statement that you made. And that is, if  
22 mandatory rotation is undertaken, you recommend that it

1 begin on a limited basis. And what do you envision by  
2 that?

3 MR. WILLIAMS: Well, I'm not quite sure. I guess  
4 if I had to venture forth today, I think I'd start with  
5 other than the big four and, and either -- I don't know  
6 how the limited basis might be designed, but it could be  
7 by, by industries that are of particular sensitivity.  
8 It could be by size. Yes, I'd have to give it more  
9 thought to come up with a more specific recommendation.

10 CHAIRMAN DOTY: We do pilot programs. I think  
11 you're suggesting probably a pilot program that's focused  
12 on, I presume, firms.

13

14 MR. WILLIAMS: Yes.

15 CHAIRMAN DOTY: Board Member Harris, you want to  
16 pick up the ball? We're going to go down the line and  
17 come back.

18 MEMBER HARRIS: Well, I wanted to focus on the  
19 same sentence that, that Jeanette did. And that is if  
20 the profession doesn't see a problem and/or cannot be  
21 proactive in effectively addressing it, then perhaps the  
22 business model of the client-auditor relationship has to

1 be changed. And a number of people have asked, you know,  
2 why are we doing this and what is the problem? And they  
3 want empirical evidence.

4           So I'd like for you to spell out for us, to the  
5 extent that you can, what you see as the problem, and how  
6 you think the profession can be proactive in terms of  
7 addressing it?

8           MR. WILLIAMS: Well, I think the best definition  
9 of the problem, or the best example of the problem, is  
10 the audit results of PCAOB. And it -- and every -- part  
11 of my sense on this, and it comes directly from personal  
12 experience, is that to some extent, I think the firms  
13 audited -- the problem presented by the PCAOB audit is  
14 dealt with at the national office in response to and in  
15 contact with, and in relation with the report that's  
16 issued by the Board.

17           From the outside, I was somewhat skeptical about  
18 what the internal consequences of the audit are within  
19 the firm itself. When I talk to auditors or firms who  
20 have been audited, I don't really sense that they feel  
21 much consequence to the audit. So I would start by  
22 really trying to understand. I mean, that may be unfair,

1 but I'd start by trying to understand what happens  
2 systemically, culturally within the firm to respond to  
3 the audit.

4 My sense is that more needs to be done, that the  
5 auditor himself or herself doesn't really know what the  
6 problems were and what conduct on the part of that  
7 auditor ought to be to assure that it doesn't happen.

8 CHAIRMAN DOTY: Board Member Ferguson? Lewis?

9 MEMBER FERGUSON: Yes. I also want to ask you  
10 questions. We all seemed to have been focused on your  
11 statement about the fact that the profession itself does  
12 not seem to perceive that there's a problem here, and  
13 that that may come from the oligopolistic structure of  
14 this industry, that there is -- oligopolies are  
15 notoriously resistant to change and conservative in their  
16 behavior, because they have only things to lose. I  
17 sometimes think of the accounting profession views this  
18 particular issue of the rotation as a storm to be  
19 weathered rather than an opportunity to examine  
20 themselves closer.

21 But I want to ask you a specific question about  
22 that. To what extent does this conservatism, aside from

1 the oligopolistic structure in the profession, come from  
2 the fact that the basic payment model of the audit is  
3 that the client pays for the audit? So that there's an  
4 inherent reluctance in the final analysis, I think, to  
5 do anything that is likely to upset the client too much,  
6 the person who's paying the bills. And particularly when  
7 the tenure of these audits are very, very long.

8           And if you look at them in a financial sense,  
9 this stream of revenue is, particularly for large  
10 clients, is effectively an annuity that could be  
11 capitalized by the market; billions -- potentially  
12 billions of dollars. To what extent is that payment  
13 model reinforce the conservatism on both the client and  
14 the auditor's part?

15           MR. WILLIAMS: Well, I think it does. I think it  
16 does substantially. The accounting firm presents itself  
17 if there is competition -- if that word fits here -- for  
18 a client on the basis of, is basically on the basis of  
19 service. It doesn't present itself -- it has a detached  
20 professional, and the very nature of the relationship  
21 becomes one of essentially keeping the clients satisfied.

22           From the firm's standpoint, they want a long-term

1 relationship. It's very understandable. I'd expect  
2 that. There's the partner in charge, his progress within  
3 the firm will depend upon how well you satisfy the  
4 client. If he loses a client, it doesn't do him much  
5 positive good within the firm. In fact, it may seriously  
6 disrupt his career.

7           From the client's standpoint, the client is  
8 focused on many cases on short-term issues, of  
9 maintaining earnings growth, of -- of keeping the market  
10 happy, and oftentimes of personal, short-term financial  
11 incentives are a part of management. All the forces at  
12 work suggest a desire for a harmonious relationship that  
13 is not built on any -- on the kind of skepticism,  
14 detachment -- you know, nobody wants to be the skunk at  
15 the picnic. And so it goes on. And it's all very  
16 understandable.

17           And part of that is, obviously is, the payment  
18 model. It's hard to visualize a different model. I mean  
19 certainly at the extremes I have, you know, federal  
20 auditors come in, would certainly change the  
21 relationship. But it creates a whole new set of problems  
22 that we don't have to presumably deal with today. But

1 it -- and to expect the audit committee -- and I'm in  
2 favor of strong audit committees. I think audit  
3 committees are doing much more and a better job today,  
4 on the basis of Sarbanes-Oxley, than they've done before.

5 But their ability -- they don't normally -- they  
6 don't have the ability, generally speaking, to intercede  
7 and become the referee between the accounting firm and  
8 the client.

9 CHAIRMAN DOTY: Board Member Hanson?

10 MEMBER HANSON: One of the benefits I personally  
11 get from these events like this, is the ability to hear  
12 from folks like you that are -- that have a long history  
13 of, of experiences. And we all learn from, from our past  
14 experience and our history. And I know from my personal  
15 reflections in my almost year and a half now of being on  
16 the board, that my views tend to change over time. And  
17 I think it -- I'd personally like to think I'm learning  
18 from experience and it shapes my view.

19 I'm sort of just curious about how your views  
20 might have changed over time on this topic, and  
21 especially since the package of the Sarbanes-Oxley Act  
22 10 years ago now, next month, and what you maybe observed

1 in conduct or any interactions with auditors, audit  
2 committees, companies more recently that -- since the  
3 reforms of Sarbanes-Oxley have been under way.

4 MR. WILLIAMS: Well, my experience is that audit  
5 -- and from what I've heard, audit committees are taking  
6 their -- by and large they're taking their work more  
7 seriously. But going to an executive session between the  
8 auditor and the committee, if the auditor asked the  
9 committee, you know, "How things are going?" "How are  
10 they going? Fine." "Do you have any real problems?"  
11 "No." "No big disagreements?" "No." Then what?

12 I mean, that's why I say that's the one area  
13 where I don't think the audit committee has the  
14 capability to probe effectively. Now I've been, in my  
15 days, as the commission we had the predecessor of this  
16 effort. There was the Metcalf committee and so forth.  
17 And we of the Public Oversight Board. And this, in a  
18 sense, as I look at it, is a very constructive outgrowth  
19 of what was then an effort for the industry, for the  
20 industry itself to regulate itself. So I think the PCAOB  
21 is a major step forward.

22 And where I come down basically is, that the

1 extent that progress is going to be made, it's going to  
2 be made by you, and how strongly, how much authority you  
3 have, and how you can resist the pressures as you exert  
4 -- have to exert more authority to resist the pressures  
5 if you're doing your own audit. Because I think it's  
6 your audits and the exposure that they get, and the  
7 pressure that they bring to bear are the most  
8 constructive force towards the end you're trying to  
9 achieve.

10           CHAIRMAN DOTY: Chairman Williams, your views  
11 about the limits of audit committees and some audit  
12 committees particularly are shared by one John C. Bogle,  
13 founder of the Vanguard, of course. And so there are a  
14 number of people who have what Jay calls the long view  
15 of this, who are concerned about some inherent limits on  
16 the ability of audit committees, no matter how much we  
17 do, to deal with the fundamental problem of management's  
18 control. And there would be other panelists who shed  
19 light from different angles on that.

20           Your written testimony really goes to the jugular  
21 vein of this subject, when you raised what Jeanette  
22 points to as the statutory mandate. And you also pull

1 apart some of the complexities of audit independence --  
2 of firm rotation as an independence issue when you say  
3 there are different segments, different industries that  
4 have different risks.

5           We do risk-based analysis in our selection of  
6 inspection. One of the things we hear is that, if  
7 anything, is that perhaps the pressure to kowtow to  
8 management and its interpretation of the business and the  
9 facts, is stronger in the area of voluntary tenders, and  
10 stronger in the younger corporations, and in the  
11 corporations that are perhaps not the majors. So you're  
12 directing us to a segment of the industry, and perhaps  
13 the combination of younger companies with more ambitious  
14 auditing, marketing programs behind them. That's a  
15 fascinating idea.

16           And it's one that is especially fascinating out  
17 here in California where we have so many young companies  
18 and so many young audit firms. And so it makes us focus  
19 on the complexity of doing something about this.

20           What would you think of some kind of a rule that  
21 invoked some form of rotation, some form of requirement  
22 of preserving independence through rotation if there is

1 a build up, an accretion of factors that seem to be  
2 dangerous, that seem to be red flags such as frequent  
3 changes in auditors, such as recruiting from the  
4 accounting firm to the financial reporting area? Is that  
5 the kind of thing that we should pursue in terms of  
6 looking for areas where our regulatory difference could  
7 be invoked?

8 MR. WILLIAMS: Well, I think those would be  
9 certainly constructive areas in which to look. What I  
10 have not done, or given any real serious thought to, is  
11 whether there are -- there probably are a series of, or  
12 a number of, of red flags that would create a kind of a  
13 litmus test, that would suggest that they be priority  
14 areas for at least deeper examination, if not, you know  
15 -- at least a presumption that rotation is a rebuttable  
16 presumption; perhaps that rotation is in order.

17 CHAIRMAN DOTY: So there's -- there should be  
18 certain -- we could think of certain things that would  
19 invoke a show-cause type hearing?

20 MR. WILLIAMS: Yes, exactly.

21 CHAIRMAN DOTY: Well, we are on schedule.

22 MR. WILLIAMS: Okay.

1 CHAIRMAN DOTY: You have got --

2 MEMBER HARRIS: Can we have --

3 CHAIRMAN DOTY: What?

4 MEMBER HARRIS: Can we have more?

5 CHAIRMAN DOTY: You want one more round? We've  
6 got a minute.

7 MEMBER HARRIS: We've got less than a minute.

8 Let me just follow-up on what I think that Jay  
9 raised in terms of the evolution of one's thinking over  
10 the years. And you were extremely helpful when you were  
11 -- the first panel that testified 10 years ago on  
12 Sarbanes-Oxley. And we have the former chairman of the  
13 SEC, and they did a terrific job in terms of laying the  
14 foundation.

15 But at that time -- and let me ask a two-prong  
16 question. You indicated that, "I would urge the  
17 commission to consider a requirement that a public  
18 company retain its auditor for a fixed term with no right  
19 to terminate. This could be for five years, or perhaps  
20 the biblical seven. After that fixed term, the  
21 corporation will be required to change auditors. As a  
22 consequence of such a requirement, the auditor would be

1 assured of the assignment, and therefore would not be  
2 threatened with the loss of the client, and could  
3 exercise truly independent judgment."

4           And of course we didn't go that route. But I'm  
5 wondering whether or not you still share your previous  
6 views on that subject?

7           And then second of all, I can't resist the  
8 temptation. You talk about the oligopoly in terms of  
9 your prepared statement. And I'm wondering whether you  
10 have any views in terms of how we promote competition  
11 within the profession.

12           MR. WILLIAMS: Well, that is a two-prong  
13 question. I think there's something to be said for if  
14 we go to a fixed term, I think it should be a secured  
15 term. And so I still stand by that part of what I was  
16 expressing at the Sarbanes-Oxley testimony. If we're  
17 going to have independence, I think we ought to assure  
18 the auditor that they're there regardless of whether  
19 management likes them or not.

20           And your second question?

21           MEMBER HARRIS: How to promote competition within  
22 the profession.

1           MR. WILLIAMS: Oh, well, I think mandatory  
2 rotation would promote competition. Short of mandatory  
3 rotation, I don't have a ready answer. With the benefit  
4 of hindsight, I just -- I think the merger of the  
5 accounting firms, given their statutory mandate, was  
6 against public policy. I don't know that anybody even  
7 raised that question at the time.

8           But I don't know how they -- at this point, I  
9 think efforts should be made to -- I don't know what it  
10 would take to encourage a Grant Thornton, for example,  
11 to decide it wanted to be part of the big five.

12           MEMBER HARRIS: Well, you're definitely not alone  
13 in that, but I couldn't resist asking the question.  
14 Because everybody is in favor of competition, but nobody  
15 seems to be coming up with too many --

16           MR. WILLIAMS: Yes.

17           MEMBER HARRIS: -- options in terms of  
18 alternatives.

19           MR. WILLIAMS: You might ask Grant Thornton to  
20 see what they have to say.

21           CHAIRMAN DOTY: Steve is right that we have a  
22 couple of minutes. Are there other questions from other

1 board members that you want to chip in?

2 Thank you for getting us off.

3 MR. WILLIAMS: Thanks a lot, Chairman.

4 CHAIRMAN DOTY: Marty? Our chief auditor, Martin  
5 Baumann. Yes?

6 MR. BAUMANN: I also wanted to probe. Everybody  
7 probed on something in your statements. And they were  
8 profound, so I thought I would probe a little deeper on  
9 one also. And I think you've raised a very interesting  
10 point with your statement that you did not believe that  
11 audit committees are capable of addressing the issues of  
12 a lack of professional skepticism and bias.

13 We heard -- we received many letters in the  
14 comment process from audit committee members, and we  
15 heard quite a bit from audit committee members at our  
16 first hearing. And by and large they felt that the  
17 decision of changing auditors should be left in their  
18 hands. And they talked about their ability to select  
19 auditors and evaluate the quality of the auditors that  
20 they hired.

21 But I think you've raised a very interesting  
22 point here, which we really -- which addresses another

1 point that came up from testimony from one of the  
2 professors about unconscious bias that takes place in the  
3 audit, in the client kind of pay -- the auditor pay  
4 model. And so the audit committee can evaluate a lot of  
5 things, as you've suggested. But can they evaluate  
6 whether or not the auditor is lacking in skepticism or  
7 is lacking in bias. And I think that's an area for  
8 further pursuit on our part in terms of questioning of  
9 audit committee members.

10 We understand you can question -- evaluate their  
11 quality. But how can you get at this issue where so many  
12 have raised about unconscious bias that takes place in  
13 this area? So I don't know if you have anything further  
14 to add on that in terms of additional research that might  
15 be helpful in that area, but I think you've raised a good  
16 point, which raises a question about the statement made  
17 by so many audit committee members, that we're the ones  
18 that are best suited to do this, to make this evaluation.

19 MR. WILLIAMS: Well, I don't know that I have  
20 anything specific to add, other than to say I wish, you  
21 know, if an audit committee's been successful in this  
22 regard, let them come forward and tell us how to do it,

1 because we can learn from it. I don't think you're going  
2 it find any examples.

3 MR. BAUMANN: Thank you.

4 MR. WILLIAMS: Thank you.

5 CHAIRMAN DOTY: We will move on to the next  
6 panel.

7 Chairman Williams, thank you again for doing  
8 this. This was above and beyond.

9 The next panel includes three distinguished  
10 commenters on this area, academicians.

11 Andrew Bailey. Andy Bailey is Professor Emeritus  
12 at the University of Illinois Urbana-Champaign. He is  
13 the former Deputy Chief Accountant of the United States  
14 Securities and Exchange Commission. He has spent three  
15 years in an academic career, recently serving as director  
16 of internal client services at Grant Thornton. He was  
17 the SEC's representative responsible for the oversight  
18 of the PCAOB when we were created, and he has spent a  
19 significant amount of time on independence issues. Past  
20 president of the American Accounting Association, which  
21 is an important body for us.

22 Jim Cox, Brainerd Currie Professor of Law at Duke

1 University. Taught in the Universities of San Francisco,  
2 Stanford, and the University of California Hastings  
3 before he came to Duke. Has been active in the affairs  
4 of the NASC, the NYSC, the standing committees of this  
5 body, the standing advisory group of the Public Company  
6 Accounting Oversight Board, and a prolific publisher in  
7 many areas of financial reporting.

8 Maureen McNichols, the Mariner S. Eccles  
9 Professor of Public and Private Management Graduate  
10 School of Business, Stanford University, Affiliated  
11 Faculty of Rock Center for Corporate Governance. We  
12 welcome her. She is a director and a member of the audit  
13 and compensation committees of companies in this area.  
14 She has a Ph.D. in accounting from the University of  
15 California, Los Angeles. A former student of Harold  
16 Williams. We welcome her.

17 With that, our process will be to move through  
18 the panel, and then we'll have questions. Andy, do you  
19 want to start us off?

20 MR BAILEY: Thank you for inviting me. These  
21 conversations remind me of my time at the SEC, and almost  
22 make me wish I was there again, because there's so many

1 issues involved here, very hard to deal with. Asking me  
2 to speak for five minutes is a real risk, but I'll try.

3 Independence, skepticism and objectivity are  
4 without doubt, in my opinion, the most important topics  
5 that the PCAOB can address. No matter how good the  
6 operating standards are, no matter how well they are  
7 adhered to, they really don't make much difference if the  
8 auditor is not independent.

9 A cultural evolution of the accounting profession  
10 to the business of accounting began in the '70s; reached  
11 its apparent peak in the '90s when the public accounting  
12 firms became the largest retail consulting organizations  
13 in the world, and the audit became only one product in  
14 a multi-product line.

15 The management emphasis of the business model  
16 fails to give primacy to the idea that the investor is  
17 the audit client, and any management-related benefits a  
18 byproduct. Audits are a public good.

19 Throughout this transition, the leadership of the  
20 firms believe they could manage any independence  
21 conflicts arising out of the management-client service  
22 business model. I believe they consistently underrate

1 the impact of the culture they have created.

2 SOX put a temporary hold on the dominance of the  
3 management-client service model with a forced refocus on  
4 the audit for third-party investors. Unfortunately, I  
5 believe the paying management-client service model is  
6 reasserting itself.

7 Today the management-client service model is  
8 tightly coupled with an industry that shares the market  
9 among a small number of participants, an oligopoly, where  
10 company audits are held for long periods, in some cases  
11 for so long as to appear to be in perpetuity, and when  
12 the client-auditor changes that do occur, they are traded  
13 within a small tight-knit group of four firms that are  
14 now too big to fail.

15 I am not the first to note that this kind of  
16 combination might not bode well for the investor.  
17 Therefore, independence proposals that may, as a  
18 byproduct, initiate discussions about further structural  
19 changes in the profession -- in the business, should be  
20 given extra points. And I think we may be discussing one  
21 of these proposals today.

22 But first, a few comments on issues that arise

1 every time any kind of significant proposal for making  
2 independence changes come up; I'll make a few comments.

3 Cost. Now, as I said, audits are a public good.  
4 Everybody here knows that. Therefore, cost should not  
5 be measured solely, or even primarily by the fee paid for  
6 the specific audit of a specific company, but rather in  
7 the likely cost that will be imposed on investors by  
8 large and small audit failures. And yet even when you  
9 look at a specific company, in most cases, audits are  
10 cheap. It's really not a cost matter, in my opinion.

11 Management pays. A payment scheme where the  
12 professional is paid, not by the client, but by the  
13 management of the company under audit, introduces  
14 independence problems, no question. I am not aware of  
15 a good alternative. And I'd be happy to comment on the  
16 insurance model that gets proposed on a regular basis,  
17 if you'd like to ask.

18 And so all I think all it really means is that we  
19 have to be more vigilant, not less on the independence  
20 issue.

21 Expertise, that is, the auditor's expertise, and  
22 transition issues come up. No doubt, firms have

1 developed specialties and have shared the market based  
2 on these specialties. Nevertheless, I find it  
3 interesting that we will entertain the idea that firms  
4 as large and talent-laden as those in question, and that  
5 pride themselves on advising managements on complex  
6 strategic and operational issues cannot develop the  
7 necessary methods to manage the required transitions and  
8 operations, and the expertise to do virtually any audit.

9           More research. More studies. Pilot programs.  
10 As an academic, I am always sympathetic to more research.  
11 However, as with many decisions positing future  
12 behaviors, research today has its limits. Waiting for  
13 more research and studies, including pilot programs  
14 fraught with their own independence issues will not  
15 likely provide the comfort we seek. It will certainly  
16 mean taking no substantive action now or in the near  
17 future.

18           Now, the proposals. Tendering with a refutable  
19 presumption of firm rotation. Put most simply, I do not  
20 believe this proposal will work, whatever its appeal, as  
21 a compromise position. The implementation will require  
22 rule making -- and we heard a little bit of that here --

1 concerning the criteria in which the rotation can be  
2 refuted.

3           This process will be an invitation for delay,  
4 dilution, and ultimately litigation, in my opinion. Both  
5 the audit firms and management will have a common  
6 incentive to lobby this matter. And failing in this  
7 effort, they will have a strong incentive to make common  
8 cause as each rotation cycle appears.

9           Mandatory firm rotation. This is simpler and  
10 more difficult to avoid. And I like the simpler solution  
11 sometimes. I will not repeat the pros and cons of  
12 mandatory rotation here. There are plusses and minuses,  
13 no doubt. I believe that mandatory rotation firms can  
14 stand on its own as a means of enhancing auditor  
15 independence, skepticism and objectivity.

16           The implementation of mandatory rotation will  
17 have to be staged. I do not think it should be pilot  
18 studies. I think it should be laid out so that everybody  
19 understands how this is going to unfold and when they  
20 will be likely impacted. Otherwise, I don't think that's  
21 going to work either.

22           In my opinion, it will be staged, and it will

1 give us time to work on the problems, and I think it will  
2 be worth the effort.

3 Now the proposal has the distinct advantage of  
4 being a significant break with a past, where we tinker  
5 with the existing independence rule structure with little  
6 success, other than to emphasize the rules game itself.  
7 More importantly, and here I do step off the cliff that  
8 some people have already stepped off of.

9 I sense that mandatory firm rotation may initiate  
10 a discussion by the various stakeholders about more  
11 fundamental changes to the structure of the auditing  
12 business and possibly a return of the professional  
13 auditor. This seems possible to me if we think not only  
14 about auditor incentives, but also about management's  
15 participation in this partnership.

16 A management that knows the joint auditor/manager  
17 and dominance have limited life may rethink its  
18 relationship to the audit, the auditor and their  
19 consultants. I must admit I only have a sense of this  
20 and not a complete story to tell at this point.

21 However, one thing is clear to me, and that is  
22 that management must be convinced that failure to protect

1 their current auditor and future auditor's independence  
2 will incur costs for them and that their responsibility  
3 for those costs will be transparent in the marketplace.

4 CHAIRMAN DOTY: And I'll thank you, Andy. Thank  
5 you. Jim Cox.

6 MR. COX: Well, I feel a little bit like déjà vu  
7 all over again. My first professional career started  
8 about five blocks away from here when there was eight  
9 major accounting firms. I worked for then Haskins &  
10 Sells. A lot of things have changed since then. In the  
11 auditing profession, because of the Supreme Court rulings  
12 about free speech, et cetera, let them engage in a lot  
13 of competition again, a process which led to a  
14 acceleration. A lot of other practices now characterize  
15 the industry as being oligopolistic. I've written about  
16 this. And while they don't compete necessarily on price,  
17 they do compete upon quality or lack of quality of  
18 services, and that is an ongoing concern.

19 One of the developments that was pointed out is  
20 almost 10 years ago, we did enact and create this body  
21 with Sarbanes-Oxley, and now we have a better roadmap  
22 about what some of the problems are with public

1 accounting. That comes about by the inspection reports  
2 and by the enforcement actions. And, unfortunately, it's  
3 a trail that has a consistent theme, and it's what's been  
4 hit here earlier, and that is the lack of professional  
5 skepticism seems to lie behind every one of these cases.

6 I mean, you have a federal -- a February  
7 Enforcement Action in the Medisys case, which I think is  
8 symptomatic of what I see in so many of the inspection  
9 reports that are carried out, as well as the enforcement  
10 actions, and that is a complete breakdown in our  
11 professional skepticism.

12 And moving beyond that, the facts of that case,  
13 and a parade of other -- a parade of horrors, I would  
14 think, if you look at the empirical evidence, there's a  
15 lot of evidence out there that we don't have the  
16 professional skepticism we have. There's a -- you know,  
17 again, the papers -- I'm talking about the more recent  
18 ones, but there's a paper on SSRN right now by Carson,  
19 et al., that looks at, for example, the failure of the  
20 audit opinion within 12 months of a bankruptcy to give  
21 a qualification. And what we find, that in the good  
22 years, that they fail in about 53 to 55 percent of cases.

1 And when you have a jarring situation in the economy,  
2 such as existed in 2002 and 2003, they miss it about --  
3 otherwise there's a rapid change in the liquidity of the  
4 firms because of external events, you find that they're  
5 missing about three-quarters of the time.

6           So, you know, it's something that explains why  
7 we, the auditors for public companies are consistently  
8 are getting it wrong more than half the time, and within  
9 12 months of a bankruptcy. And then you can trail out  
10 from that what was happening in the credit default swaps,  
11 which are doing a little bit better, than probably the  
12 auditor's qualifications. You know, this raises  
13 questions about whether the audit opinion is probably  
14 irrelevant if we can pick it up in the credit defaults  
15 market, and not pick it up in the letter. But at the  
16 same time, you think that these could be tracking in the  
17 same direction.

18           You know, related to that as well, as the  
19 disquiet is fed by, you know, constant data points being  
20 put out by audit analytics in which we find, for example,  
21 at 30 percent of the large public companies have had the  
22 same auditor for 25 years, which means that we're not

1 talking about an engagement that's serving the public  
2 interest, we're talking about a financial annuity, which  
3 is the nature of the relationship. And it goes back to  
4 our questions that Chairman Williams was talking about,  
5 about the lack of independence that flows from this.

6           You know, there's a -- there's a study, again, on  
7 SSRN, and there's a lot of studies out there. If you  
8 find one, you can, in fact, get all the rest, by Brooks,  
9 et al., in 2012, and find that the audit quality starts  
10 deteriorating by various metrics, you know, a rise in the  
11 number of questionable accruals, et cetera, about the  
12 12-year mark.

13           You know, again, if -- you know, the numbers, I  
14 believe, speak for themselves, that there's a good deal  
15 of brief concern for whether we have the right structure  
16 today for assuring professional detachment and  
17 independence on the part of the accountant.

18           Now, we do live, as we're all aware, particularly  
19 those who reside within the Beltway, in a political  
20 climate. And so it may be that what we heard Chairman  
21 Williams saying, I think is some very good wisdom, and  
22 that is that sometimes in a contemporary, legal political

1 climate, one can think about steps toward where the  
2 ultimate goal are, and the suggestions were pilot  
3 programs, et cetera.

4 I, too, do empirical work. I, too, like doing  
5 that. Maybe it gets me a raise. Fortunately I have  
6 tenure, I don't have to worry about that anymore. But  
7 nonetheless, it is a way of building, moving forward.

8 But short of those concerns, let me just suggest  
9 that there's some other ways out there. And that is --  
10 and I think we're talking about two -- killing two birds  
11 with one stone here with we're talking about auditor  
12 independence and moving in that direction. One is the  
13 question about trying to ratchet up professional  
14 independence. But it also goes back to the initial point  
15 that, again, others have mentioned, and that is that this  
16 is an industry that's not structured very well.

17 I mean, there's an oligopoly at the top. And so,  
18 you know, our fellow regulators across the pond in Europe  
19 are thinking about this not just in terms of professional  
20 skepticism, but also thinking about what the long-term  
21 approach is to introducing more competition. Okay? So  
22 we thought about this as not only as an industry-

1 structured question, but also a professional competence  
2 question. I think they would -- the vectors would point  
3 the same way, and that is that you'd like to be able to  
4 see the jobs turn over a little bit more often.

5           So there's several approaches here. In just the  
6 remaining time I have, I can list them. One, we can do  
7 nothing. I don't think that that's the answer. I don't  
8 think that's in the industry's profession interest, and  
9 I certainly don't think that's in the interest of the  
10 PCAOB, we can't do anything.

11           One is that the opposite extreme is to mandate  
12 some firm rotation. And that has the benefit of  
13 everybody understanding what the deal is and when it's  
14 going to happen, and it's a very clear message. And I  
15 would support that, but for my concerns about what the  
16 sort of geopolitical environment is. Okay?

17           So what are some of the half measures there that  
18 work? And, you know, without endorsing any one of these,  
19 I would just suggest that, one would be the approach  
20 where there would be a requirement that after X number  
21 of years -- and we can all sit down and wonder what the  
22 X is -- that the firm has to put the client has to put

1 the audit up for a bid. And included in the bidders  
2 would be the former auditor, and then have a mandatory  
3 disclosure obligation about why, if it turns out that the  
4 company, the reporting company, chose to select the  
5 former auditor, have some explanation about that.

6 And anyone can think about a variety of  
7 explanations, but at least it raises a consciousness and  
8 makes that process visible and gives other firms an  
9 opportunity to step in and compete for the bid.

10 Another idea would be something that would -- it  
11 could be totally within the control of PCAOB, and that  
12 is that -- and you may be doing this because you were  
13 pointing out, Chairman Doty, that on risk assessments and  
14 carrying out your inspections, that one of the heuristics  
15 that would be used is to link the audit tenure. And so  
16 when you carry out your inspections, not only will you  
17 be looking at targeting those firms that had a long-term  
18 historical relationship with the client that they're  
19 auditing, but should you find questions about  
20 professional judgment, then the sanction or remedy that  
21 could be imposed would be rotation. Okay. Think of this  
22 as a remedy to a problem that has been identified through

1 the independent process of an inspection. Okay?

2           The other thing that also could be within the  
3 control of the PCAOB without having to perhaps have to  
4 worry about what the scope of its authority would be that  
5 maybe some of the others of them have, and that would be  
6 the question about tinkering with the audit opinion  
7 letter. That, you know, should the audit opinion letter  
8 be fairly clear of saying, we've been auditing this firm  
9 for a hundred years.

10           You may think that that's absurd. There are  
11 eight companies, public companies in America who've had  
12 the same auditor for a hundred years. Surprising that  
13 we have eight companies in America that are still in  
14 existence over a hundred years, but nonetheless, the same  
15 auditor for that period of time. So one can think about  
16 that.

17           So those are some halfway measures. But the  
18 important thing is that this is an important journey, and  
19 one well worth taking. And I'm sure investor groups will  
20 support you right down the road. Thank you.

21           CHAIRMAN DOTY: Thank you, Professor Cox.

22 Maureen McNichols.

1 MS. McNICHOLS: Chairman Doty, commissioners and  
2 members of the PCAOB staff and the SEC, it is a great  
3 honor to speak with you this morning.

4 I joined the accounting group at Stanford in 1984  
5 and have taught a number of courses on financial  
6 reporting, financial statement analysis, and investing  
7 over the past 28 years. My students and I have studied  
8 the financial reporting issues at many well-known  
9 companies including Sunbeam, Waste Management, Enron,  
10 IBM, WorldCom, Halliburton, AIG, Tyco, CIT and Fannie  
11 Mae.

12 I also developed an elective for our students  
13 entitled "Understanding Cheating," which draws on the  
14 literatures in accounting, economics, sociology,  
15 psychology and education to understand the factors that  
16 contribute to cheating and corruption. My research  
17 focuses on the role of accounting and providing  
18 information to investors in capital markets.

19 My own research and the work of many others in  
20 accounting establishes that informative financial  
21 statements are crucial to the allocation of capital in  
22 our economy. Substantial research establishes that

1 investors are informed by financial statements, and that  
2 stock prices respond significantly to earnings  
3 announcements.

4 My dissertation documents that financial  
5 statements play a distinctive role in causing less  
6 favorable information to be disclosed on a timely basis.  
7 This is in contrast to the aggregate of competing sources  
8 of information such as management's voluntary disclosures  
9 and financial analysts.

10 In subsequent work, I and my co-authors, as well  
11 as many other researchers have examined the causes and  
12 consequences of earnings management. This research  
13 documents that investors experience significant losses  
14 when firms announce earnings restatements or other  
15 financial reporting quality issues. Furthermore, the  
16 evidence suggests that incentives to manage earnings are  
17 substantial, and that in addition to investor losses,  
18 firms that manipulate to increase their earnings often  
19 over-invest in their own businesses, increasing investor  
20 losses.

21 In other research, my co-authors and I find that  
22 the ability to predict bankruptcy is impaired when firms

1 manipulate earnings. These findings indicate that the  
2 benefits of high-quality financial statements are  
3 substantial, immeasurable. These findings also indicate  
4 that the potential to manipulate earnings is greatest  
5 where judgment is greatest.

6 I teach my students that financial statements  
7 reflect three elements: fundamental information about  
8 firms, measurement error, and discretion. The greater  
9 the potential measurement error, the greater is the  
10 judgment required, and consequently the greater the  
11 potential for managers to exercise discretion over the  
12 measures and disclosures in financial reports.

13 We are at a point in our history where  
14 unprecedented levels of judgment about values enter our  
15 financial statements and, consequently, there is  
16 unprecedented potential for management's unintentional  
17 and intentional biases to influence financial statements.

18 Furthermore, the level of judgment and discretion  
19 in financial reporting can only be expected to increase  
20 as businesses evolve and engage in ever more complex  
21 transactions and contractual arrangements as businesses  
22 expand their global reach, and as accounting standards

1 converge globally.

2           While Sarbanes-Oxley has brought substantial  
3 reforms and improvements to the reporting process, it is  
4 clear from the PCAOB's reviews, and from the financial  
5 crisis, that audit quality is not what it needs to be.  
6 Furthermore, the financial crisis makes clear that the  
7 interconnected nature of corporations and financial  
8 institutions has increased the potential harm from audit  
9 failure by orders of magnitude.

10           Entering into this ever more challenging  
11 environment are the auditors. SOX requires that the  
12 auditor maintain independence and mental attitude in all  
13 matters relating to the audit. And this is crucial to  
14 permitting financial statements to fairly present the  
15 results of operations in the financial status of firms.

16           The classic model of corporate governance is that  
17 shareholders appoint the board of directors who appoints  
18 management who hires employees and manages the firm. The  
19 independent directors on the audit committee appoint the  
20 auditor who acts on behalf of investors. In this model,  
21 investors are the principals in a cascade of principal  
22 agent relationships.

1           While the financial statements are the assertions  
2 of management, and the audit committee bears a key  
3 responsibility to assess the reasonableness of critical  
4 accounting processes and judgment, auditors have access  
5 to information and the responsibility to assess  
6 materiality that may determine whether an issue comes to  
7 the Board or the audit committee.

8           Thus, even in a world where audit committees are  
9 fully aligned with investors' interests, lack of  
10 independence in the auditor can degrade the quality of  
11 financial statements. In companies where directors are  
12 less than fully independent or are not fully diligent,  
13 the auditor's role is even more critical. However, when  
14 a firm hires its auditor, it is hard for the auditor to  
15 be truly independent.

16           One has only to look at the common language  
17 describing this relationship to see this. Audit firms  
18 speak of the companies they audit as their clients. When  
19 you look at the websites of public accounting firms, you  
20 see language that describes how their purpose is provide  
21 value to their clients and to build relationships, to  
22 help clients solve complex business problems and enhance

1 their ability to build value.

2 I believe public accounting firms were created to  
3 serve a different client, the investing public. There  
4 is substantial academic research on the effect of  
5 conflicts of interest in many domains, and the findings  
6 are very consistent.

7 One example of this research studies whether  
8 equity research analyst reports are affected by  
9 investment banking and other types of relationships. The  
10 findings indicate that affiliated analysts issue more  
11 favorable recommendations than unaffiliated analysts.

12 The findings on scientific research are similar,  
13 and indicate when scientists consult a company, their  
14 research results are more favorable to those companies.

15 Research conducted by Max Bazerman and his  
16 colleagues provides strong evidence that in many cases  
17 these biases may be unintentional rather than  
18 intentional.

19 The Sarbanes-Oxley reforms have been fully  
20 implemented, and substantial concern remains regarding  
21 the ability of auditors to remain appropriately skeptical  
22 of company assertions. I believe the lack of skepticism

1 results from the structure of the client-payer model, and  
2 it is now time to pursue alternatives to the current  
3 model where the company being audited hires its auditor.  
4 I therefore support developing a plan that provides a  
5 form of term limit or mandatory rotations for auditors.

6           Some may argue that research in accounting calls  
7 the arguments on the benefits of rotation into question,  
8 documenting a positive relation between earnings quality  
9 and auditor tenure. I would be reluctant to draw  
10 inferences about the effect of mandatory rotation from  
11 this research for several reasons.

12           First, it is hard to control for the  
13 circumstances that lead to the early years of the audit.  
14 The early years could arise because the company is newly  
15 public, or because it recently chose to switch auditors.  
16 And for either reason, its earnings quality could be  
17 lower than for firms with greater auditor tenure.  
18 Second, it is harder to separate longer auditor tenure  
19 from survivor bias in the firm, in the company.

20           Third, the findings could reflect the fact that  
21 earnings quality contributes to auditor tenure, rather  
22 than the reverse. Lastly, these studies cannot capture

1 the counterfactual at issue, how auditors perform audits  
2 when they are not concerned with maintaining the revenue  
3 stream provided by the firm they are auditing, and when  
4 they know their work will be reviewed by a successor  
5 auditor.

6           So, to conclude, I believe a form of auditor  
7 rotation is in the best interest of the investing public,  
8 as it would strengthen an auditor's ability to  
9 independently assess the reasonableness of management's  
10 measures and methods. This has the potential to improve  
11 the quality of audits and to decrease the frequency and  
12 magnitude of manipulation and errors in financial  
13 statements.

14           The structure of the PCAOB gives you unique  
15 opportunity to work with the auditing profession to meet  
16 the needs of its clients, the investing public.

17           I thank you for taking on a very challenging  
18 issue on behalf of the investing public, and for allowing  
19 you to speak me -- allowing me to speak with you today.

20           CHAIRMAN DOTY: Thank you. There are several  
21 board members leaning forward on the edge of their chair.  
22 Mr. Hanson.

1           MEMBER HANSON: Thank you. There were very  
2 insightful comments.

3           And I want to -- I want to come back to a point  
4 I made in my opening remarks about audit committees. And  
5 Professor McNichols, you mentioned audit committees  
6 briefly. But I'm reflecting on Chairman Williams'  
7 comments and his statement that we talked about that he  
8 does not believe that even the most vigilant audit  
9 committees can do their jobs in terms of assessing the  
10 professional skepticism of the auditor.

11           And later today, we're going to have some of the  
12 most prominent audit committee Chairs here in America  
13 sitting here asserting that they do have that ability.  
14 So I'm curious to see your thoughts as to -- each of you,  
15 your thoughts as to whether even the best audit committee  
16 members and Chairs, which we will have some of them  
17 sitting here today, can do their job of assessing the  
18 auditor's independence and skepticism.

19           CHAIRMAN DOTY: Andrew, you want to start the  
20 process?

21           MR. BAILEY: Yes. It's hard for me to know  
22 whether an individual on an audit committee will be able

1 to do that. I don't think that the structure of the  
2 audit committees gives me great comfort that that will  
3 be something that can be done on a regular basis.

4 One of the things I note is that there's very  
5 little consequence to failure for the audit committee  
6 members. In fact, along this whole chain of things, one  
7 of the things that's missing in many cases is a  
8 consequence, a known consequence. When you fail, this  
9 will happen.

10 Audit committees are very close to management.  
11 I've been to some of the ODX meetings, for example. I  
12 think they try hard. But their view is still that  
13 they're there to assist management. And so I don't have  
14 a lot of confidence that the audit committees will be  
15 able to do that job on any kind of consistent basis.  
16 Some will do well, some will not.

17 CHAIRMAN DOTY: Jim?

18 MR. COX: Yes, I think the audit committee  
19 suffers from some of the same illnesses that boards  
20 generally have; that is that they're bounded by time and  
21 they're bounded by information.

22 They know the company. They spend more time out.

1 They have a task that's more specific than the board,  
2 generally. But at the same time, the meetings are --  
3 there's a time, there's a plane you have to catch. And  
4 at the same time, many of these audit failures are down  
5 in the weeds. And unless you know how to answer the  
6 questions or how you interpret matters, what's being said  
7 by the auditor reporting to the audit committee, you may  
8 not be, as an audit committee member, able to follow the  
9 -- you know, follow the questions along far enough to  
10 find out where the problems are.

11 And then added to what Andrew was saying, there  
12 continues to be a cultural issue about who serves on  
13 boards. And that is, you know, a little bit of the  
14 "there but for the grace of God go I" deference to the  
15 management team.

16 So it's, you know, audit committees are doing a  
17 better job today than they were 10 years ago, and a  
18 better job than they were 25 years ago, but I think  
19 they're still dependent on the lynch pin, which is the  
20 outside auditor.

21 CHAIRMAN DOTY: Professor McNichols.

22 MS. McNICHOLS: Okay. I agree Andy and, and

1 Jim's comments. I think that a diligent audit committee,  
2 the very best audit committee in the world is not a  
3 substitute for an independent accountant, an independent  
4 auditor.

5 I think for the audit committee to fully grasp  
6 the potential biases of auditor, they have to have the  
7 information that the auditor had. And they certainly can  
8 see the extent to which the auditor probes management on  
9 their judgments. That's certainly something that's  
10 important to look for.

11 But to the extent you don't know everything the  
12 auditor saw, I think the audit committee's really not in  
13 a position to fully understand whether the auditor's  
14 judgments have been unintentionally or intentionally  
15 biased.

16 I think consistency is the key here. On some  
17 boards, things can work very, very well, but you can't  
18 assure that with purely strengthening the audit  
19 committee.

20 CHAIRMAN DOTY: Mr. Ferguson.

21 MEMBER FERGUSON: Professor McNichols, you made  
22 a statement that I found intriguing, and I think I got

1 it down correctly. And I would like to you elaborate on  
2 it, if you would.

3           You said earnings quality contributes to auditor  
4 tenure rather than the reverse. Did I quote you  
5 correctly on that?

6           MS. McNICHOLS: Right.

7           MEMBER FERGUSON: What does that mean, and how  
8 does that impact the way we should be thinking about  
9 auditor tenure?

10           MS. McNICHOLS: Well, I think the notion is that  
11 an auditor may stay with a client that has good earnings  
12 quality longer than a client that has poor earnings  
13 quality. And so the auditor has a higher probability of  
14 quitting a client that's really troubled. And that means  
15 they go into the pool of starting over, and they're in  
16 the early years of the sample where you're looking at the  
17 quality of the earnings. So that was really, I think --

18           MEMBER FERGUSON: Is that the auditor's decision,  
19 or is that a question of auditor -- an auditor risk  
20 assessment that an auditor assesses the risk of an audit  
21 where a client has poor-earnings quality as high, but  
22 from a liability standpoint?

1 MS. McNICHOLS: Well --

2 MEMBER FERGUSON: Is that what the concern is?

3 MS. McNICHOLS: It could be the auditor chooses  
4 to walk away. It could be the company goes away. In  
5 most of these studies, the company, you know, doesn't  
6 have to survive forever, it just has to survive a certain  
7 number of years.

8 And so, you know, a company that doesn't survive  
9 also could drop out of the sample. So for either reason.

10 CHAIRMAN DOTY: Steve?

11 MEMBER HARRIS: Well, I'm struck by the fact that  
12 auditors are not encouraged and sought after to serve on  
13 independent audit committees. I think that auditors know  
14 an awful lot about what goes on in an organization, and  
15 I'm struck by the fact that CEOs are encouraged to serve  
16 on independent audit committees instead of auditors.

17 So when we talk about the independence of the  
18 audit committee, I'm wondering how independent they truly  
19 are if they don't have auditors on the audit committee.

20 I have two questions. One, following up on  
21 Chairman Williams' testimony, if you were head of a --  
22 one of the firms listening to this hearing today, how

1 would you suggest they be proactive in terms of  
2 addressing the problems that you've articulated?

3           And then, second of all -- because time is  
4 limited I can't resist the temptation to ask multi  
5 questions at one point. With respect to the client,  
6 who's the primary client? I'd be interested in your --  
7 all of your views in terms of who you view as the primary  
8 client of the auditor when management pays the bill. I  
9 mean, if management's paying the bill, how can management  
10 not be the priority client? But we've all indicated that  
11 you -- some of you have indicated you believe the  
12 investor is the primary client. So if you could take  
13 those two on, I'd appreciate it.

14           CHAIRMAN DOTY: Andy, do you want to begin?  
15 Andy, do you want to begin?

16           MR. BAILEY: Let's do client first. We, as I  
17 have always understood this, and I've been -- I actually  
18 ran into people during my time at the SEC who argued  
19 contrary, but my understanding of this has always been  
20 that we got a monopoly on this activity, in the interest  
21 of the investor, third-party uses the market. And they  
22 are the client.

1           The payment scheme is an artifact that we seem to  
2 not be able to avoid.  Somebody's got to come up with the  
3 money.  All of the proposals that I have encountered  
4 about coming up with the funding to pay, have  
5 consequences that are almost, from our selfish  
6 professional point of view, at least, worst for us.  So  
7 if we have a single-party pay, like the government, or  
8 an agency, in effect, they become the arbitraries of  
9 auditing.  I mean, we basically eliminate ourselves as  
10 a profession, become a GAO public audits, if you like.

11           The insurance model's been proposed.  Josh Roman  
12 has -- a very intelligent guy, but he and I just don't  
13 agree.  All I think that that does is it shifts the  
14 nature of the payment scheme.  You now have an insurance  
15 company, for example, that likes to take premiums,  
16 probably isn't going to like to pay out the benefits, and  
17 they hire the auditor in a private contract.  And so we  
18 even lose that relationship that we would have had  
19 earlier.

20           So I don't know how to deal with the price  
21 problem, except to recognize that it's there, that it's  
22 an unusual sort of relationship that the client doesn't

1 actually pay you, somebody else does.

2 As to proactive, I'd be happy if they'd just stop  
3 being completely negative on virtually any change that  
4 might impact the way in which they do business. I mean,  
5 that would be a help.

6 I, right now -- basically, by the way, and this  
7 is maybe relevant -- I'm not sure that in this oligopoly,  
8 in a strange sense, that they do compete on quality. I  
9 think what they actually compete on is the price of the  
10 audit, and we drive that way down, because they don't  
11 perceive that as value added to them. And it's all made  
12 up in some way or another on the other services that are  
13 offered in a variety of ways, across -- not across a  
14 single client, but across the profession.

15 So proactive, it can be very hard for them to be  
16 proactive, because all of this has implications for how  
17 they're organized, how they do business and how much  
18 money they're going to make. I'd just be happy if they'd  
19 be a little less negative.

20 CHAIRMAN DOTY: Jim?

21 MR. COX: Yes, what I meant is, they don't  
22 compete on quality. They don't. I think there's a fair

1 amount of reason to support that.

2           On the client, I thought that one of the great  
3 innovations of SOX was making sure that the audit  
4 committee is the client and it represents the  
5 stakeholders of the company, which will be all in the  
6 reporting area, I believe all the financial statement  
7 users.

8           And so, unfortunately, I think audit committees  
9 haven't fully gotten that message. I don't know totally  
10 why that is. Maybe it's cultural, everybody was talking  
11 about earlier. But the client -- the client, for the  
12 auditor, is the audit firm -- I mean, the audit  
13 committee. And the audit committee represents the broad  
14 range of stakeholders, even broader than probably  
15 corporate law would probably think about, but the  
16 obligations of the directors are in that regard.

17           I thought -- and I think that that's a good  
18 model, I just -- it's not totally clear to me outside of  
19 the cultural, why it's not working better than it is.

20           And then how can various people be proactive? I  
21 actually think it's time for leadership within the  
22 accounting profession, for individuals, not just outside

1 the big four, but the big four themselves, to understand  
2 that this is kind of their last go ahead, quite frankly.

3           You know, history's a long time, and if the  
4 current SOX PCAOB model doesn't work, the next one that  
5 comes down the road is going to be a lot less appealing  
6 to them. It's going to be, as Andrew was pointing out  
7 -- you're going to be working for the federal government.  
8 And I found that pleasant. I'm not sure all auditors are  
9 going to find that that pleasant. So it's time for the  
10 industry to step up and understand that they can survive  
11 and do very well in this industry by enhancing their own  
12 professional independence.

13           CHAIRMAN DOTY: Maureen?

14           MS. McNICHOLS: I'll talk about what audit firms  
15 can do first. I think there the culture of the firm is  
16 critical. And in terms of, of enforcing a culture that  
17 motivates auditors others rewards auditors to do the  
18 right thing, I think I would like to see something like  
19 grand rounds, where they talk about, you know, cases that  
20 have been handled well and poorly, and recognize sort of  
21 what the values of the firm are in those instances, and  
22 have, you know, pretty candid discussions with their key

1 people about -- about the values that they really want  
2 to enforce in the partnership in the firm.

3 In terms of the question of who's the client, I  
4 think of its client as the investing public. I think  
5 that is the point of the audit. And while the engagement  
6 is with -- through the audit committee, not all audit  
7 committees are perfectly aligned with the investing  
8 public. And so I think the mindset should be that that  
9 is who they're there to serve.

10 In terms of payments, I think who pays is less of  
11 an issue than who makes the decision to hire and fire,  
12 and who structures the engagement and what limits there  
13 are associated with that. And that's why I think  
14 mandatory rotation can have value in terms of aligning  
15 auditors' incentives with investors.

16 CHAIRMAN DOTY: Jeanette Franzel?

17 MEMBER FRANZEL: You've all made reference to the  
18 client-payer model being flawed. And we've heard that  
19 reference from many others as well.

20 But there seems to be an acceptance that any  
21 other model, just -- we can't really realistically look  
22 at that. So given that we've got a model that people

1 believe is flawed, and you all have made references to  
2 structural changes that might be needed because of that,  
3 the inherent bias in that model, and we also talked about  
4 mandatory audit firm rotation and your views on that, I'd  
5 be curious in hearing any other structural changes that  
6 you think could or should be implemented, and what order  
7 of priority would you really place these in.

8           And then, Professor McNichols, I was also going  
9 to ask a question, really the one right after what Lew  
10 asked, and that is: You were talking about survivor bias  
11 in the firms, so I would just like to hear a little bit  
12 more about that as well.

13           MS. McNICHOLS: Okay. I could start off with  
14 survivor bias in the firm. I mean, the notion there is  
15 that a firm doesn't live a hundred years unless it  
16 actually has a good business. It has -- it may not, you  
17 know, have a perfect business over time, it has ups and  
18 downs, but you have to have a strong business to last a  
19 long time.

20           And so when you're looking at data and trying to  
21 understand whether auditor tenure -- auditors, I think  
22 are learning over time, I think the idea is, you know,

1 do auditors do a better job on their audits early in the  
2 engagement versus later, or, obviously the -- you know,  
3 the argument for many is it's when they do a poor job  
4 there's greater audit risk early in the engagement  
5 because they don't know the firm as well.

6           When you're looking at samples of data relating  
7 earnings quality, for example, and auditor tenure,  
8 there's other variables that enter into that relationship  
9 that would have to be controlled out before you could  
10 really understand whether there's higher or lower  
11 earnings quality at the beginning of the engagement  
12 versus later on, and what role the auditor actually  
13 played in achieving that, if at all.

14           So, when you have a firm that lasts a long time  
15 because it has very high-quality earnings, and an auditor  
16 that stayed with that firm, it doesn't necessarily mean  
17 that the auditor was doing a good job in controlling the  
18 firm's incentives to manage their earnings. They  
19 happened to be aligned with a very good firm in terms of  
20 a profitable, healthy company, healthy business. And so,  
21 you tend to see that higher earnings quality and auditor  
22 tenure could go together because of that.

1           So on the structural issues, I think you were  
2 thinking about structural issues vis-à-vis the  
3 relationship with -- with the client?

4           MEMBER FRANZEL: Just any other particular  
5 structural issues that you all might have in mind, or  
6 adjustment that could or should be made to the current  
7 model.

8           MS. McNICHOLS: I guess I could comment on one  
9 direction that I see, vis-à-vis audit committees. And  
10 that is in terms of compensation committees and audit  
11 committees.

12           I mean, one thing I see from the research on  
13 earnings management, as of course it's tied to management  
14 incentives, and when you have an audit committee that is  
15 not fully informed of all of the compensation  
16 arrangements and fully understanding of how exactly  
17 you're measuring the numbers that are going to determine  
18 bonuses and awards and so forth, then they don't quite  
19 know what to look for. And so things have to be very  
20 clear in terms of what's included and what's not  
21 included, and different kinds of targets.

22           And so one structural recommendation I would make

1 is that there always be someone on, you know, the audit  
2 committee and the compensation committee jointly. And  
3 some boards, I think, actually have those meetings held  
4 at the same time, and so they're completely different  
5 compositions.

6 CHAIRMAN DOTY: Andy?

7 MR. BAILEY: Yes. One thing about this  
8 conversation is that we're talking about mandatory  
9 rotation or tendering, and this really can be a multi  
10 track. It's not necessarily that we do only this and not  
11 something else.

12 And so, for example, the conversation down here,  
13 we might pursue figuring out how to make audit committees  
14 more effective, add consequences. There have been  
15 proposals that we have further limits of services that  
16 these firms can provide. There's no reason that can't  
17 be part of the conversation. Because I do think,  
18 fundamentally, this is in part a problem of a conflict  
19 of interest on these other services, where we really  
20 don't care that they perform them in a non-independent  
21 way. It's for the company that pays them.

22 On a first preference basis, you know, dangerous,

1 I would like to see -- I would have liked to have seen  
2 the Arthur Andersen option as an audit-only firm allowed  
3 to run for a while. I think there is -- and I think the  
4 firms can make -- and the people in these firms can make  
5 plenty of money. I mean, in an audit-only firm. And I  
6 don't mean very narrowly defined, but make it the 60s  
7 firm, whatever you'd like, and get rid of a large  
8 fraction of the consulting. These are the largest  
9 consulting firms in the world. They can stand alone.  
10 They don't need, I think, to have the audit.

11 Now, how are you going to get there? I have no  
12 clue. I do think that putting in mandatory rotation is  
13 likely to put a lot of pressure on the companies that are  
14 being audited, particularly if there's a consequence to  
15 their failure to predict that auditor and future  
16 auditor's independence. A real consequence may cause  
17 them to begin to rethink this.

18 I mean, the GAO had a round-table in which the  
19 issue of splitting up the firms came up. Nobody really  
20 wanted to talk about it, but it came up. And it is  
21 technically feasible to do that. It's going to be very  
22 costly, but this might actually begin putting some

1 pressure on the other side of the partnership to think  
2 about what it would mean to strip off the auditor, thus  
3 eliminating at least that particular part of the  
4 conflict, or influencing these firms to grow other  
5 consulting firms.

6 I don't know what the real answer is, I kind of  
7 -- my first preference, if I were given that authority,  
8 would be that I'd split these firms up.

9 CHAIRMAN DOTY: Jim, do you have a comment on  
10 structure?

11 MR. COX: Yes. I, you know, still continue to be  
12 bothered by the fact that the auditors do perform an  
13 awful lot of consulting services outside the prohibited  
14 list of SOX. And one of them is tax area. I think the  
15 political realities there, again, are formidable.

16 The issue I would really have there is wanting to  
17 know whether it could be some means of forcing audit  
18 committees to make a detached, or as detached a judgment  
19 as possible about whether it's possible to continue to  
20 have the auditor perform the tax services, but  
21 nevertheless have somebody else do the audit. Which is  
22 something, by the way, we're doing at Duke.

1           We decided filing 529 tax returns with various  
2 authorities around the world, that it just doesn't make  
3 sense to bring in somebody else new, but we are putting  
4 the audit up for bid this year. And we will be making  
5 a change there. That's all public knowledge.

6           So, I think greater transparency in -- somewhere,  
7 even in the audit opinion order, about how much revenue  
8 the auditors have from doing the audit services may have  
9 some chastening effect.

10           CHAIRMAN DOTY: We may have a time for a second  
11 round here. But what I find extraordinary about the  
12 panel is we've got -- with Andy Bailey, we have someone  
13 who is deputy chief accountant, spent a very significant  
14 amount of time looking at auditor independence and  
15 thinking about the principles that either undermine it  
16 or guided it. And what I take away from Andy, the cost  
17 is not the fee, but the failure.

18           I mean, the interesting thing here is that it  
19 should be a profitable business but for the kind of audit  
20 failure that results in stupendous litigation, the  
21 Parmalat-type situation. Stage predictability and  
22 thinking about this issue comes through strong in your

1 -- strongly in your statement.

2           With Jim Cox, you're suggesting that there is a  
3 range of change that could be addressed, concluding or  
4 coming to rest in a disclosure issue that if you retain,  
5 you must explain that you -- and this is of course where  
6 the FRC seems to be headed on tenure cycle in London.

7           And then -- and then from Professor McNichols,  
8 the idea that we should be mistrustful of the current --  
9 of the authoritativeness of the current literature to  
10 simply dispel in the investigation of this.

11           I mean, I think that the three of you have the  
12 advantage of having actually read and exhausted the  
13 academic literature, which many of the people reacting  
14 to this subject have not. And I take it that Maureen is  
15 cautioning us that the models that have been structured  
16 really are undermined by the terms, the tenure changes,  
17 and some of the other dynamics that go into auditor  
18 rotation studies, or the relationship of the auditor, the  
19 audit committee and the company.

20           What should we be looking at, though? Where, if  
21 there is additional work that we should do to focus on  
22 what is pragmatic and what is likely to preserve and to

1 foster an independent audit profession and not move us  
2 to a government operation or to something that is an  
3 unattainable, such as an insurance model?

4           Where should we be putting our investigation?  
5 Any thoughts on that? Since research is your business,  
6 as you've said, where do we need to do more research?

7           MR. BAILEY: As an academic, this is blasphemy,  
8 but, you know, all the research that's been done, there  
9 is -- you can find one that supports the idea. It will  
10 be narrowly done and narrowly performed. And you'll find  
11 one that is suggestive of failure of independence. And  
12 then a jump might be -- a leap might be made to auditor  
13 rotation or handling the audit committees in a different  
14 way. And we will continue to do that sort of thing.

15           And we're not bad at it. I mean, it's  
16 interesting work, and -- but I just have this feeling on  
17 this one that it's never going to resolve. You're never  
18 going to get the kind of comforts you would like to have  
19 that. You're moving, on mandatory auditor rotation, for  
20 example, is going to resolve the problem. In fact, of  
21 course it will not resolve the problem; it will change  
22 the rules of the game. But I think it's a rule changer

1 that might be much more difficult to deal with than the  
2 tinkering we've done in the past. And that tinkering,  
3 by the way, I don't mean to minimize it, it's important.

4           So I'm not sure that, despite my background, that  
5 I would suggest that you wait around a long time  
6 commissioning studies, commissioning trials and more  
7 research. We're much better as academics, frankly, of  
8 taking the change in the environment and testing what the  
9 character of that change was.

10           MR. COX: Well, you know there's always two  
11 responses to any empirical research. People say I knew  
12 that, or that can't be right. And it's a little like  
13 what Andrew is saying here is, one brick doesn't build  
14 a house. And it takes a long time. And as somebody who  
15 does empirical work, I understand how long this is.

16           I actually think that, getting ready for this, I  
17 was surprised how much literature there is already out  
18 there. And it also made me start thinking about the  
19 following, and that this is a problem largely of large  
20 reporting companies; less of a problem, I think, of small  
21 companies. And the reason I'm saying that is that there  
22 there's a fair amount, what I'll -- just out of the

1 corner of my eye -- a fair amount of changes of  
2 accounting firms each year of public reporting companies  
3 which tend to be more allocated to the smaller firms.

4           So although smaller firms have weaker reporting  
5 systems, and that's where you're going to find more of  
6 a problem, you may be starting at the top where there's  
7 less concern that the audit costs are really -- have a  
8 disproportionate impact on earnings. Maybe that's where  
9 you would start off.

10           So, again -- so I'm agreeing with Andrew that  
11 maybe just looking at the field of research right now and  
12 then get your priors and then reaching a policy judgment,  
13 is probably enough. I don't know if there needs to be  
14 a lot more research and then figuring out how you can  
15 roll this out in a sellable fashion.

16           CHAIRMAN DOTY: Do you have a parting ---

17           MR. BAILEY: You know, this business of large  
18 firms/small firms, I was one of the advocates that said  
19 that IAS -- AS-2 and 5 should be applied to the non-  
20 accelerated filers.

21           If our interest is in protecting the markets,  
22 okay, then it's the large firms and the large clients,

1 because small failures don't really impact the market  
2 much. If your interest is in protecting the investor,  
3 you've got a kind of a different kind of moral problem  
4 to deal with. So on a roll-out basis, however, starting  
5 big and working down in terms of the markets would be the  
6 way to go.

7 CHAIRMAN DOTY: Maureen?

8 MS. McNICHOLS: Yes, I concur with Andrew and  
9 Jim's comments. I think that you have the evidence you  
10 need to move ahead in terms of mandatory auditor  
11 rotation. I think -- I think the data are clear that  
12 structure contributes to unintentional and intentional  
13 biases that are very, very harmful to the economy. I  
14 think starting with sensitive companies and large  
15 companies where the benefits are the greatest, and where  
16 basically the companies are too big for audits to fail.  
17 And so I agree with sort of a starting position with  
18 perhaps the largest companies.

19 I think the other thing that's possible for the  
20 boards to do is exploit what you have learned as much as  
21 possible from all of your investigations. Perhaps it's  
22 some kind of collaboration with academics. Maybe you

1 were already doing some of that. I'm sure that many  
2 academics over the years have had, you know, tremendous  
3 interest in pursuing questions relating to audits, and  
4 are unable to access data through the firms. And so I  
5 think there's great potential to contribute to how to do  
6 better audits going forward.

7 But, vis-à-vis the decision before you today, I  
8 think the research is already there.

9 CHAIRMAN DOTY: If we're going it have a break,  
10 we should take it soon. Brian? Yes, go, sorry.

11 MR. CROTEAU: Thank you, and good morning.

12 I just have a follow-up for Professor Cox. And  
13 it relates to -- I think you've asserted that perhaps an  
14 option would be to look to mandatory re-tendering, with  
15 an option of retaining the current auditor.

16 And you've also asserted that you don't believe  
17 that firms today are competing on quality. And I just  
18 wonder, some have suggested under that type of a model  
19 firms would spend more time marketing, more time thinking  
20 about what they need to do to appease their client.

21 And I just wonder how you think about that in the  
22 context of the re-tendering option, and whether that

1 actually would drive increased quality, or whether that  
2 actually could create additional incentives that could  
3 cause us to focus more on, in fact, cost rather than  
4 quality?

5 MR. COX: I think it's very -- that's an  
6 excellent question. And unfortunately I don't have an  
7 excellent answer.

8 The answer I'll provide is along the following  
9 line. It's very difficult to communicate on quality and  
10 differences in quality when you're talking about  
11 professional services of going forward. And so I think  
12 that the real benefits wouldn't be in the sharp process  
13 that we normally see of making consumer choice on certain  
14 decisions.

15 What I would think might come about would be,  
16 hopefully -- and again, I'm less than certain about this  
17 -- that by opening it up and having the competition, that  
18 that changes somehow the dynamics and the culture within  
19 the board, okay. And because when the institutions and  
20 others see that the decision's coming up, maybe they'll  
21 be reaching out.

22 And we are finding, you know -- that's where

1 really accelerating change is occurring, is the  
2 robustness in which a wide range of financial  
3 institutions are now communicating their views to  
4 individual directors. And I think that's where the  
5 change would occur. So I don't think it's the same thing  
6 where having GM and Ford go against each other, we're  
7 talking about product quality.

8 I think it's what happens in the boardroom in  
9 terms of being an awareness that this decision's going  
10 to happen. You have these different choices. Maybe  
11 you'll change the culture. Again, emphasis on the maybe.

12 CHAIRMAN DOTY: Our chief auditor, Marty Baumann,  
13 has a quick parting question.

14 MR. BAUMANN: Thanks. I want to follow up, too,  
15 Professor Cox, on something you said. But I'd be  
16 interested in the views of others.

17 You said, plus there's cultural issues of who  
18 serves on the boards getting to the fact of are they  
19 capable of digging into the complex accounting and  
20 auditing issues, and are they independent audit  
21 committees, et cetera.

22 We also heard from Chairman Williams about can

1 audit committees really dig into some of the issues, do  
2 they have the ability to dig into some of the  
3 unintentional, you know, the bias that's there, and do  
4 they really have the capability to get behind that.

5 I don't have the statistics. I'm going to get  
6 them. I don't have the statistics of how many companies,  
7 as large as 500 or a thousand, have experienced auditors  
8 serving on them. I don't know if you do have that,  
9 because you pointed out the cultural issue.

10 I do observe that when a company has problems,  
11 when it's had restatements, it's now -- the company's in  
12 a financial crisis, there are difficulties, experienced  
13 auditors do get appointed to the boards and audit  
14 committees ultimately, and that's interesting to see that  
15 happen after the fact. But I will get the statistics on  
16 what percentage of very large companies have experienced  
17 auditors serving on them.

18 Would it make a difference, in your minds, that  
19 if audit committees did have very experienced auditors,  
20 former auditors serving on the committee in terms of this  
21 entire process of governance and/or the way in which  
22 audit committee auditor interaction and independence

1 might work?

2 MR. COX: I think the answer to that is yes. And  
3 I think that one of the reasons that makes me say yes is  
4 the following.

5 If you look at the two -- I think I'm using the  
6 appropriate titles -- the two COSO reports where you  
7 looked at SEC enforcement actions for one decade, which  
8 was leading up pretty much to the Enron collapse, and  
9 then looked at the more recent one, that, as I recall,  
10 the data there, we found a really substantial change that  
11 the variable that leapt out at you at the '79 through '89  
12 enforcement actions, was the absence of an audit  
13 committee or experienced personnel on audit committees.  
14 That was the variable that leapt out and said that's what  
15 matches up with financial frauds.

16 And then we looked at other variables that --  
17 other than the -- the audit committees were good, and  
18 they weren't a variable that was leaping out in quality.  
19 So, you know, my own feeling is that, private staffing  
20 isn't necessarily going to be the issue with the audit  
21 committee, meaning who's on there or isn't there.

22 There was a question that Board Member Harris was

1 suggesting, why do we have existing auditors on these  
2 committees or more. I actually think it's still a  
3 problem that's for the board, and that is that they're  
4 time bound and they're information bound. And they --  
5 you're still seeing things through several filters that  
6 prevents them from being as engaged as perhaps we would  
7 like to see engage the.

8 CHAIRMAN DOTY: Andy?

9 MR. BAILEY: As a practice problem with only four  
10 firms, we're not talking about being able to put active  
11 auditors on these audit committees, because that will  
12 conflict them out promptly unless they're rotated off  
13 within some specified period of time on a mandatory  
14 rotation. But, in general, the answer would be --

15 MR. BAUMANN: There are plenty of retired --

16 MR. BAILEY: Yes, that's what I was going to say.

17 MR. BAUMANN: Right. I know of one.

18 MR. COX: And as many as you can guess who have  
19 distanced themselves from their firms, it can hardly do  
20 any harm. I mean, they would actually know something  
21 about the financial issues and about the auditing issues,  
22 and the information flow is going to get better.

1 CHAIRMAN DOTY: It can't hurt.

2 MEMBER HARRIS: Yes. And I was focused just on  
3 retired auditors --

4 MR. COX: Yes.

5 MEMBER HARRIS: -- who retired at a very early  
6 age, try and get on audit committees, they go to  
7 headhunters, and they find out, no, no, we don't want  
8 you, we want CEOs. It seems to me that an independent  
9 audit committee ought to have its fair share of retired  
10 auditors or others on an independent audit committee.

11 CHAIRMAN DOTY: We're going to have to leave it  
12 there if we're going to have a break. I'm always  
13 reluctant to have closure and pose closure on board  
14 members or staff. But thank you, all three of you. We  
15 will resume.

16 And let's resume at 10 past 10:00 to get the next  
17 panel going. We'll give ourselves a 10-minute break,  
18 because we're on schedule.

19 (Whereupon, the above-entitled matter went off  
20 the record at 10:01 a.m. and resumed at 10:14 a.m.)

21 CHAIRMAN DOTY: Welcome. This is a panel of  
22 entrepreneurs who have actually founded and run

1 businesses. Charlie Drott is an independent consultant,  
2 operated your own professional services company based on  
3 Novato, California since 1982, providing investigative  
4 CPA services, expert witnesses, primarily relative to  
5 audit failures and accounting fraud for law firms, law  
6 enforcement agencies. Mr. Drott was appointed to and  
7 served a full term as a member of the California Board  
8 of Accountancy serving as chair of the board's  
9 enforcement program oversight committee. He's been chair  
10 of a peer review task force, a member of the committee  
11 on professional conduct, and has practiced with two of  
12 the major public accounting firms.

13 Brian Fox is the founder of confirmation.com, the  
14 holder of two patents granted on electronic audit  
15 confirmation, which he used as the foundation for the  
16 company that's now used by all of the top 10 banks, the  
17 Federal Reserve, more than 8,000 accounting firms, by  
18 more than 45,000 individual accountants and 106  
19 companies. Prior to founding Capital Confirmation, Mr.  
20 Fox was in Dallas as an auditor for Ernst & Young and  
21 mergers and acquisitions for PricewaterhouseCoopers, a  
22 four-time winner of the accounting profession's Top 40

1 under 40 CPA and accounting, and Entrepreneur of the  
2 Year, and on the board of the -- the advisory board of  
3 several businesses and services and mentor to  
4 entrepreneurs in 500 Military Entrepreneurship Program  
5 in Nashville. Welcome to you.

6 Steve Thomas, a founding partner of Thomas,  
7 Alexander & Forrester. Prior to that with Sullivan &  
8 Cromwell for six years. A law clerk for the Honorable  
9 Ralph Winter, one of the -- certainly one of the most  
10 foremost judicial minds in corporate governance law in  
11 the United States, in securities law. Mr. Thomas  
12 represents businesses as defendants. And what's unusual  
13 about your practice, I think, Mr. Thomas, is you have a  
14 lot of knowledge and insight into what we're inquiring  
15 into here, which are audit failures and corporate crises,  
16 but you have an active defense practice.

17 So welcome to all of you. You bring an insight  
18 and you bring a point of view that we badly need in this  
19 discussion. Charlie, we'll begin with you.

20 MR. DROTT: Thank you, Chairman Doty, members of  
21 the Board and PCAOB staff, for inviting me here today to  
22 express my views on auditor independence, mandatory audit

1 firm rotation, professional skepticism and objectivity.

2           During my work as a forensic auditor, I have  
3 investigated over 50 audit failures, many of which were  
4 large public companies. In many of these matters, I also  
5 testified as an expert witness in litigation relative to  
6 the audit failure issues, as well as fraudulent financial  
7 reporting.

8           I have concluded that the primary reasons for the  
9 majority of these failures were compromised auditor  
10 independence and lack of professional skepticism. And  
11 also, I wanted to say that true auditor independence, in  
12 my view, is never going to be achieved until the auditors  
13 are hired and paid by an entity independent of the audit  
14 client.

15           So that then asks the question, what can be done  
16 in the meantime? Well, until that day comes when  
17 auditors are hired and paid by an independent entity, a  
18 viable step forward, in my view, is enhancing auditor  
19 independence and skepticism by mandatory audit firm  
20 rotation, which I fully support.

21           Mandatory rotation has several benefits. One, it  
22 establishes a limit on the continuous stream of audit

1 fees. This will significantly free the auditor from  
2 pressure by clients to accept improper financial  
3 reporting. It would also have the benefit of a new and  
4 fresh evaluation of a client's financial reporting and  
5 internal controls. It would eliminate long-term cozy  
6 improper relationships between the auditor and its  
7 client. And it would eliminate further influences on the  
8 audit firm's decisions when many of the audit firm's  
9 partners, managers and staff have accepted positions with  
10 the client.

11 One way in which I thought that mandatory audit  
12 firm rotation could be structured, and this is just one  
13 of many ways it could be structured, is to have a 10-year  
14 rotation period. And I would not want to see more than  
15 10 years, but a 10-year rotation period directly linked  
16 to the PCAOB's inspection program.

17 If inspectors encounter an audit failure for the  
18 first time during the 10 years regarding a specific  
19 client of the audit firm, I recommend the PCAOB require  
20 a total audit team rotation. But if it happens a second  
21 time with the same client within the 10-year rotation  
22 period, then automatic rotation as the client's auditors

1 would occur.

2           Critics of the mandatory audit firm rotation make  
3 two major points. One is that there's a possible lack  
4 of audit quality and knowledge of the client in the early  
5 years of an engagement. And secondly, additional costs  
6 of changing auditors. Well, I believe just the opposite  
7 is true regarding lack of knowledge in the early years  
8 of the engagement. Audit quality, in my view, tends to  
9 suffer the longer the relationship exists because the  
10 auditor becomes too cozy with the client, can become  
11 complacent, and protects the audit income stream as a top  
12 priority.

13           Also, in a new audit engagement, the new auditors  
14 expend considerable resources in evaluating the  
15 accounting treatment of high-risk audit areas, the  
16 accounting systems and internal controls.

17           And also the argument that auditors lack  
18 knowledge of the client in a new audit, to me doesn't  
19 make a lot of sense. Because in order for the auditors  
20 to give an unqualified audit opinion, they have to fully  
21 understand the client's operations, accounting systems  
22 and controls.

1           As far as additional costs of a new audit, this  
2 generally occurs only in the first year, or perhaps the  
3 first two years in the new engagement. Audit firms, in  
4 many cases, will have -- or I should say, the client in  
5 many cases will not have any additional costs because of  
6 competitive bidding.

7           And also, clients and auditors need to understand  
8 that short-term additional audit costs, if any, are far  
9 less than the costs of litigation if the client's  
10 financial reporting is misleading and not caught by a  
11 complacent long-term auditor, who is not on his toes like  
12 a new auditor would be with new eyes focused on the  
13 client's financial reporting.

14           And I would suggest also staggering these  
15 rotations over a period of time at each firm to avoid too  
16 much disruption at any one firm. I have heard a lot of  
17 people say that emphasis should be given on the large  
18 firms, and I tend to agree with that. But I would add  
19 to it that special emphasis should be placed on large  
20 clients with high-risk audit issues, and even some  
21 smaller clients with high-risk audit issues.

22           Finally, regarding auditor skepticism and

1 objectivity, the lack of auditor skepticism and  
2 objectivity were significant factors in virtually all of  
3 the audit failures which I investigated. The most common  
4 results of the lack of professional skepticism were  
5 excessive reliance on management representations without  
6 obtaining adequate corroboration with persuasive audit  
7 evidence, and allowing improper financial reporting of  
8 a client.

9           This was particularly evident in long-term client  
10 relationships with high-risk audit areas that required  
11 critical management estimates and judgments. More  
12 emphasis needs to be placed on professional skepticism  
13 by the audit staff and audit team reviewers, to ensure  
14 that this situation is corrected through emphasizing  
15 professional skepticism during audit planning and  
16 execution, partner reviews and staff training.

17           This concludes my opening remarks, and I am happy  
18 to answer any questions you have. And I thank you very  
19 much.

20           CHAIRMAN DOTY: Thank you. Brian Fox.

21           MR. FOX: Thank you, Chairman Doty, board members  
22 and staff, for inviting me here to speak today.

1           Given the high volume of comment letters and the  
2 amount of rhetoric devoted to this subject over the last  
3 few months, it is apparent that the subject of audit firm  
4 rotation is an extremely polarizing topic. With my time,  
5 I'd like to present a point of view that I believe has  
6 been overlooked during the discussions and deliberations  
7 on these topics.

8           Think like a fraudster. I'd like to ask the  
9 Board to consider any current standards or proposed  
10 standards from the viewpoint of a fraudster. The PCAOB  
11 was created because of fraud and the billions of dollars  
12 of resulting investor losses. I believe that it is  
13 imperative to look at any PCAOB standards and proposed  
14 changes through the lens of a fraudster.

15           So in this case, what would a fraudster say about  
16 audit firm rotation? The answer's obvious. A fraudster  
17 would be wholeheartedly against it. You see, a fraudster  
18 has already fooled their auditor. That is what has  
19 allowed them to be getting away with fraud already.

20           Results from the Association of Certified Fraud  
21 Examiners show that frauds usually take place for  
22 multiple years before they are discovered, which is far

1 too late for investors who have already invested in the  
2 company. In fact, if I were a fraudster, I wouldn't have  
3 just written one letter opposing audit firm rotation, I  
4 would have written four using different letterhead with  
5 logos that I had taken off the internet.

6           As I see it, there are four sets of parties  
7 commenting on audit firm rotation. External auditors,  
8 honest issuers, fraudster issuers and the investors.  
9 Each of the first three parties is adamantly opposed to  
10 firm rotation, and understandably so. Collectively, they  
11 are also doing their best to convincing investors to take  
12 the same position.

13           Let's look at the positions of each of the first  
14 three groups. External auditors claim that higher costs  
15 and lower-quality audits will result in the first few  
16 years after firm change. But we've heard testimony from  
17 companies like TIAA-CREF whose actual experience showed  
18 lower cost in what they perceived as heightened audit  
19 quality due to new thinking by the auditors.

20           Honest issuers also don't want to change audit  
21 firms. Change always creates a heightened level of  
22 anxiety, and changing external audit firms is no

1 exception. Companies note that the new auditors will  
2 likely ask different questions, look in new areas, view  
3 things from a different point of view, and poke and prod  
4 new territory which the prior firm did not, which is  
5 exactly the point. People are creatures of habit and  
6 like what's familiar to them.

7           However fraudster issuers also rely on that  
8 familiarity, and also oppose audit firm rotation.  
9 Fraudsters try their best to befriend the auditors,  
10 because for them to pull off their fraud successfully,  
11 they have to know where the auditors are going to look,  
12 what audit procedures they're going to perform, how  
13 they're going to do their inventory counts, and how  
14 they're going to perform the confirmation process.  
15 Without this knowledge, the fraudster can never fool the  
16 auditors into signing off on the audit report. Being  
17 forced to hire a new audit firm is unthinkable for a  
18 fraudster, because it creates a heightened level of  
19 uncertainty for them, which produces a more likely chance  
20 that the fraud will be uncovered.

21           A recent look at short sellers, like companies  
22 like Muddy Waters illustrates that as a profession, we

1 may be missing the forest for trees, as was the case with  
2 Sino-Forest and any others. We need to look at how and  
3 why external auditors with much greater insight and  
4 access to the company, management and detailed financial  
5 information can miss frauds that short sellers are able  
6 to identify using just publicly available information.

7           As for audit firm concentration, while we have  
8 gone from the big eight to the big four, I think that if  
9 mandatory firm rotation is put into practice, that the  
10 current concentration of just four big firms will become  
11 less of an issue, because market needs will create a  
12 market reaction to meet the needs in the marketplace.

13           Required rebidding of the audit will not stop  
14 fraud, and will also fall short of the PCAOB's primary  
15 objective of protecting the investor. Would the  
16 executives of a company who are committing fraud which  
17 personally benefits them to the tune of millions of  
18 dollars actually switch firms because the audit fee is  
19 a million or two lower? It's impractical to assume so.  
20 In fact, even the offer of a free audit to the fraudster  
21 would be turned down because of the risk of being found  
22 out by the new auditors is too great.

1           Similarly, requiring periodic affirmative vote on  
2 the audit firm, or having a clause that allows the  
3 company to forego changing auditors if they simply  
4 document the reasons why they aren't changing, won't stop  
5 or deter fraud either. A fraudulent company will keep  
6 their auditors indefinitely using every plausible reason  
7 why, because it's in their own personal best interest not  
8 to change firms.

9           Sharing inspection reports with boards and audit  
10 committees is a great idea, and will certainly serve to  
11 enhance the audit quality of honest companies. However,  
12 for a fraudster it doesn't matter how bad his or her  
13 auditors are. Unless the fraudster is forced to do so,  
14 they will never change firms.

15           While there is much debate about what we  
16 shouldn't do, it is obvious that what we are currently  
17 doing isn't stopping fraud. We have enough facts, and  
18 it is time to take action. When an audit firm feels it  
19 can be fired an any point, there's an inherent conflict  
20 of interest that exists, at least at some level. In  
21 order to fully remove that conflict of interest, the  
22 PCAOB should consider requiring multi-year contracts with

1 pre-determined lengths and fees.

2 I believe it is also time to reconsider an audit  
3 rating scale for companies, similar to the debt-rating  
4 scales that companies receive. What actually exists  
5 today is a pass/fail model which gives no leeway to the  
6 auditors to provide better, more accurate information to  
7 the public.

8 An alternative to mandatory audit firm rotation  
9 would be a requirement to allow the shareholders to  
10 determine when to change audit firms. So that minority  
11 shareholders aren't held hostage by groups of large  
12 voting blocks, I propose a decreasing scale of  
13 shareholder approval needed to change audit firms.

14 Another alternative to audit firm rotation would  
15 be to limit any single team member from working on the  
16 same client for more than a certain number of years.

17 I want to thank the Board for allowing me to  
18 speak at this public panel and ask the Board to spend  
19 part of its deliberations thinking like a fraudster.  
20 Doing so will provide the Board with an interesting  
21 perspective on any proposed changes or current standards  
22 that I believe will allow you to see the world as the

1 fraudster sees it, which should provide some clarity as  
2 to the direction the Board should go with its proposed  
3 changes.

4 I believe in the value that our profession  
5 provides. And I believe it can also be strengthened.  
6 And on a purely personal note, I'd like to see more  
7 fraudsters go to jail and more families stop losing a  
8 significant part of their life savings. Thank you.

9 CHAIRMAN DOTY: Thank you. Steve Thomas.

10 MR. THOMAS: I've been struck today between the  
11 difference of the reality that's been discussed here and  
12 the reality that I hear every day coming out of the  
13 mouths of the actual auditors for the big firm.

14 Today, almost everyone here assumes that the  
15 audits have a public role, that auditors have a public  
16 duty, and that auditor's job is to actually find fraud.  
17 That is not what the auditors that actually go out and  
18 do the audits think. At least that's not what they tell  
19 people when they're not in front of you.

20 Over and over and over again the big firms deny  
21 that the public is any sort of a client of theirs, deny  
22 that they have any public duty, and deny that it's their

1 job to detect fraud. This isn't an isolated instance,  
2 it's in virtually every case I have representing  
3 businesses as plaintiffs and defendants.

4 I've given some examples in the handouts that  
5 I've provided to the Board. We asked auditors what does  
6 the P stand for in certified public accountant? They  
7 never know. In the first page you see for a big four  
8 audit partner who had been at the firm doing audits for  
9 over 15 or 20 years. He said, "Why is public inserted  
10 between certified and accountant? I don't know that  
11 there's any definition in the accounting literature  
12 related to public. So I don't know that public has any  
13 particular meaning today."

14 So I asked him, "So as of today, you don't know  
15 what public means in that phrase, right?" And he  
16 answered, "I don't know." If you look at ET 53, which  
17 is the ethical rule governing accountants, which also is  
18 always news to the auditors that we speak to, and I've  
19 attached it to the back, there's actually a definition  
20 of what public is.

21 So the statement by a long-time audit partner at  
22 a big four firm, "I don't know what public means," well,

1 it's defined in their own ethical rules. The accounting  
2 profession's public consists of clients, credit granters,  
3 governments, employers, investors, the business and  
4 financial community, and others who rely on the  
5 objectivity and integrity of certified public accountants  
6 to maintain the orderly functioning of commerce. That's  
7 what the rules say. But they don't know it.

8           And to show you that it's not isolated, I put in  
9 -- from another big four firm -- I asked him, "Do you  
10 understand that you have a responsibility to the public?"  
11 And he said, "I'm not sure I understand what you mean by  
12 any responsibility to the public; I mean, I always viewed  
13 myself as being responsible to myself, and that would  
14 just protect me." And I asked him, "Well do you owe a  
15 duty to the public?" And he said "No, I owe a duty to  
16 perform my audits with GAAS, that's good." And I said,  
17 "Well who do you owe that duty to?" And he said, "I  
18 think my firm and myself are it."

19           Auditor rotation is a good idea, but it's like  
20 hitting a lion with a fly swatter. The problem is not  
21 that we need to change from one great big auditing firm  
22 to another. That's just bringing in someone else who

1 doesn't have the incentive to act in the public interest.

2           Because, in fact, what was asked earlier, I think  
3 by Board Member Harris is who is the client. Well, you  
4 know, the United States Supreme Court addressed that  
5 years ago, in 1984, about who allegiance was owed to.  
6 And the United States Supreme Court said that by  
7 certifying the public reports that collectively depict  
8 a corporation's financial status, the independent auditor  
9 assumes a public responsibility transcending any  
10 employment relationship with the client. The supreme  
11 court went on to say that the auditor owes ultimate  
12 allegiance to the corporation's creditors and  
13 stockholders, as well as the investing public.

14           That's what the rules should be, and maybe people  
15 in this room assume. But it's not what the auditors who  
16 are actually doing audits assume. And that's because  
17 they don't have an incentive to act in the public  
18 interest. Their incentive is to act in their own  
19 financial interest. So any change that is going to be  
20 made is going to give -- real change is going to be a  
21 change that effects those incentives.

22           I would propose things that change the

1 incentives. Audit rotation is good. But you can't just  
2 put another fox in the hen house. The first thing I  
3 would propose is that when the PCAOB does your  
4 investigations and you find audit failure, and it is  
5 linked in any way to the failure to audit management  
6 representations, to the failure to carry out SAS 99, or  
7 the failure for professional skepticism, then the audit  
8 firm automatically foregoes its audit fees.

9           Those fees are paid to the government. They're  
10 disgorged. Why? Because the audit is a public good.  
11 Something that will actually give an incentive to the  
12 auditors to do a job that serves the public.

13           The second thing I would suggest is, if we're  
14 talking about public companies and the Public Company  
15 Accounting Oversight Board, your work should be public.  
16 The work of the PCAOB should be public. So each audit  
17 opinion that we see all look the same, right? They all  
18 look the same when they sign off. There's nothing behind  
19 it to tell you what happened. But where there's audit  
20 failure, the public, the investors and companies who are  
21 going to hire that accounting firm in the future deserve  
22 to know. They deserve to know the details of the

1 investigation, and there shouldn't be something that's  
2 kept secret for years until, you know, one of the big  
3 four just refuses to make any change, if you say, "You  
4 ultimately have to disclose it."

5           The third thing I would suggest is that we have  
6 to involve management to change the incentives, and  
7 specifically audit committees. The big issue is that,  
8 just as audit rotation tries to address, that auditors  
9 and management get too cozy. We see it in our cases all  
10 the time.

11           I have a case now where everyone agrees that the  
12 financial statements were materially misstated for seven,  
13 eight years. Same auditor signed off every year. And  
14 what happened? By the end, half of management were  
15 former auditors at the bigger accounting firm that was  
16 doing the audit. So they were just talking to their  
17 colleagues back and forth. So audit rotation addresses  
18 that. But, in fact, the audit committee must be  
19 involved.

20           Therefore, if there's an issue about management  
21 representations, meaning that the accounting firm is  
22 relying on management representations, those must be

1 disclosed in writing to the audit committee, and as part  
2 of the audit opinion, and that disclosure should say what  
3 the auditor did to actually test management's  
4 representations. That written disclosure will make  
5 accountability easier, easier for the Board, and easier  
6 for investors.

7           And, finally, if these aren't able to address the  
8 fundamental problem that we have, then I propose public  
9 audits of public companies. This system, as of now,  
10 doesn't work. The auditors themselves don't accept their  
11 responsibility. Audit failure, you find all the time;  
12 I see it every day.

13           Public audits of public companies take the firms  
14 and their conflicts of interest out of equation. That  
15 would be a greatly increased role for the PCAOB, but it  
16 could be where we're headed. Because as I've listened  
17 today, I'm not sure anyone is confident that the lack of  
18 incentive for the accounting firms to act in the public  
19 interest is being addressed. Thank you.

20           CHAIRMAN DOTY: Thank you. Lewis Ferguson?

21           MEMBER FERGUSON: Yes, I must say this. I  
22 thought the points that all of you made were intriguing

1 here. But I'd like to ask a kind of funny question that  
2 goes to the nature of the way audits are conducted today.

3           And I think you, Steve Thomas, pointed it out  
4 when you said -- or maybe you did, I can't remember who  
5 said that -- you know, auditors basically say that their  
6 job is not to find fraud, that's not what they do, that  
7 that's a different thing, that's a forensic audit and  
8 they're not doing forensic audits, they're not looking  
9 for fraud.

10           What if -- and I happen to know that one firm not  
11 in the United States is actually experimenting with this,  
12 that something that was built into the audit -- and this  
13 doesn't -- this does not solve the systemic problems, but  
14 it might solve some of the problems in the way audits  
15 occur -- what if part of what the auditor did was to take  
16 -- you might pick a different area each year, but to  
17 bring forensic auditors in and say we will look at a  
18 particular part of this audit the way a forensic auditor  
19 will do?

20           That we will essentially do a forensic audit of  
21 a particular part of the company's operations, starting  
22 with the assumption that something's wrong here, not that

1 something's right, but bring a different presumption.  
2 It could even be done by a different firm. But even with  
3 the firm, because oftentimes the forensic sections of  
4 these big firms are separate parts of the firm. Would  
5 that help? Would that help to make these -- to basically  
6 put management more -- sort of make management more  
7 concerned about the nature of the audit, about what's  
8 going on?

9           Would it help find frauds? Would it be more --  
10 would it make the auditor think more like a fraudster  
11 himself to try to find audits? What do you think about  
12 it?

13           MR. THOMAS: Well, I think yes, it would help.  
14 But I think the problem is not so much the rules, as the  
15 incentives. Right now SAS 99 requires that an auditor,  
16 for revenue recognition, assume that something could be  
17 wrong beyond professional skepticism. But we find the  
18 firms don't -- often don't even point to SAS 99.

19           So I think there are already strong rules that  
20 say that an auditor who is giving an opinion about  
21 whether there is a material misstatement due to error or  
22 fraud undisputedly had the obligation to find fraud, and

1 SAS 99 takes the presumption beyond professional  
2 skepticism, yet they still deny it.

3 So making the rules even more clear I think would  
4 be helpful, but I think it's the incentive that is more  
5 the issue than more rules, because the rules we have  
6 already require it.

7 MR. FOX: You know that's a -- really, as I look  
8 at it, the profession to some degree can't be blamed for  
9 our history, right. I mean, it's hundreds of years that  
10 we went out and essentially it wasn't until SAS 82 that  
11 we admitted the word fraud in our standards, which was  
12 updated in SAS 99.

13 And so it wasn't until recently that the majority  
14 of our profession, as Steve said, refused to admit that  
15 part of our responsibility was to find fraud and, yet we  
16 were supposed to find material misstatement. Which, if  
17 you look at a case like Parmalat, I'd say a \$4.9 billion  
18 bank account balance that didn't exist, even though that  
19 was fraud, it was certainly a material misstatement of  
20 the balance sheet as well, so it should have been caught.

21 But as we look at it, SAS 99 does require you to  
22 brainstorm, assume a revenue recognition risk. And yet

1 as I do presentations and speeches to two or three  
2 hundred folks at a time, and I ask them, I said if that's  
3 the case in order to audit revenue you'd have to look at  
4 either cash receivables, because you either received it  
5 or it's owed, how many people have altered the nature,  
6 time and the extent of their confirmation procedures from  
7 the time you were staff members, and not one person  
8 raises their hand.

9           They're still looking at a small sample as they  
10 possibly can, they're picking a few of the large items  
11 to get that sample size down, you know, smaller. Because  
12 we all played that game when we were staff, because it's  
13 a painful process. And yet as you look at a fraud like  
14 Satyam, it was a confirmation fraud, and yet the partner  
15 and senior manager both lost their job and went to jail,  
16 but we know for a fact that the senior manager and  
17 partner weren't the ones to actually be doing the  
18 confirmation procedures. And so we're not altering the  
19 nature, time and extent of our procedures. So I do think  
20 that would be beneficial.

21           And as Steve said, realigning the incentives. I  
22 mean, if you went to the far extreme, what if you -- and

1 this is impractical to do, but what if you said any audit  
2 team that actually catches the fraud, they get to split  
3 the audit fee that year amongst them. Right? I mean,  
4 that's impractical to say, but, but at least you see  
5 where we're going. That would properly align their  
6 incentives.

7           And so, you know, from our standpoint, we're  
8 doing that as a company, think like a fraudster. We're  
9 going to roll out a program somewhere to take a bite out  
10 of crime like Crime Stoppers. We're going to give an  
11 annual award of \$25,000 to staff auditors who actually  
12 catch fraud. Because we do want to align their  
13 incentives, make them -- make them think about fraud.

14           MR. DROTT: It's been around a long time that  
15 auditors have clear responsibilities with respect to  
16 dealing with possible fraud. It used to be illegal acts.  
17 Your suggestion about bringing in a forensic team, I  
18 think you said occasionally, not every year necessarily,  
19 or was it every year?

20           MEMBER FERGUSON: I said every year.

21           MR. DROTT: Every year.

22           MEMBER FERGUSON: But in different areas.

1 MR. DROTT: Right.

2 MEMBER FERGUSON: And areas that would not be  
3 known to the client.

4 MR. DROTT: I think some firms, to my knowledge,  
5 are using that, but not systematically like you're  
6 talking about, where you look at a different area each  
7 different year. I don't know of any firm that's done  
8 that. Perhaps there have, but I'm not aware of it.

9 It's not a bad idea, because forensic auditors  
10 know more about how to look at and determine whether or  
11 not there in fact has been fraud. And, yes, it's a good  
12 idea, I think. It would have to be -- I think, go  
13 through the standard setting process. It would have to  
14 be part of a standard. And I think it certainly couldn't  
15 hurt, let's put it that way. So I wouldn't be opposed  
16 to seeing something like that, because I think it's  
17 already being done on a much more limited basis.

18 CHAIRMAN DOTY: Steve Harris?

19 MEMBER HARRIS: Mr. Fox, I was struck by your --  
20 your statement in the segment titled "Missing the forest  
21 for the trees." I'd like you to answer your own  
22 question. I'm a non-accountant and a non-auditor.

1 MR. FOX: Sure.

2 MEMBER HARRIS: But I asked the same question  
3 myself, but I don't have the answer. And the question  
4 that you pose is: Why do external auditors with much  
5 greater insight and access to the company management and  
6 detailed financial information miss frauds that short  
7 sellers are able to identify using only publicly  
8 available information? How can that be, and what do we  
9 do to correct that?

10 MR. FOX: You know, some of the techniques that  
11 we should look to employ as a profession of CPAs are some  
12 of the fraud detection techniques. And it's some of the  
13 analytical things that I don't think are taking place  
14 today.

15 And so as an example, one of the things that  
16 we've seen is where in one case one of the short sellers  
17 went out and they looked at the gross margin analysis,  
18 and they mapped the gross margin movement percentage to  
19 the competition. And when they saw very little standard  
20 deviation over a four-, five-, or six-year period, they  
21 said that's -- that's statistically impossible that that  
22 company, their gross margins are going to remain so

1 steady, and yet their competition is going to move up and  
2 down with the market, and so they said something's going  
3 on. They're playing with their earnings.

4           In another case with one of the Chinese companies  
5 where they said hey we've got these television screens  
6 that rotate advertising, well, instead of taking their  
7 word for it, they actually sent out some folks and they  
8 went and looked at how many television screens they had  
9 hanging up in different places to rotate the advertising,  
10 and what they found was that, in fact, those were just  
11 regular cardboard advertisements without the ability to  
12 rotate. And so based on the revenue model, they wouldn't  
13 have the ability to have the advertising revenue because  
14 they didn't have the rotational capability on the  
15 advertising. So they shorted the stock and came out with  
16 it.

17           It's those types of things that we've got to  
18 think, you know, we have computers today, we don't need  
19 to teach our students how to add columns of numbers any  
20 longer. We need to teach them to think critically, you  
21 know.

22           I'm a CPA in the State of Texas, and I have a

1 four-hour ethics requirement that I have to do every  
2 year for CPE, which teaches me how big my signage can be,  
3 and how I need to do my name if I had a CPA firm. And  
4 yet there's no requirement for me to take any fraud  
5 courses. There's very few fraud courses in the student  
6 curriculum today. It's more of an after-ran thought.

7           So those are the types of things that we need to  
8 begin to incorporate, because computers can do a lot of  
9 the things that staff auditors used to be doing, adding  
10 columns of numbers.

11           MEMBER HARRIS: But is that changing the  
12 fundamental role of the auditor?

13           MR. FOX: I don't know if it's changing the  
14 fundamental role if our role is to protect the public.  
15 If our role is to catch -- in my opinion, to catch fraud  
16 and also to catch those folks who are pushing the  
17 envelope with their accounting assumptions, then it's  
18 probably just changing the recognition of what our role  
19 really is. Because, as we look at the frauds, whether  
20 it's K-Mart or Satyam, Revco, Ahold, Olympus, from our  
21 standpoint, those are all confirmation frauds that we  
22 see, and that's what I've been studying for the last 12

1 years, and yet those should have been caught.

2           So I don't think that those are fundamentally  
3 changing the nature of our role, I think we've got to  
4 fundamentally think about how are we doing our audits,  
5 and shouldn't those incorporate some fraud detection  
6 techniques.

7           MEMBER HARRIS: Well, I think the profession's  
8 got to look at more of their evolving role. Because what  
9 I hear back from them is that that's not our role, and  
10 we don't want to be financial analysts, we don't want to  
11 look beyond yesterday's tables or yesterday's news; our  
12 role is to essentially verify the accuracy of the  
13 numbers.

14           MR. FOX: And, unfortunately, as a profession,  
15 and I take great pride in the fact that I'm a CPA, we  
16 keep losing in the court of law when we go in there and  
17 we make those statements, because the public doesn't --  
18 they hold us to the degree of the public watchdog, and  
19 we've got to accept that role, move forward with it, and  
20 just say that that is part of our role. Otherwise, we're  
21 going to continue to lose the lawsuits in the courts of  
22 law.

1           MR. THOMAS: Mr. Harris, what I see is something  
2 a little different. I agree with what Brian is saying,  
3 that there -- as times change, the evolving role of the  
4 auditor changes. But what we see in these big frauds  
5 time after time is, if the auditor would have just  
6 followed GAAS, they would have found it. I mean, most  
7 of the time, it's not even that close.

8           So, again, it's not so much that the rules are  
9 wrong, GAAS is pretty good, and it makes a lot of sense.  
10 And if the auditors would just follow it, they'd find the  
11 fraud. What we find is they don't have the incentives  
12 to do the work that GAAS requires. In fact, their  
13 incentive is just the opposite, to hit the deadline with  
14 management, keep management happy and get hired to do the  
15 consulting work.

16           You know, and if they do rotate out, that's  
17 great, because now we can be the consultants. So, we --  
18 I haven't had a fraud case in the past -- I'm going to  
19 say, six, seven years, and these are all sizeable fraud  
20 cases where just following the rules of GAAS would not  
21 have identified the fraud.

22           MR. DROTT: You know, one of the problems that

1 hasn't been discussed here is that in high-risk audit  
2 issues, or high-risk audit areas, there's more obvious  
3 risk by definition of material misstatement on the  
4 financial statements. And what I find in all of these  
5 audit failures, generally, is that junior-level people,  
6 or let's say somebody below the rank of manager, is doing  
7 most of the work. And they don't have the experience to  
8 detect a fraud, what we call a management fraud, which  
9 was perpetrated by, let's say, top management, because  
10 top management is highly experienced, highly intelligent,  
11 if I can use the term slick and devious, and these young  
12 people don't have the experience to detect it.

13 CHAIRMAN DOTY: I'm going to turn this over to  
14 Jeanette. But just to remind the audience and the panel,  
15 that there's been a thought for some time that the PCAOB  
16 should establish a fraud center or a fraud -- a center,  
17 an institute that would examine it. It comes out of the  
18 treasury advisory committee recommendations, and it still  
19 lies behind the questions that both Lewis and Steve have  
20 posed.

21 Jeanette?

22 MEMBER FRANZEL: I appreciate the viewpoints of

1 the panelists. And because of the viewpoints they're  
2 coming in with, I'm going to ask for innovative ideas,  
3 so that's your heads up.

4 We talked a lot about auditors not following  
5 GAAS, and if they have, they could have found it, or  
6 maybe just slightly more creative audit procedures, as  
7 opposed to just the same old thing, and the incentives  
8 within the firms.

9 What do you all, after having combed through some  
10 frauds, many frauds, and, Mr. Fox, after you've taken the  
11 opportunity to really improve audit procedures, what  
12 other creative -- well in the auditing profession they  
13 might be referred to as creative, but it might be just  
14 a basic change -- what other sort of innovative changes  
15 do you think we need to implement to the audit process  
16 itself to get better results?

17 MR. DROTT: Shall I start? I'm not sure I'd call  
18 this innovative, but it would be different, and that is  
19 something I alluded to in my opening remarks, that one  
20 of the biggest problems I see in these audit failures is  
21 the over-reliance and the failure to challenge management  
22 representations in high-risk audit areas. And that's an

1 invitation for overlooking fraud right there.

2           Because what happens is, and it's really  
3 appalling, is that you have a high-risk audit area, and  
4 let's say there's fraud -- has been fraud involved, and  
5 I've seen this, and the audit team will get  
6 representations from management that everything is okay,  
7 or management will give them a spiel about how this works  
8 and this and that, and that's it. There's no  
9 corroboration with persuasive audit evidence as the  
10 standards require.

11           MEMBER FRANZEL: And what do you think the cause  
12 has been for that in the cases you've seen?

13           MR. DROTT: Lack of professional skepticism. I  
14 think that a lot of these people have grown up in these  
15 audit firms and they get -- again, it goes back to what  
16 this whole purpose is -- they get too close to the  
17 client. And I'll tell you, it's especially bad where  
18 you've had a large group of the audit firm's people move  
19 and become employed by the client, and there's a level  
20 of trust there that shouldn't be there. Because that  
21 level of trust is such that it's preventing the  
22 application of appropriate audit procedures.

1           MR. FOX: As I see it, there's really two types  
2 of audit failures, and I think we need to be clear about  
3 which one we're talking about. The one that I've heard  
4 a lot of folks talk about is really what I would call the  
5 business risk or accounting assumption failures, where  
6 we say that, you know, there weren't enough reserves,  
7 where a company is taking a business risk and they're  
8 kind of making a gamble with other folks' money, but if  
9 the gamble pays off, they're heroes.

10           But, you know, maybe once we look back at like  
11 2008, the risk was too big, we didn't have big enough  
12 reserves, we should have reserved more. That's one kind  
13 of failure. And some could call that a fraud. What I  
14 look at as fraud are those folks who are intentionally  
15 committing financial statement fraud in order to get  
16 either loans or investment money from the market, and  
17 then they take those dollars and abscond with them, and  
18 that is their intent from day one. Where there is no  
19 ability to actually see the company be successful. And  
20 that's where we've seen a lot of the frauds.

21           And so, to that question, to your question,  
22 Jeanette, the answer to me is this. We've got to go in

1 and perform audit procedures that the fraudsters don't  
2 know we're going to perform. We've got to jump and move.  
3 We've got to look in different areas, poke, prod and ask  
4 questions. Do things differently than we've done before.  
5 If we've just been doing things at year end with small  
6 sample sizes, let's do them quarterly, let's do them  
7 semiannually.

8 I was talking to a person who's wife is an  
9 auditor in China, and one of the things -- she's a  
10 partner. One of the things that she does is she actually  
11 drove to the company, grabbed the treasurer of the  
12 company in China, and said get in the car. Took away his  
13 cell phone. Drove to the bank that she wanted to go to  
14 and asked the person at the front desk to verify their  
15 account statement. That's being unique. That's being  
16 creative.

17 Now, that's expensive and we can't do that on  
18 everything, but that's the kind of way that we need to  
19 begin to think about how we're auditing and thinking like  
20 a fraudster.

21 MR. THOMAS: I appreciate what Brian's saying,  
22 and I think that's helpful. Although our experience is

1 that that's not the problem. I mean, I think now maybe  
2 the second or third biggest fraud of all time that came  
3 out at the same time of Madoff was the Petters fraud.

4           And Petters went on for 10 years as a \$3 billion  
5 fraud up in Minnesota, and he was supposedly selling  
6 electronics to Costco on a basis where he bought them  
7 wholesale and then sold them for an up-tick. Well, it  
8 turned out that for out of that nine or 10 years, he  
9 never actually sold an electronic to Costco. And the way  
10 to detect that fraud would have been to actually just  
11 test the numbers and call up Costco.

12           You don't need something super sophisticated to  
13 figure out that fraud, but it was signed off on by  
14 auditors for nine or 10 years. So, again, I think that  
15 may be helpful in some circumstances, and I think that  
16 Brian's right about that. But most of the time, just  
17 follow GAAS.

18           And what I proposed in my original remarks was  
19 that there should be, for management representations  
20 where most of these problems come from, we call it  
21 auditing by conversation, is that when they speak to  
22 management and get a representation, they should have to

1 detail to the audit committee, and in their audit  
2 opinion, what they did to test out management's  
3 representations.

4           Now to answer your question, what is more  
5 creative than that, get rid of management  
6 representations. You don't get to rely on what  
7 management tells you. You have to audit it. Now, there  
8 are very limited areas where there is not sufficient  
9 evidence and management representations are the only way  
10 to verify. And if that's the case, detail it in your  
11 audit opinion and to the audit committee. But otherwise,  
12 make it absolutely clear. It's not about a management  
13 letter and later claim "Oh, we were lied to." No you  
14 have to audit the numbers. And the creative way would  
15 say get rid of management representations.

16           CHAIRMAN DOTY: This panel has been very  
17 stimulating, and what you've done is stepped back a bit  
18 from independence and skepticism, or at least from  
19 independence and rotation, and you've said -- I think  
20 you've given us as a take away, there's a skepticism  
21 requirement to have an effective audit. It's got to  
22 project down through the team, it cannot be just at the

1 top.

2           It's a challenge to get it. It's a challenge to  
3 get the kind of thinking of creativity and of skepticism  
4 that has got to exist throughout the team. That it's  
5 expensive. But the firms must do it if they're to  
6 preserve the model of an independent accounting  
7 profession. These are big ideas. It resonates with some  
8 of the things we were told in our March meetings.

9           Independence is a wonderful thing, but if you're  
10 incompetent and not skeptical, you can think you're  
11 independent and you cannot be a very effective auditor  
12 and you will miss fraud. On the other hand, it may be  
13 or it may not be that some form of predictability in  
14 terms of the time you have the audit engagement, as Brian  
15 says, would in fact tend to inject more caution, more  
16 skepticism in the audit. That's another big issue that  
17 we're going to hear a lot about.

18           But your contribution to this discussion is a  
19 very valuable one. And we want to thank all of you. And  
20 your written contributions, as well as what you've told  
21 us today, are going to be in the record, and they're an  
22 important part of the record. Thank you.

1 ALL: Thank you very much.

2 CHAIRMAN DOTY: We're going to go to the next  
3 panel. The next panel, we're going to hear from audit  
4 committee authorities.

5 Conrad Hewitt, director of Bank of the West,  
6 former chief accountant of the United States Securities  
7 and Exchange Commission. He joined the Bank of the West  
8 board in 2009. He serves on its audit committee,  
9 executive committee, and is chairman of the trust and  
10 wealth management committee. He has many other such  
11 important positions that he discharges. He was an Ernst  
12 & Young partner for -- he was an Ernst & Young auditor  
13 and partner for 33 years, managing partner for Hawai'i,  
14 Pacific Northwest, Seattle and Northern California. He  
15 became -- and this is something I confess I did not know  
16 about Conrad Hewitt until I got this bio information --  
17 he became the superintendent of banks of the State of  
18 California. I should have known that. Formed the  
19 Department of Financial Institutions in the State of  
20 California, and became its first commissioner. Again,  
21 a new fact, he was a captain in the U.S. Air Force at  
22 Strategic Air Command Headquarters. So he brings a

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1 wealth of experience in addition to audit committees.

2           Bonnie Hill. Dr. Hill, 20 years experience in  
3 corporate governance. She is the lead director of the  
4 Home Depot Corporation, on the boards of Rand. She  
5 serves on the PCAOB's Investor Advisory Group. She was  
6 recognized by the NACD directorship as one of our most  
7 influential persons in corporate governance in 2010 and  
8 2011. She has a Doctorate of Education from the  
9 University of California at Berkeley, and is on a number  
10 of boards and audit committees.

11           Christopher Lynch, welcome. Mr. Lynch is the  
12 chairman of the audit committee of AIG, an audit  
13 committee member of Freddie Mac, and he is the non-  
14 executive chair of the board of Freddie Mac. An  
15 independent consultant, he provides a variety of service  
16 to financial intermediaries. He held a variety of  
17 positions at KPMG, including the national partner in  
18 charge of financial services, chairman of KPMG, America's  
19 Financial Services Leadership, and a fellow of the  
20 Financial Accounting Standards Board. Chris Lynch brings  
21 distinct, very distinct qualifications to this discussion  
22 and we're happy to have him.

1           Steve West, chairman of the audit committee Cisco  
2 Systems. A 30-year veteran of information technology,  
3 and the founder of Emerging Company Partners, LLC, ECP.  
4 He has held -- had a wide range of executive leadership  
5 positions. He was the president and CEO of Hitachi Data  
6 Systems, with responsibility of over 22 billion in  
7 revenue. He served in a similar senior position at EDS  
8 in Plano, Texas, COO of NCUBE in Portland, on the board  
9 of a number of public and private companies, and is an  
10 active member in the Audit Committee Leadership Network.

11           So we're honored, and we're conscious of the time  
12 that we're getting here, and the attention from people  
13 who have a lot in their day jobs.

14           Mr. Hewitt, please.

15           MR. HEWITT: Thank you, Mr. Chairman. Good  
16 morning, everyone.

17           I am very pleased to be participating in a panel  
18 of other distinguished panelists to discuss the PCAOB's  
19 concept proposal on auditors' independence and mandatory  
20 rotation of auditors. I'm also very pleased that the  
21 PCAOB has brought this important discussion to the west  
22 coast.

1           Based upon recent years, I do not recall any SEC  
2 or PCAOB round-tables on the west coast. The west coast  
3 is important because of the many public company  
4 headquarters here, as well as the type of industries here  
5 such as high tech and entertainment.

6           My comments are based on my 33 years in public  
7 accounting, my four years as a regulator of financial  
8 institutions, of being the Commissioner of Financial  
9 Institutions for the State of California, chairman of  
10 audit committees for six public companies and seven  
11 private companies, and most recently three years ago as  
12 Chief Accountant of the SEC.

13           I believe I've had much exposure and experience  
14 concerning the auditors' independence, professional  
15 judgment, skepticism, and as well as being an investor  
16 for 40 years. Investors use financial statements as one,  
17 just one of many factors before an investment decision  
18 is made, so I view our subjects today from many different  
19 experiences.

20           Regarding the auditor's independence, the auditor  
21 has many different standards to adhere to. For example,  
22 the 50 states, the AICPA, the SEC, the International

1 Ethics Standard Board, and now the PCAOB, are all  
2 involved with the independence of an auditor. It's  
3 almost impossible to comply with all the various  
4 independent standards.

5 I am concerned about the multitude and  
6 differences in independent standards in this fast-growing  
7 global economy. As some of you know, I've been a very  
8 vocal advocate of a single, high-quality international  
9 accounting standard, as well as a single high-quality set  
10 of international auditing standards. I believe the SEC  
11 and PCAOB should consider promoting a single high-quality  
12 set of independent standards to comply with, instead of  
13 the multitude of standards that exist today.

14 Based upon my experiences of various audit  
15 committees, I believe audit committees need to be more  
16 involved with the auditors' independence. The PCAOB and  
17 SEC need to focus more on audit committees to ensure the  
18 independence of auditors without requiring mandatory  
19 rotation of auditing firms. SOX gave audit committees  
20 considerable power, responsibilities and authority over  
21 auditing firms. And I believe that committees should  
22 exercise more authority.

1 I am concerned that the SEC and PCAOB requiring  
2 the mandatory rotation of auditors is maybe usurping the  
3 intent and law of Congress providing that audit  
4 committees have the power to hire and terminate external  
5 auditors even without the company's board approval.

6 One problem that exists with audit committees is  
7 the credentials and qualifications of the members of the  
8 committees and a lack of continuing education  
9 requirements for its members. The SEC could require that  
10 proxy statements would indicate that audit committee  
11 members would be required, say, to obtain four hours of  
12 continuing education annually, and maybe increasing that  
13 requirement to eight hours on an annual basis. And this  
14 would be the same type disclosure which now exists in the  
15 proxy statements for the attendance of board members at  
16 the board of directors meetings.

17 The PCAOB and SEC should devise a set of  
18 guidelines for audit committees to consider periodically  
19 with respect to the independence of the audit firm. The  
20 guidelines could be the foundation of the audit  
21 committees to discuss and document all aspects of  
22 independence with its auditors. And to me this would

1 create a greater focus on the independence and  
2 transparency.

3 As chief accountant, I create a federal advisory  
4 committee on improvements to financial reporting. The  
5 committee debated several things, such as audit  
6 compliance, the standards in the audit process. They  
7 focused on materiality also, restatements and judgments  
8 relating to accounting matters.

9 The PCAOB and SEC spends considerable time on  
10 whether a professional judgment is properly made, and  
11 it's a very important part of their responsibilities.  
12 And generally regulators of all kinds respect judgments  
13 if they are well-documented, unbiased and provide  
14 evidence to support a conclusion. By creating an  
15 environment in which all bodies understand a reasonable  
16 judgment after the fact needs to be performed by the  
17 PCAOB and the SEC. This environment would aid in the  
18 independence of the auditor.

19 The Federal Advisory Committee recommended that  
20 the SEC should issue a statement, a policy articulating  
21 how it evaluates the reasonableness of accounting  
22 judgments in making an evaluation. It also went on to

1 say the PCAOB should adopt a similar approach with  
2 respect to auditing judgments.

3           Before leaving the SEC, my staff and I and the  
4 Division of Corporation Finance and others within the SEC  
5 developed such a policy, but it was never finalized. I  
6 have that policy here today.

7           Lastly, I would like to comment on the mandatory  
8 rotation of audit firms. I do not believe that the  
9 policy would prevent accounting scandals and frauds such  
10 as Enron, WorldCom, Sunbeam, AIG, Freddie Mac,  
11 HealthSouth, Madoff and many others. There's never been  
12 any evidence that a mandatory rotation of auditors would  
13 have prevented these frauds, or even would improve the  
14 quality of the audit. And please keep in mind that these  
15 terrible events occurred over many years.

16           Many of these accounting scandals were due to  
17 existing accounting standards which are based on rules  
18 and not principles, and permitted abuses of GAAP. A  
19 fraud is always difficult to detect and prevent, and a  
20 mandatory change in auditors will not stop such frauds.

21           In summary, I implore this PCAOB to reexamine the  
22 auditors' independence and mandatory rotation of

1 auditors. The solution to the problem is not simple.  
2 The PCAOB should focus on strengthening the audit  
3 committees, so that they can carry out their  
4 responsibilities in auditing under SOX without making  
5 mandatory rules and regulations.

6 Also the PCAOB should focus on its own reasonable  
7 judgment internal policy, maybe can focus on the training  
8 of auditing firm staff with respect to independence and  
9 determining the root causes of past, current and future  
10 independent cases, and providing more transparency to the  
11 auditing firms, audit committees and investors concerning  
12 independent problems. I believe the PCAOB inspection  
13 process could identify, classify and determine solutions  
14 and results concerning auditors' independence.

15 As alternatives to mandatory rotation, I  
16 recommend -- I have six short recommendations here. One,  
17 PCAOB and SEC need to require continuing education  
18 requirements of all audit committee members with adequate  
19 disclosure in the proxy statements similar to directors'  
20 attendance at board meetings.

21 Two, that PCAOB and SEC need to develop and  
22 implement a reasonable judgment policy for internal use,

1 and then require accounting firm professionals to have  
2 a professional judgment policy.

3           Three, the audit staffs of accounting firms need  
4 to have required annual training sessions in auditors'  
5 independence, professional judgment and objectivity.

6           Four, the PCAOB and SEC need to develop  
7 guidelines for audit committees concerning auditors'  
8 independence, professional judgment and objectivity. And  
9 periodically, these audit committees need to discuss and  
10 document compliance with these guidelines.

11           Fifth, PCAOB needs to be more transparent with  
12 accounting firms, investors and audit committees of the  
13 problems found with independence and subsequent  
14 remediation of the problems. Also root causes would be  
15 very helpful, along with the best practices to reduce  
16 independent problems.

17           And sixth, the SEC and PCAOB need to be the  
18 leaders in promoting a single, global independent  
19 standard.

20           If my recommendations are adopted, I believe the  
21 auditors' independence will be enhanced for everyone.

22 SOX, SEC and the PCAOB have greatly improved the quality

1 of audits as evidenced by the great decline in the number  
2 of restatements. Because of SOX, investors do have a  
3 greater reliability on the financial statements than  
4 existed 10 years ago.

5 And I thank you for allowing me to participate in  
6 this important deliberation.

7 CHAIRMAN DOTY: Thank you, Conrad Hewitt. Bonnie  
8 Hill.

9 MS. HILL: Thank you, Mr. Chairman, members of  
10 the board. Thank you for the opportunity to share a few  
11 thoughts on the important subject at hand.

12 By now you've heard practically every argument  
13 that can be made either for or against mandatory  
14 rotation, so I will simply focus my remarks on three  
15 points that I consider important. The audit committee's  
16 role and duty to shareholders, the audit committee's  
17 relationship with independent auditors, and the cost  
18 versus the benefit of mandatory auditor rotation.

19 And I begin with the premise that the members of  
20 the board of directors are elected by shareholders, and  
21 the audit committee is selected from that board. Since  
22 the enactment of Sarbanes-Oxley, audit committees have

1 at least one financial expert on the board, on the  
2 committee, and that is by choice. I know it isn't  
3 required. But my experience is that is very beneficial  
4 and that most boards do, in fact, look for a financial  
5 expert, and that the remainder of the members be  
6 financially literate.

7           The committee has the authority to retain outside  
8 expertise whenever needed, and they do so. I also  
9 believe in most instances we are looking at some very  
10 competent individuals. And since the enactment of  
11 Sarbanes-Oxley, my experience has been that audit  
12 committee meetings have gone from two hours to four to  
13 five hours, and the number of meetings has nearly doubled  
14 in an effort to be thorough.

15           Audit committees are directly responsible, under  
16 Sarbanes-Oxley, and related SEC and stock exchange rules  
17 for overseeing the independent auditor. Audit committees  
18 are also tasked with fiduciary responsibility to  
19 shareholders and the oversight of the integrity of a  
20 company's financial statements. It is the audit  
21 committee that can better understand the needs and risks  
22 faced on its company, and determine whether the cost of

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1 rotation are outweighed by the need for a new team and  
2 a fresh set of eyes.

3           If an audit committee determines that its company  
4 needs a new audit firm after consideration of the  
5 circumstances faced by that particular company, these  
6 additional costs would be warranted. But it would not  
7 be in the best interest of that company's shareholders  
8 to whom the audit committee is responsible to incur those  
9 costs when they are not warranted by any specific issues  
10 or concern.

11           I've had the experience with two companies being  
12 part of a decision to rotate the auditor. It was  
13 recommended to the board by the audit committee. It was  
14 the right thing to do, and it was in the best interest  
15 of the company and its shareholders.

16           With regard to the relationship between the  
17 auditor and the audit committee, the concerns about  
18 independence, objectivity and professional skepticism are  
19 good, they're interesting, and particularly since most  
20 audit committees regularly evaluate the independent  
21 auditor's performance. And clearly I'm dealing with my  
22 experience and not, you know, everyone else's. But they

1 do that to ensure that they are both independent and  
2 qualified.

3           An audit firm is not a person. It is a  
4 collection of individuals with different skills and  
5 characteristics. There are already regular changes to  
6 the personnel performing an audit, whether due to rules  
7 that require mandatory rotation of audit partners every  
8 five or seven years, natural attrition that occurs with  
9 any firm, or targeted rotation to address skill levels,  
10 expertise and training needs of audit staff.

11           And then third, we look at the increased cost.  
12 The cost of bringing a new audit firm on board is not  
13 insignificant. It includes non-monetary costs of  
14 significant management time and effort needed to educate  
15 the new team. A 2011 study by Audit Analytics of audit  
16 fees paid by companies Russell 3000 show that the highest  
17 fees for companies with auditors were with those that had  
18 a tenure of five years or less.

19           There is practical concern about whether audit  
20 firms will be able to sufficiently staff their audit  
21 teams with qualified personnel if each year they are  
22 facing the logistical challenge of placing entirely new

1 teams with multiple clients in different locations  
2 throughout the country and internationally.

3 For companies, this means a pass through of  
4 relocation and hiring costs necessary to staff the audit.  
5 Increased cost may also arise from other accounting firms  
6 providing non-audit services. At any given time, there  
7 may not be a qualified, independent alternative firm,  
8 because many companies use other audit firms to provide  
9 non-audit services that the independent auditor cannot  
10 provide under applicable rules.

11 And as you know, to qualify as independent, an  
12 accounting firm must wait until the completion of any  
13 audit and professional engagement period, essentially the  
14 period covered by the relevant financial statements in  
15 which it performs certain non-audit services. And it  
16 cannot audit any period in which it performed those  
17 services.

18 To ensure an independent alternative, a company  
19 would also have to consider rotating its non-audit  
20 services, periodically ending engagements with other  
21 firms far enough in advance to allow them to serve as the  
22 independent audit firm. Many of these non-audit services

1 are for matters that cover an extended period of time,  
2 such as an M&A transaction, tax matters, investigations  
3 or consulting services where it is not practical or cost  
4 effective to terminate an engagement before completion.

5           So in closing my remarks, I would give you a  
6 specific example where there might be a shortage of  
7 feasible alternatives.

8           As a \$70 billion company, the Home Depot, where  
9 I serve as lead director, is effectively limited to using  
10 one of the big four audit firms to ensure adequate  
11 resources and global reach for our audit. KPMG is our  
12 independent audit firm. We also used Deloitte & Touche  
13 for tax planning strategies as we think they're best  
14 suited for what we need. If we were required to rotate  
15 audit firms and wanted to continue to use Deloitte &  
16 Touche for tax planning strategies, they would be  
17 precluded from being our independent auditor, thereby  
18 reducing the field from four down to two.

19           They also currently audit our principal  
20 competitor. So we would not be inclined to retain them  
21 as our independent auditor for competitive reasons. If  
22 I were faced with a situation in which we had to use them

1 as our audit firm, given the lack of alternatives, we'd  
2 insist on a completely separate D&T team, and face  
3 possible resource availability and allocation issues.

4 At various times, we also use  
5 PricewaterhouseCoopers and Ernst & Young for internal  
6 audit, tax, vendor compliance and consulting matters.  
7 If forced to rotate firms, we would have to access and  
8 reassign services in order to render one of the firms  
9 independent and qualified to serve as our auditor. Being  
10 limited to only two large firms that could serve as  
11 auditors significantly decreases our leverage for  
12 negotiating fees.

13 Even among the big four, we need to ensure that  
14 the audit firm selected has sufficient retail experience,  
15 and particularly with respect to the retail method of  
16 inventory accounting, which is fairly unique to our  
17 industry, and it has a significant impact on our  
18 accounting, it's even less likely that a smaller boutique  
19 firm has this expertise.

20 I won't go through the non-audit -- the non-  
21 monetary costs, because I think you understand those.  
22 You've heard enough. But like most companies, we've

1 leaned our staff down with our financial accounting  
2 personnel fully engaged in supporting the business.  
3 Large portions of time spent with a new audit team would  
4 either force us to add staff who need to be trained, or  
5 require our personnel to prioritize or delay tasks that  
6 are critical. And so this is not just a one-year impact,  
7 but can last for several years.

8           As I mentioned earlier, there's already routine  
9 rotation occurring with the current independent auditors'  
10 team, but without the disruption of losing the entire  
11 team. And I won't go through all of that, because I know  
12 time is short. But like many of those who have gone  
13 before me, I applaud the PCAOB's desire to enhance  
14 auditor independence, objectivity, and professional  
15 skepticism. But I believe a proposal would undermine the  
16 responsibilities and accountabilities of the audit  
17 committee and would not improve the quality of the  
18 independent financial statements enough to overcome the  
19 down sides, which I believe you've heard a lot of  
20 already.

21           And, so, I would encourage you -- I'm not going  
22 to give you a way to do your job, I'm not even going to

1 give recommendations, because you've had enough of those,  
2 but I would just say that when you look at the issues  
3 that are involved, that you would consider a closer  
4 relationship with audit committees and audit committee  
5 chairs, and really an understanding of what happens in  
6 the audit committee, as well as the boardroom as you  
7 deliberate on this important issue. Thank you.

8 CHAIRMAN DOTY: Thank you. Christopher Lynch.

9 MR. LYNCH: Chairman Doty, members of the board,  
10 and members of the staff, first thank you for your  
11 service. I can tell -- assure you, over the last three  
12 and a half years, spending a great deal of time in  
13 Washington, the challenges, many challenges you face.  
14 And so it's greatly appreciated.

15 Thank you for inviting me here today to comment  
16 on the Concept Release and a topic that I think is  
17 fundamental to all the capital market participants. The  
18 vantage point I will share, I think is multifaceted, and  
19 I hope brings a unique perspective.

20 During my career, I've been an audit partner, a  
21 staff member of a standard setter, a technical partner  
22 in our national office, a senior partner running an

1 industry practice, an audit committee chair, and a board  
2 chair. And while the value I've derived from the  
3 external auditors' role has varied depending upon the  
4 seat that I occupied, I've always insisted that the  
5 independence of the firm, its lead partner, and its  
6 entire engagement team were critical to those  
7 collaborations.

8           So let me start by affirming my complete support  
9 that external auditors must be, in fact and appearance,  
10 independent of the clients for which they issue their  
11 audit reports. Some participants in this discussion cite  
12 the declines in the recent board reports, inspection  
13 reports, and the business failures from 2008 and the  
14 financial crisis as anecdotal evidence that external  
15 auditors are not meeting the marketplace's expectations,  
16 and that tendering or mandatory auditor rotation will  
17 address that shortcoming.

18           I don't see a meaningful correlation between  
19 these variables, nor do I believe that mandatory auditor  
20 rotation would achieve this objective. The Concept  
21 Release establishes a premise that an audit firm with a  
22 long client relationship, say greater than 10 or 15

1 years, may lose its independence, or that the engagement  
2 team may be less capable of exercising professional  
3 skepticism.

4           If you've ever served as an audit signing partner  
5 in the Sarbanes-Oxley era, or been through the incredibly  
6 comprehensive and rigorous examination process of the  
7 PCAOB inspection, I don't think you could possibly have  
8 that view. As a signing partner, you know you stand  
9 alone and with your work papers, and that's it. As an  
10 audit signing partner, it was irrelevant to me what the  
11 positions of my predecessors were. It was irrelevant to  
12 me what the position of my firm was. I was not going to  
13 risk my reputation or that of my engagement team to  
14 appease a client or fail to walk head on into a difficult  
15 business judgment.

16           And since 2011, in the SEC's whistleblower  
17 program, all types of issues are now being surfaced,  
18 accounting, disclosure, third-party data, code of  
19 conduct, ethics valuation, modeling, expenses, estimates,  
20 and yes, even judgment. So in the last two years, I've  
21 learned no department, no executive, no matter how high  
22 nor how low in the organization can escape

1 whistleblowers. This is our new reality.

2           So considering the watchful eyes of a legion of  
3 whistleblowers that can exist in internal audit,  
4 accounting, policy, legal compliance, business, and yes,  
5 even vendors, and yes, even our customers, it's pretty  
6 hard to imagine an engagement partner who doesn't feel  
7 the pressure that is out there right now to summon up the  
8 courage to push back on any issue that they felt had not  
9 been appropriately addressed by management.

10           The Concept Release also discusses one potential  
11 benefit of mandatory auditor rotation, the fresh look.  
12 But let's explore what is already occurring in practice.  
13 The average tenure of a Fortune 500 CEO is seven years,  
14 the CFO five years. The audit signing partner rotates  
15 off the account in five years, the ancillary partner is  
16 seven years.

17           Emerging best practices in the audit committee  
18 and boardrooms is that audit committee chairs rotate out  
19 of their positions after roughly some predetermined  
20 number of years. An emerging number that's coming out  
21 of this is five. And many other audit committee members  
22 rotate off the committee on a staggered basis.

1           So in the end of a hypothetical five- or ten-year  
2 mandatory auditor rotation period, the marketplace's  
3 concern that external auditors have lost their  
4 independence has already been remedied by the existing  
5 market forces. There isn't a single key player left at  
6 the table in this relationship that has not been  
7 replaced.

8           But let's be clear, there are many opportunities  
9 to improve auditor performance, and I'll identify three  
10 broad categories of recommendations.

11           The first is performance contracts. They are  
12 used to memorialize a totality of an enterprise's  
13 collective expectations of the conduct of the audit  
14 during the year. They are hard to put in place. They  
15 are very time consuming to put in place. They require  
16 rigorous negotiations, but they are an excellent tool to  
17 then come back at the end of the year and objectively,  
18 verifiably with clean documentation demonstrate to all  
19 interested constituents the performance of that firm.

20           Second, clients need to be more involved in the  
21 selection of the lead partner. Given the importance of  
22 this role, most market participants expect that audit

1 committee chairs and the candidates have had qualitative  
2 interactions beyond the one or two brief meetings that  
3 typically occur before that appointment. My experience  
4 also suggests that the transition time of these incoming  
5 lead partners varies considerably depending upon the  
6 size, complexity, and yes, profitability of the account.

7           And finally, in the area of governance, I see  
8 several opportunities for improvement, and many of them  
9 resist -- reside within the audit committee itself. We  
10 need to strengthen our skills and our experiences,  
11 because this role is very difficult. Given the  
12 complexity today, we also need to question whether an  
13 executive who ran a company 10 years ago or was  
14 tangentially near a finance function somewhere in their  
15 career is really qualified to be a financial expert  
16 today.

17           We need to be more proactive. We have to reach  
18 out as audit committee members to regulators, employees  
19 and business units and support functions, and we need to  
20 do that without senior management present. I've used  
21 this technique where I try and have these one-on-one  
22 sessions outside of the audit committee agenda because

1 it just doesn't lend itself. But we have a  
2 responsibility to make sure that the information that's  
3 coming to us has not been censored and has not been  
4 filtered in any inappropriate way.

5 Next we need to insist that audit -- external  
6 auditors are bringing their divisional partners and their  
7 topical specialists into the room. They need to hear  
8 firsthand the expectations of my committee, our board  
9 members, as to candor, transparency and being forthright.  
10 And they also need to know beyond the lead partner what  
11 -- that they are accountable to every member of our audit  
12 committee.

13 And with respect to tendering, I've had  
14 experience at both of my boards, and I would say the  
15 results are mixed. In one case, we spent approximately  
16 a year because of a looming mandatory rotational  
17 deadline, only to conclude that under the facts and  
18 circumstances, it was a poor decision to even go forward  
19 with it.

20 In the other instance, the board and our audit  
21 committee charter had the provision that we would  
22 consider once every five years whether an RFP is

1 appropriate or not for the external auditor.

2           So, in conclusion, I think that existing audit  
3 committee charters and governance practices of public  
4 registrants are sufficiently comprehensive to ensure  
5 independence and objectivity is safeguarded. Thank you  
6 very much for permitting me to participate in this  
7 discussion.

8           CHAIRMAN DOTY: Thank you. Steven West.

9           MR. WEST: Thank you, Mr. Chairman and the board.  
10 I very much appreciate the opportunity to participate on  
11 this panel on behalf of the audit committee of Cisco  
12 Systems, and discuss my views on auditor independence and  
13 mandatory firm rotation.

14           The concept of auditor independence is not only  
15 critical to the PCAOB and the auditing profession, but  
16 is a cornerstone of the primary responsibilities of an  
17 audit committee, and is important to the company's  
18 investors and shareholders. The knowledge and experience  
19 of an audit committee puts it in the best position to  
20 evaluate the effectiveness of a company's independent  
21 auditors.

22           Introducing mandatory audit firm rotations would

1 eliminate an audit committee's ability to select and  
2 retain the best-suited audit firm based on a  
3 comprehensive set of considerations that only the audit  
4 committee is in the position to evaluate. In fact,  
5 instituting a mandatory audit firm rotation rule will  
6 have the effect of diminishing the committee's  
7 responsibility for this critical oversight role, thereby  
8 limiting its own effectiveness.

9           At Cisco, our audit committee sets expectations,  
10 and we conduct ourselves in a manner that fosters an  
11 open, challenging environment which supports healthy  
12 skepticism and objectivity by our independent auditor.

13           Tenure actually allows us to nurture this type of  
14 relationship, which I believe supports audit quality.  
15 Our ongoing open discussions about risk, accounting and  
16 auditing issues, as well as our review of the auditor's  
17 audit scope and audit results facilitates our evaluation  
18 of the audit firm's understanding of the company's  
19 business, businesses and risks, the comprehensiveness of  
20 their audit plan, their technical and other capabilities,  
21 and their independence and objectivity, and their ability  
22 to meet the company's changing needs on a global base.

1           It is primarily these considerations and not  
2 tenure that we use to evaluate the effectiveness of the  
3 audit firm. In large complex multinational companies  
4 such as Cisco, it takes years to develop a sufficiently  
5 deep level of knowledge of the company, which is required  
6 to adequately perform a high-quality audit. As their  
7 knowledge base continues to grow over time, the audit  
8 firm builds a better foundation from which they can  
9 assess and test the company's assertions.

10           It could be argued that while time builds this  
11 knowledge base and leads to audit effectiveness, it also  
12 creates a sense of familiarity that could lead to a loss  
13 of independence. My view is that the requirements to  
14 rotate the audit engagement partner every five years, as  
15 instituted by the Sarbanes-Oxley Act effectively  
16 addresses this risk, while providing the proper balance  
17 of retaining the audit firm's cumulative knowledge of the  
18 company's businesses, risk processes, and people, which  
19 improves overall quality.

20           I believe sacrificing this relationship due to  
21 length of service would be counterproductive to achieving  
22 a high level of audit quality that audit committee

1 shareholders and the PCAOB expect.

2           In addition, many companies such as Cisco operate  
3 in a complex multinational environment and use firms to  
4 perform non-audit accounting-related service, which are  
5 critical to its businesses. Mandatory audit firm  
6 rotation will either limit the pool of available  
7 alternative firms due to existing relationships for non-  
8 audit services, or require companies to also rotate the  
9 firms who provide the non-audit services, thereby  
10 creating potential conflicts among service providers.

11           I do not believe it's in the best interest of  
12 companies and their shareholders to burden them with the  
13 negative impacts and the many unintended consequences of  
14 mandatory audit firm rotation or retendering, especially  
15 since there is no clear evidence that tenure diminishes  
16 audit quality.

17           While I am supportive of -- while I am not  
18 supportive of a one size fits all approach that would  
19 result in making a change when the incumbent auditor is  
20 providing a quality audit, I am supportive of any of the  
21 alternatives that facilitate consistently higher  
22 effectiveness of audit committees in evaluating

1 independent auditors. These alternatives could include  
2 enhancing reporting of PCAOB inspections to audit  
3 committees, to include key themes and root causes of  
4 quality problems.

5 I would also suggest that enhanced quality  
6 reports from the audit firms addressing quality controls,  
7 quality issues and quality initiatives to improve and  
8 remediate any quality concerns in that firm. These would  
9 provide additional important information for audit  
10 committees to consider when setting expectations,  
11 challenging and evaluating the audit firm's capabilities,  
12 independence, objectivity and skepticism on a regular  
13 basis.

14 I think actions such as this would better address  
15 the problem, as it enhances the audit committee's  
16 governance role and ability to ensure auditor  
17 independence.

18 Thank you again for inviting me to participate  
19 here today and providing me with an opportunity to speak  
20 with you on this topic.

21 CHAIRMAN DOTY: Thank you. Jeanette Franzel.

22 MEMBER FRANZEL: One of the things that we have

1 discussed in a whole lot of different contexts here is  
2 the role of the audit committee, is it sufficient, is it  
3 not, does it need to be reformed? -- et cetera -- and  
4 we've heard from folks that when audit committees work  
5 well, it really helps enhance the audit process, but that  
6 there is inconsistency in practice out there.

7           And I would like to hear from the audit committee  
8 members on this panel, and I guess you all are: What are  
9 the specific things that you are doing as an audit  
10 committee member that give you assurance?

11           And what are you asking your auditor to do to  
12 give you assurance that the audit firm is in fact  
13 independent and using an appropriate level of  
14 professional skepticism, and that they are thoroughly  
15 auditing material high-risk areas, especially areas  
16 involving management judgments and management estimates?

17           MS. HILL: One of the things that I think is very  
18 helpful in this is the executive sessions that audit  
19 committees have with the auditors, and it's rather  
20 interesting what you get out of those meetings when  
21 management is not present and you ask directly about  
22 various sundry items that you think really need to be

1 reviewed. So I highly advocate the executive sessions,  
2 and I think they're very effective in helping the  
3 committee get to the root of some issues directly with  
4 the auditors.

5 MR. LYNCH: I'll share a couple, Jeanette. We  
6 have quarterly reporting from the external auditor as to  
7 any independence considerations that are occurring across  
8 the globe, and the committee takes that every 90 days.

9 Another thing that I think is important is at  
10 least once a year somewhere around the early stages of  
11 the external auditor formulating their global audit plan,  
12 I'll spend an entire day with their team, with no members  
13 of management from the firm present, but only their lead  
14 partners, their senior managers from around the globe,  
15 so that they understand the expectations of our  
16 committee. But more importantly, that I'm sensitized to  
17 the unique views that are emerging from around the globe,  
18 and the trajectory of where they see emerging risks.

19 And the third element I would state that I think  
20 has been very helpful is, we've introduced the concept,  
21 and I think most of the firms have been, but a heat map  
22 of where they see the risk in the organization, the

1 volume, the potential magnitude for error. But most  
2 importantly, not that they have a heat map, but that I  
3 aligned that heat map with the risk assessments that  
4 exist in my enterprise risk management function in the  
5 company, my internal audit function, and my compliance  
6 function.

7 MR. WEST: I would echo what my fellow panelists  
8 here said. But I would also suggest that participating  
9 with other audit committee members or audit committee  
10 chairs in some type of a formal process or a network that  
11 allows you to hear their issues, what they're seeing in  
12 their part of the business, and then, you know, working  
13 to merge that in with how you deal with your external  
14 auditor in the programs.

15 MR. HEWITT: Okay, one of the things we do is ask  
16 our external auditing firms about 404 and 404(b) or  
17 404(a) under SOX, the evaluation of internal control  
18 system by management and by the -- opined by the external  
19 auditors as to the material weaknesses, significant  
20 deficiencies, automation versus manual systems and those  
21 types of important things. We do this in executive  
22 session without our internal auditor there and

1 management, and it's very helpful.

2 CHAIRMAN DOTY: Steve Harris.

3 MEMBER HARRIS: Mr. Hewitt, I would like to  
4 follow up on your third recommendation, which I think was  
5 close to or exactly the same that Mr. Drott introduced  
6 beforehand, which is required annual training sessions  
7 in auditors independence, professional skepticism,  
8 professional judgment and objectivity. And in our  
9 inspection reports, in terms of remediation, we require  
10 additional training in a number of different instances.

11 But could you add with some degree of specificity  
12 on your recommendation? Because it's easy to say that  
13 we ought to just have training. But how would you  
14 conduct such training? What would you require with  
15 respect to that training?

16 MR. HEWITT: Well, if I were the PCAOB, I would  
17 provide -- I think it ought to be required of all -- of  
18 your one thousand plus auditing firms that you inspect  
19 that some kind of a training session be held so many  
20 hours concerning these items of concern, the  
21 independence, the objectivity, you know, professional  
22 skepticism, and those types of judgments that they do.

1           And I don't know if I would do it at every level,  
2 but I certainly would do it the first three or four years  
3 to build the foundation so these auditors have the  
4 attitude and the knowledge to be skeptical of a  
5 management accounting matter. And I think you probably  
6 need to provide some guidelines on what that training  
7 should include. I would say, you know, it's a state of  
8 mind on some of it and the attitude. But examples of  
9 what has happened in the past, and it could be like a  
10 case study in the training process.

11           And it would not be -- I'm talking about maybe,  
12 you know -- the larger firms, I know they have annual  
13 training sessions for all levels, and that adds to the  
14 quality of the audit in my mind. It did in my situation.  
15 And I think that the smaller firms really don't do this,  
16 but you're also looking at who does most of the audits  
17 of the Fortune 500 and so forth. It's 80 percent  
18 probably done, I think, by the big four.

19           But those need to be implemented. And you  
20 mentioned you do recommend training sessions, but maybe  
21 it's spotty. But I'm talking about a broad requirement  
22 of all auditing firms.

1           MEMBER HARRIS: Well, I guess my question really  
2 is: Do you think it's the role of the PCAOB and the SEC  
3 to establish guidelines for that training. So rather  
4 than say we want training, do you think that we ought to  
5 work on --

6           MR. HEWITT: That would not bother me.

7           MEMBER HARRIS: -- solving it all?

8           MR. HEWITT: I established the guidelines for  
9 interpreted guidance on evaluations of internal controls  
10 by management, and I think that helped management and the  
11 external auditors. No, I think that would be good.

12           MEMBER HARRIS: And then -- my time's up -- but,  
13 Ms. Hill, I just want to thank you for your participation  
14 and your recommendations on the investor advisory group  
15 of the PCAOB. We welcome all your recommendations, so  
16 thank you.

17           MS. HILL: Thank you.

18           CHAIRMAN DOTY: Lewis Ferguson.

19           MEMBER FERGUSON: One of things a couple of you  
20 mentioned was the fact that one of the problems with  
21 mandatory auditor rotation is that, given the fact that  
22 for any large company you're likely to have services of

1 various sorts performed by all of the big four, a number  
2 of the big four, so that in any given -- if you were to  
3 make a determination to rotate, you'd be very limited in  
4 what your choices were.

5           And it strikes me that this is a problem with the  
6 business models that the firms have chosen to undertake.  
7 That if they've chosen, it's like a -- you know, a person  
8 who comes to you and says well, you know, you really  
9 can't change this model because I've put myself in such  
10 a position that there really is no alternative. You give  
11 the firms no alternative.

12           Does this argue for -- which is something that  
13 the European community is concerned about -- does this  
14 argue for our thinking about the possibility of audit-  
15 only firms, that they could perform no services beyond  
16 audits for their clients, and that these firms will be  
17 limited to that? And therefore you would not be -- if  
18 you did determine that you wanted to rotate, you would  
19 not be limited by the independence rules? What do you  
20 think of that? Or do you see these things creating a  
21 problem?

22           MR. LYNCH: I guess one reaction. You're right,

1 particularly the big four of which I'm most familiar  
2 with, do have -- offer a litany of services. But I would  
3 say that when I look in totality at the global spend of  
4 a company like AIG, there are a whole variety of -- a  
5 long list of boutique firms that bring valuation skills,  
6 modeling skills, actuarial skills, transformational  
7 skills, project management skills, technology skills.

8           So I think the marketplace is actually actively  
9 looking for diversification opportunities of their spend,  
10 and I think increasingly audit committees are very  
11 sensitive, and I think this is probably an emerging  
12 practice that we're not looking at just the spend of the  
13 external auditor, we're looking at the spend of all the  
14 professional services firms, including investment banks  
15 and legal, so that we know what our option is somewhere  
16 down the road, if we were so inclined.

17           MS. HILL: I would agree with what my colleague  
18 just said. I would -- I would say that yes, we probably  
19 have gotten ourselves in a box. But many of us do use  
20 other firms. I mean, we use other firms, small firms for  
21 different activities that you have throughout the  
22 company. But when you're dealing with things, you know,

1 such as mergers and acquisitions and share repurchase  
2 and, you know, some major issue, you really are limited  
3 by the capability of the firms that you use.

4           So if there is an opportunity, I think, to expand  
5 the services group, sure, everybody would probably like  
6 to see that. There was a time we weren't in a situation  
7 with four. And I think most others can go back and  
8 remember when there were eight, and then there were  
9 seven, and so forth and so on. You know, heaven forbid  
10 something happen to one of the four, and then we're  
11 really stuck.

12           So, you know, I would say that there is a --  
13 there are uses that are being made of smaller boutique  
14 firms, but I would say that not on the major audits, and  
15 I don't think we're close to being able to do that yet.

16           CHAIRMAN DOTY: Jay Hanson?

17           MEMBER HANSON: I was at an audit committee  
18 conference last week put on by a practicing law  
19 institute, and I was just struck by the discussion of  
20 scope creep, or what the audit committee's responsibility  
21 is today compared to what it was maybe originally  
22 envisioned as, and here you're all smiling, and oh, amen.

1 And so I appreciate everything that you do.

2           And the opening panelists this morning, Chairman  
3 Williams effectively raised the questions, gee, if there  
4 are success stories around audit committees effectively  
5 challenging their auditors on independence and  
6 skepticism, bring it on, I'd like to hear them. And I  
7 think I kind of heard you describing, at least  
8 generically, the practices you do, and I appreciate that  
9 you probably don't want to call out specifically, maybe  
10 issues that you had with your audit firms. But if  
11 there's any more on that that you want to comment, I  
12 welcome that.

13           But my question is just something else. And that  
14 is, in my opening comments I said that we've heard a  
15 number of people suggest and advocate, and some of you  
16 have touched on it, to enable us to tell you more.  
17 Specifically, if we inspect the audit of Home Depot or  
18 Bank of the West or AIG or Cisco, to be able to talk with  
19 you directly about, "We came in and inspected the audit  
20 and here's what we found," which we believe would  
21 require legislation to enable us to do that.

22           And I'm scratching my head to think of the

1 downside of that, because personally I don't see any  
2 downside, other than us figuring out how we would do it.  
3 And so comments and supports or downsides that you would  
4 see to effectively advocate that we should have some  
5 legislation to enable us to speak to you more directly  
6 about what we found on your audit.

7 MR. HEWITT: I'll speak to that, because I think  
8 you bring up a very interesting subject of communications  
9 from the PCAOB directly to the audit committees. Audit  
10 committees that I have served on and observed as chief  
11 accountant, very few of them get any feedback from their  
12 external auditors as to what the inspection -- very  
13 detailed, detailed findings were, and what the  
14 remediation should be. So I think it would be a good  
15 policy to do that.

16 The downside of it would be strictly legal of  
17 some kind, to get a safe harbor situation, to permit that  
18 communication with audit committees, I think it would  
19 enhance the performance of the audit committees.

20 MS. HILL: I don't see any downside to having  
21 that kind of interaction. I think back to the time when  
22 it was considered a no-no, if you will, to have directors

1 talking with shareholders, with major investors, and now  
2 there's a move afoot to have much more of that  
3 engagement. Certainly understanding Reg FD, but really  
4 having more engagement.

5 I think that without having that kind of  
6 feedback, audit committees are oftentimes flying blind.  
7 I mean, you know, you hear there's an inspection and  
8 there's something wrong and you have no clue. And yet  
9 -- and still you have an obligation to shareholders, you  
10 have duties of care and loyalty and all those other  
11 things, and in many ways your hands are tied because  
12 you're not able to really exercise the judgment and the  
13 oversight that you need.

14 MR. LYNCH: When I first came into my role at  
15 AIG, the 2007 external auditor's report was being looked  
16 at. And as I went through 2008, 2009, 2010, kind of  
17 still waiting to hear on that process, and it would be  
18 easy to quip that "Is reporting on that timeline really  
19 relevant?"

20 But I do think, in fairness to the process, the  
21 external auditor was very candid. They indicated that  
22 there were a variety of shortcomings. They were very

1 forthright in saying, you know, we have to address these  
2 deficiencies, they are real and we are on it. And that  
3 has been incorporated and integrated into the current  
4 audit scope and technique.

5           So on one hand, I could envision, since  
6 effectively that regulator-regulatee relationship exists  
7 with the external audit firm, it would seem to me there  
8 may be a way that, with the firm's permission, for you  
9 to participate in those debriefings, and that possibly  
10 that would not require a legislative construct that might  
11 be limiting for you.

12           But that feedback is terribly important. And  
13 you're right, Mr. Hanson, I think we effectively had to  
14 rely upon the firm's leadership and that lead partner to  
15 convey accurately the results of your finding. Now once  
16 it actually came out, I felt very comfortably that they  
17 had relayed accurately what the nature of your findings  
18 were.

19           MR. WEST: I would also agree with that. I think  
20 it's terribly important for us as audit committee members  
21 and chairs to get additional feedback from the PCAOB.  
22 And definitely for the companies that we sit on the

1 boards of.

2           But I would also kind of go one step further.  
3 If it was possible to somehow look at -- or I would like  
4 to get feedback, in general, of what you saw from other  
5 companies that are relatively our size, so that we could  
6 then therefore be focused on possible issues with our  
7 firm. So it's not just what our firm did, but maybe what  
8 other companies that are relatively the size of Cisco,  
9 you know, and what kind of things you saw. Not  
10 necessarily by name, but in some generic form.

11           CHAIRMAN DOTY: Marty? Chief Auditor Baumann.

12           MR. BAUMANN: Thank you. I just wanted to follow  
13 up on one point. And I know, Ms. Hill, you made the  
14 point, but I think others have endorsed it, and my own  
15 experience as an auditor, it was a common practice.

16           It goes to the question that Jeanette was asking  
17 about, how do you as audit committee members get  
18 comfortable that your auditors are independent and acting  
19 with professional skepticism. And I'm talking about  
20 independent in mental attitude, not the -- they're  
21 complying to a variety of ownership rules and things like  
22 that.

1           A point was made about the value of the executive  
2 sessions. And I don't want to discourage executive  
3 sessions by any means. But I was wondering if you could  
4 be any more explicit in terms of what you think an audit  
5 committee member gains in those executive sessions, and  
6 how would an audit committee member do that in terms of  
7 learning about the auditor's independence and skepticism?

8           I guess I'd be skeptical if an auditor said  
9 something in an executive session that they were afraid  
10 to say with management there. So I'm sort of wondering  
11 what does a member learn that helps them in that regard,  
12 in the executive session?

13           MS. HILL: I have a question that's a favorite  
14 question of mine when meeting with the auditors in  
15 executive sessions. And that is, if you were sitting in  
16 my seat and you had just gone through the meeting that  
17 we've had, is there something that you would see that you  
18 think I should ask that hasn't been asked, and is there  
19 something we haven't covered that you think should be  
20 covered.

21           I think what happens, is that it's not that they  
22 don't disclose when management is sitting there, because

1 they do when we look at the review say we've had a  
2 difference of opinion here, and the auditor's in the room  
3 during this time, the internal auditors, or management,  
4 and they'll say but we have resolved it.

5           Sometimes the committee wants to dig deeper on  
6 that, and the time is not always there in the meetings  
7 themselves. There is an opportunity to ask questions  
8 that may not have come up during the course of the  
9 meeting, and you can do that in executive session as  
10 well. I think it's one of the reasons that executive  
11 sessions are required for independent directors when the  
12 CEO or management is not present.

13           It gives you an opportunity to reflect on things  
14 that you've heard that you may not have asked about, or  
15 may not have even crossed your mind that you can deal  
16 with after the fact. It doesn't mean you might not call  
17 the management team back in and say hey, this came up and  
18 we need to hear from you, we need to know, you know, more  
19 about -- we need more color on what you had to say about  
20 this particular issue.

21           So it really does just give a little bit of  
22 additional opportunity for things that just don't cross

1 over in the course of the regular meetings.

2 MR. HEWITT: One of the things I ask the external  
3 auditors in executive session, I want to know about the  
4 quality of our accounting financial treasury personnel.  
5 Are they making proper judgments on the subjective  
6 estimates that are in many in the accounting financial  
7 reports. And that gives me some idea.

8 And they're usually pretty straightforward with  
9 it, and say, "Hey, this person's -- you need to add  
10 another assistant controller because of the complexity  
11 and the growth of the company and so forth." So that's  
12 one example that I do all the time.

13 MR. WEST: I think the executive sessions are  
14 important, and we gain a lot of benefit from that. But  
15 I also think there's significant opportunity to be  
16 engaged with the audit partners or any of the audit team  
17 outside of those meetings and pick up the phone and call  
18 and set up some time to speak with them about what issues  
19 they're seeing, and not just make it on the meetings.  
20 And I think you get a lot more value from your partner  
21 in understanding what their issues are. Thank you.

22 MR. LYNCH: I would just say, Marty, in quick

1 response, in a way, if I hear something during an  
2 executive session, I feel like I haven't done my job.  
3 I am probing, reaching, challenging transactions,  
4 judgments, go live dates, I want to hear from them. And  
5 I -- you know, right or wrong, we all play devil's  
6 advocate a little bit. We challenge management. You  
7 better be the one to bring it to me first. And I  
8 challenge the external auditors, you better be the one  
9 to bring it to me first.

10           Somebody's pretty quick with a phone call, and  
11 there's usually not a delta of more than five or 10  
12 minutes in between those calls. So I think both methods  
13 -- both sides get the message the expectations are high.

14           MS. HILL: I would agree. But I would tell you  
15 that you will inevitably miss something. If that weren't  
16 the case, we might not be sitting here today. So it's  
17 all good and it works, and that's why we're here today.

18           CHAIRMAN DOTY: Thank you. Thanks to the panel.  
19 We have time for a brief break. Why don't we take a 10-  
20 minute break and get back here by just before 10 past  
21 noon, and we'll finish up.

22           ALL: Thank you again.

1 CHAIRMAN DOTY: Thank you all.

2 (Whereupon, the above-entitled matter went off  
3 the record at 11:57 a.m. and resumed at 12:10 p.m.)

4 CHAIRMAN DOTY: We have a panel. We have most of  
5 a board. Audit committees, investors and corporate --  
6 corporate chiefs, and people who have had actual  
7 responsibility for making investment decisions and  
8 directing audits.

9 We have Roger Dunbar, chairman of the board and  
10 audit committee of Silicon Valley Bank. Roger Dunbar has  
11 deep roots in Silicon Valley. He's the current chairman  
12 of Silicon Valley Bank's board of directors, chairman of  
13 its audit committee. Retired from Ernst & Young in 2004  
14 where he he'd had a variety of positions since '74,  
15 leadership positions in the firm from '85, global vice  
16 chairman of EUI Global Limited, London Strategic Growth  
17 Markets and venture capital partner in charge and area  
18 managing partner of Silicon Valley and the Pacific  
19 Northwest area for the firm. Taught at Santa Clara's  
20 University Graduate School of Business. He's had  
21 programs at Northwestern's Kellogg School, and a director  
22 of Desert Mountain Property and Desert Mountain Club,

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1 Inc..

2 Eric Keller. Chief operating Officer, Kleiner  
3 Perkins Caufield & Byers. Served as chief operating  
4 officer since 2008. He as extensive operational and  
5 finance expertise with entrepreneurs that KPCB backs in  
6 the green, digital and life science technologies. Before  
7 joining KPCB, he was CEO of Movaris, a private software  
8 company providing a suite of financial governance  
9 applications. Earlier in his career, chief financial  
10 officer and application service provider Corio, business  
11 communications companies Aspect Communications, medical  
12 device manufacturer Ventrivet, scientific instruments  
13 firm Dionex. And he counsels CEOs on business strategy  
14 and organizational and operational matters. In all  
15 firms, he developed teams of the processes that enabled  
16 the companies to grow. He was named in 2006 one of the  
17 100 most influential people in finance by Treasury & Risk  
18 Magazine. Holds a B.S. degree from Cornell, and an MBA  
19 from the University of California at Berkeley.

20 Mike Kwatinetz. General partner Azure Capital  
21 Partners. Founding general partner with Azure Capital  
22 Partners, where he specializes in software and related

1 infrastructure technologies. His current board  
2 memberships are BlogHer, Cooking, Education.com,  
3 Knowledge Adventure, Medsphere, Open Road and Rooftop  
4 Comedy. Prior to Azure, he was the group head of  
5 technology research managing director, and the senior  
6 software and hardware analyst at several major investment  
7 banks, including Credit Suisse, First Boston, Deutsche  
8 Bank Securities and Paine Webber. He was also a senior  
9 research analyst at Sanford Bernstein. Prior to this  
10 technology research career, he was the CEO of Woodbury  
11 Computer Associates, and that was a successful  
12 enterprise. And he was Institutional Investors number  
13 one Large-Cap "Home-Run Hitter" for stock selection among  
14 Wall Street analysts, and remained among the top five in  
15 1999. Furthermore, Reuters and the "Wall Street Journal"  
16 had selected him as the number one PC analyst in that  
17 annual survey we all look at and read. Served on the  
18 boards of the firm Woodbury Computer Associates, Bill Me  
19 Later, later acquired by Ebay. He's been in a number of  
20 the firms that have later gone on to merger with  
21 household names as well.

22 Mike Maher. Chief financial officer, U.S.

1 Venture Partners, founding member National Venture  
2 Capital Association CFO Task Force. He joined the U.S.  
3 Venture Capital Partners as chief financial officer in  
4 '91 responsible for financial reporting, legal and tax  
5 matters, general administration for USVP and its funds.  
6 He currently serves as a member of the IPED Board, a  
7 participating member of a National Venture Capital  
8 Association CFO Task Force, active member of the American  
9 Institute of CPA Investment Companies Expert Panel. He  
10 had been an audit partner with Ernst & Young serving  
11 clients for 17 years in a variety of industries,  
12 including financial services, health care, manufacturing  
13 and pension plans. B.Sc. cum laude from Santa Clara  
14 university.

15           So we have four distinguished Californians,  
16 people who are rooted in the technology culture and the  
17 valley here. We welcome you. We appreciate you taking  
18 the time to do this with us. Please proceed, Mr. Dunbar.

19           MR. DUNBAR: I would tell you that it's  
20 interesting, I've changed some of my comments from  
21 sitting and listening to the opening presentations by  
22 different participants, and I will say something. That

1 I've come to the conclusion you have a very difficult  
2 challenge ahead of you.

3 CHAIRMAN DOTY: Thank you.

4 MR. DUNBAR: I think you are the only group that  
5 hasn't been blasted by some of the prior -- prior  
6 presenters. Most audit committees, and auditors, and  
7 companies and CEOs have taken their fair shots. And so  
8 sitting back in the audience, I'm reminded of a comment  
9 that Andy Grove once said, that leadership requires flat  
10 molars, which means you grind your teeth a lot. And so  
11 it was interesting to listen to it. But what it really  
12 did is, I think it somehow it does pertain to a couple  
13 of my comments.

14 The first one being the difference between  
15 correlation and causation. One of the challenges that  
16 we've always dealt with is understanding what problem  
17 we're trying to fix. And I think one of the things that  
18 is confusing for some of us on this side is to -- we  
19 clearly understand the problems we're trying to fix  
20 today. I think certainly you can say, you know, we're  
21 very concerned about failed audits.

22 I would also tell you that as a chair of an audit

1 committee, as a prior auditor, we're scared to death of  
2 having a failed audit continually. I will tell you that  
3 the Sarbanes-Oxley, the PCAOB has improved everything for  
4 us from the standpoint that although it scares the  
5 partners in the firms to have an inspection go on, it has  
6 changed the attitude, and it's changed dynamics about how  
7 they perform the services with companies, especially  
8 public companies.

9 I would say that a couple of recommendations I  
10 got, one of them is that -- I spent a number of years in  
11 the Navy, and one of the most life changing concepts was  
12 -- came from in naval operation is that said in most  
13 large companies, in most large organizations, we tend to  
14 penalize the majority for the acts of the minority as  
15 opposed to keelhaul the offenders.

16 And so one of the things that I look at in this  
17 is saying, you know, a lot of us can talk and be cynical  
18 about the accountability that people have today and who  
19 really -- who really experiences dire consequences for  
20 their behaviors. I think at some level, we really do  
21 need to keep that in consideration as you approach this,  
22 is, are we really penalizing and holding accountable

1 those people who have really been off the reservation and  
2 off track on this and have caused failures.

3           And that means, to me, both the firm, the  
4 individual partner. I think at some level it relates to  
5 the audit committee, what they did. And I know, I am  
6 sure I will probably offend some people who are on audit  
7 committees by this statement of, you know, how dare you,  
8 but I think that that's one of the issues that we really  
9 have to deal with. Because I do believe that when you  
10 see -- as an audit committee chairman, when you see  
11 people who are sanctioned or you see the issues they're  
12 dealing with, the first question is to our auditor, do  
13 we have this same problem; do you have this problem; talk  
14 to me about what's going on here. And you really start  
15 to drill down.

16           And so I would encourage you, to the extent -- I  
17 know there's sensitivity about disclosing to the public  
18 your findings, but I would really encourage you to  
19 disclose those. I personally think it ought to be a part  
20 of the required communications between the auditor and  
21 the audit committee. We have a lot of other things we  
22 talk about, but I would add that to the list of certain

1 key findings.

2 I would also say that I think that there's a need  
3 for mandatory board education. Now, once again, I am  
4 biased because I came out as a CPA and we had mandatory  
5 continuing education. I think that there is a need --  
6 and I just came back from yesterday's Stanford's  
7 Directors College, there was a period for -- on Silicon  
8 Valley Banks where we had to report how much education  
9 we had, and then it went away.

10 And I realize that it may not be within your  
11 purview, but I think at some level life is changing so  
12 fast in business today that we need to have a continuing  
13 education requirement. I realize that that has costs  
14 associated with it, but once again, as one of the earlier  
15 participants said, cost needs to be defined in a more  
16 broad term. And I think the cost of educating the audit  
17 committee and boards, or requiring a certain amount of  
18 education, will add to -- will add to the -- to the --  
19 or minimize the amount of audit failures.

20 One of the last things I want to talk about is,  
21 firms have -- having been a practicing partner and client  
22 handler, I went through the period where we had

1 consulting firms, we had consulting operations, and the  
2 consultants came in and tried to generate revenue out of  
3 your audit client. And, you know, you would hear all the  
4 arguments that say well, you know, our auditors know our  
5 system better, so it would be better for our consultants  
6 to do the work than somebody else's consultant.

7           Having lost a number of clients because of the  
8 independence, having to resign them, making that  
9 decision, I think that's -- that's an item that I would  
10 say where now the firms, all four of the previous five  
11 big firms, have now reinstated advisory services, which  
12 I think for consulting. And I would -- I would suggest  
13 we look at that.

14           That's basically my opening comments. And I  
15 appreciate the opportunity. And thank you very much.

16           CHAIRMAN DOTY: Thank you, Mr. Dunbar. Eric  
17 Keller.

18           MR. KELLER: Chairman Doty, commissioners and  
19 staff to the PCAOB, as others, I'm very appreciative of  
20 the opportunity to speak here today. And in particular,  
21 I want to thank you for making the travel out here too,  
22 whether it turns out to be a nice day in northern

1 California, we would like to have more people from  
2 various regulatory agencies come out here, and if you  
3 ever have the opportunity to come down to Palo Alto, we'd  
4 welcome you there as well.

5 My own perspective is based on 30 years as a  
6 finance executive here in Silicon Valley for both private  
7 and public companies, and more recently as the chief  
8 operating officer for a venture capital firm. I'm  
9 interested in the auditor rotation proposal and how it  
10 would affect the more than 200 portfolio companies that  
11 we're investors in, as well as the annual audits of our  
12 venture funds.

13 All of us whose careers involve financial  
14 reporting strongly agree with the importance of having  
15 independent, objective auditors who understand the  
16 financial statements of clients with relevant industry  
17 expertise, full understanding of accounting principles,  
18 and a healthy dose of professional skepticism. The key  
19 question is whether mandatory auditor rotation is the  
20 best approach for improving the accountability of  
21 auditors.

22 I agree that there are challenges with the

1 current system, including conflicts for auditors, who,  
2 once having issued reports on financial statements,  
3 subsequently conclude that those statements are wrong.  
4 However, I don't think the term limits for auditors are  
5 the best approach to addressing these challenges. And  
6 here briefly are my reasons.

7           First, as others have mentioned, I believe that  
8 boards of directors are in the best position to make  
9 auditor decisions and should retain responsibility for  
10 appointing, and if appropriate, changing auditors.  
11 Today, finance executives, audit committees and auditors  
12 operate under tremendous pressure to get the financial  
13 statements and associated disclosures right. This  
14 pressure reflects the strong sense of fiduciary  
15 responsibility to investors, liability concerns under  
16 securities regulations, and importantly, inspections  
17 performed both by the SEC and the PCAOB. And, candidly,  
18 the strongest possible warning to auditors against  
19 getting co-opted by their clients took place with the  
20 dismantling of Arthur Andersen.

21           Second, term limits for auditors are as likely to  
22 weaken audits and financial reporting as to strengthen

1 them. For example, rather than cleaning up its act just  
2 prior to a new auditor coming on board, the existing  
3 audit firm is much more likely to aggressively defend its  
4 accounting subsequent to the auditor change.

5 In addition, audit firms may have reduced  
6 incentives to staff, what I would call end-of-term  
7 audits, with the best resources. This is a concern due  
8 to the complexity of accounting rules that place a heavy  
9 burden on auditors to fully understand client systems,  
10 processes and controls, as well as GAAP and regulatory  
11 financial reporting requirements.

12 Third, as others have mentioned, the number of  
13 audit firms capable of conducting audits for many  
14 organizations is very limited and may be further narrowed  
15 by conflicts. Audit firms differ considerably in the  
16 depth of their expertise by geographic area, industry,  
17 and stage of company. Finding an audit firm that  
18 understands your industry is critical, and mandatory  
19 rotations could reduce incentives for these firms to  
20 develop deep domain expertise, particularly in rapidly  
21 emerging industries.

22 Finally, changing auditors will involve

1 considerable direct and indirect costs as the new auditor  
2 gets up to speed. For large, global organizations, it  
3 may require much more than a single audit cycle, because  
4 the new audit firm adequately understands the client  
5 organization. Inevitably, there will be significant  
6 productivity losses for both the auditor and the client.

7           In the absence of evidence clearly linking the  
8 statements in audit failures to the lack of auditor  
9 objectivity and skepticism, I personally suspect that the  
10 most important causes of these failures are the  
11 burgeoning complexity of financial reporting, greatly  
12 expanded disclosures, and the increased precision  
13 required for financial statements. As an example,  
14 venture capital firms determine fair value for their  
15 investments in private companies pursuant to ASC 20. In  
16 some cases, we use a differential equation created by two  
17 famous financial theorists to establish the value of an  
18 early-stage company that is years away from revenue.

19           Discussions with auditors on the application  
20 evaluation model, input assumptions and sensitivity  
21 analyses involves substantial time and costs. In my  
22 view, the results suffer from a problem of implied

1 precision. The option pricing model generate a very  
2 specific answer. However, whether this output is useful  
3 to our investors in assessing the value of the early-  
4 stage company is another matter.

5 So what more can be done to enhance auditor  
6 independence, objectivity and professional skepticism in  
7 the absence of magic bullets? I think we should focus  
8 on the basics.

9 First, leverage audit committees to hold auditors  
10 and finance teams to high standards and ensure that  
11 auditors both appear and are independent. This means  
12 setting expectations for performance of both management  
13 and auditors, having robust discussions about financial  
14 reporting matters and audits, and challenging management  
15 to reconsider historical accounting policies as  
16 businesses evolve.

17 Second, continued rotations of lead audit  
18 partners and requiring detailed disclosure of non audit-  
19 related services performed by the audit firms.

20 Third, continue audit inspections by the PCAOB,  
21 that, as others have said, are having a very significant  
22 impact.

1           And finally, as others have mentioned, it's very  
2 important that you publicize the causes of these audit  
3 failures, so that the audit firms, public companies and  
4 audit committees understand the issues and take seriously  
5 their responsibility to address them.

6           As finance executives, we're data driven. If you  
7 give us the data, we can respond to it. These steps may  
8 not sound as powerful as mandatory rotation, but in the  
9 long term, I think they'll have a bigger impact. Thank  
10 you for inviting me.

11           CHAIRMAN DOTY: Thank you. Mike Kwatinetz.

12           MR. KWATINETZ: First of all, thank you. Thank  
13 you for inviting me to speak.

14           In my written statement, I've detailed a number  
15 of concerns I have regarding auditor rotation. And I'm  
16 not going to go into the same level of detail here,  
17 probably reiterating a few points that Eric pointed out.

18           So, we believe very strongly that the first two  
19 years of a new auditor, our costs would increase in two  
20 ways. The cost of the audit itself will go up as  
21 entirely new professionals learn about the company being  
22 audited. But also the staff of the audited company would

1 spend considerably more time informing this new team and  
2 providing documents that have already been well looked  
3 at by the prior audit firm.

4 In addition, more dollars would be spent by the  
5 audit firms in marketing and selling since you would have  
6 more opportunities for new audits to come up.

7 Secondly, as a new audit firm would be far less  
8 familiar with the company, we believe that the risk  
9 associated with this unfamiliarity would actually  
10 increase the potential for material misstatements to go  
11 undetected.

12 And then, finally, to reiterate part of what Eric  
13 was talking about, in some sectors, there's only one  
14 audit firm that has really strong industry knowledge.  
15 Forcing a company that is using that firm to rotate to  
16 someone else may substantially increase the risk of  
17 material misstatements being missed.

18 It also has several other consequences. A firm  
19 that doesn't understand an industry may require the  
20 entity to change accounting methods in a way that, while  
21 technically correct, lowers the quality of financial  
22 statements. On the other hand, auditors that are

1 industry experts can also help the firm being audited by  
2 describing best practices in that industry and helping  
3 the firm move more towards best practices.

4           So what are some of the -- and I have a lot more  
5 in my written statement, but I'll move on to potential  
6 alternatives. And I've put them in two categories. One  
7 is within the framework of versus auditor rotation, and  
8 the second is a little broader.

9           So there's been discussion of partner rotation  
10 within a firm, and I agree that partner rotation within  
11 the audit firm would improve independence while  
12 preserving the built-up knowledge of the auditors.  
13 However, it doesn't fully solve the key issues that  
14 concern the Oversight Board. Namely, the potential that  
15 an audit firm may become too close to a client, or  
16 concerned about the annuity associated with the audit.

17           So while I believe partner rotation is  
18 beneficial, it does not appear to be sufficient to  
19 overcome some of the issues that have caused the Board  
20 to consider mandatory rotation. So I have one possible  
21 solution to those issues, which is independent manager  
22 placement.

1 I think this is a pretty viable alternative to  
2 mandatory rotation, especially -- so every firm, if this  
3 was adopted, would -- every major audit firm would  
4 require each audit manager in the firm to be subject to  
5 mandatory rotation for about a year. Every audit firm  
6 would be required to utilize at least one manager every  
7 other year, or whatever's the appropriate time, from  
8 another firm on every major audit.

9 The managers would be randomly chosen, but would  
10 need to be from another firm. The manager selected would  
11 replace one of the prior year's managers who came from  
12 the audit firm conducting the audit. The independent  
13 manager would participate in audit planning, have access  
14 to all work papers, and participate in each step of the  
15 audit. At the end of the audit, the manager would be  
16 required to fill out a short report, commenting on issues  
17 he or she thought relevant to the Oversight Board.

18 What this process would do, it would introduce an  
19 independent player who's at a fairly senior level within  
20 the audit without adding time or expense, and without  
21 reducing the knowledge that the existing auditors brought  
22 to the table. If independent manager placement is

1 adopted and an audit firm was found to have a number of  
2 deficiencies related to a specific client, then audit  
3 rotation could be mandated on that client by the PCAOB.

4           Now, Roger was talking a little bit about what  
5 problem are we trying to fix. And I assume that the  
6 broader issue for the PCAOB is to ensure that financial  
7 statements provide the high quality of information to  
8 help users make better decisions. In considering  
9 alternatives to auditor rotation, what I'm about to talk  
10 about responds to the broader issue.

11           Everyone should want accounting standards to lead  
12 to the most correct representation of a company's  
13 financial results. But what if a requirement that is  
14 more theoretically correct, like the one talked about by  
15 Eric, also leads to inconsistencies reporting among  
16 companies in the same industry, creates more  
17 opportunities for misstatements of results that are  
18 difficult for auditors to detect, and/or reduces  
19 transparency to ordinary users of financial statements.  
20 I think that's something -- all of these things should  
21 be considered in establishing audit standards.

22           And it would help if we did consider them to

1 reduce material misstatements if this was done. Because  
2 financial reporting standards do not place understanding  
3 current operating performance as the priority, many  
4 investors rely on company pro forma statements, which are  
5 not subject to the same scrutiny and regulation, but  
6 better reflect ongoing earnings potential. And I have  
7 a lot of experience as a former analyst on Wall Street,  
8 where about a third of the companies that I followed at  
9 that time, we ignored GAAP accounting completely.

10 So it's a dangerous situation when many users of  
11 financial statements are essentially ignoring GAAP.  
12 Especially since the non-GAAP pro forma statements they  
13 rely on are far less regulated. A few examples of the  
14 material differences between GAAP and pro forma earnings  
15 are as follows.

16 For fiscal 2012, Salesforce recorded a GAAP  
17 earnings per share loss of nine cents, and pro forma  
18 earnings of \$1.36. The \$1.36 is what investors used.  
19 For Q1 of fiscal 2013, NVIDIA reported GAAP earnings of  
20 10 cents per share, and pro forma earnings that were 60  
21 percent higher. For the first quarter of fiscal 2012,  
22 Zynga reported a GAAP earnings loss of 85 million, pro

1 forma adjusted EBITDA of 87 million profit, and pro forma  
2 net income of 47 million.

3           This was so confusing to the financial press  
4 even, that Reuters initially announced that the company  
5 had lost \$85 million, and that was the GAAP number, but  
6 not the number that had been reported in the press  
7 previously as the expected earnings number. Many assumed  
8 they had substantially missed the Wall Street forecast.  
9 Later in the day, the Associated Press reported that  
10 Zynga had in fact earned six cents per share, which beat  
11 the Wall Street expectations.

12           While this discussion may seem a sidetrack from  
13 auditor rotation, it's very relevant to the Oversight  
14 Board's goal of preventing material misstatements.  
15 Investors may buy or sell a stock upon hearing the  
16 initial GAAP number thinking the company has fallen far  
17 short of the pro forma earnings estimate made by analysts  
18 and reported by the press.

19           So, in summary, I believe the Oversight Board's  
20 goal of reducing material misstatements in financial  
21 reporting is quite worthy. The current approach appears  
22 to be a little too specific from my point of view,

1 whether or not to require rotation of auditors. I  
2 believe this approach has more negatives than positives,  
3 and could lead to higher costs and less detection of  
4 misstatements.

5 I've suggested two other means of improvement,  
6 one is requiring both partner rotation within a firm, and  
7 also placing independent audit managers from other firms  
8 in larger audits on a rotating basis. The second is  
9 shifting the emphasis of accounting standards from purist  
10 accounting towards accounting that is more relevant to  
11 uses of financial statements and more easily auditable.

12 In any case, I think a very careful, explicit and  
13 objective cost benefit analysis needs to be performed on  
14 all alternatives occurred. Thank you.

15 CHAIRMAN DOTY: Thank you. Michael Maher.

16 MR. MAHER: Mr. Chairman and members of the  
17 board, thank you for the opportunity to participate in  
18 this continuing dialogue on the Concept Release and  
19 auditor independence and audit firm rotation. I'd like  
20 to echo the comments with respect to appreciation for  
21 your coming out here to the west coast. It's very much  
22 appreciated, and we look forward to further -- further

1 trips.

2           While the Concept Release contained at least 17  
3 specific questions, I believe the primary questions that  
4 was asked was, would mandatory auditor rotation enhance  
5 or ensure auditor independence, objectivity and  
6 professional skepticism. And as I prepared for this  
7 opportunity to address the board, I undertook a cursory  
8 review of the number of the related materials, including  
9 some of the over 600 comment letters that were received,  
10 both pro and con, and some of the comments provided in  
11 earlier panels, as well as having conversations with a  
12 number of investing partners at venture capital firms and  
13 CFOs.

14           By the way, I can tell you that as recently as  
15 last week, I surveyed in excess of 100 VC private equity  
16 CFOs, and 95 percent of that group are opposed to auditor  
17 rotation.

18           I was particularly struck by the statement of the  
19 Board's Investor Advisory Group found on page 15 of the  
20 Concept Release regarding investor confidence, and that  
21 prompted me to refine the audit firm rotation questions  
22 as follows:

1           Does the achievement of greater auditor  
2 independence, objectivity and professional skepticism  
3 increase the quality of financial reporting and improve  
4 investors' confidence in such reports?

5           Which leads to the final question, and I think  
6 the goal of this exercise, is: What steps can be taken  
7 to improve investors' confidence in the quality of  
8 financial reporting?

9           That is the bottom line.

10          And I think it's too simple. And while a  
11 desirable goal to suggest that we just have to eliminate  
12 misleading financial statements, ultimately, this is not  
13 going to be an auditor-only solution. I don't think that  
14 auditor rotation is the final answer. It's a possible  
15 answer.

16          But you've asked me to address thoughts on  
17 auditor rotation, and so I'd like to lay a framework for,  
18 first of all, understanding what causes misleading  
19 financial statements.

20          For the sake of the dialogue, I'd like to  
21 stipulate that there are five major players in the  
22 development of a set of financial statements. You have

1 the standard setters, you have management of the company,  
2 there's the audit committee of the company, the auditors  
3 of the financial statements, and ultimately the  
4 regulators. All five of them have a role in these  
5 financial statements.

6 In addition to that, I'd like to stipulate what  
7 the primary causes of materially misleading financial  
8 statements are. Fraud with intentional deception by  
9 management, or by management and the audit committee, or  
10 by management and the audit committee and the auditor,  
11 or any combination thereof. You have unintentional  
12 errors. You have differences of opinion in terms of the  
13 interpretation of facts. And you have differences of  
14 opinion with respect to the application of GAAP.

15 So the question here is, how does the auditor  
16 become involved in each of these causes for material  
17 misstatement. We'll stipulate for a second that the  
18 auditor should catch each of these. But the question  
19 becomes, how does it -- how does he do it. And there are  
20 cause says for why they don't identify these problems.

21 And what I ultimately concluded was that the  
22 causes for not identifying them with respect to fraud and

1 unintentional error would -- would be insufficient scope  
2 of work or a lack of objectivity and professional  
3 skepticism. And that the causes for differences of --  
4 or failure to catch a problem with respect to differences  
5 of opinion could be lack of independence.

6           On the other hand, what we don't know is how many  
7 of these material misstatements, or potential  
8 misstatements have actually been caught by the auditors  
9 before the financial statements were issued. And what  
10 leads to the ability of the auditor to identify those  
11 problems is the issue of -- of their continuity. So the  
12 institutional knowledge, the knowledge of where to look,  
13 the ability to have an open dialogue with the company,  
14 with its management, with the board of directors or with  
15 the audit committee all lead to an ability to identify  
16 these problems. And that is something that you're going  
17 to lose in a rotation situation.

18           So at the conclusion of that little exercise, I  
19 came out and said okay, I'm 50/50 on auditor rotation,  
20 you know. One problem is that auditor rotation -- and  
21 I see my time is up -- only occurs every 10 years. And  
22 so that means there's a period of time when you're not

1 going to identify rotation -- or rotation is not going  
2 to identify the -- the error.

3           Very quickly, I did a very quick calculation of  
4 the cost of rotation. We've heard people indicate that  
5 in the year of rotation there's a 20 percent increase in  
6 the cost. If you spread that over 10 years, that's two  
7 percent. Two percent of the annual audit fees of just  
8 the 10 largest firms, approximately -- it's about \$800  
9 million according to one of the recent reports I read  
10 online. \$800 million equates to something along the  
11 lines of the sixth largest firm that currently exists.  
12 That firm employs roughly 6,000 people.

13           So you're talking about a need to identify  
14 somewhere between four and 6,000 additional man years in  
15 the system every year to accommodate auditor rotation.  
16 I would just suggest that there are easier ways -- not  
17 easier ways, but better ways to spend that money. One  
18 would be to modify how peer review works.

19           And that would be so that it's a -- instead of  
20 being a retrospective review, it is a contemporaneous  
21 review. The second would be for audit committees to have  
22 independent experts at their disposal that would help

1 them to review the work. And then finally, in repeated  
2 egregious situations, we should allow the PCAOB to create  
3 a process that allows them to either mandate or recommend  
4 auditor rotation, but that would be the last -- the last  
5 step. Thank you.

6 CHAIRMAN DOTY: Well, thank you. Jay Hanson?

7 MEMBER HANSON: Thanks for all your comments.

8 I've been thinking about all the disconnects we  
9 have between the views of some that so strongly advocate  
10 that rotation is the only solution and those that  
11 advocate that rotation is crazy and it wouldn't work even  
12 if we could and would implement it. And I think about  
13 life and how we all go through life viewing life through  
14 a set of lenses that we're given, and it's our collective  
15 experiences. And so I'd like to think that I've got a  
16 set of bifocals on now that I've lived most of my life  
17 as an auditor, and now I'm a regulator.

18 And we've got two gentlemen here, the book ends,  
19 Michael Maher and Roger Dunbar, that were auditors, and  
20 now are involved as investors. And especially, Michael,  
21 I want to direct a question to you first, and any of you  
22 are welcome to weigh in on it.

1           So Michael started his career as an auditor, a  
2 substantial part of his career, and then since then he's  
3 been a CFO and an investor. So you've got a very unique  
4 perspective to see life with -- I'll call them trifocals  
5 -- that you've seen life as an auditor, as a CFO, and an  
6 investor. So I really, really respect the views of those  
7 that come to us with that unique perspective.

8           And so my question is: Why do you think there's  
9 such a big disconnect between those that -- that see  
10 rotation as the only solution, and those that see  
11 rotation as a -- as a crazy solution?

12           And I'll let any of you weigh in on that, but  
13 that's one of the things that as a board member I'm kind  
14 of struggling with that. Because I'm trying to see it  
15 in as many lights as I can. I don't have the perspective  
16 like many of you do, as being investors or investor  
17 representatives on audit committees.

18           MR. MAHER: I believe that one of the issues with  
19 respect to rotation, is that there's a tremendous cost  
20 that is associated with it. And those of us -- I've been  
21 through an auditor rotation. I've been through auditor  
22 rotations in both sides, both as the auditor and as the

1 CFO, and when you go through that process, especially as  
2 a CFO, there's a tremendous cost. There's a tremendous  
3 disruption to the organization in terms of trying to  
4 identify what the new auditors need.

5 In addition to that, with respect to whether a  
6 rotation makes sense, I'm not sure that we have a full  
7 understanding as to what the particular issues are.  
8 We've heard, for example, that there are audit failures,  
9 and then we've also heard, I believe the term was audit  
10 -- Roger help me. Not, not -- audit deficiencies. Yes,  
11 audit deficiencies. And I think there's a big difference  
12 between audit deficiencies and audit failures.

13 In my sense, I believe most of what we're  
14 experiencing are audit deficiencies. That while there  
15 are restatements of financial statements in some  
16 situations, in most cases, the -- it's a deficiency in  
17 how the auditor carried out their job. And so from the  
18 perspective of the chief financial officer of an  
19 organization or as an investor, I don't want to see the  
20 disruption in my organization for the lack of a positive  
21 output. So it's a cost benefit relationship.

22 MR. DUNBAR: I would just say that -- maybe I did

1 in an inarticulate way -- but one of the things that  
2 happens, and one of the appreciations I've walked away  
3 from this today is that everybody has a different set of  
4 glasses, and everybody's glasses were manufactured  
5 somewhere else. And some people have their glasses on  
6 and some people take their glasses off. And that's one  
7 of the challenges you've got, because the people who have  
8 talked are very passionate about their opinions.

9           And it's about to be a thing that they all  
10 believe that this is the solution. That's why I always  
11 come back and say what's the problem, what are we trying  
12 to resolve, and are there multiple solutions to the  
13 problem. My natural tendency of being an auditor and  
14 having lived both sides of it is, the rotation is a  
15 solution, I think it may be as -- as Mike just said, be  
16 a higher-cost solution than the benefit.

17           I also think that it has some unintended  
18 consequences about how the board takes responsibility and  
19 how specifically the audit committee takes  
20 responsibility. There are, as Mr. Baumann brought up --  
21 I think there are things -- and once again, I'm biased,  
22 this is my own bias -- our audit committee is different

1 once you put a retired audit partner on the audit  
2 committee than what it was before. And there's a whole  
3 issue about pushing the audit committee to do their job  
4 and understand what their job is.

5           So I do think there's solutions to it. Once  
6 again, it's a quick fix to say -- not a quick fix --  
7 relatively it's a quick fix to say this is the way we're  
8 going to deal with it, but you're really talking about  
9 evaluating someone else's state of mind, and that becomes  
10 difficult, because your perception and my perception may  
11 disagree, or your judgment and my judgment might  
12 disagree. How do you get the solution to say, okay, come  
13 to it. And I think there's just a lot of passion and  
14 anxiety around it because there has been a lot of  
15 failures where people don't feel that people were  
16 sufficiently held accountable.

17           MR. KELLER: I would just add a couple of things  
18 to that. Analogies are always problematic. But what I  
19 kept thinking about was this; it's like term limits.  
20 We're running a term limits experiment here in the State  
21 of California. We've had it in place for a number of  
22 years. I have good friends who strongly support it. I

1 know others who don't support it. I think the jury's out  
2 about whether it's really working or not.

3           The other -- so I think part of it is just an  
4 orientation that people have about whether it's time to  
5 sort of in effect throw the bums out, let's get somebody  
6 new in; new broom sweeps clean, whatever you want to call  
7 it. Right, there are people who believe that.

8           My experience in dealing with auditors, and I  
9 worked with each of the big four firms, the remaining big  
10 four firms over 30 years in Silicon Valley, having signed  
11 more than 60 10-Qs and 10-Ks as a CFO of various public  
12 companies. And the way I summarized them, the best ones,  
13 and I've worked with the best ones, are the best partners  
14 that audit firms are like a giant brick wall covered with  
15 a very thin layer of marshmallow; they're soft and sweet  
16 on the outside, but if you push, they're completely  
17 immovable.

18           And the ones I've worked with are tough-minded.  
19 They are very tough-minded people. And the difference  
20 in orientation I think you're hearing here today, is  
21 people who believe that there's this idea of collusion  
22 that management gets into with its auditors, that their

1 fees are there. I can tell you, I have friends who have  
2 lost their jobs and their life savings because of what  
3 happened with Arthur Andersen. I'm not saying it was  
4 handled correctly or incorrectly, I'm just saying it is  
5 what it is.

6           After that, the idea that anyone would -- would  
7 risk their careers, their livelihood because of audit  
8 fees, I don't -- that doesn't resonate for me. But I  
9 know other people, including some of the speakers here  
10 from earlier panels who believe it strongly. So that's  
11 a different orientation.

12           MR. KWATINETZ: I'd like to add from a lifetime  
13 investor point of view, I think often what I've seen is  
14 that -- is an idealism that comes in accounting. That  
15 people could figure anything out, even with no  
16 experience. And that purity is the perfect thing to go  
17 for. And, you know, as a pragmatist -- and Eric brought  
18 a little bit of this up with the VC industry -- there's  
19 been some things that have been implemented that, while  
20 theoretically we're getting a perfect answer, in fact  
21 we've just created the next fraud.

22           And it's because we've gone to something that, in

1 theory, is objective and in practice is totally  
2 subjective. And so there's no way that anybody who is  
3 on the audit side can properly figure out our comparables  
4 for a private company that are relevant. And we've been  
5 told by our auditors we don't like to mop things up.  
6 We're nervous if there's not a new round.

7           We had a company that just did a new round a  
8 month ago, so an independent investor set the valuation,  
9 they said that's not the right answer, the theory. The  
10 actual result is not the right answer, the theory is the  
11 right answer. So, and I've seen a lot of differences of  
12 opinion in terms of where you come from. And I think you  
13 should analyze which constituencies were on which side  
14 of the table with this.

15           And I'm guessing ones that are more involved in  
16 management and investing are further against auditor  
17 rotation. This is a pure guess. Because, from a cost-  
18 benefit point of view, it doesn't really make sense. And  
19 also from a pragmatic point of view, the new auditors  
20 won't have the depth of knowledge, and you're actually  
21 increasing risk by doing it. And the theorists will be  
22 more for it, so.

1 CHAIRMAN DOTY: Lewis Ferguson?

2 MEMBER FERGUSON: You all have raised a whole  
3 pile of questions already in my mind. Each of you has  
4 said things that I've found provocative and interesting  
5 and would like to ask questions about. But to confine  
6 myself to one question, and it's something we've been  
7 thinking about as a Board here.

8 The PCAOB, as you know, has great expertise  
9 through its inspection process, and -- and an enormous  
10 depth of knowledge over the life of this organization  
11 we've looked at about 1,800 separate audits both here and  
12 abroad. We are limited in terms of what we can convey  
13 to the public by the statute.

14 But with the consent of the auditing firm, and  
15 the auditing firm itself can disclose to you the  
16 confidential parts of its reports, would you find it  
17 useful and interesting as members of audit committees to  
18 know more about what we have found specifically with  
19 respect to inspections that we have done of firms that  
20 are members of the audit committee of members of the  
21 board of directors?

22 Would you find it interesting to have

1 communications with the PCAOB and its staff, with the  
2 consent of the auditor, about the results of the  
3 inspection findings of an audit that you're particularly  
4 involved with?

5 MR. DUNBAR: Absolutely. I think that's a really  
6 needed item. And I think it needs to be done in a way  
7 -- right now, a lot of the communications with the audit  
8 committees is the result of complying with the letters  
9 -- with the statute, is, we get big glossies. You know,  
10 you get a multicolored glossy, and quite frankly, you  
11 know, in a board, you flip through it. But what you  
12 really need is a very -- you know, and this is probably  
13 my Silicon Valley upbringing -- give me the five points  
14 that we really need to focus with.

15 And I personally would encourage, you know, the  
16 firm -- and I've just now made a note for my next audit  
17 committee meeting, is that I want to understand what  
18 their perception is of the issues that are causing audit  
19 failures that they've been issued, or items where one of  
20 their partners has been sanctioned, in very, very tacit  
21 ways.

22 MR. KELLER: So I would say it is not

1 interesting, it is essential to get that information out  
2 to people. Let me give a specific example.

3           Silicon Valley in the 30 years I've been here has  
4 transitioned. It used to be a hardware place. It used  
5 to be a place where people made widgets, and then we went  
6 to software, and now we're making intangibles.  
7 Accounting for these things is very exciting for all of  
8 us. But what happened with software rev rec, revenue  
9 recognition, was, it took a concerted effort by public  
10 companies, by the SEC, by the FASB and other -- and the  
11 big six or big four or whatever we were at at that  
12 particular point in time to figure this out.

13           It was only by shining a spotlight on the bad  
14 things that had happened, that we figured out that we had  
15 to have a much more coherent set of rules about how to  
16 recognize revenue in a software company. And I would  
17 encourage you, I think there's a wealth of data that  
18 exists within the PCAOB, the results of your inspections,  
19 and you could do an enormous benefit for audit committees  
20 by disclosing that information so we can see what are the  
21 hot areas, what are the things you're concerned about.  
22 Believe me, we can react to them.

1 I also serve on the -- I chaired audit committee  
2 of a public committee, and we will be all over this. But  
3 we need the data to do that. That would be helpful.

4 MR. KWATINETZ: Yeah, I would agree that it's  
5 essential that you release it in actually two ways. One  
6 is on the specific audit that I'm on the committee of,  
7 I'd like to have information. But then I also think it  
8 would be very helpful in a very generic way to point out  
9 where risks are that the audit committee should be  
10 focused on and thinking about. So I think both of those  
11 would be very valuable.

12 MR. MAHER: I would agree that the information is  
13 important. I'd be a little bit more specific about it.  
14 I would have the results of each -- each PCAOB review  
15 discussed with the specific audit committee. I'd include  
16 PCAOB reviewers in that meeting, and I would have from  
17 that -- essentially what they used to do in the old days  
18 when we gave out management letters, which is that  
19 there's a written plan.

20 We either agree with the deficiencies, or in some  
21 cases, and these are the changes that are going to be  
22 made either in the internal controls of management or in

1 the process by which the audit is completed. Or we agree  
2 that while the deficiency is noted, it's not that  
3 material, and we're not going to do anything about it.

4 CHAIRMAN DOTY: Steve Harris.

5 MEMBER HARRIS: Well, I'm most interested in  
6 independence, objectivity and professional skepticism and  
7 how to increase that. You know, mandatory rotation is  
8 -- I wouldn't say it's a peripheral issue; it's directly  
9 related. But the issue to me is, how to increase  
10 objectivity, independence and skepticism. And that's a  
11 concern shared internationally.

12 I mentioned that in my very brief statement there  
13 was a meeting of regulators in Korea recently, and the  
14 common finding that they all articulated was auditors'  
15 professional skepticism and auditor independence. That  
16 was in their press release. So how do we deal with that  
17 not only domestically but internationally is what I'm  
18 focused on.

19 I do find that there's a little bit of a  
20 disconnect. I do not want to vouch for these figures,  
21 because I don't have any idea whether they're credible  
22 or whether they're not. But later on today, we're going

1 to hear the 52 percent of public companies voluntarily  
2 changed auditors between 2003 and 2006, and auditor  
3 rotation is already a way of life for local government  
4 and non-profit audit clients, and the costs are not  
5 prohibitive. I don't know whether that's accurate or  
6 inaccurate, but we've got to get the empirical data one  
7 way or another. That's -- that's something that we have  
8 to focus on.

9           But, Mr. Dunbar, you raised an issue with respect  
10 to -- I think I heard you say concern about advisory  
11 services. What did you have in mind with that? And what  
12 should we be focusing on in terms of the independence of  
13 advisory services or otherwise?

14           MR. DUNBAR: One of the things that we have  
15 instituted is to absolutely set parameters on how much  
16 our auditors can provide us in non-audit services in  
17 dollar amounts.

18           My concern is, having lost companies because of  
19 the actions of our consultants, having watch a partner's  
20 career be destroyed when it really wasn't his fault. But  
21 because the consulting generation of revenue, all the  
22 firms appear to me to have reinstated -- they call them

1 different things -- advisory services, aka consulting,  
2 and the firms may find this testimony, that I'm a  
3 turncoat on them -- but quite frankly, I just yesterday  
4 had a conversation with our CFO saying no, these -- our  
5 auditor cannot do these services.

6           So there's an increase in creep, what I call  
7 scope creep, of wanting to provide these ancillary  
8 services to audit clients as opposed to, in my firm, we  
9 used to call it channel one revenues and channel two  
10 revenues. Channel one was audit clients, channel two was  
11 non-audit clients. And we've managed it that way.

12           So I am personally worried, as I watch this come  
13 in, it seems innocuous now, but the scope creep around,  
14 trying to get your audit for -- your auditor's firm was  
15 trying to get you to spend money with them in that area,  
16 I think, is a challenge or a risk.

17           MEMBER HARRIS: Do any of the others of you have  
18 any concerns?

19           MR. KELLER: I think it's a very interesting  
20 question, and it is something that I think, serving on  
21 an audit committee, I think I'm very sensitive to as  
22 well. I also think it would be worth looking into what

1 the history's been here, because there was a time in the  
2 late 1990s where there was an effort to get the large  
3 accounting firms to spin off their consulting practices.  
4 So Ernst & Young spun theirs off to Capgemini, and  
5 BearingPoint was a spin out of KPMG. It may be worth  
6 looking into what that experience was. I don't -- I  
7 can't summarize it for you, but I think it would be worth  
8 looking into what that experience was, what worked in  
9 that effort and what did not work in that effort.

10 But I do think that part of it isn't just  
11 independence, it's the appearance of independence, and  
12 that's also important. And I think when you look at that  
13 disclosure, which is a great disclosure, by the way,  
14 maybe it be expanded in the annual proxy statement to say  
15 where the fees come from. If you look down there and see  
16 huge fees relative to the audit fees that are being spent  
17 on other ancillary kinds of services, I think it's --  
18 it's not unreasonable for a -- for an investor to look  
19 at that and scratch their head and worry about  
20 independence. It's a fair question.

21 MR. KWATINETZ: So I was a manager in the  
22 consulting side of Ernst & Young. And I can readily see

1 some of the issues that could -- could happen that way.  
2 I also felt that by having the consulting side -- and  
3 this is a tricky thing, we actually enhanced some of the  
4 audit value. And there were things that the consultants  
5 brought from a knowledge point of view that the auditors  
6 didn't have in their training. This was ages ago, so I  
7 don't know how it's changed.

8           So there is an offset, but I think that, you  
9 know, the way that it's moved toward trying to restrict  
10 the amount that auditors will do in consulting is  
11 probably the right thing. But if you go back to the  
12 history of auditing, it was supposed to be a value added  
13 service in terms of helping the company as opposed to a  
14 service that was a mandated service.

15           And I think it's more viewed as a mandated  
16 service now as opposed to a valued added service. And  
17 it's a very important distinction in terms of how  
18 companies look at their auditors. So the consulting side  
19 added value. And so that's something to weigh when  
20 you're thinking about it. And value could be helping the  
21 company improve the way it reports, and, you know, having  
22 more things that are valuable to investors in the

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1 company.

2 I just want to add one thing. The suggestion I  
3 made of partner -- of manager rotation, I'd really  
4 encourage you to think about whether that's something  
5 that would be on a -- semi -- you know, a biannual basis.  
6 And that would, I believe, increase the diligence of the  
7 existing auditors, knowing that a manager from another  
8 firm would be part of their audit team every other year.  
9 I think that's something that might be another way to go  
10 and accomplish some of the objectives of auditor rotation  
11 without the cost and the loss of knowledge that's  
12 associated with it.

13 MR. MAHER: I would just add that I think it's  
14 correct to minimize the amount of consulting services  
15 that the firms provide. On the other hand, I wouldn't  
16 want to see that definition be so tight as to preclude  
17 collaborative efforts on major accounting issues.

18 To be blunt, the size of the most recent ASU on  
19 fair value was 331 pages. I don't have a staff that's  
20 big enough to sit there and look at a 331-page document  
21 from FASB on fair value. Fair value is the biggest issue  
22 that I have to face internally on financial reporting.

1 So I have to look to my auditors for some assistance in  
2 how to deal with -- with this.

3 So if consulting is limited to, you know, some of  
4 the tax services that we get because they tie in, and  
5 working with them on a collaborative basis, I think  
6 that's fine. Going to these much larger situations where  
7 you're selling systems -- and I don't think the firms do  
8 that anymore -- but that would be a concern. So I would  
9 -- I would agree with Roger and the rest of the  
10 panelists; we need to monitor how much that consulting  
11 is becoming.

12 CHAIRMAN DOTY: Jeanette?

13 MEMBER FRANZEL: This has been a very rich  
14 discussion. And you all have mentioned the complexity  
15 of financial reporting and disclosures and some of the  
16 very difficult situations your particular companies have  
17 faced. And -- but that the goal is reliability of  
18 financial reporting overall. And so that does involve  
19 more than the audit.

20 And I wonder if you have any comments on the  
21 balance there and what you're seeing in terms of  
22 effective ways to mitigate the financial reporting risks

1 through the audit?

2 MR. KWATINETZ: I -- you know, Michael talked  
3 about the different constituencies that are involved, and  
4 I think you have to think of the constituencies that  
5 mandate reporting. To me, it doesn't matter what the  
6 auditor's to do, a lot of people are losing money because  
7 of the way that financial reporting is mandated.

8 I had a personal experience when I was on Wall  
9 Street, and I have it in my written thing, Compaq  
10 acquired DEC. They then said they were growing 36  
11 percent when they were actually shrinking. And there was  
12 no requirement for them to put anything in their  
13 financial reports about organic growth versus purchase  
14 growth. And it's not that it couldn't be detected, but  
15 it just happened I was the only analyst on Wall Street  
16 that showed the comparison based on adding the two  
17 together the prior year.

18 What happened is, the stock collapsed when they  
19 got close to the -- you know, to annualizing. They had  
20 to reveal that they weren't going to keep growing at 36  
21 percent, that it was almost like a fraud, but it was all  
22 within accepted reporting. They didn't do anything that

1 was un-allowed. Nothing wrong with the auditors.

2 Nothing was required.

3           So I think that if you study the broader issue,  
4 which is how do we make the reporting better, you may  
5 come to conclusions that you have to go to a 331-page  
6 requirement. Is that actually enriching the reporting  
7 to the users of the statement? Or is it adding a  
8 financial burden that actually causes every firm to  
9 report the same thing differently? And you're actually  
10 increasing the risk of misstatement by doing that.

11           MR. KELLER: So I have a simple thought  
12 experiment to suggest. If we had a company called ABC,  
13 Inc. that makes -- is a cloud -- a based widget company,  
14 all right; and we take the five largest audit firms and  
15 we give them -- actually, it's a hypothetical, so they  
16 all go in at the same time, they get the same budget, the  
17 same number of hours, and they audit this company. I  
18 have two questions that comes out of the following  
19 experiment.

20           One, will the resulting five sets of financial  
21 statements, MD&A footnotes, et cetera, be the same? The  
22 answer is, of course they won't be the same. Because the

1 firms will pursue different issues. They'll look at  
2 different issues. And they focus on different things.  
3 And it also reflects the complexity that's inherent in  
4 our financial reporting system. And by the way, I don't  
5 think that's going to go away. I think we're in a world  
6 of intangibles now, and it's not going to go away.

7           The more interesting question to me is to ask  
8 this question: Does the fact that those results are  
9 different, even materially different, mean that one of  
10 those financial statements is right and the others are  
11 wrong? And I suggest to you that in a very complex  
12 accounting world that we live in, that is not necessarily  
13 the case. That it's possible to have different sets of  
14 financials, even for the same identical company at the  
15 same point in time that are -- that are both GAAP and  
16 GAAS compliant, and that's just a -- that is an outcome  
17 of a very, very complicated set of accounting  
18 requirements. So we just have to recognize that.  
19 There's no one right set of numbers for any entity. It's  
20 just not possible.

21           MEMBER HANSON: Eric, can I just interrupt with  
22 a quick question on that? Would you view or do you think

1 it's possible that if you were trying to evaluate the  
2 quality of the accounting principles behind vastly  
3 different numbers for the identical company, that they  
4 be equal quality of the accounting principles, it's just  
5 that there's different assumptions built in?

6 MR. KELLER: I think -- here's an example. Is if  
7 you're using an option -- I'll go back to the option  
8 pricing model, which is the hammer that we're using for  
9 every real and perceived nail out there today in the  
10 world we live in, venture capital, right.

11 The input assumptions in that are not statutory.  
12 We have to figure out what they are. They involve  
13 judgment. Depending on how you pick those assumptions  
14 and test them and measure them and those kind of things,  
15 you will get radically different outcomes. And so I do  
16 think you can have high-quality audits done with the best  
17 of intentions by people that end up in very different  
18 parts.

19 I would actually go a step further. I don't know  
20 that that's necessarily a bad thing. I think it's  
21 actually good to have different people focused on  
22 different things, because they'll find issues where

1 others would no. So that's just a -- you know, again,  
2 it's fun in Silicon Valley, it's sort of a sport to rail  
3 against the complexity of accounting standards. You  
4 know, non-finance people like to do it. But it is the  
5 world we live in today. I don't think it's -- it is not  
6 -- simply not going to go away.

7 I'd love to have, instead of an 800 -- a 320-page  
8 document, a 30-page document. But I don't think we're  
9 going to get there, frankly.

10 CHAIRMAN DOTY: Are there other questions? Are  
11 there other questions by board members or staff?

12 We're over time, but there comes a -- there comes  
13 out of this a certain sense that the four of you embrace  
14 the situation we have. Different numbers, as long as we  
15 don't penalize the majority and we can't find the  
16 wrongdoer to keelhaul, or make that public, don't  
17 keelhaul the wrongdoer, it's -- there's a certain  
18 sporting legitimacy to finding -- for an analyst to be  
19 able to find out from the financial reporting that we  
20 have what the average investor can; it's part of the  
21 game. And after all, it's tough to change your auditors.

22 Why don't I come -- I'm going back to what Andy

1 Bailey said this morning, that the accounting profession  
2 -- we are here today because at critical moments in our  
3 country's history, the accounting profession dug its  
4 heels in and -- and said no change, don't do it, too  
5 expensive, too difficult. That's troubling to a lawyer  
6 who has admired the accounting profession and has lived  
7 through a few of these terms of his career.

8           Is it the considered judgment of the panel that  
9 there is no circumstance in which the PCAOB, looking at  
10 the performance of an audit by a firm that has had an  
11 engagement for 20 years, and has gone through a process  
12 that may have resulted in actually influencing the  
13 consultation process to get to a result that management  
14 wanted, there's no circumstance in which we should step  
15 in and say we think there's been a failure of skepticism  
16 here; we think there's been a failure to perform audit  
17 procedures that even would have existed under GAAS, let  
18 alone our existing standards; no circumstance in which  
19 we should look at the auditing firm, big, large or small,  
20 medium size and say in this engagement, in this case you  
21 are no longer independent? Show us cause why we should  
22 determine that you're not independent as to this firm.

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1           Is it your view that that is overstepping the  
2 area that we should not tread for the audit committee and  
3 the sanctity of the audit?

4           MR. KWATINETZ: I've actually put in my written  
5 statement that you should do that. So I have it under  
6 the manager rotation. But it's the -- it's the same  
7 exact thing. If you find whether it's through manager  
8 rotation or your own internal -- if you find that a firm  
9 has not fulfilled its responsibilities and you feel  
10 they've been -- let's not say negligent, but less than  
11 perfect, you know, on some scale not up to where they  
12 should be, then I think you should mandate a change.

13           CHAIRMAN DOTY: And that's information --

14           MR. KWATINETZ: That's different than required  
15 rotation.

16           CHAIRMAN DOTY: It is. I mean, I'm really trying  
17 to understand where you all come together on common  
18 ground. I think it also is the understanding that you  
19 think that in a case we find that, we ought to be able  
20 to go straight -- there ought to be a kind of reporting  
21 up or sounding out by the Board directly to the audit  
22 committee right there and then.

1           MR. DUNBAR: That would be my one caveat, is that  
2 I would think that that ought to be brought immediately  
3 to the audit committee, and I guess at some level, once  
4 again, it's -- you can always put yourself out there.  
5 But I would think if the audit committee doesn't react  
6 to that and you look at it, and there's always difference  
7 upon opinion and judgments, but I would be suspect of an  
8 audit committee that didn't act on that, quite frankly.  
9 But I would -- I would not give audit committees the  
10 opportunity to abdicate responsibility.

11           MR. KELLER: I would only add to that, that if  
12 during a PCAOB inspection you found that an audit was --  
13 was flawed, and that led to a restatement of the  
14 financials for the company, I think if that audit  
15 committee doesn't consider swapping out the auditors, I  
16 think that's -- that would be -- that they would have a  
17 responsibility to do that. They would have to do that.

18           I can't comment on your statutory authority. But  
19 again, I think that the -- I think that the dialogue --  
20 that's why the specifics here are important to us, so you  
21 can hear we're all saying much the same thing about  
22 giving us more specifics. The more specifics we have,

1 the better off we are. And I think we will react to it.

2 CHAIRMAN DOTY: Well you, along with Jim Cox  
3 earlier today and Andrew Bailey, others that had been  
4 here, and that were in Washington on the 21st, what  
5 you're doing in part is asking us to reflect on our own  
6 process and our own remedies, and to think about whether  
7 our remedies, perhaps, are inadequate, but should be  
8 looked at again.

9 MR. KWATINETZ: You know, just to throw it back  
10 at you, don't you think it's almost negligent on the  
11 PCAOB's part to know that something is being done wrong  
12 and not communicate it?

13 CHAIRMAN DOTY: Well, the Congress took a  
14 different view. The Congress took a -- on that note --  
15 on that note, perhaps we'll adjourn for lunch. Thank you  
16 all.

17 (Whereupon, the above-entitled matter went off  
18 the record at 1:14 p.m. and resumed at 2:00 p.m.)

19 CHAIRMAN DOTY: Well, good afternoon. Thank you  
20 for being here. The panel today gets us back into the  
21 public sector.

22 We have David Eaton, the Vice President of Proxy

1 Research, Glass, Lewis & Co. He is -- his department  
2 analyzes proxies in more than a hundred countries and  
3 publishes analyses for nearly 20,000 shareholder meetings  
4 annually. At Glass Lewis, he has held multiple positions  
5 including U.S. research analyst, director of Glass Lewis'  
6 Common Law Research Team. More recently, AVP of  
7 Compensation Research, partly responsible for the  
8 company's compensation analysis globally, with oversight  
9 of the firm's say on pay policies. In this role, he also  
10 oversaw environmental, social and governance research and  
11 proposal analysis. Prior to joining Glass Lewis, he  
12 worked as a research analyst for GovernanceMetrics. He  
13 joined Mercer Consulting, managed their Global Executive  
14 Remuneration Research and Insights Team for two years  
15 before returning to Glass Lewis. He's a frequent speaker  
16 in industry conferences, client events and webcasts, and  
17 his views on governance and compensation-related issues  
18 have been cited in media throughout the country. He  
19 holds a Bachelors degree in Economics from Haverford  
20 College, a Masters degree in Business Administration from  
21 the Yale University School of Management. David, we  
22 welcome you.

1           Janice Hester Amey, Portfolio Manager, Corporate  
2 Governance, California State Teachers' Retirement System  
3 (CalSTRS). She is a portfolio manager in the Corporate  
4 Governance Unit at CalSTRS, responsible for day-to-day  
5 management and the development of policies and guidelines  
6 relative to the activist investment managers and  
7 corporate governance. CalSTRS is a public pension fund,  
8 of course, established for the benefit of California  
9 public school teachers over 80 years ago. It serves  
10 800,000 members, retirees and beneficiaries, has a  
11 portfolio valued at \$152 billion as of February 29, 2012,  
12 and Corporate Governance represents about \$4 billion of  
13 those assets. She has spent -- Ms. Amey has spent over  
14 20 years in the investments area, most equally split  
15 between the public and the private sectors. And we  
16 welcome you, Janice Hester Amey.

17           Robin Madsen, Chief Financial Officer, California  
18 State Teachers' Retirement System, responsible for  
19 providing leadership, strategic planning, management  
20 direction and policy guidance to CalSTRS Financial  
21 Services Function. Joined CalSTRS in June 2009 as a  
22 special consultant to the CFO. Prior to joining CalSTRS,

1 she was involved in financial information technology  
2 consulting for private and -- public and private sector  
3 entities in California, Oregon and Washington for more  
4 than 20 years. Began her consulting career with Peat  
5 Marwick. Owned and operated two consulting organizations  
6 for 13 years, and then prior to that she was the  
7 assistant controller and assistant vice president for  
8 Kaufman and Broad's Mortgage Company, as well as the loan  
9 accounting manager for a wholesale mortgage banker,  
10 Farmers Savings Bank. So she brings a great deal of  
11 private sector investment experience to this table.

12           And we are delighted you're here. We're  
13 grateful for your insights.

14           And I will turn it over to David Eaton. Please,  
15 you may begin, David.

16           MR. EATON: Okay. Thank you for having me. And  
17 thank you for inviting Glass Lewis to participate in this  
18 public forum. Should -- should I go through just a brief  
19 statement? Is that the --

20           CHAIRMAN DOTY: Of course. Deliver a few  
21 remarks, and then we'll pass it down the table; we'll  
22 come back and ask questions.

1           MR. EATON: Perfect. I'll -- I'll keep it brief.  
2 So, in short, Glass Lewis supports the PCAOB's efforts  
3 to ensure auditor independence. We certainly believe  
4 that disinterested, independent judgment of a company's  
5 financial statements plays a vital role in investor  
6 confidence in the company and its management, and in the  
7 board of directors.

8           Glass Lewis, for those of you who are unfamiliar  
9 with our role, we're an independent governance analysis  
10 and proxy voting firm. We serve institutional investors  
11 globally. We have over 900 clients who manage over \$15  
12 trillion in assets. These include some of the largest  
13 pension plans, asset managers and mutual funds. Our  
14 research focused on the long-term financial impact of  
15 investment and proxy vote decisions. We empower  
16 institutional investors to make sound decisions by  
17 uncovering and accessing governance, business, legal,  
18 political and accounting risks.

19           The purpose of our research and what we look at  
20 is, we look to drive -- we look for to give advice to  
21 institutional investors, to all of our clients, in fact,  
22 to facilitate shareholder voting in favor of governance

1 structures that will drive performance, that will create  
2 shareholder value, and that will maintain a proper tone  
3 at the top at the, at the company. And in this sense,  
4 we do look for -- count the boards with a record of  
5 protecting shareholder value, mitigating risk, and  
6 delivering value over the medium to long term.

7           We -- we strongly believe that the auditor's role  
8 is as a gatekeeper. It's crucial in ensuring the  
9 integrity and transparency of the financial information  
10 necessary to protecting the shareholder value.  
11 Shareholders rely on an auditor to ask the tough  
12 questions and to do a thorough analysis of a company's  
13 books to ensure that the information provided to  
14 shareholders is complete, accurate and fair. And that  
15 -- and so it is a reasonable representation of a  
16 company's financial position.

17           The only way shareholders can make a rational  
18 investment decision is if the market is equipped with  
19 accurate information about a company's fiscal health.  
20 We -- Glass Lewis does believe that auditor rotation can  
21 ensure both the independence of the auditor and the  
22 integrity of the audit. We will typically recommend

1 supporting proposals, although they are very rare, that  
2 do ask for auditor rotation.

3           We do feel, however, that mandatory audit  
4 rotation is something to be considered; though mandatory  
5 is definitely debatable. We do feel that Sarbanes-Oxley  
6 has put some -- some strong checks and safeguards  
7 regarding independence and integrity and objectivity in  
8 place, including -- particularly moving the  
9 responsibility to the audit committee for supervising,  
10 selecting and compensating the external auditor.

11           And I guess in conclusion, I would just say that  
12 audit rotation, when combined with -- with limiting non  
13 audit-related services, moving audit committee -- the  
14 responsibility to the audit committee, as well as the SOX  
15 requirement that we audit -- partner rotations is  
16 mandatory when combined -- when combining all of those  
17 aspects, we feel that the independence and objectivity  
18 of auditors has improved in the past decade.

19           CHAIRMAN DOTY: That's very helpful, and thank  
20 you, David. Ms. Amey.

21           (Pause.)

22           CHAIRMAN DOTY: Janice put your -- yeah, there we

1 go.

2 MS. AMEY: Thank you for having me. My name is  
3 Janice Hester Amey. I'm a portfolio manager in the  
4 corporate governance area of the CalSTRS investments  
5 office. Been there since the mid '80s.

6 We have done a lot of comments all the way back  
7 to 2002 on this governance issue and the proper role of  
8 the Board Oversight of the audit process. And just as  
9 David said, we certainly believe that auditor rotation  
10 can be a tool that audit committees can use in order to  
11 get a -- a better quality audit, or an audit that has  
12 greater integrity, greater independence of the auditor.  
13 However, as a fund, we have not been in support of making  
14 that requirement mandatory. We'd like to leave the audit  
15 committee as the people that are in charge of the  
16 relationship.

17 However, in doing our research for this meeting,  
18 I did look at some surveys and studies, the last one done  
19 by Protiviti, which actually was surveying public  
20 companies on this very question. And even though as  
21 investors what we're trying to do is not give companies  
22 more regulations and structures than they need to -- to

1 look over the assets and grow the assets, it may look at  
2 those from -- if this survey is -- it can hold up, it may  
3 look as though the companies are somewhat differently  
4 responding.

5           For instance, nearly half of the public companies  
6 that were surveyed by Protiviti agreed that rotation  
7 would improve auditing. And that was among accelerated  
8 filers. And among large accelerated filers, 47 percent  
9 were in favor of rotation. While in non-accelerated  
10 filers, 50 percent were in favor of rotation.

11           So I think we -- we are looking for a solution  
12 that still leaves the oversight role at the board level,  
13 and leaves the decision at the board level. And I think  
14 we would still come out in not being in favor of  
15 mandatory rotation. But it does seem that if the  
16 companies feel that they're not getting the right kinds  
17 of audits, and that this is a tool that they should have,  
18 we'd certainly support that.

19           CHAIRMAN DOTY: Robin Madsen.

20           MS. MADSEN: Hi. I'm really just here to tell  
21 you about our experience with auditor rotation, because  
22 we have been through several auditor rotation cycles, and

1 are just into our second year with the new auditor that  
2 came out of a -- a public sector procurement process.  
3 So because of our unique position in the public sector  
4 and the transparency required in our board reporting, we  
5 really do need to go through rotation. So -- and we have  
6 over the course of the last three or four audit cycles.

7           We have had -- our auditors have tenure with us  
8 for between four and eight years. In this last RFP  
9 process, we looked significantly at the issue of  
10 independence and whether it was important to exclude the  
11 prior auditor from the procurement process, and  
12 determined that it was not. So the prior auditor, as  
13 well as a competitor were part of our finalists, and were  
14 interviewed by our audit and risk management committee.

15           There was some discussion about the independence  
16 issue in that committee meeting, but that did not end up  
17 being the determining factor for the award of the  
18 contract. We did end up selecting new auditors, but not  
19 as a byproduct of any requirement for rotation in  
20 particular, but just because it seemed like that was a  
21 better choice. So there was a management recommendation  
22 and a robust discussion with our audits and risk

1 management committee.

2           Given the structure of our board as  
3 representative of our membership, as well as composition  
4 from statutory offices and public representatives, we  
5 actually have a financial expert that the audit and risk  
6 management committee has hired. So most of the dialogue  
7 was prompted by questions from that financial expert, who  
8 happens to be a professor at the University of California  
9 Davis. So, you know, from a more academic perspective.

10           And, again, my -- my recollection -- although I  
11 didn't go back and listen to the tape -- my recollections  
12 were that, there were -- you know, there were discussions  
13 of the pros and cons of actually rotating the auditor.  
14 But the cost in terms of actual dollar costs, because  
15 there were differences in price, as well as the, you  
16 know, more of the soft cost, what's it going to cost us,  
17 what are we losing in terms of expertise, and what are  
18 we gaining in terms of a new set of perspectives.

19           As the person who's been largely responsible for  
20 interacting with the new auditors, and whose staff are  
21 on the line with the new auditors, I can tell you that  
22 it is expensive, both in dollars terms, and in staff

1 time.

2 My conclusion, personally from this particular  
3 seat that I'm sitting in, is that that expense has been  
4 compensated and then some by the value that we have  
5 gained from a new set of eyes on our business. And it's  
6 not just in terms of the quality of the financial  
7 statements, because we haven't actually had them  
8 recommend any changes to the financial statements, but  
9 it's been in the conversations with the audit team and  
10 the fact that they are asking a new set of questions that  
11 have led staff and management alike to look at their own  
12 operations and determine whether they should be asking  
13 different questions.

14 So I would see it as a ripple effect out into the  
15 organization and not purely limited to the financial  
16 statement results. Because, as I said, there really have  
17 not been any -- any discussions about making changes to  
18 those financial statements. But it really has been a  
19 different perspective on questions about our business  
20 operations, where the risks are, have we been thinking  
21 of all those places where we could be subject to material  
22 misstatement, those kinds of thought processes have

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1 definitely been amplified by the presence of a new -- a  
2 new partner in -- in our auditing firm.

3           So what I can tell you is -- and, again, we're in  
4 a public procurement environment, so I have no idea how  
5 this translates into another arena, but we did experience  
6 actually a 30 to 40 percent increase in cost in the first  
7 year. Now we went from a regional firm to a more -- a  
8 national firm, so there's obviously a gap there. I'm not  
9 sure how to mitigate that. I haven't done any economic  
10 research to discount it, but certainly there,, that could  
11 be done.

12           I will say that the partner involvement in our  
13 audit in the differences in the scale of the firm has  
14 been significant. There's been a significant difference  
15 there which would also contribute to the variation in  
16 cost.

17           In terms of the comments about -- that people  
18 have made about the expertise in the industry, I -- I  
19 haven't found that to be the case. And we have a fairly  
20 complicated set of -- we have -- we're in a complicated  
21 business. So, especially with all of the public  
22 notoriety of pensions right now, it is complicated not

1 only from the actual running of the financial services  
2 organizations, but also in terms of public perception.

3           And I think our new auditors have done a very  
4 good job of coming up to speed bringing the right  
5 expertise to the table to be able to give us a very high-  
6 quality audit.

7           On the consulting front, we use a variety of  
8 firms that are not our auditors. We cannot use our  
9 auditors at all, although that is not precluded, our  
10 audit and risk management committee would have to approve  
11 it. But we have not -- we have not had trouble getting  
12 expertise to the table to do the other kind of work we  
13 need done, whether it's assistance in internal audits,  
14 because we do hire assistants for internal audits,  
15 particularly when it comes to the investment portfolio,  
16 to management consulting, the industry that I came out  
17 of, CATS compliance, we deal with those issues as well.  
18 So hopefully that provides a different perspective.

19           CHAIRMAN DOTY: Thank you. The brevity of this  
20 is going to allow us to have more than one pass through  
21 this panel. But to clarify, CalSTRS does not have a  
22 policy in place now that you will rotate your audit firm

1 every X number of years; or do you have that?

2 MS. MADSEN: Well, there's no specific policy on  
3 audit rotation for CalSTRS. What we have are public  
4 procurement requirements. And so because we are bidding  
5 audit as a public sector contract, when we go up for bid,  
6 we establish the tenure of that engagement, and there is  
7 code that allows us to extend for a year. But after  
8 that, we need to re-solicit.

9 CHAIRMAN DOTY: Thank you, that's a helpful  
10 clarification. Jeanette Franzel, question?

11 MEMBER FRANZEL: Yes. You've all noted that you  
12 don't necessarily favor mandatory audit firm rotation,  
13 but that there are cases where it could be useful to  
14 rotate, but not under a mandatory regime.

15 Can you talk a little bit about the criteria  
16 that you use at Glass Lewis and CalSTRS? And then, Ms.  
17 Madsen, maybe some of the criteria that you all were  
18 considering as well in your procurement for the need to  
19 rotate.

20 MR. EATON: Sure. As I was telling a few people  
21 at lunch, there's -- there's few and far between  
22 opportunities for Glass Lewis to -- to recommend to our

1 clients on the -- specifically on the issue of auditor  
2 rotation. It just doesn't show up on an annual meeting,  
3 on a ballot as a proposal.

4           However, there is, of course, the ratification of  
5 the auditor. And over time, that proposal's really  
6 become a routine item. And -- and, you know, we're --  
7 we're the first ones to admit that. And I think most of  
8 our clients admit that too. And as such, you know, we  
9 do have some very stringent points where we will  
10 recommend against that ratification. However, it's been  
11 approximately two percent of all ratification of auditor  
12 proposals that we have recommended against in the last  
13 three years.

14           And the main reason driving that recommendation,  
15 that negative recommendation, over four-fifths of the  
16 time, it has to do with the auditor relationship with the  
17 company in terms of the contract, whether that is limit  
18 liability issues or other sorts of provisions that we are  
19 opposed to.

20           We -- we do look to recommend against the  
21 ratification of an auditor in -- we have eight different  
22 things in our policy guidelines. I won't go through them

1 all, but the primary reasons that we do, like I said,  
2 first there is the contractual reasons between the  
3 company and the auditor that we might oppose. But also,  
4 we do look at the -- at the fees. And we look at, you  
5 know, the audit fees plus the audit-related fees as  
6 compared to the tax fees and other non-audit fees.

7           And we have a -- what I would say is a pretty  
8 lenient threshold there, where we believe that at least  
9 50 percent of those -- of the aggregate fees need to be,  
10 you know, paid in terms of audit and audit-related. I  
11 know some of our clients have a much -- much more  
12 stringent, you know, thresholds in that -- in that sense.

13           We will -- I think what gets a little more to the  
14 point is we also will recommend against the ratification  
15 of an auditor and do feel that a rotation of the auditor  
16 is necessary when there's been recent material  
17 restatements of annual financial statements, including  
18 those resulting in -- the reporting of material  
19 weaknesses and internal controls, and including late  
20 filings where the audit -- where it's -- we can determine  
21 that the auditor bears some responsibility for the  
22 restatement or late filing.

1 MS. AMEY: Yeah, I would support many of the  
2 reasons that David said. I think he makes a really good  
3 point that as shareholders, you get to vote on the  
4 ratification. You don't get to vote on the rotation  
5 unless there's a proposal from a shareholder asking that  
6 auditors be rotated.

7 But I think there are things that the audit  
8 committee could do if they want to involve investors more  
9 in this question. And some of that would be disclosing  
10 in the proxy statement the tenure of the audit, or of the  
11 audit firm. And any other issues, how they issue -- how  
12 they judge the performance of the audit firm, and what,  
13 what that judgment says about this firm that they are  
14 recommending. I think that would help investors.

15 Like David, we certainly look when there have  
16 been restatements at companies. We do use some analysis  
17 when you have an issue that shows you that there's a  
18 problem with an audit firm. We look at the information  
19 that's provided by unit of MSCI called CSRA that we hire.  
20 We also hire Audit Integrity. We pay attention to  
21 research from Audit Analytics, and we realize that, you  
22 know, 25 percent of the companies in the S&P 500 have had

1 the same auditor for 25 plus years.

2           If you go to the Russell, the number is I think  
3 36 percent have had the same auditor for over 40 years,  
4 and within the Russell index, I think there are eight  
5 companies that have of the same auditor for a hundred  
6 years.

7           So I think that, you know, we need some more  
8 disclosure, even if you're not asking companies to  
9 necessarily recommend a rotation, certainly I think the  
10 CalSTRS process of putting it out for bid and having --  
11 having everybody on both sides of the table look at what  
12 they've been getting and what they've been providing, and  
13 possibly getting some insight as to ways that you might  
14 get a better auditor is also an idea that I think we're  
15 firmly in support of.

16           MS. MADSEN: So, Jeanette your question for me as  
17 to kinds of things that we've thought about in making the  
18 recommendation, and I guess, you know, as I was looking  
19 to other people's spots, I think the things that would  
20 drive me in my seat are, you know, the worst problems to  
21 have are the ones you don't know about.

22           So I don't know how else to say it. And so a new

1 set of eyes coming in to help you find those so that you  
2 can take the appropriate steps to mitigate the risk that  
3 are causing those to be a problem.

4 CHAIRMAN DOTY: Steve Harris?

5 MEMBER HARRIS: In terms of the expertise to  
6 conduct an audit as say, CalSTRS, how many firms outside  
7 the big four have the expertise, and to what extent is  
8 the -- to what extent can we increase the competition  
9 with respect to firms bidding on your work? I mean, how  
10 many people have the necessary professionalism to do it?

11 MS. MADSEN: Well, we haven't had a big four,  
12 six, eight -- I forget when it diminished, you know.  
13 When I was there it was nine, because there was still --  
14 there were still nine.

15 So we, we actually look at the top 30 audit firms  
16 when we went out for bid. I mean, that was kind of the  
17 way we walked into it. We have somebody who's in the,  
18 you know, mid -- the lower half of the top 10. We got  
19 two bids in that range. We didn't get any of the big  
20 four. You know, we have a liability provision that is  
21 challenging for many audit firms to deal with. And it  
22 took negotiation. I mean, the hardest part of our

1 transition was negotiating the contract.

2 MEMBER HARRIS: With other than the big four?

3 MS. MADSEN: With other than the big four. So  
4 somebody in the -- in the top 10, but not in the big  
5 four.

6 MEMBER HARRIS: And have you found that they're  
7 able do the work that's required?

8 MS. MADSEN: Oh, yes, absolutely. And it's a  
9 combination of people. It's not from a single office.  
10 It's -- it's really spread out. You know, we have a  
11 partner who's an expert in the public sector. We have  
12 a valuation partner. We have a separate -- they brought  
13 in their separate valuation firm. I mean, you can  
14 understand, given the nature of our financial statements  
15 that that would be where the risk is, on the investment  
16 side.

17 So, so we've got both actuarial and investment  
18 expertise, as well as a valuation firm that they've hired  
19 to -- to help ensure that what we are stating the value  
20 of our assets are, and our gains and losses are accurate.  
21 So, so it's -- I'm not going to say it's, it's all been  
22 resident in the single office of that -- that firm, but

1 I'm definitely very impressed with their expertise and  
2 the ability they have to reach into resources in various  
3 places to bring those people to the table.

4 MEMBER HARRIS: Thank you.

5 CHAIRMAN DOTY: Lewis.

6 MEMBER FERGUSON: I have a question that sort of  
7 comes out of the -- grows out of sort of the implication  
8 of the practice that's followed by public sector agencies  
9 like yours. And it seems like most public sector,  
10 whether they're pensions or government agencies do rotate  
11 their auditors periodically. They may not have mandatory  
12 auditor rotation requirements, but they do it. TIAA-  
13 CREF, for example, does it as a matter of policy. You  
14 and I suspect CalPERS does it because of the procurement  
15 rules.

16 But what underlies the procurement rules is a  
17 sense that we don't want these relationships to become  
18 privileged relationships. That they need to be looked  
19 at again periodically.

20 Given this -- my question comes out of that.  
21 Given the fact that you all believe that is the correct  
22 policy for yourselves, and given the fact that agencies

1 like yours are huge owners of the stock of public  
2 companies; in fact, perhaps if you look at the equity  
3 holdings of the largest American companies -- maybe not  
4 a majority, but certainly a significant plurality of the  
5 holdings are held by, by pension firms, investment firms  
6 of various sorts that have these policies -- why do you  
7 all not push those companies to adopt -- not necessarily  
8 mandatory rotation, but periodic rotation if you believe  
9 for yourselves that that's the appropriate policy?

10 MS. AMEY: No, I don't think that's over. I  
11 think that one of the things that we wanted to do was to  
12 see what happens with what the PCAOB is doing before we  
13 approach companies. But we certainly -- I don't know  
14 that we would push them for a mandatory rotation, but I  
15 do think that there is a -- there will be engagements,  
16 talking to companies about putting the business out for  
17 bid after a certain amount of years. And I think the  
18 issue is we don't know if it's the 15 years that Bob  
19 Pozen recommends. We think it's more than five.  
20 Certainly less than 40.

21 But we certainly want to approach companies about  
22 at least putting the business out for bid, allowing the

1 existing auditor to bid on the business, and to give  
2 investors more of the information that presumably they're  
3 using to evaluate the auditor.

4 MEMBER HANSON: Okay. More questions for Robin.

5 And this is -- my question's really to -- if you  
6 can share just a little bit more about the context of  
7 your -- of the scale of your engagement and how many --  
8 how many people you have. Or how many people in the  
9 financial reporting structure within CalSTRS, how many  
10 -- how many people the audit firm has all involved, how  
11 many locations, and how many locations you have. I don't  
12 know if you're all in, what Sacramento or if you've got  
13 locations all over the country or world. And if the  
14 auditors need to be in those places too.

15 MS. MADSEN: So in terms of our operations, we  
16 have a large headquarters facility in west Sacramento,  
17 and we have a small satellite office in Glendale,  
18 California, where we do retirement counseling for  
19 teachers in southern California. So we're certainly not  
20 a multinational presence. Where -- where we get  
21 multinational is in due diligence that we do with our  
22 external managers and our private investments. So we do

1 experience that, but that's not the scale of our  
2 operation.

3           As you can imagine, a lot of the accounting that  
4 is done for our investments is elsewhere. So of the  
5 private assets -- we get audited financial statements;  
6 that's what we rely on. So, you know, it's, again, from  
7 where I sit in terms of the side of the operation that  
8 I'm responsible for, it's very small in comparison to the  
9 companies that we invest in. Hence my desire to be a  
10 part of this panel and not a panel of those -- from those  
11 companies that we invest in.

12           But in terms of the complexity of the business  
13 that we need to present to our audience -- so, granted  
14 the scale is different. You know, my accounting shop is  
15 75 people, okay, not -- not big at all. In terms of the  
16 audit team that's working -- and I have not gone through  
17 and done this calculation and listed all of the people  
18 out, but there are five different partners. The staff  
19 underneath them I'm thinking maybe is 20. I mean, that's  
20 kind of where I'm guessing things are. But I don't have  
21 that specific number. So that could be wrong. I just  
22 want to give you that caveat.

1 MEMBER HANSON: Good. And just a follow-up  
2 question to the question that Board Member Harris asked.

3 With the number of firms that you felt were  
4 qualified to propose, and whether it being based in the  
5 Sacramento area was important to you. I don't know if  
6 the firm -- the lead partner and team if it's based here  
7 or if it's based somewhere else.

8 MS. MADSEN: Well, the -- let's see, the signing  
9 partner is in Indiana. The engagement partner is in  
10 Texas. The valuation partner is in Kentucky. The senior  
11 manager is in Ohio. The actuarial firm is in Chicago.  
12 I think that's the list that I can come up with at the  
13 moment. They fly.

14 CHAIRMAN DOTY: If history teaches us anything,  
15 it would be that when the people at the table and others  
16 like you decide that it's a good thing that firms  
17 reconsider their audit relationship every 15 years, every  
18 10 years, and when your opinions are headed in that  
19 direction, that this is something that's going to happen.

20 It's -- and the PCAOB could do nothing here, and  
21 it may well be that whatever board is sitting here five  
22 years from now or six years from now, will be looking at

1 a very different circumstance in which many, many  
2 companies are going just as they did, going away from  
3 staggered boards, just as they went towards separating  
4 chairmen from CEO -- you name it. Just as they went  
5 toward a poison pill that would only be exercised in the  
6 -- after a shareholder vote, et cetera, et cetera, et  
7 cetera, as a great man once said, then it may well be  
8 that there are many of the best firms that are already  
9 doing this.

10           And in fact, we heard today from one of our most  
11 distinguished panelists, and what people need is really  
12 the ability to plan. Once you have a schedule, and if  
13 people knew that by the year 2020 there would be a  
14 predictable regime in effect, that that would be plenty  
15 of time for a lot of good things to happen, for people  
16 to start training up, for people to start making their  
17 choices about where their consulting business was going  
18 to go. All sorts things could happen.

19           But what it's made me think sitting here today  
20 listening to a lot of very thoughtful comments, is that  
21 the people who are the least likely to make the plans,  
22 the least likely to reexamine their relationships, are

1 exactly the one -- exactly the ones that we hear about.  
2 They are the marginal players, they are the fraudsters,  
3 they are the people that one of our panelists clearly  
4 pointed out are always thinking about how to cut the  
5 corners, and that we need to think more like.

6           Are we, in other words, in the position -- if  
7 we're going to focus our efforts, shouldn't we be  
8 thinking, for example, principally about what to do to  
9 make sure that the people that we -- that we reduce the  
10 business clientele for Charlie Drott, that in fact we go  
11 out and start working on the companies that are the least  
12 likely to make the right choice for the right reason,  
13 with some kind of rule-making scheme, or some kind of a  
14 procedure.

15           And what would that be? What should we do about  
16 that? You could agree, or you could say I'm out of my  
17 mind, or you could -- you could -- but you're going to  
18 have to make -- you will be making these choices as  
19 people who vote the proxies, or tell others to do it.

20           MS. AMEY: Yeah. I mean, I don't think we can  
21 argue about what you just said. I think as an investor  
22 one of the things that, in our discussions at CalSTRS

1 about this policy is, that, you know, we think that there  
2 are -- and I'm not sure if it would be the industry or  
3 if it's going to be the client telling the audit firm --  
4 but to minimize the risk of mistakes, if there is a  
5 transition to a new auditing firm, we think that there  
6 should be some sort of schedule for turning over the  
7 documents to the new audit firm so that we can cut down  
8 on the risk for investors.

9           Much like what you see happening in medicine  
10 today where you, you can go to another doctor but they've  
11 all got information and all the tests that you have  
12 already had. And, you know, you can get a solution  
13 that's a lot faster than everybody starting from scratch  
14 and making mistakes or overlooking things and just  
15 driving up the cost for no good business reason. So I  
16 think we would like to see some protections of -- like  
17 that before, you know -- well, not before, but certainly  
18 in conjunction with transitions, whether it's 15 years  
19 or 10. You know, and I think --

20           MS. MADSEN: You know, and I, I did some thinking  
21 about the solutions, just again from our own perspective.  
22 And we're very reliant on our actuaries, and there are

1 no standards of practice that require rotation in  
2 actuaries. But we have established -- and again, this is  
3 a peer review process that we -- where we hire another  
4 actuarial firm to come in and audit the work of our  
5 actuaries to see if they can replicate it within  
6 reasonable tolerances.

7           The other thing that -- just in terms of  
8 comparing those -- those domains, which have some similar  
9 characteristics, is the actuaries actually sign their  
10 opinions with their names. So again, it's a --

11           CHAIRMAN DOTY: Wow.

12           MS. MADSEN: -- yeah, they do. So, I mean, it's  
13 just a -- there's just difference in the standards of  
14 practice. And so, again, that was just something that  
15 I thought about given the feat that I'm in, that provided  
16 some comparability in terms of another perspective.

17           MR. EATON: Just to echo a little bit of what  
18 Janice said, I completely agree that the process and  
19 structure around that transition really needs to be  
20 established. And really -- from an investor point of  
21 view, no matter what the issue is, like you said, whether  
22 it's separation of chair/CEO or whatever the topic du

1 jour is, it really involves a degree of transparency and  
2 a degree of process that is involved so investors do have  
3 that -- that confidence that a proper process is being  
4 followed. And that the intentions of the -- of that  
5 process, which, of course is ensuring the independence  
6 and objectivity of the -- of the audit, is in fact what  
7 it's working towards.

8 CHAIRMAN DOTY: If opponents of rotation do point  
9 out that if you -- if you in fact had a handover period,  
10 and if the audit firm knew the hand over period was  
11 coming, if that were the regime that operated throughout  
12 the auditing regime, then there would be an identity of  
13 interest in the handing over and the receiving firm to  
14 make sure that each case, the handing over -- the  
15 handover and the completeness of the record was  
16 satisfactory to both of them.

17 Did you -- did you do any of that when you  
18 changed auditors?

19 MS. MADSEN: So, and again, I was reflecting on  
20 that as I was listening to people earlier in the day.  
21 So, yes, there was a transition period in terms of access  
22 to the records, so that was part of our contractual

1 requirements. We saw that the new auditor went in and  
2 reviewed the work papers of the prior auditor. We have  
3 that same requirement in the -- in this contract, so that  
4 there is a transition process that -- you know, and  
5 again, we're a public entity, so there are different  
6 issues associated with it.

7           And my experience in -- because I was there both  
8 during the last audit of the prior auditors and -- and,  
9 you know, and through this transition period, that the  
10 prior auditors actually were very conscientious about  
11 making sure that they had thoroughly documented their  
12 conclusions, probably more so than in prior audits. So,  
13 just anecdotal information.

14           CHAIRMAN DOTY: Are there questions by the  
15 observers or panelists?

16           MEMBER HARRIS: I had a question with respect to  
17 your attachment A dealing with financial experts.  
18 Although you don't quite label it as financial experts.  
19 But once again, you focus on CEOs or other senior  
20 executive officers. I'm just reading it from here, and  
21 so it's a generic question, you don't have to have it in  
22 front of you.

1           But just a CEO or other senior officer. And once  
2 again, I wonder why you don't focus on either retired  
3 auditors. Because, we heard this morning, I think, from  
4 the chair of an audit committee, that he's a little bit  
5 concerned about retired CEOs, and I've got absolutely  
6 nothing against retired CEOs, but they might not be the  
7 best financial experts.

8           And so why would you focus, in terms of who you  
9 would want on an audit committee, auditors who, certainly  
10 once they retired and maybe -- well, they would have the  
11 experience and the expertise. So I would just ask you  
12 to consider that. Because, as I say, on item three it  
13 says all members of the audit committee or person's whose  
14 past and current employment experience, education  
15 demonstrate expertise in finance and/or accounting,  
16 including being or having been a CEO or other executive  
17 officer. I would just encourage you to think about a  
18 broader definition of financial expert.

19           MS. AMEY: I think that was -- that guideline was  
20 written around the time of the SOX package. And I think  
21 we wanted to -- not so much narrow it to CEOs as to say  
22 that it would be okay if a CEO was also -- a retired CEO

1 was a financial expert. But we'll certainly -- when we  
2 look at the guidelines again, we'll certainly consider  
3 retired auditors.

4 MEMBER HARRIS: And the last question I got.  
5 Glass Lewis is a premier research firm. And so what  
6 we're hearing throughout the day is the need for  
7 empirical data to support whatever action we may or may  
8 not take. So when you say we typically support audit-  
9 related proposals regarding mandatory auditor rotation,  
10 when the proposal uses a reasonable period of time,  
11 usually not less than five to seven years, if you can --  
12 if you develop any empirical data supporting why you  
13 would do that, that would be helpful.

14 MR. EATON: Yeah, I think that's a really good  
15 question. And, you know, one of the -- one of the things  
16 I should point out is the way that our policies are  
17 really driven is twofold. It's one from our clients,  
18 what our clients believe strongly in and also academic  
19 research and studies. And this is actually an area where  
20 the -- the quote that you have is not surrounded by  
21 particular depth beyond that, because -- just for that  
22 fact.

1           Our, our clients have not -- have not really  
2 pushed on this issue. As I said before, there hasn't  
3 been -- there's really not an opportunity for investors  
4 to vote on this issue very frequently. But also, that  
5 the academic literature and studies around it, from what  
6 I've seen, have been pretty much a mixed bag, if you  
7 will. So where those exact years that are in that quote  
8 come from, has to do with, I believe a shareholder  
9 proposal from a few years ago. But I wouldn't quote me  
10 on that.

11           CHAIRMAN DOTY: We're at the end of time on this  
12 panel. I want to thank you. It's been terrific. And  
13 while the -- we're now going back to independent  
14 directors, and while the independent directors make their  
15 way to the table, we will say thank you again to you all  
16 for doing this.

17           The new panel is Julie Allecta, Trustee and  
18 Chairman of the Audit Committee of Forward Funds. Vice  
19 president and director of Wild Care Bay Area, a non-  
20 profit. First vice president and director of the Ottoman  
21 Kenya and Research non-profit. Began her legal career  
22 in 1977 with the United States Securities and Exchange

1 Commission in Washington DC and its Office of General  
2 Counsel. In her private practice, moved to San  
3 Francisco, specialized in consulting financial  
4 institutions -- counseling financial institutions and  
5 boards on financial institutions -- boards of financial  
6 institutions, providing legal advice on complex financial  
7 regulation and investment products. She had a career at  
8 Paul Hastings, a distinguished law firm here, retired in  
9 2009 as senior partner chair Emeritus of that firm's  
10 renowned investment management practice group. She  
11 lectures and she provides investment advice and has been  
12 admitted to several Bars around the country, a real  
13 specialist in this area.

14 Bill Baribault, Trustee and Independent director  
15 of American Funds, and chairman of Oakwood Enterprise.  
16 Has served as Chief Executive Officer and Chairman of  
17 Oakwood Enterprises, previously chief operating officer  
18 and director of Henry Company, the chairman of  
19 Professional Business Bank until 2009. Throughout his  
20 career, he has held various positions including chief  
21 executive officer and chairman of Elect-Air for a number  
22 of companies. So he's been -- he's been in senior

1 management positions with several companies, a number of  
2 advisory and trustee boards for charitable, educational  
3 and non-profit organizations in the area.

4 Bill Cvengros, Janus Funds. Cvengros is a  
5 Trustee and Independent Director of Janus Funds, a  
6 leading mutual fund company offering equity, fixed income  
7 and alternative funds to individuals, companies and  
8 retirement plans. Also has served as chairman of its  
9 committee. He's been Chairman of National Retirement  
10 Partners, a national network of advisors to corporate  
11 retirement plans. And previously a Chairman of  
12 PacketVideo Corporation. Past CEO and president of Pimco  
13 Advisors, LLC, and has been on a number of boards. He  
14 is -- he is currently the chairman of the audit committee  
15 of Janus Funds.

16 So we're -- we have a group of people who have  
17 seen it from several areas. So we welcome you and thank  
18 you, and turn it over to Julie Allecta.

19 MS. ALLECTA: Good afternoon. And thank you  
20 very much, Chairman Doty. That was a very nice  
21 introduction.

22 And I also add that as a young lawyer I had the

1 privilege of training under Bob Pozen and Harvey Pitt,  
2 so --

3 CHAIRMAN DOTY: I would say that's satisfying two  
4 of the most demanding critics. It will make this panel  
5 no problem.

6 MS. ALLECTA: Yes.

7 CHAIRMAN DOTY: This board no problem for you.

8 MS. ALLECTA: And welcome other board members as  
9 well. I hope you're -- you're enjoying good California  
10 weather.

11 I'm the independent director of the Forward  
12 Funds, which is a San Francisco-based mutual fund group.  
13 And I'll just point out that you've got a really nice  
14 cross section here, because the Forward Funds represent  
15 what I would call a smaller fund group, five billion.

16 Janus represents a very sizeable fund group. And  
17 then we have the American Funds, who are in the -- you  
18 know, extremely large fund group, would you say, right  
19 up there. So it's a great cross section. And I  
20 appreciate being part of the panel.

21 My comments today are my personal views and not  
22 the views of the Forward Funds. And I want to focus

1 specifically on two areas where the PCAOB requested  
2 comments, and two areas that I don't think have been  
3 talked about a lot so far. Because you've heard, I  
4 believe it's Barbara -- or Bonnie Hill pointed out,  
5 you've heard a lot of things over and over again. I'm  
6 trying to find something different, different information  
7 to bring to you.

8           One of -- one point I'd like to make is that  
9 there is a unique aspect to the structure. Perhaps not  
10 unique, maybe it's just an unusual aspect of the  
11 structure of a mutual fund that makes a rule like  
12 mandatory audit firm rotation particularly inappropriate  
13 for funds. So this might go to the question 26 on the  
14 Concept Release, page 21, which says is there a subset  
15 of issues that maybe we ought to think about differently.  
16 And I think mutual funds might be one such subset.

17           In the United States, we developed a highly  
18 successful model for mutual fund governance based on the  
19 Investment Company Act. And that Act incorporates a lot  
20 of independent guarantees, particularly with respect to  
21 the audit process. The Sarbanes-Oxley amendments in 2002  
22 enhanced those quite a bit. So this may be a small

1 segment of the issue or industry that isn't as affected  
2 by audit scandals and problems.

3 I want to endorse the comments submitted by the  
4 Mutual Fund Directors Forum and the Investment Directors  
5 Council, and very quickly just generally point out that  
6 they made good points that rotation, audit firm rotation  
7 would impose burdensome costs to mutual funds, which  
8 would get directly passed onto shareholders. There's no  
9 products that mutual funds make where we can somehow  
10 build it into the cost of our goods sold or something  
11 like that.

12 The increase in cost is going to go directly to  
13 a diminished return to investors. It would likely be  
14 diminished in audit quality and an increase in the risk  
15 of errors or things not as well looked into, valuation  
16 issues not as carefully explored.

17 Plus, there's a very limited number of audit  
18 firms. We've talked about that. And I think that Bonnie  
19 Hill made that wonderful observation of timing. Well  
20 think how much more complicated it is for the mutual fund  
21 where you have a variety of investment pools with  
22 different year ends, one every month. I mean, now you're

1 -- now you've logarithmically leveraged the difficulty  
2 of moving from one audit firm to another. Because even  
3 a small group like the Forward Funds uses -- heavily uses  
4 two of the four firms that do 99 percent of the work in  
5 this area. And, well, there just are practical  
6 constraints on audit firm rotation.

7           But what I think is really special, and what I'd  
8 like to emphasize in my remarks, is to be very clear in  
9 thinking about the investment pool, which is the mutual  
10 fund and the management and administration companies that  
11 prepare the financial statements for the investment fund.

12           Investment companies are just the assets. It  
13 doesn't have employees. It really doesn't have  
14 operations. But it is a client of management firms,  
15 distribution firms and administration firms. And it pays  
16 those firms, it outsource to those firms for preparation  
17 of financial statements, among other things. Those  
18 firms, they have their own boards, their own  
19 shareholders, their own auditors. But for the pool of  
20 asset, there's a very independent board there, and  
21 independent audit committee and those individuals select  
22 the auditors that are going to review the financial

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1 statements prepared by the management firms and  
2 administration firms that the fund employs.

3           So there is already a separation of function that  
4 provides additional firewalls or insulations or -- or  
5 independence protection. And I -- I'm not sure that in  
6 the comments that I've read so far, in the comment  
7 letters that, that that has really come out as a -- as  
8 an excellent reason why mutual funds and similar entities  
9 need to be thought of differently.

10           The other issue that I want to point out, and  
11 maybe it's just a reminder, is that there are so many  
12 independent guarantees in the Investment Company Act and  
13 in the regulations. Not only is the pool separate and  
14 the board separate, but independent directors are  
15 exclusively in control of adding new independent  
16 directors. The ability of management to exert influence  
17 diminished quite a bit by statutory protections.

18           There also is, by required law, a compliance  
19 officer that looks at financial statement and accounting  
20 matters and reports to the board. And this is -- this  
21 is a staff person, if you want to think of it that way,  
22 that is an exclusive watchdog over the service

1 organizations for the independent directors, then the  
2 financial expert and the other guarantees of quality and  
3 independence.

4           So this structure means that it's very difficult  
5 for -- it's like it's hard for me to envision any way in  
6 which the management companies or administration  
7 companies can -- can bias or lean on the audit firms with  
8 respect to the tough audit calls. I loved, I loved the  
9 analogy this morning of a good audit partner to the inch  
10 of marshmallow around the brick column, because that  
11 really is the ideal audit partner. And the -- the  
12 ability of -- of -- well, of being able to influence a  
13 tough call on valuation or how a security should be  
14 classified for purposes of valuation, or how a tax issue  
15 should be looked at, I think is -- it's very difficult  
16 to do in the fund industry.

17           I've probably used up my time, but there's  
18 another part of the Concept Release that I would like to  
19 address, and that is, despite the fact that I feel mutual  
20 funds are different and already have great audit  
21 integrity, I think there's always room to think about  
22 improvement. And it's healthy to think about ways that

1 audit integrity can be improved. And in thinking about  
2 it, I have two observations to throw out to you.

3           One is, it would be expensive to mandatorily  
4 rotate audit firms, and it might be impossible even. But  
5 there's no reason why a concurring audit couldn't be done  
6 every -- I don't want to be like Bob Pozen and pull out  
7 an arbitrary number -- but every seven years, every eight  
8 years by another firm. A second audit, yes, there's a  
9 cost, but that's defrayed over a period of time. And  
10 that might also serve the benefit of a periodic RFP  
11 because it introduces another of the audit firm's to the  
12 board and to the audit committee in the primary role of  
13 auditor. So I think the concurring audit approach might  
14 be one you bed think about.

15           I also think if you want to start with areas  
16 where there are the most -- the most conflicts. In my  
17 experience, the most conflict-full situation is the  
18 situation where the audit firm that is auditing the pool  
19 of assets is also doing the primary audit or substantial  
20 non-audit work for one of the major administration,  
21 management or distribution companies. In other words,  
22 you've got the same firm working on both sides of the

1 stem, either as primary auditor or as a substantial  
2 consultant.

3           There you've got some economic pressures. I  
4 don't want to say there's a conflict. But it might be  
5 in those situations that you would want to think about  
6 introducing additional, either PCAOB inspections or  
7 controls.

8           And with that, I'll turn the mic over to my  
9 colleague, Bill Baribault.

10           MR. BARIBAULT: Thank you very much. And thank  
11 you, Mr. Chairman and the board for traveling to  
12 California and giving us an opportunity to present to  
13 you.

14           I'm going to -- thank you for that introduction  
15 as well, so I'll skip that in my notes here. But it's  
16 important that we recognize that my views are not  
17 necessarily the views of other board and audit committee  
18 members of the American Funds and Capital Research and  
19 Management Investment Advisor, the investment advisor in  
20 our case.

21           I am an independent director and a trustee of the  
22 16 of the fixed income American Funds. American Funds

1 Insurance Series, American Funds Portfolio Series, and  
2 American Funds Target Date Funds. Most importantly  
3 regarding my perspective, I am also a shareholder in the  
4 funds.

5           Based on the responsibilities and interests of an  
6 independent director and shareholder, I'm especially  
7 interested in audit independence and quality. I concur  
8 with the recommendation made last December by our  
9 American Funds audit committee chairpersons.

10           Their recommendation, and I quote, are, "Diverse  
11 backgrounds combined with our expertise, our experiences  
12 as audit committee chairpersons, lead us to the  
13 conclusion that mandatory audit firm rotation does not  
14 achieve a subjective."

15           Two comments, and you've heard of a lot of pros  
16 and cons during the day of -- of audit firm rotation, but  
17 two observations in our case. First, based on the size  
18 of our fund complex, we have two audit firms, which gives  
19 our boards a very great opportunity to review the work  
20 of two firms, to review their perspective on challenges,  
21 regulatory changes and all the issues that we face with  
22 our board of responsibility.

1           Second, and thank you to the PCAOB's most recent  
2 inspection, we were able to sit with one of our audit  
3 firms and go through the Part II report and deal in great  
4 detail with what had occurred, how they handled, and what  
5 immediate action they were taking, and basically a very  
6 open discussion and dialogue between that audit firm as  
7 a consequence of your inspection.

8           So while you hear many criticisms, this is an  
9 interesting opportunity to point out that we had a very  
10 lively exchange with an audit firm because of your  
11 inspection.

12           This panel discussion presents an opportunity to  
13 share ideas that contribute to the fundamental goal of  
14 auditor independence and quality. The following list of  
15 recommendations, I believe, facilitates auditor  
16 independence, skepticism, objectivity, audit quality,  
17 which leads to an increase in audit committee  
18 effectiveness.

19           First, it would be great if you were able to  
20 share individual inspection reports with the audit firm's  
21 clients, whose audits have been selected for review, in  
22 order to have transparency, promote discussion, and

1 enhance the audit committee's review of the engagement.

2           Second, expand PCAOB's advisory network to  
3 include various industry representations. For example,  
4 investment fund audit committee members can add  
5 perspective issues and opportunities for quality  
6 improvement specific to their industry sector.

7           Third, consider sanctions and penalties that  
8 encourage audit firm rotation for material findings, such  
9 as undiscovered financial statement fraud from the lack  
10 of professional skepticism.

11           Four, review all auditing standards and practices  
12 adopted by the PCAOB since its inception to determine  
13 their impact on quality and independence.

14           Five, compile and publish a list of best  
15 practices from the database of inspections to share with  
16 all audit committees to facilitate their learning and  
17 review of audit firm performance.

18           Six, recommend guidelines for audit committees to  
19 consider audit firm rotation based on calendar, event or  
20 partner change, for example.

21           Seven, compile in a systematic manner the  
22 circumstances that gave rise to the lack of professional

1 skepticism, and share those with audit committee.

2           There is a running theme here, and you've heard  
3 a bunch of it earlier today, is to the extent that  
4 there's more transparency, more communication, and better  
5 education for audit committee members, the results will  
6 be that much more positive.

7           I appreciate the opportunity today to discuss the  
8 issues on auditor independence.

9           MR. CVENGROS: Thank you. And I second the  
10 remarks about comes to the west coast. Very helpful to  
11 meet the people and person face-to-face as well.

12           My name is Bill Cvengros, and I am an independent  
13 trustee and director of the Janus funds, and chair of the  
14 audit committee. I think some of my background here, it  
15 might be helpful, and I just want to just highlight a few  
16 things in terms of this -- this discussion.

17           I've been a CEO of a public company and reported  
18 audit results to analysts and other investors as well.  
19 I'm the director of three other public companies, and  
20 each of those I've been a member and a chair of the audit  
21 committee at some point in that cycle.

22           It's interesting to note, as I look back, that

1 this has taken place over the span of about 25 years.  
2 I'm not as young as Andy Bailey, but -- so I've had the  
3 '80s and '90s and about 2000s and so on. I think it's  
4 relevant in that it's been an opportunity to observe the  
5 progression that's taken place for oversight and  
6 regulatory issues over this period of time, as well as  
7 the improvement and the best practices, I think, of audit  
8 committees.

9           Like others, I can't speak for my colleagues at  
10 Janus, but I can say that the trustees of the Janus funds  
11 have a very strong view on the issue of independence in  
12 terms of the trustees themselves, as well as the audit  
13 firm. We view that as fundamental and critical to our  
14 mission of representing the shareholders of our funds.  
15 And in this regard we have a couple of points I'd like  
16 to point out.

17           In contrast to some funds who merely have -- who  
18 have requirements to have, I think, three-quarters  
19 independent directors, we have 100 percent of our  
20 trustees are independent. There's no management from the  
21 advisor. It's totally independent, including the audit  
22 committee, of course.

1           We have a board practice of, including all the  
2 trustees in the audit committee meetings, even though  
3 they're not members of the audit committee, they think  
4 it's such an important thing to be part of those  
5 meetings, so hear what the auditor has to say, and also  
6 to be part of the executive session that takes place with  
7 the auditor. And it's also true that the audit firm is  
8 separate on the funds from the auditing firm that's the  
9 chief firm for the advisor, Janus Capital.

10           So my views are in -- not in favor of mandatory  
11 audit rotation, and I have several reasons. I'll go over  
12 some of them. A major reason, frankly, is what happened  
13 with the PCAOB since the creation of its, you know,  
14 authorization with SOX. You have made numerous and wide-  
15 ranging improvements, proposals and standards, some might  
16 say prodigious. These have been focusing, in many cases,  
17 on audit quality and independence of auditing firms. You  
18 certainly have been very busy. So, you know, hats off  
19 to you.

20           And I've observed over the last 25 years, as I've  
21 said, a true progression of these requirements in best  
22 practices. And I think overall the audit process and the

1 oversight has improved drastically. Not to say we  
2 haven't had mistakes, but the bar has certainly been  
3 raised. And, you know, you've been leading the effort  
4 in that regard.

5 I think two things really stand out to me, and  
6 one is the audit partner rotation which does bring a new  
7 set of eyes, often from a different part of the country,  
8 a different part of the firm, and as well as as the PCAOB  
9 review of the audit firm's audit process. There is no  
10 audit partner in the country that was excited about the  
11 fact that the PCAOB was going to review them.

12 I also think as a result of all this there's been  
13 fewer, not more, audit failures and misstatements of a  
14 material nature. And this is all in the context of a  
15 world that is much more complex, particularly in the  
16 mutual fund business, much more complicated instruments,  
17 as well as a world that's been under a lot of stress  
18 economically in terms of the financial markets.

19 Another reason I'm not in favor is, that many  
20 have talked about, the increased costs, the proposal  
21 process, the transition, the sales and marketing efforts,  
22 and these would be, in fact, borne by the shareholders

1 of the funds. There's just nobody else there to bear it.  
2 And on top of that, there's -- beyond the mutual fund  
3 business, there's also the already-increased requirements  
4 that are costing public companies more and more money to  
5 be public, particularly small and mid-sized companies.

6           There's one thing about the sales and marketing,  
7 if there were different persons involved in that process,  
8 you might hear fewer accountant jokes because of the  
9 nature of the marketers, but -- strike that from the  
10 record -- but anyway.

11           I'm very concerned about the disruption at the  
12 time of change, the orientation period. Many have talked  
13 about that. There is a window there for increased risk  
14 in audit failure. I think there's a general sense here  
15 by many that shorter-term engagements that are forced by  
16 mandatory change would be introducing another level of  
17 risk.

18           In the case of the Janus funds, as other funds,  
19 mutual fund companies are a special breed. The '40 Act  
20 is very complicated, specialized, et cetera, we all know  
21 that. And it is very essential to have the leaders in  
22 the industry that are on top of the '40 Act in terms of

1 the auditing firms. And there aren't that many. I think  
2 the -- we use like, Julie mentioned, two of the four  
3 firms already. And I think the audit committees and the  
4 clients are best served if, in fact, they are able to  
5 find the best and retain the best, if they still think  
6 they are the best.

7           Finally, I have a concern about unintended  
8 consequences about something like this. It may encourage  
9 different business model changes at the auditing firms.  
10 This could increase the already extensive travel. One  
11 impact may be on women in the profession because of the  
12 increased travel of partners and managers on audits, they  
13 may not be as interested as being a partner, if that's  
14 going to be the case. And there probably might be some  
15 other locational issues as well.

16           That being said, is there room for improvement;  
17 I think so. But the question is how. And others have  
18 given their views. My view would be to focus on making  
19 the existing oversight standards as effective as possible  
20 to allow a period of continued digestion and evaluation  
21 of the impact of the numerous changes and proposals that  
22 have been made over the last few years.

1           But there is one thing I think would be a major  
2 improvement right now within the context of those  
3 standards, and that would be share the non-public  
4 information of the PCAOB reviews with the audit  
5 committee. And I can assure you that, you know, a well-  
6 intentioned independent audit committee is going to take  
7 those to heart very seriously. And if they are of the  
8 nature that it dictates that they are taking the proper  
9 skepticism, independence, and competence, than there  
10 would be a review and re-tendering of that audit  
11 assignment.

12           So, if after further review and research, the  
13 PCAOB thinks there should be something more done in this  
14 area besides what's in place now, I could see a step in  
15 the direction of having a mandatory re-tendering of the  
16 audit firm assignment after a long tenure. Maybe it's  
17 10 years or more. If they would open up the process and  
18 still allow the audit committee to have the authority and  
19 control to retain the firm that they think is the best  
20 or hire a new one. So, thank you very much.

21           CHAIRMAN DOTY: Well, thank you all. And we have  
22 some question time. And we're going to start with Steve.

1 Once again, Steve Harris.

2 MEMBER HARRIS: Well, Ms. Allecta, I can't resist  
3 the temptation, because you worked for two legends and  
4 you cited them. As you just cited one as well.

5 Putting the mutual fund complex aside, with  
6 respect to the entire rest of the universe, because I  
7 think you had mentioned Bob Pozen has written about  
8 mandatory re-tendering under limited circumstances, but  
9 he's editorialized on that. And then Chairman Pitt has  
10 indicated in highly limited circumstances -- and I don't  
11 want to get in cross purposes with Chairman Pitt -- but  
12 in highly limited circumstances, were there very  
13 deficiencies in audit quality, he would support some form  
14 of mandatory rotation.

15 Are there any circumstances at all that you would  
16 support mandatory re-tendering or mandatory rotation?

17 MS. ALLECTA: Are you asking with respect to  
18 operating companies? Yes, I think that's correct.

19 MEMBER HARRIS: Yes. Yes.

20 MS. ALLECTA: And I think the answer is yes. I  
21 think there are circumstances that were actually  
22 highlighted very nicely by the panel that preceded this

1 one. There are circumstances where there's enough --  
2 financial statements are really -- the integrity of the  
3 financial statements can't be overstated.

4 And where there is evidence that the accounting  
5 firm has been sloppy, has been lazy or perhaps more  
6 culpable in producing financial statements that are just  
7 erroneous or perhaps even fraudulent in some respect,  
8 misleading, certainly that is, you know, a call for  
9 replacement.

10 But mandatory replacement for -- just because the  
11 clock is ticking, there may be industries where there are  
12 so many subjective issues, where GAAP is so unclear or  
13 allows a variety of interpretations, there may be  
14 industries just as special in those respects as mutual  
15 funds are in our respects, that require that fresh set  
16 of eyes and that disciplined change. So I would never  
17 say no. I suppose the answer is yes, but I'm not  
18 knowledgeable enough about which industries might, might  
19 really benefit from a mandatory audit firm rotation.

20 Did I dodge the question well enough? Good.

21 MEMBER HARRIS: No. And Mr. Baribault?

22 MR. BARIBAULT: I think I established in my

1 bullet point a theme that would be applicable to -- to  
2 all business sectors. If there's a material misstatement  
3 or an issue with a financial statement, an audit  
4 committee has a responsibility to challenge the audit  
5 firm, revisit the question, possibly look outside for  
6 help in evaluating what that was. PCAOB, in a case of  
7 an inspection report, might raise something to that  
8 level. And I think there is a responsibility. And I  
9 think it should be encouraged.

10 I think, again, what I'm focused on most clearly  
11 here is the concept of a calendar replacing a process.  
12 I think responsible audit committees are well-prepared,  
13 well-trained. I heard a comment earlier today about  
14 encouraging retired partners from audit firms to  
15 participate. We in fact do have that in our structure.  
16 We have people from the regulatory side. So our attempt  
17 is to create an audit committee and a board that's very  
18 responsive to current issues and current engagements.  
19 And we would be very suspect of a finding that would rise  
20 to that level.

21 CHAIRMAN DOTY: Lew? Lewis?

22 MEMBER FERGUSON: First I just want to ask a

1 quick question, but I don't want this to count as my real  
2 question. An information question. It's a half  
3 question. And this is to Mr. Baribault.

4           You mentioned that one of your audit firms had  
5 shared with you what we call part two of our inspection  
6 report, which is the sort of confidential part of the  
7 audit report that deals with the firm's quality control.  
8 Did you happen to know whether that part had already been  
9 made public by the firm -- or by us for a failure to  
10 remediate, or were they shared that with you which they  
11 can do, during the period while we still have no ability  
12 to make it public? Because that's a very important  
13 question to me. Do you know?

14           MR. BARIBAULT: The answer's somewhat -- it  
15 overlapped during that period of time. But we became  
16 directly involved after it was public.

17           MEMBER FERGUSON: Okay.

18           MR. BARIBAULT: But we did understand there might  
19 be -- or probability that it would be made public. What  
20 I'm encouraging the board to consider is, it would  
21 enhance the process if audit committees would  
22 automatically receive that information. It would create

1 for a much sooner, spirited discussion, an open dialogue,  
2 and the information would be helpful.

3 MEMBER FERGUSON: You could get that by -- if you  
4 mandated it or put into your agreement with the auditor  
5 that that part -- that that be made available to you even  
6 during the period when it's confident. But we can't make  
7 it -- we have no ability to make it available during the  
8 confidential, but the auditor can.

9 MR. BARIBAULT: But what the request is that,  
10 could you consider for the particular firm that's been  
11 audited, the client relationship, making that report  
12 public, I think that's something that we would like the  
13 PCAOB to consider.

14 MEMBER FERGUSON: My real question to all of you  
15 is a different kind of question.

16 As trustees of these mutual funds, you're  
17 shareholders; you also act as shareholders of  
18 enterprises. And, frankly, shareholders with a lot of  
19 clout. Do you ever think of, or would it be an advisable  
20 thing to use your voting power as shareholders -- not  
21 necessarily to push for mandatory rotation, but just to  
22 use your power as shareholders to suggest to firms that

1 perhaps they want to consider auditor rotation.

2           Particularly in cases, for example -- I used the  
3 example of the financial industry recently when not a  
4 single major bank in this country had a going concern  
5 opinion, and shortly after some of these financial  
6 statements were issued in 2007 and 2008, massive bailouts  
7 had to be undertaken by the federal government. Is that  
8 a case where perhaps people like you all, holders in  
9 large of shares should have suggested to these firms that  
10 maybe they wanted to consider auditor rotation in that  
11 case?

12           MR. CVENGROS: Well, my view is, the shareholders  
13 should speak up in those instances. The large  
14 institutional investors try to do that at times, and  
15 sometimes it makes a dent and moves the dial. And in our  
16 case, I'm not sure we control enough of the, you know,  
17 investment assets in a hundred billion dollar complex in  
18 the case of Janus to really move that dial that way.

19           MR. BARIBAULT: I would submit, in our  
20 environment, our proxy committee has some very healthy  
21 debates on voting and what the issues will be, and  
22 decisions and recommendations. So it does come under

1 great scrutiny in our -- in our complex.

2 MS. ALLECTA: Even in our small fund group, we  
3 take our proxy voting very seriously. But there is --  
4 there's very little influence beside billion dollars  
5 spread around can do, so. But it's a -- but all of us  
6 together have a lot of influence. And firms like Glass  
7 Lewis are very helpful in providing guidance to us.

8 And increasingly, I think, there's more  
9 willingness -- now I'm just speaking generally -- there's  
10 more willingness to take mutual fund proxy voting  
11 seriously. It used to be that we voted with our feet.  
12 If you didn't like a company, you sold it. That was --  
13 or, regardless of whether you liked it or not, if you  
14 thought the price was going to go up, you bought it or  
15 held it. Now, I think there's much more consideration  
16 about ethics and issues like that within the proxy  
17 voting, rules and procedures and protocols that all fund  
18 groups have. So, yes, there's a movement in that  
19 direction, low-hill trend.

20 CHAIRMAN DOTY: Jeanette Franzel?

21 MEMBER FRANZEL: I want to make sure I understand  
22 the unique structure that you cited that would maybe make

1 a mandatory firm rotation requirement inappropriate for  
2 the mutual fund industry.

3           You talked about the pool of assets and then the  
4 management and administration company that prepares the  
5 financial statements. And the, I guess the safeguards  
6 that were there. If you could elaborate on that a little  
7 bit.

8           And then each of you mentioned you were using two  
9 audit firms. And I wanted to just follow up to ask if  
10 those firms were doing, were both doing audit work, or  
11 one was the consulting firm and one was the audit firm.

12           MS. ALLECTA: I'll answer the second question,  
13 because it's a quick answer. With the exception of the  
14 American Funds, I think it's fair to say that most fund  
15 groups have one firm that does the primary audit. But  
16 because of the nature of the securities that are held in  
17 these investment pools, and because of the tax issues and  
18 tax issues in India and foreign countries, and a variety  
19 of complex issues like that, there usually is a second  
20 firm that is brought in for consulting purposes in that  
21 area. And there may be other non-audit work that's done  
22 by a second firm that has to do with the tax evaluation

1 issues.

2           And Bill can elaborate as to what Janus uses its  
3 second auditor firm. But one primary firm.

4           The second -- or on the first question, I think  
5 the point that I was trying to make is that -- I'm going  
6 to use an example not at this table. I'm going to use  
7 the Franklin Funds. At Franklin resources, you have a  
8 public company. You've got a board of directors. You've  
9 got shareholders who own money in that public company.  
10 You've got an auditor that audits those financial  
11 statements. And people buy and sell that stock in  
12 reliance on financial statements. They haven't -- may  
13 have a penny -- not a penny invested in a Franklin fund.

14           Over on the funds side, you've got a separate  
15 group of shareholders who are the investors in the pool  
16 of money that Franklin resources employees have decided  
17 should be in that pool. And you've got a separate board,  
18 and you've got a separate audit committee. And there's  
19 more independence on that side than on the Franklin  
20 resources side.

21           Management of Franklin resources, quite frankly,  
22 has impact on the composition of its board of directors,

1 on what happens in the audit committee, and what happens  
2 in the preparation of financial statements for itself and  
3 in the selection of auditors. It has less impact, less  
4 ability to influence the selection of auditors and the  
5 work of the auditors and the integrity of the audit on  
6 the side of the funds where there's this other structure,  
7 other board in charge.

8 I don't know if that makes it any clearer, but  
9 hopefully it does.

10 MEMBER FRANZEL: Yes, thank you.

11 MR. CVENGROS: And in our case, we use the -- we  
12 have a primary audit firm. And then the other one that  
13 we use is there for a non-required, but we think best  
14 practice to have a SAS 16 for all of our major service  
15 providers. So it gives us checks on the controls of  
16 those service providers.

17 MR. BARIBAULT: In the case of our funds, we have  
18 two audit firms, each one basically auditing different  
19 parts of the complex. So they are, they're equals in a  
20 sense. They're not one subservient to the other.

21 What I think makes that situation work well for  
22 us, is it gives us the ability each year, when we are

1 reviewing the engagement for an upcoming period, do we  
2 have the kind of criticism we're expecting, do we have  
3 the skepticism, the curiosity to really chase issues that  
4 are important to us as a board. And by having two  
5 different audit firms basically, as we have, really  
6 facilitates the process, because you'll find different  
7 nuances coming from one, and the other enables us to  
8 spend time with each of them, and really almost get the  
9 best practices from -- from each.

10           The other information that's, I think, relevant  
11 to this is, we, unlike any other -- you might say public  
12 company boards -- we not the board of the investment  
13 advisor. We're not the same as a public company. We're  
14 not looking at compensation of officers of the company.  
15 We are really there to look critically at two activities.  
16 One, the audit process engagement for the public  
17 accounting firm. We also have the same two of four that  
18 everybody kind of refers to.

19           But equally important; on an annual basis, we  
20 actually renew the engagement for the investment advisor.  
21 We discuss fees. We discuss performance. But where our  
22 firewall on that other side of not trying to run the

1 investment advisor or the management company. And that  
2 gives this board a tremendous increase in its  
3 independence, the scope and breadth of what it looks to.

4 And I think there's a risk element that's  
5 different in the fund business. The books get closed  
6 every day. Everything is market to market at the closing  
7 of a day. So I listened to one of your earlier panels  
8 and there was a discussion of fair valuation. Well, we  
9 do it every single day. And one of the audit firm's  
10 primary responsibilities is to really validate that  
11 process, make certain its accurate and look for  
12 variations or anything that might be a challenge.

13 So there's a great intensity on what is important  
14 to our investor. And our investor is our shareholder.  
15 And we view that we have the responsibility, I think the  
16 supreme court somewhere along the way made a reference  
17 that we are the watchdogs on behalf of the stockholder,  
18 investor.

19 MEMBER HARRIS: I want to follow up on a couple  
20 points you've made about expertise of the audit firm in  
21 the mutual fund area in this '40 Act. And the drawback  
22 to a format like this where you're talking to us is, you

1 don't get a chance to sit face-to-face with the people  
2 that have the opposite view, and actually have a debate  
3 about some of the issues. And so this is my way of  
4 creating the debate about that expertise issue.

5           We've heard in other round-tables, other forums,  
6 in fact from some speakers this morning that, you know,  
7 audit firms, they might not have an expertise in  
8 something, but they will never claim they can't do the  
9 work, and they will always figure it out and get it done.  
10 And looked at what happened when Andersen failed, that  
11 lots of firms jumped in and got the work done. And so  
12 this expertise argument is way overblown, way overrated.  
13 There's plenty of firms that you could pick from, the big  
14 four and any one of the top hundred firms could do the  
15 work.

16           So if I were the cynic in your face saying that's  
17 an overblown excuse, what's your response?

18           MR. CVENGROS: My response would be that the  
19 market sort of tells you, you know, which firms in a way  
20 are showing their expertise and they become the leaders  
21 in that field. And the other ones that never made it or  
22 didn't last, they didn't have the expertise to keep up

1 with the myriad of regulations and rules and so on that  
2 go on with the Investment Company Act of '40. And they  
3 don't have the staff to keep up with the number one  
4 thing, which Bill mentioned, which is valuing the  
5 securities daily.

6           And not every one of them is liquid, you know,  
7 with a real active market. So you have to have other  
8 checks and balances to make sure that your level two and  
9 your level three valuations are put in place properly.  
10 And then you get into some of the things in terms of  
11 international funds, and they have their own particular  
12 rules which a local, a very reputable local firm, you  
13 know, a regional firm, you know, may be capable. But  
14 when they start to go internationally for funds, well,  
15 that's a different thing, you know. You get in a  
16 different world.

17           MS. ALLECTA: And let me start by saying I think  
18 the word expertise might not be quite the right word.

19           In the beginning, life was simple. We invested  
20 primarily in publicly-traded stock exchange listed  
21 securities, and there were excellent boutique '40 Act  
22 accounting firms, as well as numerous larger firms. Life

1 got more complicated, particularly in the valuation area.

2           And now with the need to have independent  
3 valuation verification, the audit firms that can do  
4 mutual funds -- and by the way, we're not a huge industry  
5 segment. So if you're making a decision to specialize  
6 in this area and to build in the technology, you've got  
7 to have enough market out there to support it. They have  
8 to spend an incredible amount of money, energy and  
9 resource on developing valuation sophistication. Smaller  
10 firms can't make this investment. So smaller firms, the  
11 better ones, have been absorbed by the larger firms.  
12 Just because the world's become more complicated, you  
13 need a much higher degree of technical support for that.

14           It's also true on the tax side. The tax side of  
15 mutual fund investing has become much more complicated,  
16 because we now own Slovenian-defaulted debt. We now own  
17 securities in Sri Lanka through different entities,  
18 because you can't have direct non-local ownership, et  
19 cetera. So there are -- there have come into existence  
20 huge areas of complexity that smaller firms simply can't  
21 support the investment.

22           It's not that they don't have the expertise, they

1 just don't have the capital. There's been a capital  
2 hurdle that they can't overcome.

3 MR. BARIBAULT: My personal response on the  
4 concept of specialization is to easily summarize as --  
5 in the context of the audit partner, and are there enough  
6 audit partners who are around to have these expertise.  
7 There may be. But it goes far beyond that.

8 When we see the audit partners rotating, when we  
9 see new, young aspiring partners in this growth mode of  
10 learning this particular industry or specialization, when  
11 we see the people supporting them, it's clear that, as  
12 you comment, the investment that's involved, but it's  
13 also the resolve and commitment to aggregate and pull  
14 together that talent into one firm.

15 And that's very difficult to outsource to other  
16 resources. Because it is a career. It's a point of  
17 specialization. And we've been able to see -- I've been  
18 able to see specifically the growth of young people in  
19 a firm, and one day will make partner, and one day maybe  
20 be, you know, partner assigned to our assignment, and all  
21 the breadth and depths that they've had as real  
22 experience would be hard to duplicate on the outside.

1           MEMBER HARRIS: What's the universe that we're  
2 talking about with respect to the audit firms that have  
3 the appropriate level of expertise of what we're talking  
4 about here? Because you take a look at the various  
5 industry figures in terms of concentration. Are we  
6 talking about a handful, a half a dozen? Or what's, in  
7 terms of the audit firms that are capable of auditing a  
8 mutual fund complex, what --

9           MS. ALLECTA: I don't want to get into trouble  
10 here. There are the big four. And among the big four,  
11 there are probably three that are -- that enjoy a little  
12 bit better reputation. Although that varies a little  
13 bit. Hedge funds and funds that are more on that side  
14 might see it differently.

15           There's one that is dominant among the big four,  
16 but perhaps not hugely dominant. And there are a few  
17 smaller firms that are competent, but they couldn't --  
18 they couldn't handle a company of Forward Fund's size,  
19 which is quite modest, five billion. But they certainly  
20 could handle smaller pools and have some degree of  
21 sophistication, provided the instruments in those pools  
22 weren't too difficult to value.

1           And I believe in the Independent Directors  
2 Council letter, they pointed out that 99 percent of the  
3 assets of the industry are in fact audited by these four  
4 firms. So that tells you something about the  
5 concentration.

6           MEMBER HARRIS: I'm just wondering why partners  
7 at these firms, for example, wouldn't set up a boutique  
8 firm.

9           MS. ALLECTA: Well, many of the best partners at  
10 those firms were in boutique firms. One was them was  
11 McGladrey & Pullen. They could not afford to invest in  
12 the technology to do the independent valuation work  
13 necessary to independently value the securities held in  
14 the portfolios of a Janus international fund or a Forward  
15 alternatives fund.

16           So it was just a question of the world becoming  
17 more complicated and demanding more technology than a  
18 small audit firm with a few number of partners could  
19 afford to take on.

20           MEMBER HARRIS: So are we essentially saying that  
21 this is a natural oligopoly?

22           MS. ALLECTA: It has -- yes, it has. And I was

1 intrigued by the way in the immediate past panel, CalSTRS  
2 went from a regional provider to a national provider.  
3 I don't know why, but I just made a note. Here's another  
4 case we've gone the oligopolistic path.

5           And I think it's something important for the  
6 PCAOB to look at, is whether the demands we make on the  
7 integrity and quality of the audit are such that firms  
8 that want to play in the audit business for big companies  
9 or for companies like mutual funds that have complex  
10 instruments have to make such significant capital  
11 investments that you're promoting natural oligopolies.

12           MR. BARIBAULT: I think it was presented at an  
13 earlier session, that by going to the top 10, there was  
14 a significant cost increase, and the belief there was,  
15 that that was in the best interest of independence and  
16 maybe accuracy.

17           It's our perspective, with the two people -- the  
18 two firms that we use that we have that bit of  
19 competition in-house already. We have the kind of due  
20 diligence that we have pursued.

21           And if we then begin to compare costs and the  
22 alternatives, we would be spending our shareholders'

1 money, then that becomes, as an independent director and  
2 a shareholder and not with the audit firm or with the  
3 investment management company, it really is all about the  
4 shareholder. So we're very focused on that balance  
5 between quality, independence, skepticism and cost.  
6 That's why you find us concerned about cost.

7 MEMBER FERGUSON: I have a question that, you  
8 know, I'm intrigued by the fact that you have the  
9 benefits of watching two audit firms do the same thing  
10 essentially. And we've had various -- or heard of  
11 various proposals at different times about -- for  
12 example, you may have heard the panel early today where  
13 one of the panelists suggested rotating in a manager from  
14 a different firm. We've had people suggest to us that  
15 periodically the concurring partner come from a different  
16 firm. Or that sometimes, perhaps periodically there  
17 should be a concurring audit. I think you suggested this  
18 is a second audit.

19 Based on your own experiences, the experiences of  
20 any of you with seeing two audit firms work at once where  
21 you see that, do you think a proposal like that makes  
22 sense where audit committees should periodically have a

1 second person, kind of a second firm or second  
2 individuals in the team or from outside it is firm take  
3 a look at what the auditor is doing to give the board of  
4 directors and the audit committee a broader perspective  
5 on the -- or particularly where the relationship is a  
6 long one between the auditor and the company?

7 MR. BARIBAULT: I do not support that. The cost  
8 associated versus what's really occurring in the  
9 marketplace -- so my question would be, what evidence,  
10 what's happened in this marketplace to create the  
11 interest and the need? What are the metrics?

12 There was some conversation earlier about  
13 understanding of the research. If PCAOB were to share  
14 with us best practices and share with us maybe without  
15 naming parties, the information that's contained in those  
16 examinations, then I think you'd be achieving the same  
17 thing. You'd be achieving the challenge that's  
18 appropriate, and yet the audit committee would still  
19 maintain its primary responsibility to the shareholder,  
20 and in one of those roles under the '40s Act selection  
21 of the audit firm.

22 MS. ALLECTA: I suggested it because, in part

1 because -- I and hope this is not a violation of  
2 attorney-client privilege, but at one point I had the  
3 honor of being counsel to the American Funds, and I saw  
4 this practice, and in my mind it created some very  
5 healthy benefits, not the least of which was the ability  
6 to negotiate contract terms.

7           For somebody like the Forward Funds, trying to  
8 put in a clause like we want to be able to see part two  
9 of any PCAOB -- I mean that would be like going onto  
10 iTunes and clicking don't agree and then expecting to get  
11 something. I mean, there's no negotiating leverage that  
12 any fund group under \$20 billion has with an audit firm.

13           So two audit firms does enrich the experience,  
14 just the way going out on an RFP enriches the experience.  
15 And it's a cost. And so I think one needs to do the cost  
16 benefit analysis carefully. You don't want to do it  
17 casually. You don't want to invite people to come in and  
18 -- I don't like the RFP suggestion, because that's kind  
19 of like saying we're really inclined to keep the guys we  
20 have but we feel like, you know, we got to have a beauty  
21 contest.

22           I like it because we're saying, "We're paying you

1 for a real service. You're going it come in and do an  
2 audit." And in the meantime, we get to see a whole new  
3 approach, a whole new way of doing things. And as an  
4 audit committee chair, it gets me thinking. And so I  
5 think it could be a healthy process, and I think the cost  
6 could be made reasonable.

7 Do I think it's necessary? No. I mean, my  
8 bottom line is, I think it's an unnecessary additional  
9 assurance right now. But if you find that you need  
10 additional assurances from mutual funds, I think that's  
11 an idea that I'd like to hear other people comment on.

12 MR. BARIBAULT: I have one additional thought.  
13 There could be an assumption -- and I'm adverse to it --  
14 that there's an opinion-shopping process going on that  
15 could be introduced into the process unintentionally, but  
16 still there. So I revert back to having a highly  
17 disciplined audit committee with good information who's  
18 well-educated, is committed to continuing education, and  
19 asks all the right questions. And by you pointing that  
20 out to us, helping us in that forum will make us much  
21 more effective.

22 MR. CVENGROS: And I would just add that not all

1 mutual fund complexes are in a position, really, to have  
2 two auditing firms. I mean, if you're -- if there's many  
3 trusts, separates trusts and funds as maybe American  
4 Funds, it gives you that opportunity to do it because  
5 there's a scale there that you can operate with each of  
6 these auditing firms.

7           But to segment smaller number of funds and have  
8 two auditors in with the advisors working with them is  
9 -- it would be cumbersome and additional costs to the  
10 shareholders. But I think it's a great idea that  
11 American can do that.

12           CHAIRMAN DOTY: We are scheduled for a break, a  
13 five-minute break. But I want to thank this panel,  
14 because all of your comments, of course, and your papers  
15 go into the record. We have the record to look back on  
16 and to be able to rely on all of your thoughts.

17           You have made a very thoughtful presentation of  
18 some very important distinctions between the mutual fund  
19 industry in the operating company universe, and they're,  
20 all of them, very useful to us in evaluating what we have  
21 to do, especially with regard to the specific proposals  
22 that Bill Baribault made, and that you each in our own

1 way have indicated in your materials. So thank you.

2 And we'll break briefly. And we'll be back here  
3 at, let's say 3:50.

4 (Whereupon, the above-entitled matter went off  
5 the record at 3:44 p.m. and resumed at 3:50 p.m.)

6 CHAIRMAN DOTY: Well, I'm sure the preparers feel  
7 that it's been a long day, and that we're late getting  
8 to the preparers. But we're now -- that's where we are  
9 now.

10 Ken Goldman, Senior Vice President and Chief  
11 Financial Officer, Fortinet, Inc., a provider of unified  
12 threat management solutions. He served as senior vice  
13 president, finance and administration and chief financial  
14 officer of Siebel Systems, Inc., the software solutions  
15 and services giant acquired by Oracle in January 2006.  
16 Prior to August 2000, he served as senior vice president  
17 of finance, chief financial officer of Excite@Home  
18 Corporation and Sybase. He served as chief financial  
19 officer at Cypress Semiconductor and VLSI Technology.  
20 Named among America's 15 most connected capitalists for  
21 2010 by Forbes Magazine. We're going to have to talk  
22 about that, Ken Goldman. And served on the board --

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1 numerous boards of public companies, and he was a member  
2 of the Treasury Advisory Committee on the auditing  
3 profession. And previously served on the FASB's primary  
4 Advisory Group, the Financial Accounting Standards  
5 Advisory Council.

6           Welcome, Kenneth Goldman. You bring a lot to  
7 this discussion. And we do want to know -- we do want  
8 to know what you had to do to be connected; whether it  
9 was electronic or virtual is going to be very important.

10           Richard Levy. Rich Levy is Executive Vice  
11 President and Controller of Wells Fargo. Joined Wells  
12 Fargo as controller in 2002. Has over 30 years of public  
13 accounting and financial services industry experience.  
14 Before joining the company, he was senior vice president  
15 and controller for New York Life. Previously a partner  
16 with Coopers & Lybrand where he headed the firm's  
17 national tax practice for financial institutions. And  
18 before his experience at Coopers & Lybrand, he was a  
19 senior VP at Mid-Atlantic, a New Jersey-based regional  
20 bank holding company. Began his career with Deloitte &  
21 Touche. Welcome, Rich Levy. Good to have you.

22           Kevin McBride, External Reporting and Treasury

1 Accounting Controller of Intel Corporation. Mr. McBride  
2 is the -- is responsible in Intel for leading Intel's  
3 treasury accounting and SEC reporting activities. He  
4 joined Intel in 2000 as an accounting policy manager.  
5 In 2005, he completed a two-year fellowship at the  
6 Financial Accounting Standards Board. Mr. McBride has  
7 led and managed Intel's technical accounting activities  
8 through 2009. And prior to joining Intel, he was an  
9 audit manager at KPMG in Portland, Oregon. He's  
10 participated in numerous professional initiatives,  
11 including the FBI's annual current financial reporting  
12 issues, the AICPA National Convention, and the SEC  
13 Institute Conference on Fair Value Measurements. He is  
14 a member of the Center for Audit Quality SEC Regulations  
15 Committee. Welcome, Kevin, McBride.

16 Welcome to all of you. Thank you. And we'll  
17 start, Ken Goldman, with you.

18 MR. GOLDMAN: How's that? Starting now? Okay.

19 So, anyway, thank you, Chairman Doty, and other  
20 members for inviting myself and others, and frankly for  
21 coming out here to the west coast and getting our  
22 thoughts.

1 I do plan on, very quickly, talking about my  
2 background relative to this committee. Some things I've  
3 done to prepare for this panel, my sense of pros and cons  
4 related to the mandatory auditor rotation, and honestly  
5 some other alternatives that I think would help improve  
6 auditor effectiveness to this committee.

7 You are correct, by way of background, I am a CFO  
8 of Fortinet. I have been actually CFO over a number of  
9 public companies that you note. Actually, 30 years going  
10 on being a CFO of public -- primarily public companies.  
11 Over 25 years, actually, of public. On a number of  
12 public boards and private boards. Actually, well over  
13 20 over the last few years.

14 Currently chairman of the audit committee of NXP  
15 Semiconductor, on the -- also Infinera, and was chairman  
16 of the audit committee of Juniper, Starent and Legato.  
17 So I've been in a variety of things. Plus I'm on the --  
18 I still remain on the board of Cornell University, and  
19 I'm going to come back to that in a while.

20 In terms of preparing for today, I did review my  
21 experiences, my experience on the FASAC board of  
22 1999/2003, the Advisory Committee on the Auditing

1 Profession that you mentioned, and you said a number of  
2 the recommendations that we came up with, sort of  
3 unfortunately that report, you may note, came out in  
4 October of 2008, very timely, and I think now sits in a  
5 museum, all 12 binders of such. But I will come back to  
6 some of the comments and recommendations there, because  
7 I think they -- they bear on today.

8           Let me take -- let me actually do -- talk about  
9 some of the progress. And I think people forget this, and  
10 I did hear some other panelists talk about that today.  
11 So since Sarbanes-Oxley in 2002, we now have CEOs' and  
12 CFOs' certifications. We have mandatory five-year  
13 partner rotations. We have SOX for internal controls.  
14 We have auditor services independence requirements. We  
15 have the audit committee response overseeing the  
16 auditors. We have a more robust private regulatory  
17 regime, thankfully under yourselves. We have audit  
18 committees composed of expert members. We have more  
19 frequent mandatory filing reviews by the SEC and a whole  
20 host of other changes.

21           So actually you have to step back, and before you  
22 want to make some changes, think about some of the

1 progress that has been made. And I also thought that  
2 back to -- because I remember the period well in the late  
3 '90s, in like 1990s, and there were a few bad apples, so  
4 to speak, and I would sometimes remind people not to take  
5 too much from some bad folks when most folks do -- and  
6 I would say the CFOs and audit committees that I know  
7 take this job -- and auditors take this job very, very  
8 seriously.

9           And I did note, I was looking at some of the  
10 data, that audit restatements are down 80 percent from  
11 2005. Class action lawsuits down by over half in that  
12 time frame. So let me now address mandatory auditor  
13 rotation, which I am not in favor of, which you can  
14 probably expect.

15           For those with short memories, I would remind  
16 you, we used to have eight firms. Through misplaced  
17 consolidation, in my judgment, and elimination of Arthur  
18 Andersen, we're now down to four. And I think I just  
19 actually heard the prior panelist note that these four  
20 firms now audit 98 percent of the market capitalization  
21 of U.S. public companies. That's actually comparable for  
22 other major capital markets.

1           In practice, we use, I use other firms for  
2 various other non-audit services, which now, by the way  
3 -- and our own financials, our own auditors, and as well  
4 as the others, you know, our non-audit service from our  
5 own firm is down to like 20 percent from 50 percent that  
6 it was back in 2002. And in many cases, you may have  
7 other auditors as your customers. So it makes it very,  
8 very hard.

9           Other industries you find constraints relative to  
10 industry experience by geographic presence that severely  
11 limits the alternatives. And ironically and perversely,  
12 changing auditors many times has a negative connotation  
13 for investors. Either an existing auditor prefers not  
14 to work for the company or vice versa, and hard to really  
15 -- it's hard to understand fully the rationale for the  
16 auditor change by investors.

17           In a related situation, I was on a -- I'm  
18 actually still on the Cornell University board, a number  
19 of years ago, we actually did put up our audit for a  
20 competitive bid. And we did change from an existing  
21 auditor to a new auditor, not for cost, which was  
22 incidentally -- which ended up becoming more competitive

1 then our prior firm, but because the new firm uniquely  
2 possessed relevant industry experience auditing the very  
3 top university similar to our size, and could field a  
4 team for us in Ithaca, which is no easy task.

5 I also mentioned we never really looked at a  
6 non-big four firm. And so -- and this firm also -- so  
7 when you look at it, actually it's interesting. For  
8 example, the four firms -- we did move from the existing  
9 firm in this case, and it was really one firm that really  
10 had what we considered to be not only the relevant  
11 experience, but in this case, geographic presence both  
12 in Ithaca and actually coming out of Syracuse.

13 So I -- I've broken up my general recommendations  
14 into two parts here just to sort of make it easier to  
15 digest, and some more relate to mandatory auditor  
16 rotation, and then others some other general suggestions.

17 I would actually require large companies to bid  
18 out the audit every 10 to 15 years, some flexibility in  
19 that time frame. And if they choose to keep their  
20 existing firm, explain why. Additionally, all public  
21 company audit changes and reasons must be disclosed.  
22 Auditing firms must notify the PCAOB of premature auditor

1 -- premature engagement partner changes at audit clients.

2           You know, in thinking of this, I actually was  
3 thinking about last study results of companies that have  
4 changed auditors relative to audit quality. Is there a  
5 link between audit quality and changing auditors? Do  
6 negative perceptions exist regarding auditor changes?  
7 What is the fundamental reason and benefit or problem  
8 were trying to fix via audit rotation? And so think  
9 about all of those in terms of making a change.

10           Two, I like Arthur Levitt's suggestion of when a  
11 mandatory audit change may need to be addressed. For  
12 example, when there are restatements, non-audit services  
13 become too high, and so forth.

14           Three -- you're going to like this one -- require  
15 both engagement partner and reviewing partner to sign the  
16 opinion, either a 10-K or the proxy. Span scope of audit  
17 committee reporting proxy relating to auditor  
18 independence, objectivity and professional judgment. I  
19 would more formalize the role of the reviewing partner.  
20 I find the reviewing partner, even though it's a very  
21 important aspect, is not totally clear sometimes.

22           Five, publicize and issue best practices and

1 learning developed through the PCAOB reviews of company  
2 audits and make these more public to the companies  
3 involved. Continue to publicize and replicate  
4 improvements made in firm audit methodologies. Audit  
5 firms to discuss inspection results more fully with the  
6 company audit committees.

7           Controversially, perhaps, increase the mandatory  
8 -- contrary to what you -- what everybody was talking  
9 about -- increase the mandatory partner rotation from  
10 five years back to seven. In reality, the first two  
11 years -- I see this over and over -- are training and  
12 learning the account.

13           There are a couple of good years in the middle,  
14 about three years maybe, and then year five is when  
15 rotation. So before you get into changing, you know, the  
16 five years, the first couple of years the new person --  
17 the new partner's getting onboard, you know two or three  
18 years where they're fully onboard, and then all of a  
19 sudden you're back into a partner rotation. It just  
20 seems like every -- I'm going through this constantly in  
21 terms of partner rotation.

22           And you know something, it's all about the

1 people. I would focus on ensuring appropriate human  
2 capital steps to ensure trained and competent auditors  
3 at all levels. And I certainly hope we don't suggest a  
4 mandatory CFO rotation.

5           Let me just take -- you know, one more minute,  
6 and I'll talk about some other suggestions that I thought  
7 of. One, PCAOB consider developing and disclosing key  
8 indicators of audit quality, disclose such indicators and  
9 monitor them. PCAOB to ensure -- to issue constructive  
10 recommendations based on its findings relative to audit  
11 quality.

12           All public companies adopt annual shareholder  
13 ratification of public company auditors. One of the  
14 things we did address a lot in the treasury was the  
15 ensuring of viability and preservation of four firms I  
16 would hate to see if we went lower. So large auditing  
17 firms produce a public annual report with audited GAAP  
18 financials, including key indicators of audit quality,  
19 effectiveness, and also consider adding independent board  
20 members.

21           Four, recognize many of the restatements result  
22 from recently issued and complex pronouncements such as

1 those relating to complex financial instruments, fair  
2 value accounting and so forth. Let's work to balance  
3 accounting theoretical accuracy with practical  
4 implementation implications.

5           Five, provide training and develop -- and  
6 promulgate best practices in terms of running audit  
7 committees. Provide training of audit committee members  
8 and audit committee expertise.

9           I would add that we've gone from a period where  
10 we used to have four to six meetings a year to 10, 12 and  
11 more audit committee meetings.

12           And six, align standard certifications for audit  
13 firm and employees between federal, state and other  
14 related bodies. It's interesting how you have different  
15 standards between states and federal and so forth. And  
16 consolidate the rules of various oversight bodies such  
17 as the SEC, PCAOB and AICPA regarding independence  
18 requirements among public company auditors free of  
19 conflicts of interest.

20           And the very last one, my last comment, there is  
21 really no substitution for reasoned professional judgment  
22 and possessing a good ethical compass. And remembering,

1 as I was told early in my very first job, disclosure is  
2 my friend, is shining a light on transparency.

3 So with that, I leave it to Richard.

4 CHAIRMAN DOTY: Ken, are your comments written?  
5 Can you -- you're leaving us a manuscript, I hope.

6 MR. GOLDMAN: I could leave this if you want,  
7 yes.

8 CHAIRMAN DOTY: It would be very helpful.

9 MR. GOLDMAN: Yes.

10 CHAIRMAN DOTY: All right.

11 MR. LEVY: Chairman Doty, members of the PCAOB  
12 and observers, thank you for inviting me to participate  
13 in this public meeting to address the very important  
14 topic of audit firm rotation and auditor independence.

15 Auditor independence is critical to ensuring  
16 audit quality. However, existing professional standards  
17 and practices, including additional safeguards  
18 established pursuant to the Sarbanes-Oxley Act of 2002  
19 already effectively ensure that auditors remain  
20 independent in both fact and appearance.

21 While the intentions of the PCAOB proposal to  
22 promote and improve audit quality are laudable, we do not

1 believe there is sufficient evidence to support the  
2 underlying assertion that lack of auditor independence  
3 is a pervasive problem or a primary cause of audit  
4 failures. Our audit committee is best qualified to  
5 determine when external auditors should be replaced. In  
6 order to credibly challenge both management and the  
7 external auditors, the audit committee must retain full  
8 oversight responsibility.

9           When in the judgment of the audit committee the  
10 performance of management or the quality of the audit is  
11 adversely impacted by a perceived or actual lack of  
12 auditor independence, it is the fundamental  
13 responsibility of the audit committee to determine  
14 whether a change in the external auditor is necessary.  
15 That responsibility should not be undermined by  
16 regulatory intervention.

17           Audit inspections performed by the PCAOB have not  
18 yielded a significant number of deficient audits.  
19 Several years after the implementation of Sarbanes-Oxley,  
20 the PCAOB has acknowledged that audit quality has  
21 improved. Neither academic studies nor the use of  
22 inspection activities, which typically target higher-risk

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1 audits have indicated correlation between audit failures  
2 and a lack of auditor independence.

3           Effective and comprehensive quality control  
4 measures that ensure and enhance auditor independence  
5 exists today, and we directly experience the  
6 effectiveness of these measures as our auditors  
7 continuously adopt their audit procedures as a result of  
8 feedback from the PCAOB.

9           Audit firms are subject to onerous internal and  
10 external quality control measures, including measures  
11 enacted under Sarbanes-Oxley to improve auditor  
12 independence. Audit firms are required to communicate  
13 the description of all client relationships, the audit  
14 firm's quality control procedures, and material findings  
15 from peer or internal reviews and PCAOB inspection  
16 activities. Other rules place limitations on hiring  
17 audit firm personnel, prohibit performance of certain  
18 non-audit services, and limit the tenure of the audit  
19 engagement partners.

20           Meaningful distinctions also exist to ensure  
21 quality control measures are adhered to, including the  
22 signaling of potential audit failures in public SEC

1 filings, the assessment of financial penalties,  
2 employment actions, or more severe sanctions. It is not  
3 reasonable to assume incumbent auditors would audit any  
4 more rigorously simply because they would be subject to  
5 mandatory rotation.

6           There's a practical limit to the number of viable  
7 replacement audit firm candidates. Large, complex  
8 multinational companies are realistically limited to  
9 using -- to using one of the big four accounting firms.  
10 However, given the unique market, operational and  
11 technical accounting perspectives of the financial  
12 services industry, we believe only two of the big four  
13 accounting firms would be viable candidates for our  
14 company and our large bank peers.

15           The field of viable audit firm candidates is also  
16 limited by existing rules meant to enhance auditor  
17 independence by prohibiting the performance of certain  
18 non-audit services, a portion of which is typically  
19 divided among the remaining big four firms. Non-audit  
20 service frequently represent significant complex  
21 multi-year projects, and it is not feasible to expect  
22 that such projects could be completed or transferred to

1 a replacement firm in a timely manner without significant  
2 cost or interruption -- or disruption.

3           When potential replacement firms do not have  
4 adequate expertise or resources, audit firms may have no  
5 other choice but to hire resources from the incumbent  
6 audit firms. For similar reasons, we are concerned that  
7 audit or non-audit service may be awarded to  
8 less-qualified audit firms.

9           Each of these reasonably possible scenarios will  
10 counteract the perceived benefit of mandatory rotation  
11 while bidding up the cost of industry expertise. The  
12 potential incremental cost of mandatory audit rotation  
13 will be significant, with some estimates increasing  
14 first-year audit costs by 20 percent.

15           However, this assessment does not contemplate the  
16 implemental costs associated with reporting requirements  
17 imposed by post Sarbanes-Oxley legislation, and pending  
18 new regulations under the Dodd-Frank Act, the increased  
19 leverage that audit firms may have in setting fees, and  
20 the audit inefficiencies and learning-curve costs a  
21 replacement firm will incur examining complex  
22 registrants.

1           Lastly, there are potentially significant  
2 unquantifiable costs related to audit-detection risks  
3 after a rotation. We are troubled that the PCAOB has not  
4 performed a meaningful study to determine if the  
5 incremental cost of mandatory auditor rotation are  
6 justified.

7           Although we do not support mandatory auditor  
8 rotation, we do believe there are opportunities to  
9 enhance audit quality and promote auditor objectivity  
10 that would be more effective and less disruptive than  
11 mandatory auditor rotation. We recommend that the PCAOB  
12 consider enhancing required communications and  
13 information available to audit committee by sharing with  
14 them the results of its inspections of registrants'  
15 auditors, as well as publishing the results of its  
16 overall inspection program in a format specifically  
17 tailored for the use by audit committees.

18           Revisiting the requirements for qualifying as a  
19 financial expert of the audit committee to ensure audit  
20 committee financial experts have the requested financial  
21 reporting expertise to effectively perform the oversight  
22 responsibility over the auditor relationship is another

1 suggestion.

2           And finally, enhancing auditor training  
3 requirements to specifically address audit quality  
4 concerns identified by the PCAOB inspections, as well as  
5 assessing the adequacy of existing training programs at  
6 auditing firms, with appropriate emphasis on professional  
7 skepticism training.

8           In closing, we believe existing safeguards  
9 provide -- provided by professional standards and  
10 practices, combined with the oversight provided by audit  
11 committees have been effective in ensuring and promoting  
12 auditor independence. Mandatory auditor rotation will  
13 increase audit risk, subject reporting entities to  
14 substantial incremental costs, create conflicts of  
15 interest among potential replacement audit firms, and  
16 limit competition due to the concentration of industry  
17 expertise and geographical reach.

18           We believe mandatory auditor rotation will  
19 replace a perceived audit risk with tangible and more  
20 serious audit risks which could severely damage audit  
21 quality. Therefore, we strongly encourage the PCAOB to  
22 review other alternatives to enhance audit quality and

1 promote auditor objectivity.

2 CHAIRMAN DOTY: Kevin McBride.

3 MR. McBRIDE: Good afternoon. Thank you for the  
4 opportunity to provide Intel's views on auditor  
5 independence and rotation. The Board has conducted  
6 extensive research and outreach on this topic, and in my  
7 opinion certainly has demonstrated its commitment to  
8 protect investors and fulfill its mission.

9 I am Kevin McBride, and as mentioned in my  
10 introduction, I serve as Intel's external reporting and  
11 treasury and accounting controller. My responsibilities  
12 include ensuring that our finances comply with SEC rules  
13 and regulations, and that our process in developing and  
14 preparing our financial statements are transparent to  
15 management, the auditors and the audit committee.

16 I'd like to spend just a few moments summarizing  
17 Intel's position and make a couple of additional comments  
18 on ideas that have been shared during the Board's  
19 outreach.

20 Auditor skepticism and objectivity are essential  
21 to high audit quality. I think the question is, how to  
22 enhance skepticism and objectivity. With respect to

1 skepticism, I believe that there are two critical  
2 components, deep subject matter knowledge and the desire  
3 to get to the right answer. Let me take the first  
4 component, which is the deep subject matter knowledge.

5 Intel's annual revenue for 2011 was approximately  
6 54 billion with over 80 percent of that revenue generated  
7 outside the United States. We also manufacture, test,  
8 and assemble products in six countries outside of the  
9 U.S. So in addition to our consolidated reports filed  
10 with the SEC, we file over 150 statutory reports around  
11 the world, and in fact in over 40 countries.

12 Our business model and geographic dispersion  
13 require deep knowledge of our business, as well as  
14 domestic and international rules and regulations. So in  
15 order to file those high-quality reports with the  
16 relevant jurisdictions, we develop and train a highly  
17 skilled workforce. It takes us about four to six years  
18 to develop our technical staff, and another four to six  
19 years to develop an individual with the skills necessary  
20 to manage that staff, and our controllers with oversight  
21 over those managers generally have about 20 years  
22 experience.

1           And we enhance that experience through periodic  
2 rotations to ensure that our managers, as well as our  
3 controllers have broad experience necessary to deal with  
4 the complexity of our business. And we need that deep  
5 expertise to be matched by our auditors.

6           Which brings me to my first objection with  
7 mandatory firm rotation. I don't believe that a fresh set  
8 of eyes will have the deep subject matter expertise in  
9 the early years of the new audit relationship to  
10 demonstrate the skepticism that the Board desires and the  
11 companies need.

12           So when I look at the cost benefit equation  
13 associated with audit rotation, I see three costs. One  
14 in an increase in fees, which has already been talked  
15 about. Second is the cost associated with taking  
16 management time to help the auditors understand the  
17 people, the processes and the systems that translate the  
18 business into meaningful financial information.

19           And third is the cost associated with rotating  
20 service providers for the non-audit related services that  
21 companies like Intel procure from the other big four  
22 audit firms. In fact, that steep learning curve makes

1 the auditors acutely reliant upon management, which I  
2 think is the very thing that auditor rotation is trying  
3 to avoid.

4 In applying auditor rotation in the largest  
5 companies exacerbates these issues, given the complexity  
6 of those companies. Further, it undermines the company's  
7 ability to select a big four firm that is best suited to  
8 provide the relevant non-audit service. So when I think  
9 of the cost benefit equation, I believe mandatory  
10 rotation will not produce the desired outcome in the  
11 early years of the new audit.

12 The other component of skepticism in my mind is  
13 the desire to get to the right answer. That means  
14 looking at reasonable alternatives and understanding the  
15 relevant merits of those alternatives. I believe this  
16 is an important attribute. But it's consistently  
17 demonstrated by our auditors. Perhaps more can be done  
18 to share that information with the audit committee to  
19 give them visibility into the -- into our auditors'  
20 passion for getting to the right answer.

21 The other necessary trait is objectivity. To  
22 address this concern, I've heard of the insurance-based

1 alternative to existing client-payee model. I believe  
2 the notion is that the auditors cannot be objective if  
3 they're paid directly by the company. But the changes  
4 set forth in Sarbanes-Oxley Act make a marked improvement  
5 in numerous areas, including requiring that the auditors  
6 work for the audit committee and requiring that the audit  
7 committee is comprised of individuals independent of the  
8 company.

9           Let's put that fact aside for a moment and talk  
10 about the insurance model. And I'm selecting this model  
11 because I think it's particularly illuminating with  
12 respect to a potential way forward.

13           The insurance-based model presumes that the  
14 auditors are more objective if paid by the insurance  
15 company rather than the audit committee. But I think  
16 there's more to it than that. First, the company, the  
17 audit insurance company would need more insight into  
18 audit failure. The model presumes that a subpar audit  
19 could lead to an increase in the insurer's claims, and  
20 thus a decrease in revenue to the offending firm.

21           I think there's an important element missing from  
22 that equation, and that is information. In order to

1 properly risk adjust insurance premiums and value the  
2 services provided by the firm, the insurer would need to  
3 understand the nature of the audit issues. Was the issue  
4 systematic or was it isolated. Was it a matter of a  
5 failed procedure, a lack of independence, lack of good  
6 judgment, lack of education? Was it something related  
7 just to the audit team? Is it the office or is it the  
8 entire firm.

9           The insurance provider could then use that  
10 information and model and appropriately extrapolate the  
11 issue. Also, the insurance provider would need immediate  
12 feedback about audit failure. It couldn't wait months  
13 or even years to learn about audit failures. In order  
14 to understand the quality of the audit, I believe audit  
15 committees require no less timely and thorough  
16 information. And armed with that type of timely and  
17 thorough information, an audit committee can make a more  
18 informed decision about auditor retention.

19           So to be clear, I oppose mandatory auditor  
20 rotation. However, I clearly recognize that auditor  
21 rotation is an appropriate solution in certain  
22 circumstances. But I believe it's the audit committee's

1 duty to make that determination, and audit committees  
2 would benefit by understanding the results of PCAOB's  
3 inspections. Thank you.

4 CHAIRMAN DOTY: Okay. Jay, do you want to start?

5 MEMBER HANSON: Thanks. Good comments from all  
6 of you.

7 This morning, we heard from a couple of our  
8 opening panels make assertions about audit committees;  
9 that effectively, they're not up to the job of policing  
10 auditor independence, objectivity and skepticism. You're  
11 in the position of having -- having felt the brunt of  
12 what auditors are going through in terms of reform from  
13 our inspections and new standards over the last 10 years,  
14 and I -- and I think probably more acutely in the last  
15 three or four years. And you're also in the position of  
16 having to answer to the audit committees in terms of what  
17 they're asking you more acutely about, you know, today,  
18 from what we're hearing and saying.

19 So I would ask of each of you to share a bit of  
20 personal experience about how things are different now  
21 in even just the last couple of years compared to the pre  
22 Sarbanes-Oxley era, both in terms of your interaction

1 with the auditors, as well as interactions with the audit  
2 committee. So that's my main question.

3           And then -- and then for Rich and Kenneth, I want  
4 to follow up on something that Kevin just said about --  
5 about advocating that -- or supporting the idea that we  
6 should be able to give -- or it would be desirable for  
7 us to give audit committees more timely, direct, specific  
8 feedback on what we've seen in audits of your -- of your  
9 businesses. And whether as preparers you would find that  
10 troubling or if you would support that. So, two  
11 questions wrapped into my time.

12           MR. GOLDMAN: Yes, well, I guess -- I think the  
13 -- you know, in terms of the committee -- you know, in  
14 terms of committees and how we see it, I mean, I think  
15 -- I'm trying to understand your first question in terms  
16 of what really --

17           MEMBER HANSON: The question, it's really what  
18 has changed in how you interact with both the audit  
19 committee and the auditors in the last -- the last few  
20 years that --

21           MR. GOLDMAN: Well, I think that the number one  
22 change actually starts with a comment I made is, instead

1 of having four or five meetings a year, you literally  
2 have, you know, 10, 12. And let me just explain how to  
3 really works in practice, and maybe you don't know this.

4 I mean, you obviously have a meeting to review  
5 before the earnings -- before the earnings come out, you  
6 have a meeting to review the relevant Q or K. When I'm  
7 -- and I'm talking about when I'm on the -- when I'm on  
8 the audit committee, you know, I tend to have a couple  
9 extra meetings to go over special subjects, and so easily  
10 have 10 to 12 meetings a year. It is -- I'd say before  
11 we had this, it used to be four or five.

12 I would also say, I sort of -- I probably talked  
13 fast before -- you know, when I thought about, you know,  
14 pre Sarbanes, it's interesting a lot of people in the  
15 Valley are pretty down on Sarbanes, and you'll hear a lot  
16 of negatives, and I actually think there's a lot of good  
17 that came out of it. So I'll probably get some lashings  
18 when I get back home. But the reality is, the fact that  
19 you now need, you know, independent members of the audit  
20 committee, they need to be relevant -- understanding of  
21 the -- have the relevant experience and understanding  
22 accounting.

1 I mean, I can think of several firms that got  
2 into, quote/unquote, trouble in financial services, which  
3 were composed of audit committee members which weren't  
4 related to the industry, didn't have the appropriate  
5 accounting expertise. And so I think the -- all of us,  
6 whether I look at myself as a preparer, I look at myself  
7 as an audit committee member, because I do both, you  
8 know, we all -- or at least the people I know, take the  
9 job very, very seriously. The requirements are much more  
10 extreme.

11 And -- and so the point that I made is, the thing  
12 I asked for -- I actually have a meeting with a KPMG case  
13 with -- because I've asked them to give me what you're  
14 saying is best practices for audit committees. Because  
15 one of the things is, it's hard to get really a sense of  
16 what are other people doing, and so I was up to risk now  
17 and so forth. But what I'm trying to say is what's  
18 really -- what's new in the last year or two years or  
19 three years. So I've asked this case, KPMG meeting to  
20 provide the audit committee of NXP, what is the -- what  
21 are the best practices you are seeing relative to audit  
22 committees.

1           But the last point I make relative to the  
2 question you asked is, I think in terms of the PCAOB, I  
3 think -- I think there's a mix, if I could say. I think  
4 the auditors feel a little bit of, certainly lashings  
5 that they're getting. Some of it I think they feel is  
6 deserve; some of it they may feel is undeserved.

7           But I think it's -- we all would benefit just  
8 sort of -- and you could find a way to parse that out and  
9 say, you know -- and the comment to that is here are the  
10 general comments that we think could be helpful in terms  
11 of things you're seeing across the board, not unique, but  
12 across the board that would be helpful for us as  
13 preparers, and our committee members, that we should be  
14 on the lookout for. I mean, I think that would be very,  
15 very helpful to have better -- and the other thing is  
16 they have it more current. And so to have findings that  
17 are a year old and not two or three years old in terms  
18 of what you're seeing when you do your -- your audits.  
19 So that would be my first comment.

20           MR. LEVY: Just to weigh in also on the impact of  
21 Sarbanes-Oxley, I actually can understate this, I think  
22 it was a very profound impact on both the audit

1 profession, and quite frankly, on registrants. It's not  
2 just about the financial statements as they've been  
3 rendered, but also the control environment. And so we  
4 spend a considerable amount of time not just talking  
5 about what the results are, but what the control  
6 environment is, and what could be a material weakness,  
7 significant deficiency, or even a deficiency.

8           So it's not just something that would emerge in  
9 a period or an issue in the period, but something that  
10 you're processing your -- your whole infrastructure  
11 could -- infrastructure could potentially not detect and  
12 allow to be ultimately a financial statement issue, or  
13 a misstatement. So I think that the auditors themselves,  
14 as well as the registrants have really had to lift the  
15 game up as a result of the whole SOX process.

16           In addition, I think that, you know, you guys  
17 have actually played a meaningful role, because typically  
18 in the relationship with a registrant and its auditor  
19 prior to Sarbanes-Oxley, prior to the advent of the  
20 PCAOB, there really would be the constructive tension  
21 around the SEC, maybe in a financial institution in terms  
22 -- well, from a common letter perspective and their

1 oversight, from a financial institutional perspective,  
2 obviously the bank regulators play a continual role with  
3 their presence, and that actually can impact financial  
4 results.

5           But now, quite frankly, you are coming in and  
6 doing your targeted reviews and inspections, and when you  
7 see an issue, it may not be at a Wells Fargo, it might  
8 be at another large bank peer, you are raising that  
9 issue, and you're raising that issue with the firms,  
10 you're raising that issue with the SEC. A good example  
11 is the Level 2 market valuations, and that was a  
12 concerted effort that we -- we certainly felt as an  
13 industry. And at Wells Fargo obviously demonstrating to  
14 our auditor that we in fact had a good sense on our, you  
15 know, Level 2 provided market values.

16           And so the process has actually morphed to the  
17 better. Yes, that might entail more audit work from the  
18 firm and more hours and more costs, but quite frankly,  
19 I can tell you that there is -- there is a constructive  
20 tension that exists in the current environment with  
21 regards to our audit committees. I would also say that  
22 they've benefited from the Sarbanes-Oxley Act. Clearly

1 having financial expertise is very important on the  
2 committee.

3           And, again, having that skepticism really has to  
4 start from that top. You know, in terms of a well-  
5 controlled organization, it's the tone and tenor from the  
6 top that you will always say is one of the global  
7 controls that you want to look for. Well, I would -- I  
8 would second that at the audit committee level. That  
9 tone, tenor, attention to detail being an activist board.  
10 All right?

11           And I would tell you that the level of activity  
12 and engagement that I've seen at, not only Wells Fargo,  
13 but quite frankly, in what I'll call my prior life, has  
14 really been elevated. So to the extent that there's an  
15 opportunity here, it's to continue to increase and  
16 elevate that engagement by the firm by the audit  
17 committee. And quite frankly, ensuring that it's not  
18 just the large registrants that are able to attract  
19 talent to their audit committees, and the -- and the  
20 required subject matter expertise, but that actually you  
21 -- we want to make sure that all public registrants have  
22 a good quality audit committee.

1           MR. McBRIDE: I think there's four notable  
2 changes that I see post Sarbanes-Oxley.

3           Well, the first one is the ongoing management of  
4 technical issues that arise each quarter. What we do,  
5 as a matter of process is, as the quarter develops, we  
6 identify those issues that are going to be important to  
7 the quarter, and we have a meeting with management, talk  
8 about the relevant views on that and the alternatives,  
9 and I we present that -- those issues to the auditor.  
10 We actively manage that list throughout the quarter. And  
11 at the end of the quarter, once the issues are resolved,  
12 then we select the items that we need to talk to the  
13 audit committee about. And that's, that's something  
14 that's new post Sarbanes-Oxley.

15           I think another one is the -- I think Rich  
16 touched on this -- is the identification of things that  
17 are occurring, either new accounting standards or, you  
18 know, issues coming out of the SEC inspections, or PCAOB  
19 inspections; that we meet every quarter with our auditors  
20 and have a conversation with senior management about  
21 those issues. It's an opportunity for our auditors, as  
22 well as they bring in the national office -- an office

1 expert to talk about those issues and the firm's views  
2 with respect to those issues. And we get an opportunity  
3 to ask questions and really understand where auditor --  
4 where our auditors are coming from.

5           The third -- and Rich did hit on this one  
6 absolutely -- is a discussion of control deficiencies.  
7 The discussions we have with respect to control  
8 deficiencies is really trying to get to what went wrong,  
9 what's the root cause. One of the things we see -- and  
10 this is actually very relevant to the comment I made with  
11 respect to audit quality in the earlier years of -- of  
12 an audit rotation, is what we see when people rotate in  
13 jobs at our company, is that we have to provide quite a  
14 bit more oversight and review on particular desks when  
15 people rotate, because of the risk of a person immersing  
16 themselves in a new process with new issues that they're  
17 not familiar with.

18           And so issues arise out of that, and we talk  
19 about those every quarter in our -- in our quarterly  
20 controls review. So that's new since Sarbanes-Oxley.

21           The other point I wanted to make is with respect  
22 to auditor rotation. When -- we've had, within the last

1 three years, a new lead audit partner that came in and  
2 questioned some of our critical accounting estimates, so  
3 some of the things we did was we prepared a kind of  
4 report out on our accounting process, our key estimates,  
5 our judgments.

6 We walked their lead partner through those --  
7 those items, as well as he brought in -- this is on an  
8 issue related to fair value in particular that I'm  
9 thinking of -- they brought in the national partner in  
10 charge of valuation. They brought in valuation experts.  
11 They had staff, and senior and other partners in that  
12 meeting. We brought in our relevant experts that are  
13 involved in valuation and the process, and we walked  
14 through the issues. And it's an opportunity for them to  
15 get educated, as well as for us to get educated on the  
16 latest views of these issues.

17 So I think those are some of the things that I  
18 noticed, some of the changes that we've seen since the  
19 start of Sarbanes-Oxley.

20 MEMBER FERGUSON: One of the things that I think  
21 each of you mentioned -- and you're sort of not unique  
22 in this; it's been mentioned throughout the day by

1 panelists, has to do with one of the problems with  
2 mandatory rotation. And it would be -- it might just be  
3 with rotation in general -- is the fact that to the  
4 extent that large enterprises use non-audit services from  
5 other big four firms under the independence rules you're  
6 very limited. So if you had to rotate, either that would  
7 limit your choice of those service providers, or, you  
8 know, might -- if you had to rotate in a very short-term  
9 basis, might preclude certain people from being your  
10 auditors at all.

11           It strikes me in many ways that this is a problem  
12 of the firm's own creation. They have chosen to go into  
13 these businesses. And frankly, the most rapidly-growing  
14 parts of the business of the big audit firms are the  
15 advisory service, growing much more rapidly than the --  
16 than the audit business.

17           Does this argue for strict limitations on the  
18 kinds of non-audit services that audit firms should be  
19 able to provide, including going so far as to having  
20 audit-only firms, a proposal that's being considered by  
21 the European community right now?

22           But, I mean, you know, these problems which I

1 think we realize or recognize are very real in today's  
2 environment, are problems created by the firms  
3 themselves. They have created this universe. I mean,  
4 you haven't. So what's your reaction to that?

5 MR. GOLDMAN: Well, it sounds good in principle.  
6 The problem in practice, and it comes back to the 98  
7 percent which some of us talked about, if you want good  
8 tax advice that you can't use your own firm for, the  
9 reality is, you know -- and I looked at, yes, I don't  
10 want to be negative on some of the firms you'll be seeing  
11 on session 10 here, but the reality is there aren't many  
12 firms that could provide that.

13 And so if you want the best service that can do  
14 these questions you have, you've got to look for the best  
15 folks. And so you have to find -- how do you find a way  
16 to have other firms provide those services. So in our  
17 case, we use Ernst & Young for tax services when our  
18 auditor is Deloitte. I mean, I don't know -- I mean, I  
19 could look -- you know -- so you're saying how do you use  
20 a non-big four, so to speak, and I don't think the others  
21 have nearly the competency that we want to see in terms  
22 of some of the structures that we're looking at right

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1 now.

2           So, you know, you're right, we didn't create the  
3 problem. I would argue the problem was created when we  
4 collectively allowed eight to go to four, and we are  
5 where we are.

6           The other problem I have is, there are a lot of  
7 firms I ask for, you know, to provide tax, probably the  
8 most relevant one that I think all of us will agree we  
9 use the firms for. And there's a lot of firms that just  
10 don't have the people and capability to provide that  
11 service. And so that is, I think, heart of the issue.

12           MR. LEVY: And just to jump on -- first of all,  
13 if you were to go down that direction, clearly you would  
14 need to have a respectable time frame for transition,  
15 because you certainly wouldn't the want disruption  
16 between a firm that was engaged, to then have to exit  
17 before finishing a project. But that's it.

18           I'm really not a supporter. I think this is a  
19 bad proposal. It's really kind of creating just a, if  
20 you will, the high priest of audit. We just had audit  
21 purists. I think it's been a debate that's -- that's been  
22 kicked around and seems to be recycling. I think there's

1 a tremendous amount of benefits that the firms actually  
2 are able to provide -- to pick up on where Ken was going  
3 -- by virtue of their experience. So when -- when you  
4 bring together the accounting knowledge, the tax  
5 knowledge, the consulting knowledge, it actually creates  
6 quite a powerful capability and skill set that actually  
7 is lacking in the marketplace without that synergy.

8           So, you know, there is a real benefit to users of  
9 service like tax or consulting, because when there's new  
10 legislation like Dodd-Frank, and there's an aspect of --  
11 of complexity, living will, how do you interpret, who do  
12 you implement, those are all items that even large  
13 sophisticated financial institutions would like to get  
14 the best and brightest minds' input on. And I think that  
15 you want to have that capability at its -- at a high  
16 level. So just a couple thoughts.

17           MR. McBRIDE: My concern is where do you draw the  
18 line there. In particular, we enter into a complex  
19 business arrangements, and oftentimes the firm can draw  
20 on transaction services to help and work through the  
21 accounting issues relevant to that transaction. Or it  
22 could be a valuation issue, where they can draw on their

1 valuation services practice to help review particular  
2 accounting issues.

3           So, you know, right now I know that those areas  
4 serve as a resource to the audit team, and in some cases  
5 to the company in working through technical matters. So,  
6 you know, my concern is where do we draw the line. Where  
7 would you draw the line if we were going to go down that  
8 road?

9           MR. GOLDMAN: I would add, one of the things  
10 that's interesting enough that we learn when we're on the  
11 treasury committee, and you can ask this question later,  
12 but the -- and we had all the CEOs of the various -- or  
13 most of the firms below the top four, and interestingly  
14 enough -- if I could paraphrase most of them had no  
15 desire to get much bigger. They actually like the spot  
16 they were in. They were under the radar. They liked the  
17 less, quote/unquote, legal liability they thought they  
18 had.

19           And so the idea of having them -- I mean, I'm  
20 sure you're probably looking at whether you get any of  
21 those to become a big -- a five or six -- the reality is,  
22 the sense we had in the committee, none of them wanted

1 to go there. They were actually very happy with where  
2 they were. So the practicality of having that expertise  
3 to the next level, you know, is really a very different  
4 level.

5 MEMBER HARRIS: Mr. Goldman, when you said that  
6 disclosure is my best friend, what did you have in mind  
7 in terms of improving audit quality and independence  
8 objectivity?

9 MR. GOLDMAN: Well, you know, that's funny, I  
10 learned that -- I literally heard that from an audit  
11 partner at E&Y, and you can tell it struck with me ever  
12 since -- stuck with me ever since. And it was a very  
13 simple comment, is when it doubt, disclose everything to  
14 your auditors. When it doubt, disclose it in your  
15 footnotes.

16 And so -- and then you shine a light on  
17 everything and then everyone can make their own  
18 assessment as to, you know, the issue, if you will. And  
19 so it's something I've lived with, you know, if you will,  
20 since I've been doing this, is, you know, disclosure.  
21 It's a simple comment, disclosure is my friend. If it's  
22 disclosed, everyone can see it, and you find a lot of the

1 issues.

2           Then you -- you may have disagreements as to it,  
3 but at least it's all out there, and it's understood.  
4 And so that's something I've used forever. And it's a  
5 when in doubt, to me, put it in the footnotes, put more  
6 than -- more than you need in there, disclose everything  
7 to the auditors, and -- and then you -- then you may have  
8 to arm wrestle them some things, but at least everyone  
9 knows what it is. And you make, hopefully, professional,  
10 reasonable judgments. So that's the way I've lived in  
11 terms of my job.

12           MEMBER HARRIS: In terms of the disclosure to  
13 investors, what would that mean? How does that  
14 translate?

15           MR. GOLDMAN: Well, I mean, I think -- you know,  
16 again, it's the same concept. I mean, the thing is you  
17 asked that question -- because I do IR as well -- I mean,  
18 the thing you have to be a little careful about is what  
19 metrics do you want disclosed, because, you know, you  
20 find once you disclose a metric you have to consistently  
21 disclose it.

22           But it's the same comment, if you -- if you --

1 any of you -- you know, you'd probably get bored silly  
2 -- but if you listen to what we provide at Fortinet, yes,  
3 we probably go -- I go about 25 minutes discussing my --  
4 you know, results of the quarters, we were one of the  
5 very first companies -- and actually auditors didn't want  
6 me to do this -- but we actually provided pro forma  
7 comments, you know, obviously back to the GAAP numbers  
8 in our filings, because that was one of the things the  
9 SEC asked for or suggested to make the numbers -- you  
10 know, make your communications very consistent between  
11 what you provide the investors and what you provide the  
12 -- in your filings. And we did that.

13           And, you know, my auditor said, geez, you know,  
14 it's not GAAP - blah-blah-blah -- and we said I'm going  
15 to do it anyway because the SEC wants it, and we're going  
16 to make sure it's consistent, we're going to make sure  
17 we do the reconciliations, which we do. And you're  
18 probably going to be now looking at my numbers.

19           But -- but I think, again, it's the idea of show  
20 it there, let everyone see the numbers, see how -- see  
21 how the public and the investors see our numbers. And  
22 so, again, I look very carefully at what's required. And

1 obviously if -- if we hadn't -- if that I hadn't  
2 encouraged it, I wouldn't have done it. But I actually  
3 think that's good, as an example.

4 MEMBER FRANZEL: I want to follow-up a little bit  
5 on Jay's question about what has changed. And you all  
6 indicated that things have certainly gotten better since  
7 the Sarbanes-Oxley Act.

8 But I'd like you to elaborate on how this played  
9 out during the financial crisis in terms of increased  
10 auditor skepticism, if you saw such a thing, as well as  
11 audit committee oversight.

12 MR. LEVY: Well, given it's a financial crisis  
13 question, I think we've -- we are living through it. And  
14 I would tell you that there was a lot of focus around  
15 almost all things financial, probably starting with the  
16 valuation of financial instruments during a time frame  
17 where the market had ceased. And so what was the right  
18 valuation from a fair value perspective.

19 A lot of -- a lot of discussion, a lot of  
20 inquiry, a lot of justification to provide on our part,  
21 and actually good dialogue all the way through and up to  
22 the audit committee on the allowance for loan loss and

1 the adequacy of the allowance for loan loss, especially  
2 in a time frame where, you know, linear trends no longer  
3 were working, where there were step functions and values  
4 of underlying collateral that wasn't thought would be  
5 secured loans becoming, essentially, unsecured loans.

6           The value of the, let's say, a second lien, home  
7 equity lien where the, the value of the house no longer  
8 supports it. You know, what is the adequacy of the --  
9 of the allowance. Or, in essence, what's the right  
10 estimate of the loss content. That skepticism actually  
11 has continued in terms of -- I think -- I call it  
12 constructive tension.

13           Because even to this point when we still see that  
14 the GSCs are putting back more and more of the mortgages  
15 that were sold, that they, they are looking at having  
16 repurchased. And so that process, as you look to anyone  
17 in the service, mortgage servicing space will attest and  
18 it's clear in the financial statements continues to be  
19 an evolving area, what is the amount of the probable and  
20 estimable repurchase obligation.

21           So I would tell you that across the board on  
22 almost all of -- in fact, all of the critical accounting

1 policy areas, more, more in-depth examination, in  
2 essence, fortified, lots more time spent, and also during  
3 acquisitions because we happened to be in the position  
4 to acquire and merge with Wachovia, Wachovia had a -- has  
5 a wonderful franchise, but in 2008 it also had a pretty  
6 significant level of loans that would be classified as  
7 purchase credit impaired loans. What is a purchase  
8 credit impaired loan? How did you determine it? What  
9 was the amount of the loss content that has to be set up  
10 in terms of the SOP 03-3?

11           So very technical, very deep dive. And quite  
12 frankly, if I'm on your side of the table I want to make  
13 sure that the examiners, the firm is actually up to those  
14 -- those tasks. Again, I came back to my opening  
15 remarks, at the level that we're at and our other large  
16 bank peers, there's really two firms that -- that really  
17 audit those.

18           So it's not even a four-firm oligopoly. But  
19 that's very critical to have, if you want to continue  
20 using my term constructive tension, it's very important  
21 to have the best, most capable firm doing that  
22 examination.

1           MR. McBRIDE: And I'd add to that. And we have  
2 an investment portfolio that includes an equity kind of  
3 a venture capitalist arm. So we have -- excuse me -- we  
4 had valuation issues. It sounds like Rich's were much  
5 more complicated -- but we had a number of valuation  
6 issues in the investment portfolio.

7           But it went beyond that. We're, you know, quite  
8 a few intangible assets on our balance sheets, so we were  
9 getting into the valuation of businesses and tangible  
10 assets, etcetera, and there's quite a bit of scrutiny  
11 placed on, you know, the future cash flows associated  
12 with the businesses and recoverability good will, as well  
13 as the intangible sites.

14           And then you have to look at, you know, the tax  
15 side of all those issues, whether, you know, you could  
16 recover some of the deferred tax assets associated with  
17 the things that are on our balance sheets. So valuation  
18 up and down the balance sheet was really the key to that  
19 year-end audit.

20           CHAIRMAN DOTY: Intel has substantial foreign  
21 operations, as you noted earlier, Kevin. What are you  
22 doing about the emerging pattern, the patchwork of tenure

1 and rotation requirements that are emerging around the  
2 world, different parts of the world? How are you dealing  
3 with that?

4 MR. McBRIDE: So is the question -- just to make  
5 sure I understand the question -- is the question: Are  
6 we concerned about what would happen if, say, in Europe,  
7 they do move to mandatory rotations and how that could  
8 impact?

9 CHAIRMAN DOTY: Yes, that's of interest also.  
10 What kinds of plans are you making for the rotation  
11 regimes that are already in effect in certain countries?  
12 And certainly the proposal that looks as if it's moving  
13 forward in the UK of tenure, if you don't re-tender you  
14 must explain? There are a number of variants of this  
15 that we've been talking about through the day that are  
16 sort of gaining steam in their different levels in  
17 different parts of the world. And it seems to me that  
18 you all would be thinking about that.

19 MR. McBRIDE: You're right. We do file -- like  
20 I said, we file in 150 different jurisdictions. What I'm  
21 not sure of with respect to those proposals, is whether  
22 or not those impact listed companies, because we're only

1 listed in the U.S., or whether it relates to the  
2 statutory audits.

3           And if it does relate to the statutory audits --  
4 right now we have an integrated audit, and that's very  
5 important to us, because we get the efficiencies, because  
6 having one firm throughout the world that understands our  
7 practices gives us the ability to, you know, leverage the  
8 practices, the understanding of that institutional  
9 knowledge that both we and the auditors have.

10           But I'm not familiar enough with respect to those  
11 proposals to understand whether they do impact the  
12 statutory requirements. And if they do impact the  
13 statutory requirements, then that's something we need to  
14 get.

15           CHAIRMAN DOTY: Well, that's fair enough. I  
16 think we've exhausted time. Are there any other  
17 questions from anyone on the staff or the Board?

18           If not, it remains to thank you for having done  
19 this. This was a very informative presentation, and we  
20 look forward to seeing you again.

21           MR. GOLDMAN: Thank you. I just had one more  
22 comment actually. Just to give you a sense the

1 importance. I think all the -- both our company and all  
2 the committees I have been on, what you see today is the  
3 CEOs will now attend audit committees. And just showing  
4 how important and how substantive and fundamental the  
5 work that's being done is, you find CEOs now -- it's  
6 almost obligatory, but, you know, but -- because they're  
7 not on the committee, as you know, but they do now  
8 attend.

9 I don't know if they're your companies, but. So  
10 it's one of the things you have seen over the last 10  
11 years since Sarbanes, and maybe even before that started,  
12 but the CEOs now attend these meetings. And again, the  
13 business aspects that are reviewed in these committee  
14 meetings are much more substantive, again, than they were  
15 back, say in the '80s or '90s.

16 So I -- again, just showing how -- how the audit  
17 committee has sort of become much more profound as a  
18 committee relative to running the company.

19 CHAIRMAN DOTY: Do you see any change increment  
20 in the attempts of the CEO to determine the membership,  
21 the constitution or control the general tenure of the  
22 audit committee? There's a concern that many people have

1 raised that as the audit committees become more  
2 important, as it is in fact the centerpiece of  
3 Sarbanes-Oxley, that management in the form of the CEO  
4 does take a lot of care in trying to be sure who's on  
5 that committee.

6 MR. GOLDMAN: I think in a positive way,  
7 actually. And I'm not sure what direction you were  
8 going. But, I mean, I think the CEO actually, you know,  
9 does want to make sure that we have, you know, good audit  
10 committee members that do add value. So, whereas I think  
11 in the past they may have thought just another committee,  
12 I don't need to go to it, you know. It's sort of  
13 interesting, but now they actually care who is on the  
14 committee because they attend the committee.

15 And they, you know, I think they want to make  
16 sure it's people that they can -- you know, make sure  
17 that it's people that they can understand that they find  
18 helpful to them running the business, and know the  
19 business.

20 CHAIRMAN DOTY: But you don't think there's been  
21 an impairment of independence of the audit committee in  
22 that circumstance?

1           MR. GOLDMAN: I don't think so. I don't, you  
2 know --

3           MR. McBRIDE: I mean, the CEO is certifying  
4 financial statements along with the CFO, and it's  
5 important for them to understand the issues that are  
6 being discussed at that level. So yes, I mean, I echo  
7 the comments.

8           MR. LEVY: I just want to second what Ken is  
9 saying. I think the -- the objective of the CEO would  
10 be to have the best quality members who actually can  
11 understand, because accounting has become very  
12 sophisticated, and the audit resulting. And quite  
13 frankly, also, the risk focus that the committee has to  
14 examine, even outside of just the financials, has become  
15 such critical elements of making sure a company's well  
16 run, that it is really a focus that has enhanced the  
17 independence and enhanced the caliber of the members on  
18 the committee.

19           CHAIRMAN DOTY: With tenure of CEOs and CFOs  
20 becoming predictable, as you pointed out, Rich, it is an  
21 ironic result that sort of occurs. And of course what  
22 we've heard during the day, that in fact the audit firm

1 that is not rotated every 10 years or that goes for 30,  
2 40, 50, 70 years, that firm really becomes more in  
3 control of the corporate accounting enterprise than the  
4 CEO or the CFO perhaps.

5           Is there any -- is there any thought that if CFO  
6 or CEO terms are becoming subject to this kind of a  
7 rotation that it becomes very important, as Ken Goldman  
8 says, that at least every 15 years, that there be a  
9 tender and if you retained you explain?

10           In other words, does the tenure issue talked  
11 about on the management side reinforce the necessity of  
12 having a having a fresh look at the audit relationship  
13 at least every 15 years?

14           MR. LEVY: It's probably a worthwhile item to  
15 consider. I mean, I think there are opportunities for  
16 enhancing the existing structure. I think that the  
17 fundamental issue in the accounting space is, is actually  
18 the chief accountant, quite frankly. And in fact, also  
19 having accounting or, you know, chief accountants, CFOs  
20 and/or former partners on the committee, that is very  
21 helpful to that constructive tension. Because I don't  
22 think it matters if the CFO is there for 10 years or a

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1 year, or the CEO for that matter. I think it's really  
2 the governance and the infrastructure and what has been  
3 laid in terms of the foundation.

4           So if a mandatory re-bid is helpful to the  
5 process, that's fine. I find, I find that there's still  
6 a very steep learning curve at any organization. And  
7 it's hard enough -- to the point where Kevin was making  
8 -- for our own staff to come up to speed. And I think  
9 that is a very big -- a factor that the decision-makers,  
10 the committee would have to consider.

11           CHAIRMAN DOTY: Yes. But we may have the burden.  
12 It's very interesting that in this complex world,  
13 accounting becoming complex, the operations scattered,  
14 the necessity of having at least many affiliate firms  
15 involved, even some non-affiliates, the 900 plus member  
16 of the audit team scattered worldwide, the audit team  
17 rotating, many of the issues of management are there if  
18 you don't reexamine your audit relationship, it would  
19 seem to me. There are many, many of the retraining  
20 issues that you're going to have without regard to  
21 whether there's a new audit team coming in. Think about  
22 it.

1           You've done a great job. Thank you for being  
2 such a great panel.

3           Yes, we'll go to the next panel. we have two  
4 regulators; two regulators from a foreign -- a non-U.S.  
5 jurisdiction.

6           We have David Gerald, Founder, President and  
7 Chief Executive Officer of the Securities Investors  
8 Association of Singapore. He founded the association in  
9 1999 to contest the freeze of new shares owned by 172,000  
10 Singapore investors and Malaysian companies by the  
11 Malaysian government. They now have 70,000 investor  
12 members. They are the voice of retail investors in  
13 Singapore. They are supported by the OECD and the  
14 Accounting and Corporate Regulatory Authority of  
15 Singapore, the Singapore Exchange. Mr. Gerald was  
16 appointed in 2010 by the Monetary Authority of Singapore  
17 to be a Singapore -- to the Singapore Corporate  
18 Governance Council Task to review the Corporate  
19 Governance Code to promote high standards. And he has  
20 been in private practice in his career, a legal career  
21 spanning 30 years.

22           Kiochiro Kuramochi is the Deputy Chief Accountant

1 for Internal Accounting and Auditing and Disclosure  
2 Division of the Financial Services Agency of Japan, a  
3 very close collaborator with our own PCAOB and Audit  
4 Inspection Cross-Border Board Oversight, and a member of  
5 IFIAR, appearing here for the first time before the Vice  
6 Chairman of IFIAR.

7 We welcome you both and look forward to hearing  
8 what you have to tell us about your own regimes and what  
9 you see in these concepts.

10 MR. GERALD: Thank you. Thank you Chairman and  
11 members of the PCAOB. Thank you very much very inviting  
12 me to share my views as an investor on auditor  
13 independence, objectivity, professional skepticism.

14 You are seeking public comment on how this could  
15 be enhanced on mandatory audit firm -- especially  
16 mandatory audit firm rotation. At the outset, I wish to  
17 say, sir, the views expressed in my opening remarks are  
18 entirely my own and do not necessarily reflect those of  
19 Singapore or the Securities Investors Association,  
20 Singapore. I am neither an accountant nor an auditor.  
21 As you have said, I'm a lawyer with -- in practice for  
22 many years, but only recently my involvement with

1 auditors; a simple-minded investor, sir, so please do  
2 accept my apology if I reflect the ignorance of the  
3 practice of auditors as understood by this honorable  
4 Board.

5           With markets opening up in Asia and the  
6 liberalization of investing rules, it is now easier for  
7 investors to do cross-border investing. Corporate  
8 governance and accounting standards are not well  
9 developed, especially in countries like China and India.  
10 Shareholder activism is also not prevalent in Asia.

11           Auditor independence is the key to investor  
12 confidence in financial statements. The fact that the  
13 financial statements are audited gives them a level of  
14 comfort when placing reliance on the auditor's statements  
15 for investing in the public listed company. But the  
16 current method of appointing and remunerating auditors  
17 have raised doubts in the minds of some investors on the  
18 independence of auditors. This is exacerbated by  
19 instances of failure on the part of auditors like  
20 Andersen and Enron. Central to this issue is a question  
21 whether there are sufficient safeguards and effective  
22 supervision of auditors in place to minimize failures.

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1           Some investors in Singapore are of the view that  
2 since it is the audit client who pays the auditor's fee,  
3 they doubt the complete independence of auditors. Such  
4 a situation, according to them, threatens the auditor's  
5 independence. But they are in the minority.

6           Whilst some clamor for third-party appointment of  
7 auditors and payment, canvassing that would be the answer  
8 to their worries, I take the considered view that so long  
9 as there are sufficient and effective safeguards to  
10 protect investors and sufficient sanctions put in place,  
11 together with stringent oversight by independent  
12 regulators, the call for independent third-party  
13 appointment and payment may not be necessary now. One  
14 should continue to place faith in qualified and regulated  
15 auditors as professionals capable of exercising integrity  
16 and independence.

17           Not to do so may affect the future of the  
18 profession adversely. Unless statistics support such a  
19 drastic move, status quo should be preferred. Such a  
20 move would also, I am advised, require Congressional  
21 approval here. One should not paint the entire audit  
22 profession with the same brush used to paint those few

1 who have failed. Every profession, sir, has had its fair  
2 share of shame brought by recalcitrant members. After  
3 all, to err is only human. One can never stop audit  
4 failures completely as long as humans are involved.

5 To date, in Singapore, there has not been a call  
6 from investors for a change in the mode of appointment  
7 and payment of auditors, because they have lost  
8 confidence in the integrity of the audit profession. In  
9 fact, on the value that external auditors bring to  
10 shareholders, ACCA and SIAS in Singapore conducted a  
11 survey in 2010 dealing mainly with the perspectives of  
12 educated and savvy investors. We surveyed 30,000  
13 investors, and the findings are as follows:

14 Overall, 90 percent of the respondents felt that  
15 the external audit in its current form and scope bring  
16 value to them. Only a minority felt it had very little  
17 or no value to them because of the historical nature of  
18 financial statements on which the audit opinion was  
19 formed.

20 Eighty percent of respondents felt that audited  
21 financial statements were important to them in making  
22 investment decisions.

1 More than 85 percent of the respondents felt that  
2 the provision of non-financial information such as  
3 corporate governance practices and corporate social  
4 responsibility issues would serve their decision-making  
5 purposes.

6 Independent audit oversight, the question  
7 investors have asked for many years, who audits the  
8 auditors. Expectation of investors have been met in some  
9 Asian countries. Supervision of audit quality and  
10 auditors now in place, but not in China, India, Hong Kong  
11 and a few others. On auditing the audit firm, Singapore,  
12 Malaysia, Thailand and South Korea have implemented  
13 independent audit oversight by audit regulators.  
14 Application of International Standards Quality Controls  
15 1, ensuring certain systems and quality controls are also  
16 in place in these countries.

17 Investors in some of the above-mentioned  
18 countries are becoming aware of the function of audit  
19 regulator, and therefore the comfort level is increasing.  
20 Investors' understanding of audit committee, however,  
21 especially in Asia, needs improvement. They need to  
22 understand the role of audit committees better, and need

1 to engage the audit chairman at meetings to ensure that  
2 the committee has discharged its role adequately.  
3 Singapore Companies Act 201B subsection (5) outlines the  
4 functions of the audit committee, which is to review the  
5 audit.

6           Firstly, the audit plan; secondly, the evaluation  
7 of the system of internal accountancy controls; thirdly  
8 is audit report; fourthly, the assistance given by the  
9 company's officers to the auditor, et cetera. Investors  
10 need to question the audit chairman on these matters at  
11 meetings.

12           Investor confidence in audit work could be  
13 boosted through with greater education, awareness about  
14 audit quality, the independent audit regulator's rule of  
15 auditing the auditors. This helps to ensure that  
16 auditors follow standards and perform well in key areas  
17 like professional skepticism, which helps ensure that the  
18 corporate governance system works as it stands -- as it  
19 should.

20           On mandatory rotation of auditors, the arguments  
21 in favor and against mandatory rotation are well  
22 documented, publicized and will therefore not be

1 canvassed here by me. Currently, to avoid too much  
2 familiarity between auditors and their client, the Stock  
3 Exchange in Singapore listing rules, and many other  
4 jurisdictions require the audit partner to be rotated  
5 every five years. The International Federation of  
6 Accountants also requires rotation of audit partners  
7 every seven years. Quality control reviews are also  
8 undertaken by a second partner of the audit firm carrying  
9 out the audit.

10           It is sufficient to say that the current practice  
11 of rotation should continue with enhanced and effective  
12 safeguards, and allow the PCAOB and other regulators  
13 around the world to monitor the effectiveness of the  
14 current practice of rotation of auditors every five  
15 years.

16           Moreover, the measures introduced by Sarbanes-  
17 Oxley, pursuant to the Enron debacle, does provide  
18 important and useful safeguards. The shifting of  
19 responsibility to the audit committee from the management  
20 to hire auditors and oversee the engagement and the  
21 prohibition of certain non-audit services to clients  
22 should give further assurance to investors. But more

1 importantly, the establishment of the independent  
2 oversight of the auditing profession by PCAOB in the U.S.  
3 and equivalent bodies ACRA in Singapore should increase  
4 the level of assurance to investors. The Accountants Act  
5 also in Singapore is similar to those in the west,  
6 prohibits auditors from providing certain services,  
7 including internal audit services to clients. There are  
8 regulations under the Act governing independence and  
9 ethics applicable to auditors, breach of which will  
10 attract sanctions.

11 In view of the above, it is sufficient to leave  
12 it to the audit committee and the shareholders of the  
13 company at annual meetings to decide on the appointment  
14 of suitable auditors for the company, and it is for the  
15 board to decide on the auditors appropriate remuneration.

16 It must also be noted that it is the shareholders  
17 who appoint the auditors at the annual general meeting  
18 proposed by the board of directors. Shareholders need  
19 to be active at meetings and query the board on the basis  
20 for the recommendation of the auditor to be voted on, the  
21 quantum of payment recommended and the length of the  
22 engagement of the issues that will be addressed by the

1 auditors to justify quantum.

2 Shareholder activism is necessary to ensure that  
3 the right auditors are appointed and paid correctly.  
4 Should the shareholders be active on these issues, in my  
5 view, the likelihood of auditors and the management of  
6 the listed companies acting in cahoots will be further  
7 minimized.

8 I would like to make very quickly three  
9 recommendations.

10 Mandate full time internal auditor. Perhaps to  
11 enhance not only vigilance against fraud and criminal  
12 activity, but also professional skepticism and quality  
13 of audit, public listed companies should be mandated to  
14 appoint full-time internal auditors. A full-time  
15 internal auditor, though engaged by the company through  
16 the audit committee, should report directly to the audit  
17 committee, the chairman and the board, and not the CEO.  
18 He should report to the CEO only on operational and  
19 administrative matters.

20 The advantage of this suggestion is that it will  
21 give the necessary assurance investors are looking for  
22 in avoiding a situation like Enron, and will also

1 minimize mistakes. As demonstrated by Cynthia Cooper in  
2 the WorldCom case, an internal auditor can act quickly  
3 to bring misconduct to justice. The internal auditor  
4 could be the watchdog for the investors and the  
5 stakeholders of the company. In my view, this will also  
6 enhance the independence of external auditors. It will  
7 also help in the appointment and remuneration of external  
8 auditors. It will make the issue of mandatory rotation  
9 a moot point. This way the management will be kept in  
10 check. Internal auditors presence will help external  
11 auditor to shorten time to understand the company's  
12 culture, besides minimizing fraud within.

13           Second recommendation would be that we should  
14 enhance board's responsibility. The most effective fraud  
15 prevention is to have an effective board that is  
16 responsible for risk governance and internal controls.  
17 The board is now required to play a more proactive role  
18 under these new and tough rules issued by the Singapore  
19 Exchange, effective on 29 September, 2011, the 2012 Code  
20 of Corporate Governance issued by the Monetary Authority  
21 of Singapore on 2nd May 2012, and the Risk Governance  
22 Guidance for Listed Boards Guidelines issued by Corporate

1 Governance Council on 10th May, 2012.

2           The board must identify risk areas, set risk  
3 tolerance strategies, and oversee implementation of risk  
4 management. On an ongoing basis, the board needs to  
5 continually monitor and assess the adequacy of the risk  
6 management managers it has put in place, oversee the  
7 system of internal controls, and ensure that management  
8 takes appropriate steps to mitigate risks.

9           Thirdly, transparency. There must be  
10 transparency of independent oversight work. I support  
11 the view that the independent oversight regulator's work  
12 should be made public so that investors will be in the  
13 know. It will enable the investors as shareholders to  
14 make an informed decision on the appointment of auditors.

15           In conclusion, it is the enhancement of  
16 safeguards, and not changing the current model of  
17 appointment of auditors and payment to them is what is  
18 needed. Thank you, sir.

19           CHAIRMAN DOTY: Thank you for that thoughtful  
20 view of Singapore and law and the markets.

21           And Koichiro?

22           MR. KURAMOCHI: Chairman Doty, members and staff

1 of the PCAOB, thank you very much for this opportunity  
2 to participate in this discussion of auditor  
3 independence, objectivity and professional skepticism.  
4 Please be reminded that at the outset that the views I  
5 express this afternoon are my own remarks and are not  
6 necessarily representing those of Japan or the Financial  
7 Services Agency.

8           With respect to the enhancement of the audit  
9 quality, we have also had many discussions in Japan for  
10 decades and have made a series of reforms to our systems  
11 and auditing standards. The steps we have taken on  
12 auditor independence, objectivity and professional  
13 skepticism include the following:

14           The Certified Public Accountants Act, our  
15 legislation governing CPAs and auditor activities,  
16 stipulates principles such as independence, and further  
17 prescribes specific requirements for independence. For  
18 example, lead audit engagement partners and audit  
19 reviewing partners are subject to five-year rotation  
20 requirements with a five-year cooling-off period, similar  
21 to the United States. And all the other audit partners  
22 are subject to a seven-year rotation requirement with a

1 two-year cooling-off period.

2 Other examples include stringent restrictions on  
3 non-audit services. In addition, the Certified Public  
4 Accountants and Auditing Oversight Board, which is called  
5 CPAAOB was established as an independent body in the  
6 ambit of the FSA in 2004, and it has been conducting CPA  
7 examinations, as well as inspections of the audit firms.  
8 The Japanese auditing standards as set by the Business  
9 Accounting Council, which is established under the FSA.

10 Furthermore, we are currently engaged in revising  
11 the Japanese auditing standards to enhance auditors'  
12 professional skepticism, as well as auditors' response  
13 to accounting frauds. Audit committee of the Business  
14 Accounting Council started deliberation on this topic in  
15 May 2012, aiming at concluding the discussion in about  
16 one year. I personally expect the following matters  
17 would be covered in the deliberation.

18 One, reaffirming the importance of professional  
19 skepticism.

20 Two, clarifying auditors' response to accounting  
21 frauds.

22 Three, how the firm-level involvement should be

1 articulated.

2 Four, enhancing auditors' report by including  
3 additional information.

4 Five, improving education and training to deal  
5 with accounting frauds.

6 Six, how audit evidence should be evaluated.

7 Seven, how auditors should modify auditor --  
8 audit planning to address a revised assessment of risk  
9 of material misstatement or an identification of fraud  
10 risk factor.

11 The PCAOB's Concept Release discusses audit firm  
12 rotation from various aspects. We also debated over  
13 potential audit firm rotation six years ago. At that  
14 time, there was an accounting fraud incident committed  
15 by a large listed company and the company's auditor  
16 issued a clean opinion, although the auditor's audit  
17 partners had knowledge of the fraud.

18 In response to the incident, we deliberated on  
19 how auditor independence should be enhanced. After a  
20 thorough deliberation, the stringent partner rotation I  
21 mentioned earlier, rather than audit firm rotation, was  
22 introduced, because of the following reasons.

1           One, disruption of the auditor's accumulation of  
2 knowledge and experiences.

3           Two, costs associated with the change in  
4 auditors, on the auditors' as well as issuers' sides.

5           Three, the fact that mandatory audit firm  
6 rotation had not been put in place in major developed  
7 countries.

8           Four, practical difficulties in audit firm  
9 rotation due to limited number of large audit firms.

10           As a result of the financial crisis, we  
11 understand that various debates are in progress in --  
12 with regards to audits in the United States, as well as  
13 Europe, although direct effects of the financial crisis  
14 were relatively limited in our country compared with the  
15 situations in the United States and in Europe.

16           Japan also experienced the burst of the bubble  
17 economy in the 1990s, and subsequent collapse of large  
18 companies. Prompted by such incidents, we have debated  
19 over the role of audits for decades and implemented  
20 various changes in our systems. We consider that the  
21 measures responding to accounting frauds should evolve,  
22 as accounting frauds become increasingly scheming and

1 complicated. At the same time, we believe that  
2 exercising professional skepticism should be the  
3 foundation for the financial statement audit.

4 We understand that institutional measures such as  
5 audit firm rotation are debated when audit failure  
6 occurs, as we also have similar experiences. However,  
7 when revising the established system, we believe that it  
8 is important to have cool-headed discussions, carefully  
9 exploring whether or not the possible change would truly  
10 have positive effects on professional skepticism or  
11 accumulation of knowledge/experiences of auditors.

12 Given the globalization of corporate activities,  
13 audit systems are getting increasingly prone to global  
14 influence, and PCAOB's decision could have certain  
15 effects on Japanese companies and Japanese audit firms.

16 I appreciate this opportunity to express my views  
17 today, and I hope that PCAOB gives due consideration to  
18 various views and reaches an appropriate decision at the  
19 end.

20 Thank you very much.

21 CHAIRMAN DOTY: Thank you both.

22 I have to say before asking any of my colleagues

1 whether they have questions, that, on behalf of the  
2 PCAOB, I know that you know that we value very much the  
3 relationship we have with each of your governments on  
4 cross-border oversight. It's meant a great deal to us  
5 to know that where there are issues of inspection that  
6 can be troubling, that you -- we've always found a very  
7 helpful, cooperative attitude in both of your regimes,  
8 both of your countries toward our inspections. And we  
9 think it's worked to our mutual benefit. And we look  
10 forward to continuing to do it.

11 I hear David's comments on some of the regimes --  
12 on some of the states in his region that are not  
13 accessible and that are not transparent, and I know that  
14 in your own -- in Japan, it's been a special benefit, we  
15 think, that we've been able to conduct inspections and  
16 reach the point at which in the last year we achieved as  
17 absolute -- an actual formal protocol on it.

18 With that, and not knowing how much our board  
19 members want to get into foreign law, I will nonetheless  
20 ask Steve Harris, any thoughts?

21 MEMBER HARRIS: I do have a question. But I want  
22 to defer it to our Vice Chairman.

1 CHAIRMAN DOTY: All right. Lewis, anything?

2 MEMBER FERGUSON: I have a question. It's kind  
3 of one that puts you on the spot here. This has nothing  
4 to do with the auditor rotation. As you know, the -- you  
5 may or may not know, the PCAOB has over 900 non-U.S.  
6 audit firms registered with us, including 100 in China,  
7 50 in the People's Republic of China and roughly 50 in  
8 Hong Kong. We're not able to inspect those firms. We've  
9 been negotiating with China, but we're not able to  
10 inspect those firms. I don't know if we will be able to.

11 Those firms audit registrants and companies that  
12 are registered in the United States that actually have  
13 billions of dollars of market capitalization in this  
14 country held by U.S. shareholders.

15 What's your advice to us? What do we do? How do  
16 you advise -- I mean, you all live in Asia, you know the  
17 market there, you know the climate there. What do you  
18 suggest we do with these, with these audits?

19 MR. GERALD: These are companies that are listed  
20 NASDAQ or --

21 MEMBER FERGUSON: The New York Stock Exchange,  
22 yes.

1           MR. GERALD: Oh, the New York Stock Exchange.  
2 And these companies have -- and we have the same problem  
3 as Singapore, they are listed in Singapore but they are  
4 operating in China, management in China, monies are kept  
5 in China, and they have two people sitting in an office  
6 in Singapore.

7           And we've had -- on my return, I'm having a  
8 dialogue session with the shareholders of a company  
9 called China Sky. They are refusing to comply with the  
10 listing rules, and challenging the Exchange, taking the  
11 Exchange to court, but they're all in China; they won't  
12 come to Singapore. So I think the regulators have to now  
13 really think about how to deal with foreign listings,  
14 because foreign listings are becoming a liability to the  
15 shareholders.

16           What do we do with them? If they're listed in  
17 Singapore, I'm suggesting to the exchange that they ought  
18 to provide a bond, a bank, you know, bond, or they must  
19 provide some sort of safety net for the investors in  
20 Singapore before taking the monies outside Singapore.  
21 From Singapore, if you want to transfer it to China, you  
22 ought to have the safeguards.

1 I'm asking the Exchange can we look at the  
2 safeguard. This is not about a Singapore company doing  
3 something wrong to Singapore investors; we can take them  
4 to court. But this is about the foreign company which  
5 runs away and cannot subject themselves -- do not want  
6 to subject themselves to the jurisdiction of Singapore  
7 or United States.

8 So you've got to ask these people, if they want  
9 to come to the United States or Singapore and raise funds  
10 from the public, from our citizens, they have to give  
11 some assurance that they will not deal with the citizens  
12 wrongly; they will not do the things that, you know, that  
13 the others have done. Because I'm sorry, all have to be  
14 treated equally. You've got a constitutional issue  
15 there.

16 But in Singapore we are thinking of putting  
17 pressure on the, you know, on the regulators to ask if  
18 they would put safeguards in place, either requiring  
19 independent directors or the auditors of the companies  
20 to certify that the monies are being transferred for  
21 genuine bona fide reasons and that it should not be  
22 transferred like they did in one case, because I know in

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1 one case 80 million was transferred.

2           And do you know what, I spoke to the chairman  
3 through an interpreter on the phone, and he said all the  
4 monies are safe, 80 million. And the next day, the  
5 independent -- the executive directors made the statement  
6 that we are only 17 million. And then the following day,  
7 another person makes a statement saying that we are not  
8 going to give you any more.

9           So, you see, if foreign listings are coming to  
10 the United States or to our country, we need to put  
11 safeguards in place. That's my reply to your question.

12           MR. KURAMOCHI: Thank you for the question. This  
13 is a very difficult question. At the same time, what I  
14 can say here is, I think we have to continue the  
15 discussion so that they realize, international  
16 corporations really provide the mutual benefit.

17           Actually, I am also working for IOSCO. IOSCO is  
18 the International Corporation for the Security Regulator,  
19 and I'm working on the Accounting and Disclosure  
20 Committee, which is a standing committee, and China has  
21 a representative on that committee. And we have a lot  
22 of dialogue. And this kind of continued dialogue

1 actually, you know, changed the perception.

2           What I can say is, we have to continue the  
3 dialogue. And having seen the globalization over the  
4 capital market, it is kind of impossible to isolate one  
5 country from other countries. So I think the continued  
6 dialogue could open the door. Thank you.

7           MR. GERALD: Chairman, if I may add a few more  
8 comments. From my experience, the Chinese government  
9 does not want to cooperate with the foreign exchanges,  
10 because the Chinese -- they do not like Chinese companies  
11 listing elsewhere. They said they have not gone through  
12 us. I went to see the Chinese ambassador in Singapore,  
13 and they appointed a very senior officer to see me, and  
14 he said that we will do everything we can, but never got  
15 back to me. When I got back to them, the answer is  
16 there's nothing we can really do.

17           There isn't an extradition treaty between  
18 Singapore and China to bring those culprits back. And  
19 I do not know about the United States, but they are  
20 refusing to everyone. So it's going to be very difficult  
21 to enforce. So investors are being asked to look at  
22 these companies very carefully by us before they embark

1 on investing or parting with their precious dollars. And  
2 I think there must be this reckoning by investors, that  
3 if you invest in a foreign company where everything is  
4 outside, you're not going to get -- trace or track your  
5 money -- you may not be able to track your dollar; that's  
6 the bottom line. So you've got to be very, very careful.

7           Having said that, there are also very  
8 enlightening Chinese companies in Singapore who follow  
9 proper governance and who are interested in, you know,  
10 working with us. So these are the -- we've got about 14  
11 companies that have gone astray. But the rest of the  
12 156, you know, we find many of them are realizing that  
13 they need to, if they come to Singapore, they need to  
14 work with us, they need to work with our regulators'  
15 Exchange on corporate governance.

16           MEMBER HARRIS: Well, Mr. Gerald, I just want to  
17 express my appreciation for your testimony in Busan,  
18 South Korea in terms of the importance of establishing  
19 independent audit regimes in the Asia community, which  
20 is not currently the case in a number of jurisdictions.

21           MR. GERALD: Yes.

22           MEMBER HARRIS: I thought that was very powerful

1 testimony. And we realize you traveled quite a bit to  
2 get here today, and very much appreciate your testimony  
3 today.

4 MR. GERALD: Thank you, sir. Thank you very much  
5 for inviting me. I'm always available to improve the  
6 situation for shareholders.

7 MEMBER HARRIS: And then, Mr. Kuramochi, it's --  
8 once again, we very much appreciate your being a member  
9 of the Investor Working Group of IFIAR, and your  
10 participation has been very helpful, and we look forward  
11 to that continued assistance in London.

12 MR. KURAMOCHI: Thank you very much.

13 MEMBER HARRIS: I note that, that you indicate  
14 here that there's other audit partner rotations and team  
15 rotations subject to a seven-year rotation requirement  
16 in Japan. If you could either send us some background  
17 in terms of how you reached the seven-year team rotation  
18 and why that's important in Japan and how that came  
19 about, that would be appreciated, or if you know the  
20 answer right now.

21 Others have talked about not only engagement  
22 partner rotation, which we have under Sarbanes-Oxley, but

1 people have recommended team rotation. And if you care  
2 to comment, why does Japan think it's important to have  
3 seven-year team rotation?

4 MR. KURAMOCHI: Okay. And so first I have to  
5 clarify. So we have a like two-tier partner rotation  
6 system. The engagement partner, I mean the lead  
7 engagement partner has to be rotated by five years. And  
8 the rest of the partners or lead partners have to be  
9 rotated by seven years.

10 The reason why we think all the partners have to  
11 be subject to the, you know, this rotation requirement  
12 is, you know, there's interaction between management and  
13 the partners, and in certain periods we have to change,  
14 you know, all the partners. And I think this is very  
15 important to keep the independence of the audit firm to  
16 change all the partners.

17 MEMBER HARRIS: Thank you.

18 CHAIRMAN DOTY: We have about less than 10  
19 seconds left on time.

20 Brian, yes, go.

21 MR. CROTEAU: Thank you very much. My question  
22 I think is a quick question for David, and it relates to

1 what I think -- and you might correct me if I'm wrong,  
2 or if you're able to talk about this that would be  
3 helpful -- but I think there was a requirement for  
4 rotation of firms, at least for banks in Singapore, that  
5 was lifted in 2008 but had been implemented before that.  
6 I'm not sure if it ever took effect, but I think in 2008  
7 there were concerns over disruption. It was lifted. But  
8 I wondered if you could just say a few words about that  
9 and provide a little background about that.

10 MR. GERALD: Yes, you've got me there. But the  
11 reason is I think that Singapore is also grappling with  
12 bringing in little island, institutions, financial  
13 institutions, listing companies, and companies to list  
14 in Singapore, and there had been some feedback on the  
15 disruption is costly to the banking industry, and  
16 therefore there was a review.

17 But those methods are still under review, and I  
18 do not know -- I'm not a part of the regulators, you  
19 know, in business. But I think as we go along, new rules  
20 will evolve to make it easier for banks to do business.

21 If I may ask, Mr. Chairman, any reaction to the  
22 suggestion that you should mandate internal auditors as

1 a full-time officer in the, in the public listed  
2 companies? We are trying to do that in Singapore now.  
3 I mean, our association is pushing for that.

4 CHAIRMAN DOTY: U.S. public companies routinely  
5 now have full-time internal audit services. It's not  
6 something the PCAOB would normally do under our  
7 authority. Our authority is over registered firms, not  
8 over corporate governance structures or the management  
9 structure of a business corporation. I think the SEC  
10 disclosure regime gets very clearly to us. So a company  
11 that did not have an internal audit function would have  
12 to say something about that. That would be something I  
13 think that would make it very difficult. Marty?

14 MR. BAUMANN: Thanks. I have a question for  
15 Koichiro.

16 Many who have talked here today talked about the  
17 fact that it would be very hard to change auditors in the  
18 United States because there's only four firms auditing  
19 98 percent of the market cap or whatever it is. And for  
20 Japanese listed companies, do you have essentially the  
21 same thing? Is your market dominated by just four firms  
22 for the Japanese-listed companies in Japan?

1           MR. KURAMOCHI: The situation is very similar,  
2 especially for the large listed companies. Most of the  
3 large listed companies are audited by four audit firms,  
4 the four accounting firms. Because large listed  
5 companies have subsidiaries all over the world, and they  
6 have to get audited, and their international network is  
7 very, very essential. So that is why, you know,  
8 concentration situation in Japan is very similar to the  
9 United States. Thank you.

10           CHAIRMAN DOTY: I guess I should also say that  
11 our communications with auditor committee standards  
12 would, David Gerald, it would require the auditor to talk  
13 to the audit committee about their assessment of the  
14 strength of internal audits, whether or not it was  
15 adequate, and whether or not they were reliable. So we  
16 get at -- there are two disclosure channels into the  
17 existence of being a full-time internal audit.

18           I think it's for me to say thank you all again  
19 for coming a long way and for being good partners in  
20 cross-border oversight.

21           MR. GERALD: Thank you.

22           MR. KURAMOCHI: Thank you very much.

1 CHAIRMAN DOTY: And we now are going to the  
2 firms.

3 David Follett. Dave Follett is the Chief  
4 Practice Officer of Moss Adams, LLP. He's practiced  
5 public accounting since 1992. He's been a partner since  
6 2001. In October 2011, he was appointed Chief Practice  
7 Officer of Moss Adams. In this roll, he has full  
8 responsibility for client service, oversight of industry  
9 service groups, and responsibility for the firm's  
10 business development functions. Extensive experience  
11 working with larger middle-market companies, public and  
12 private. Past chair of the firm's SEC corporate finance  
13 group. Co-chair of the International Services Group.  
14 Continues to serve as the reviewing partner on audits of  
15 public companies. Professional accounting fellow with  
16 the Division of Corporation and Finance of the SEC.  
17 Welcome to Dave Follett. And other professional  
18 qualifications that are in his resume.

19 Tom Gard joined Armanino & McKenna, LLP as an  
20 audit partner in 1996. Became partner in charge of the  
21 audit practice, 2005. Seven years with KPMG, became an  
22 audit senior manager, and served as CFO and COO for a

1 regional and commercial insurance brokerage. He's been  
2 a certified public accountant since 1984, member of the  
3 AICPA. In 2002, received his accreditation from the  
4 AICPA in Business Valuation. Been qualified as an expert  
5 witness in various jurisdictions. Extremely involved  
6 with clientele on the distribution of financial services  
7 and technology sections, has deep experience with  
8 publicly-traded clientele and the rules and regs of the  
9 SEC. Welcome Tom Gard, and to Dave Follett.

10 Paul Regan, Chairman of Hemming Morse. Mr. Regan  
11 is chairman. Has been a certified public accountant for  
12 more than 40 years. His work in the accounting  
13 profession includes experience as an auditor and a  
14 consultant. As an auditor, he served as an engagement  
15 partner, supervised audits of public and private  
16 companies. As an accounting expert, he has testified in  
17 more than 100 trials and arbitrations and in more than  
18 200 depositions, and has worked on more than 750 complex  
19 litigation matters, many of these involving extensive  
20 analysis and determination of GAAP, our own auditing  
21 standards, and SEC reporting. His testimony has been on  
22 behalf of companies, as well as for various state and

1 federal agencies. He has undergraduate and graduate  
2 degrees in accounting. Designated by the American -- by  
3 the AICPA as a Certified Financial Forensics, a CFF. He  
4 is a past chair of the California Society of Certified  
5 Public Accountants, and is a current member of its  
6 council. Also past member of the AICPA's governing  
7 council.

8           Gilbert Vasquez, Managing Partner, Vasquez &  
9 Company. He has managed and directed a successful  
10 practice in public accounting, auditing, taxation, and  
11 financial consulting since 1967. Recognized as a  
12 prominent CPA, community leader and entrepreneur. Past  
13 president of the California Board of Accountancy. Many  
14 honors, including the Mexican-American Legal Defense and  
15 Education Fund Achievement Award, the Coca Cola Golden  
16 Hammer Award, Citizen of the Year by the Northeast  
17 Chapter of the American Red Cross. And there are other  
18 awards here that go on and on. Holds a Bachelor of  
19 Science in Business Administration and a major in  
20 accounting from Cal State Los Angeles, and is a  
21 credentialed professor of accounting.

22           Welcome to all of you. You bring a very

1 important segment of all of this issue of the  
2 independence and objectivity to this Board, and we thank  
3 you for being here.

4 Dave Follett.

5 MR. FOLLETT: All right. Thank you, Chairman  
6 Doty, members of the PCAOB, and observers.

7 I am David Follett, the Chief Practice Officer  
8 from Moss Adams. Moss Adams is the largest accounting  
9 firm based in the western United States, and we are the  
10 auditor of many middle-market and smaller public  
11 companies. In addition, we serve privately-held and  
12 other public interest entities, including those who plan  
13 to seek capital in the U.S. equity markets in the future.  
14 We have been inspected by the PCAOB three times,  
15 including our initial inspection six years ago.

16 My firm appreciates the opportunity to  
17 participate in this public meeting on auditor  
18 independence and audit firm rotation, to further  
19 discussion on ways to enhance auditor independence,  
20 objectivity and professional skepticism. We are committed  
21 to the ongoing efforts to continue to improve audit  
22 quality in our firm and in the profession.

1           We believe SOX has had a positive impact on audit  
2 quality. The creation of the PCAOB and the strengthening  
3 of the role of the audit committee have built a solid  
4 foundation for enhancing investor protection. I  
5 personally served as the signing engagement partner on  
6 the audits of issuers, and believe in and have witnessed  
7 improvement in audit quality since the enactment of  
8 Sarbanes-Oxley in 2002. This includes the enhanced  
9 oversight and participation of audit committees.

10           Auditor objectivity and professional skepticism  
11 are at the root of audit quality. The PCAOB and the  
12 profession should continue to seek ways to improve  
13 objectivity and skepticism. Actions taken for  
14 improvement by the PCAOB should be supported by objective  
15 evidence of the cost to implement, and more important,  
16 the achievement of the benefit of improved audit quality.  
17 As I will discuss further, we do not believe mandatory  
18 firm rotation achieves the objectives of improving audit  
19 objectivity, and therefore we, along with the majority  
20 of stakeholders who have commented on this Concept  
21 Release, are opposed to the PCAOB's proposal.

22           We believe mandate of firm rotation would

1 undermine the authority of the audit committee whose role  
2 has been enhanced by the implementation of SOX. Audit  
3 committees are essential to maintaining an appropriate  
4 oversight of the issuer-auditor relationship. Mandatory  
5 firm rotation inappropriately prohibits an entity's  
6 ability to continue with an existing auditor even if the  
7 audit committee determines it's in the best interest of  
8 the entities shareholders.

9           And I would insert that while there's been some  
10 comments on the activities and the role that the audit  
11 committees play, I can comment in the smaller and  
12 middle-market companies. I'm pleased to say that what  
13 we see is a very robust activity and communications in  
14 dialogue with those committees, and they're very engaged  
15 in the company's operations and their role. Further,  
16 research does not support audit firm longevity as a root  
17 cause for audit failures or a lack of objectivity or  
18 skepticism. Mandatory rotation would cause significant  
19 disruption and an increase in costs. We believe there  
20 would be a disproportionate burden on middle-market and  
21 smaller public companies as a result of mandatory  
22 rotation.

1           SOX has improved audit quality in many ways. In  
2 response to the increased responsibility placed on  
3 management to assess and report on internal controls of  
4 financial reporting, SEC issuers have been more  
5 responsive to improving upon internal control  
6 deficiencies. Audit committees have also become more  
7 involved in the understanding of the internal control  
8 deficiencies identified by management and the auditor,  
9 and more insistent in requiring changes be implemented  
10 to address these deficiencies.

11           In addition, requiring audit committees to be  
12 responsible for the hiring, retention and termination  
13 decisions of the independent registered accounting firm  
14 has created a better oversight to the relationship  
15 between management and the auditor. Finally, the PCAOB  
16 inspection process has helped firms identify areas to  
17 improve audit quality. Overall, these areas create  
18 foundations and opportunities for continued improvement.

19           As noted in many of the comment letters received  
20 by the PCAOB, there are alternatives to mandatory firm  
21 rotation that involve less risk and less cost. We  
22 recommend that PCAOB focus its efforts on constructive

1 dialogue with stakeholders to determine alternative  
2 approaches to mandatory firm rotation that will have a  
3 positive impact on auditor independence, objectivity and  
4 professional skepticism, such as the following.

5           Engaging with audit committees to improve their  
6 corporate governance practices, including the training,  
7 evaluation of auditor performance, and the sharing of  
8 best practices.

9           Performing root cause analysis of audit  
10 deficiencies identified during internal and PCAOB  
11 inspections, and providing more open collaboration  
12 between the PCAOB and the profession on steps to be taken  
13 in response to these findings.

14           Third, increasing transparency between auditor  
15 and audit committees, including the communication  
16 inspection findings, and enhancing audit firm quality  
17 control and training with a focus on continued  
18 improvement of objectivity, skepticism and audit  
19 performance.

20           The profession has come a long ways over these  
21 last 10 years, but we also recognize that continued  
22 improvement is necessary. Moss Adams looks forward to

1 the opportunity to participate in the efforts to improve  
2 audit quality. We appreciate the opportunity to  
3 participate in these important round-tables and look  
4 forward to the discussion today.

5 MR. GARD: Thank you. On behalf of Armanino  
6 McKenna, I appreciate the opportunity to participate in  
7 this panel to express our views on various means to  
8 enhance auditor independence, objectivity and  
9 professional skepticism.

10 I'd like to take this opportunity to give the  
11 Board a brief overview of our firm. Over the past 50  
12 years, Armanino McKenna has become largest  
13 California-based accounting firm with over 350  
14 professionals located in the San Francisco Bay Area and  
15 throughout the west coast. We provide audit, tax and  
16 consulting services to a diversified client base  
17 operating in multiple industries. Our audit clients are  
18 both privately held and publicly traded, and include many  
19 with either national or international operations.

20 Typically, these accounts are headquartered in  
21 the Bay Area, with multiple locations either across the  
22 country or around the globe. We have provided services

1 to registrants for nearly 20 years, including services  
2 in connection with various offerings.

3           Quality is the cornerstone of our firm's audit  
4 service approach. We are proud that the results of our  
5 peer reviews and periodic inspections demonstrate the  
6 quality with which we approach our work. The primary  
7 goal of our profession has to be to develop and preserve  
8 investor and creditor confidence in financial  
9 information. Anything less than that is not acceptable.  
10 I think most of us could agree on this objective. If we  
11 do not enhance investor and creditor confidence in the  
12 client's financial statements, we must question the value  
13 of the services we are providing.

14           The pursuit of audit quality is a major objective  
15 for standard-setting organizations around the world. In  
16 December of 2011, various audit reform proposals were  
17 advanced in the European Union, including mandatory  
18 rotation of audit firms with defined cooling-off periods  
19 and prohibition from providing non-audit services to  
20 public interest entities. Similar requirements are being  
21 evaluated around the globe to determine their effect on  
22 audit effectiveness. We applaud all actions towards the

1 goal of increasing audit effectiveness.

2           Audit firm rotation is a significant  
3 consideration. Since the adoption of the Sarbanes-Oxley  
4 Act, engagement partner rotation has been required after  
5 five years. If audit firm rotation is to be implemented,  
6 the ramifications of such a change will need to be fully  
7 evaluated. The costs and benefits of such change must  
8 be carefully weighed and balanced. Requiring rotation  
9 of the audit firm will have some negative consequences.  
10 These have been discussed repeatedly in prior public  
11 meetings and comment letters. I will not repeat all of  
12 these possible consequences here.

13           However, a main ramification is the disruption  
14 caused by any change and the additional time and effort  
15 required to bring a new audit firm up to speed with the  
16 company being audited. No matter how well-coordinated  
17 the transition is, a change does involve significant time  
18 and effort of both registrant and audit firm personnel.

19           It is also my experience that it may take an  
20 audit firm at least one audit cycle, if not more, to  
21 fully acquaint themselves with the company being audited,  
22 to be able to design and implement the most effective

1 audit they can plan. Thus, audit firm rotation may  
2 actually decrease audit effectiveness in the early years  
3 of the rotation.

4           This statement in no way implies that the  
5 first-year audit is in some way deficient, that it's just  
6 not planned with the same level of understanding of  
7 company operations that is obtained after going through  
8 the entire audit process. Subsequent audits benefit from  
9 this understanding, and the efficiency and effectiveness  
10 of subsequent years audit improve.

11           The main driver for audit firm rotation is to  
12 prevent complacency in the auditor by introducing new  
13 perspectives at regular intervals. However, I'm not  
14 aware of strong evidence showing a direct correlation  
15 between auditor tenure and audit deficiencies, much less  
16 the amount of time before complacency begins to occur.  
17 The PCAOB in its Concept Release stated preliminary  
18 analysis appears to show no correlation between auditor  
19 tenure and number of comments in PCAOB inspection  
20 reports. Thus, are we considering a remedy to audit  
21 deficiencies that will not be effective?

22           In any respect, doesn't the rotation of the

1 engagement partner already make significant strides  
2 toward preventing such complacency? Certainly, a new  
3 perspective and a fresh re-questioning of audit approach  
4 in past decisions is inherently healthy in the audit  
5 process. Thus, are we really obtaining diminishing  
6 returns on improving audit effectiveness by requiring  
7 audit firm rotation in lieu of the current audit partner  
8 rotation? In other words, are the costs incurred to  
9 rotate the audit firm worth the incremental benefits?

10           We do see one potential benefit of audit firm  
11 rotation that should not to be understated. In a  
12 marketplace with many viable audit firms vying for a  
13 company's business, there should be inherently healthy  
14 competition. A company can typically choose its audit  
15 firm from firms of varying size, skill sets and  
16 demographics, and with certain differences in audit  
17 approach. However, for registrants, the overwhelming  
18 audit service providers are national firms, and of  
19 national firms, very markedly, the big four firms.

20           Thus the competitive landscape in selecting an  
21 audit firm for public companies is very different from  
22 the landscape enjoyed by private companies. Preference

1 for national firms is dictated by several factors, some  
2 very valid, and other reasons, perhaps legacies from  
3 common practice.

4           Certainly, very large public registrants may  
5 require the largest public accounting firms to benefit  
6 from the audit firm's geographical diversity and  
7 locations. However, many registrants are not as  
8 geographically spread and could benefit from the service  
9 approach that smaller firms provide. We believe there  
10 are many registrants that a regional firm like ours can  
11 service in a more responsive manner, where we are just  
12 a better match of resources to the company's primary  
13 needs.

14           However, given the current competitive landscape,  
15 the frequency of registrants looking beyond the national  
16 firms is relatively low. Underwriters, private equity  
17 firms and financial institutions with long business  
18 relationships with various national firms help perpetuate  
19 this marketplace. Again, sometimes are warranted for the  
20 size and geographical footprint of the company in  
21 question, but many times not.

22           Requiring audit firm rotation could assist in

1 changing the competitive landscape for audit services to  
2 registrants. As the vast majority of registrants are  
3 audited by the big four accounting firms, requiring audit  
4 firm rotation would make for some interesting decisions  
5 for registrants. Many times consideration of other big  
6 four firms is not feasible as many may be conflicted  
7 given other services provided to the registrant. It's  
8 not uncommon for a registrant to utilize other firms to  
9 perform tax provision, internal audit, internal control,  
10 IT and valuation services. Thus the registrant's choices  
11 upon firm rotation may be few, if they solely look to the  
12 national firms, and more particularly the big four firms.

13           With fewer alternatives, perhaps the registrant  
14 will be more inclined to consider regional audit firms.  
15 More likely, other large firms will make the investment  
16 to become stronger national and/or global firms to  
17 increase the alternatives available to large registrants.  
18 Competition generally leads to new solutions and  
19 providers. I do not believe we should be afraid of  
20 increasing competition because the pool of large audit  
21 firms now appears small. If the opportunity is strong,  
22 other providers will position themselves to fill this

1 need, especially given lead time to prepare.

2           Requiring audit firm rotation could lead to a  
3 more interactive and participatory market for audit  
4 services. This increased marketplace will provide more  
5 options to the registrant, and thereby will enable the  
6 registrant to find the firm that best fits the  
7 registrant's particular needs and circumstances.  
8 Long-term increased audit quality of course cannot be  
9 compromised; however, competition generally leads to  
10 innovation and improvement, results that investors and  
11 creditors will value. The benefits and costs of  
12 mandatory audit firm rotation are difficult to quantify  
13 with precision, but must be obviously carefully weighed.

14           I want to express my appreciation to the PCAOB  
15 for the opportunity to participate in this panel. I look  
16 forward to continued dialogue and evaluation of this  
17 issue.

18           CHAIRMAN DOTY: Paul Regan.

19           MR. REGAN: Good afternoon, Mr. Chairman, and  
20 thank you for giving me the opportunity to make comments  
21 on the audit firm rotation issue. And thank you to the  
22 Board as well.

1 I'll try not to read my comments. I understand  
2 you have my comments in front of you. There's a couple  
3 of paragraphs that I might read to make particular  
4 points. You do have an understanding that my background,  
5 a couple of particular points that really provide the  
6 basis for my comments. And the basis for my comments are  
7 my individual experience. They're not the views of my  
8 firm. They're not the views of organizations that I am  
9 associated with.

10 I have been audit chair of a public company. I  
11 have been on audit committees of public companies and I  
12 have and continue to be on audit committees of non-profit  
13 companies.

14 The experience that particularly, is particularly  
15 relevant to my comments here today is in my investigation  
16 of significant audit failures since the early 1980s.  
17 You'll see I've listed in item 4 on page 1 of my comments  
18 some companies that I have investigated and I have  
19 testified on. And they include the Sunbeam Corporation,  
20 Enron Corporation, Xerox Corporation, Parmalat which is  
21 an Italian entity, and Mini-Scribe which was one of the,  
22 one of the early audit failures that I was associated

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1 with, the bricks that were disguised as 20 and 40  
2 megabyte hard drives.

3 My work has principally been for the Securities  
4 and Exchange Commission, testifying as an expert on both  
5 GAAP and GAAS, as well as the FDIC, but certainly the  
6 Resolution Trust Corporation in the '80s got me involved  
7 in this process, mostly in financial institutions in  
8 Texas, Oklahoma, Florida, New York, California, Colorado.  
9 And I also assist the PCAOB, and I have testified for the  
10 PCAOB with respect to audit failure issues.

11 My work has involved investigations around the  
12 world. They have involved auditors that are big eight,  
13 big six, big five, big four, medium-sized companies,  
14 medium-sized firms, as well as small firms. I have done  
15 and reviewed audits that were performed in the United  
16 States, Europe, Canada, Asia, South and Central America,  
17 as well as India.

18 As a consequence, my comments on mandatory firm  
19 rotation come principally from that experience and that  
20 environment. And when I read the Concept Release, there  
21 were some statements in that Release that I'm very  
22 familiar with, and I witnessed and I've seen and I think

1 are troubling. On page 2 of my comments, you'll see that  
2 I've identified five that I think are particularly  
3 important.

4 I think that the annual inspections, you've  
5 commented in the Concept Release, the inspections now are  
6 approximately 2,800, and that you've discovered and  
7 analyzed several hundred cases involving what they deem  
8 to be audit failures. In assessing that, I find that  
9 very troubling. It's a significant number, and it's  
10 concerning to me and it's concerning to, I think, a lot  
11 of other users of audited financial statements.

12 What's perhaps even more troubling is, included  
13 in the concept statement, is that although your, your  
14 results on the 2010 inspections are not complete, you do  
15 observe that you're identifying more issues now than in  
16 prior years. And that in some instances, you're looking  
17 at entities again, and there is repetition of past  
18 identified significant deficiencies. And that is, in  
19 addition, very troubling.

20 The last three points, rather than repeating  
21 them, are very similar to what I consistently have seen  
22 in my work; that is, an absence of professional

1 skepticism and acceptance of client representations  
2 without the application of appropriate auditing  
3 procedures, and an absence of objectivity. And in many  
4 instances, even activity that borders on advocacy rather  
5 than independence and professional skepticism.

6           In the cases that I've worked on, what I have  
7 seen, and what I apply a filter of, if there had been an  
8 audit rotation, is it likely that the defects in the  
9 underlying financial statements, the material departures  
10 from GAAP, would they have been detected. I think it's  
11 likely that they would have been, certainly would have  
12 been detected sooner, either because of the concern by  
13 the existing engagement team, that a new team would be  
14 replacing them in the near future from a new firm, or,  
15 in the absence of the new firm, having caution because  
16 of that concern of being replaced by another firm with  
17 a new, fresh set of eyes, then the new firm might not be  
18 willing to accept the improprieties which were in place  
19 causing a material misstatement of financial statements.

20           I've certainly read a lot of the comments that  
21 you folks have been reading and hearing. I also see the  
22 comment about partner rotation, and in the cases that I

1 worked on, partner rotation has proven to be very  
2 ineffective. And there are two principal reasons for it  
3 being ineffective.

4           And that is, that the partner who is rotated in  
5 is typically self-selected by the firm. And in some  
6 instances, selected with influence by the client. Self  
7 selection by the firm tends to select someone who is  
8 already familiar with the issues and/or familiar with the  
9 improprieties which are eventually disclosed.

10           In addition, even if the new partner comes in  
11 from -- and not having a vested interest in prior  
12 engagements, if the new partner witnesses a circumstance  
13 where there is a material misstatement of  
14 previously-issued financial statements, that new partner  
15 is subjected to monumental pressures. Because with a  
16 restatement brings massive costs to the accounting firm,  
17 massive costs to the client, probably loss of the client,  
18 massive costs of litigation, and potentially the loss of  
19 an ability to continue to practice. And some new  
20 partners are very -- well they in fact have been  
21 reluctant to bring that onslaught of cost and difficulty  
22 on them.

1 I've got a couple of comments which I think may  
2 be particularly helpful. I see a number of comments that  
3 have been made about the enormous cost of changing the  
4 auditors, but I also, in my experience, have seen changes  
5 in auditors where the costs have been reduced; the fees  
6 are less by the new auditor than the old auditor.

7 A suggestion with respect to cost reductions and  
8 quality enhancement that I would encourage you to  
9 consider. If there is rotation, the firms need help in  
10 being efficient and effective in rotation. And I think  
11 a very good source of that help is requiring the  
12 predecessor auditor to provide access, not only to  
13 certain working papers, but certainly the risk  
14 assessments and the audit work papers relating to key  
15 areas of risk with respect to the financial statements.  
16 Cooperation from the predecessor auditor would help the  
17 new auditor plan and perform an audit on a more  
18 cost-effective basis and more effective auditing  
19 procedures.

20 Finally, with respect to implementation, you  
21 certainly can't require that everyone change in seven  
22 years or five years. This is something that does need

1 to be staggered in your implementation plan. Thank you.

2 CHAIRMAN DOTY: Gilbert Vasquez.

3 MR. VASQUEZ: Thank you, Chairman Doty, members  
4 of the panel, and other guests.

5 I've been managing partner of a firm since its  
6 inception almost -- more than 40 years ago. I'm very  
7 proud to say that in that time period, we've never been  
8 sued, we've never had any complaints issued against our  
9 firm. Our firm will always be probably classified as a  
10 minority firm.

11 In addition to being past president of the  
12 California Board of Accountancy, I'm also the founder of  
13 ALPFA, which used to be Latino CPAs, and from an idea to  
14 -- I understand that our next conference which will be  
15 in August we're going to have more than 20,000 members  
16 -- I feel pretty good about that. And I started that  
17 organization because I wanted to have Latinos be  
18 represented in the accounting profession.

19 I have the distinction of serving on more than 10  
20 private companies and more than 20 non-profit companies.  
21 Of the private companies I've been involved in, five have  
22 been publicly traded. I currently sit on two boards, and

1 on the two boards since I've been chair, we've changed  
2 the auditors. In both instances the fees went down  
3 fairly significantly. There's always a learning curve,  
4 but the learning curve with smaller companies; I don't  
5 think it's as great as it is with large companies.

6 Our firm has a choice of registered PCAOB, we  
7 have a small SEC practice, but mostly we do a lot of  
8 governmental clients, a lot of non-profit clients, small  
9 private companies, tax consulting work like many other  
10 firms do. And so my experience in doing this, kind of  
11 makes me look at auditor rotation/firm rotation slightly  
12 differently than perhaps some of the other presenters.

13 One of the things that I've always felt is that  
14 the incumbent firm has a relationship with clients that  
15 will span decades, that there's a lot of pressure on that  
16 partner to be -- to make sure that that client doesn't  
17 leave that firm. And therefore, sometimes it can have  
18 an effect on independence, as well as perception.

19 And so when it comes to both firm rotation and  
20 auditor rotation, my perception is different. And aside  
21 from performing audits under the PCAOB standards,  
22 because\ we do so many governmental clients, we do work

1 under, under GAGAS, and then we do a lot of work under  
2 Circular AB-134.

3           And so in this industry there's a lot of RFPs  
4 that are going off. There's a lot of firm rotation. We  
5 get used to bidding consistently in our -- for these  
6 engagements. And obviously we always have to be  
7 competitive. The proposals are very extensive. They're  
8 very detailed because we're providing, really, the basis  
9 of how we're going to perform the audit. Some of our  
10 engagements have been in excess of \$2 million, so we're  
11 talking about pretty good fees.

12           In the prior testimonies that, that you received,  
13 one of the ones that I read, 52 percent of the public  
14 companies voluntarily changed auditors between 2003 and  
15 2006. So in a sense we have firm rotation taking place  
16 now. The European Commission's Green Paper talks about  
17 joint audits. In especially the government audit area,  
18 we do joint audits all the time. We're subcontractors,  
19 we're joint ventures. The process is seamless. The  
20 larger the entity, the more reason to have a firm like  
21 ours involved and other smaller firms.

22           So I don't maybe have the bias that others might

1 have when they look at either firm rotation and working  
2 at auditing, because, again, where I've seen that it's  
3 going to be cost prohibitive or it's ineffective and it  
4 doesn't work well, when you've been doing it as long as  
5 I have for 25 years with some of the big four firms and  
6 other firms, it's worked very, very well.

7           So my recommendation, based on 45 years of  
8 experience, and again coming from a slightly different  
9 environment is, I would be in favor of certainly  
10 mandatory rotation of accounting firms after a  
11 predetermined period. And if not mandatory, certainly a  
12 mandatory RFP period. Because that way, the firm that  
13 is doing the audit I think understands that somebody else  
14 may be looking over their shoulder, and there's a bit of  
15 complacency.

16           When I was working in federal, I was onboard 19  
17 years, we had the same audit firm from the inception  
18 until we sold out. So for years we had the same audit.  
19 And of course there was no PCAOB, there was no partner  
20 rotation, but there was a sense of, you know, we didn't  
21 need to go out to bid. This company sold in 1995, so a  
22 little bit before, you know, our time period here for

1 this issue.

2           In addition to that, I believe that if you do  
3 have mandatory rotation, that you'd be looking at  
4 multiple-year audit opportunity. And of course you're  
5 bidding it out hopefully with firms that would have an  
6 audit team in place. I think the audit team also gives  
7 the lead firm a reason to be a little more conscious  
8 about how they do work.

9           As it relates to publicly-traded companies, I  
10 think that the CPA firms that have been found in  
11 violation of SEC or PCAOB should at least be prohibited  
12 from doing work for that company for three years, until  
13 after the violations have been cleared up.

14           And finally, as it relates to policies that you  
15 see with federal contracting opportunities, the National  
16 Football League recruited minority coaches, minority  
17 firms should be given an opportunity to be joint members  
18 of audit teams that are bidding for services, especially  
19 in the private sector. We're kind of locked out of a lot  
20 of these opportunities, especially the larger ones.

21           And again, we're talking about industries. And  
22 here in California, we have large utilities. I believe

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1 that those are, again, both size, I think, and industry,  
2 are easier in a sense of trying to implement either  
3 mandatory rotation or at least an RFP after a certain  
4 period of time. I think you see it will affect your  
5 cost. I think it will make more people a little more  
6 efficient. I think they'll be more conscious.

7 Thank you very much for allowing me the  
8 opportunity to present my views, and I look forward to  
9 our discussion.

10 CHAIRMAN DOTY: Thank you, all.

11 Jeanette?

12 MEMBER FRANZEL: Well, I think it's very  
13 appropriate that we have this panel as our final panel,  
14 because you all presented all of the dilemmas and the  
15 various viewpoints that we have been hearing and that we  
16 need to weigh.

17 On the other hand, we hear that Sarbanes-Oxley  
18 Act actually has increased audit quality, and therefore  
19 maybe we don't need to, to take further steps. We hear  
20 we've got a difficult competitive landscape out there,  
21 and maybe rotation could help with that, serious fraud  
22 cases that could have potentially been discovered earlier

1 with rotation, and then the government non-profit  
2 experience with very commonly -- where they commonly use  
3 teams of audits to do joint audits and regular rotation,  
4 and that market seems to have adjusted to that just fine.  
5 So I think we've got a lot to think about here.

6 I am curious about the Sarbanes-Oxley Act  
7 increasing audit quality. And maybe to the extent that  
8 all of you can speak to this, what specifically have you  
9 seen that you can say has increased audit quality in your  
10 experience? And I would ask all of the panelists to  
11 address that question.

12 MR. FOLLETT: Well, I'll go ahead and start us  
13 off. You know, I've seen it on almost every level.  
14 Starting, first and foremost, the relationship that we  
15 have as the audit firm with the audit committee, and  
16 specifically the chair of that audit committee is just  
17 dramatically different than it was.

18 And, you know, the companies that we typically  
19 deal with are in the range of the, you know, market  
20 capitalizations of 30 to 40 million all the way up to  
21 north of a billion dollars in market cap, so there's some  
22 diversity there.

1           But what we've seen in, in pretty much most  
2 cases, and it took some of those companies the first  
3 early years of SOX to evolve and to see how the new world  
4 was, but the level of dialogue that we have with those  
5 audit committees is, is very similar to what you heard  
6 from the presenters from the larger companies. I mean,  
7 dialogue with committee chairs on a routine basis. I'm  
8 talking about, not just the, the quarterly issues that  
9 you run into, but looking at prospective matters that may  
10 be facing the company, how they're evaluating risk, where  
11 we're seeing new areas of audit risks. And just the  
12 changing nature of the companies.

13           And the one thing that you have with companies of  
14 this size is they're, I'll use the term volatile. And  
15 what I mean by that, there's usually something going on.  
16 They could be evaluating a transaction; they, sometimes  
17 they get acquired; numerous things go on in this space.  
18 And just the level of dialogue we have with the  
19 committees, that's the starting point.

20           And then that trickles down to the relationship  
21 we have with management. And certainly the interaction,  
22 our approach to our internal inspections and what the,

1 the dialogue we have with the PCAOB inspectors, it  
2 certainly, you know, did not exist pre- SOX. It's just,  
3 it's just dramatically changing in all respects.

4 And maybe I'll turn it over to you, Tom, at this  
5 point.

6 MR. GARD: Yes, I think I'd echo what was just  
7 said as far as the engagement of the audit committees.  
8 The market cap -- the companies that we audit, their  
9 market cap is very similar to what, what was just  
10 indicated that Moss Adams handles as well. But the, the  
11 engagement of the audit committee has improved  
12 dramatically. Clarifying or maybe emphasizing their role  
13 and their responsibilities has really led to active  
14 engagement on their part.

15 I think a couple other thoughts too, is requiring  
16 the certification of statements by the CFO and CEO. In  
17 some cases, perhaps that is focus the CEO a little more  
18 clearly that he's signing off as well, that he needs to  
19 know what's happening in some of those areas in some of  
20 those key decisions, the fact that they're looking at,  
21 I think increased internal control awareness, just the  
22 whole -- whether it's tested or attested to by the

1 auditors or not, the companies having to go through and  
2 make sure that their internal control systems are in  
3 place and functioning on a quarterly basis I think has  
4 led to some great improvements in that area.

5 MR. REGAN: I would agree that both the  
6 strengthening of the audit committee and the  
7 certifications have enhanced awareness and the importance  
8 of accurate financial reporting. I think the strength  
9 of the individuals on the audit committee has been  
10 improved. My own personal practice and chair of the  
11 audit committee of a public company is, I very much  
12 wanted the engagement partner and the concurring partner  
13 to have my home phone number, my work phone number, my  
14 email address, and I got calls at night, I got calls on  
15 Sundays to discuss anything that was concerning the audit  
16 partner.

17 However, in the audit frauds that I've looked at,  
18 the auditor and management have been very careful to not  
19 include the audit committee members in an understanding  
20 and an awareness of the matters which eventually turn to  
21 restatement and were found to be improper GAAP reporting.  
22 So the audit committees are walled off in those

1 circumstances. And unfortunately I see circumstances  
2 where people are dishonest. And so I have a distorted  
3 perspective and a bad sample size.

4           That's why when I look at your sample size, it's  
5 2,800, and when I see that you too are experiencing  
6 hundreds of the significant deficiencies, I'm wondering  
7 how bad my sample size is. My sample size for  
8 significant audit failure is probably less than a  
9 hundred, but it's getting close to a hundred.

10           MR. VASQUEZ: Well, I happen to sit on both sides  
11 of the fence as an audit committee chair. I can see that  
12 the firms are better versed on all the issues that our  
13 clients seem to have, at least I think on the  
14 organizations and companies that I sit on; more frequent  
15 communication.

16           I think on our firm side, the big difference is  
17 auditor skepticism. I think, I think that in the old  
18 days you just kind of presumed that things were okay. Now  
19 you come in and you take a look, you're always concerned  
20 about internal controls, you're always concerned about  
21 -- you do a background check on people. So you really  
22 are better trained, more willing to ask the tougher

1 questions, required to ask the tougher questions, and  
2 understanding that at any point in time you can get sued.  
3 And so that certainly makes you want to do a better job,  
4 and I think that's why we do a better job as well.

5 MR. REGAN: In my prior answer, I don't mean to  
6 imply that the auditor was dishonest. The fraud resided  
7 with, principally within management. Parmalat may have  
8 been a different situation. There are some situations  
9 where perhaps the auditor was involved in the fraud. The  
10 auditors tend to have a lack of professional,  
11 professional skepticism and acceptance of client  
12 representations, and a failure to gather persuasive  
13 evidence. And when you got a dishonest client, that's  
14 not going to lead to a good result many times.

15 MEMBER HARRIS: Do you have any wrap-up thoughts  
16 in terms of how the profession or the PCAOB can further  
17 enhance investor confidence in the audit?

18 MR. REGAN: Well, I think the database of  
19 solution probably resides within your 2,800 inspections.  
20 It preceded 2010. On that, I think you've got to analyze  
21 those failures that occurred, and those failures that are  
22 repeating.

1           And within that analysis, you have to make a very  
2 difficult decision of whether things like audit firm  
3 rotation is, you know, the balance of -- is it going to  
4 be costly. Certainly it's going to be disruptive in the  
5 public accounting world and in the client world. But  
6 you're going to have to -- you're armed with that  
7 information, and you're going to have to make that  
8 assessment.

9           Again, in my experience, firm rotation would  
10 likely have shortened the period of time or precluded  
11 many of the frauds that I've seen. So that -- and you're  
12 doing that. And this is not an easy task, I'm sure,  
13 because the comment letters that I read are not very  
14 favorable toward this, but I believe it would improve  
15 audit quality and significantly.

16           MR. GARD: I think the step has to be, in some  
17 respects, me as an auditor, I'm looking for causation and  
18 analyzing the results of your inspections, and being able  
19 to -- right now we're saying there is no direct  
20 correlation, or you haven't found a direct correlation  
21 between audit tenure and audit deficiencies. I think  
22 that causes a lot of problems for people, seeing that

1 this could be a solution, mandatory audit rotation.

2           Somehow, better analysis of that data, and being  
3 able to extract root cause for significant deficiencies  
4 or audit failure I think is the step that needs to be  
5 done.

6           MR. VASQUEZ: One other note. You mentioned  
7 auditor-only firms. I think that that would cause more  
8 opportunities for more CPA firms. Clearly, if you have  
9 auditor rotation, that's also going to expand the number  
10 of firms that can grow in expertise. Right now you have  
11 the vast majority of registrants are with four firms.  
12 I think that's never a good policy. That's never a good  
13 business for America. So this is maybe another item to  
14 think about.

15           MR. FOLLETT: I'll just add that when listening  
16 to testimony, including our own panel, it seems to me  
17 that the issue tends to go back to two fundamental  
18 questions or issues. And that is, the first is, again,  
19 this fresh eyes argument. Getting a different group of  
20 people, whether it's a different firm, just different  
21 individuals to look at the issues at a company in both  
22 an audit and accounting perspective.

1           And, you know, I would argue that what we have  
2 seen with the audit, the audit partner required rotation,  
3 the concurring partner rotation, and then the other  
4 limitations on other partners involved with the  
5 engagement, you have a natural evolution of teams and the  
6 people who are involved. You don't have the same staff  
7 accountant working on engagements year after year,  
8 because obviously they progressed in their career. So  
9 when you look back on the history of tenures, you have  
10 different people involved.

11           And in addition, you also have different people  
12 involved with the company, managements change, internal  
13 auditors come in. And so I think we're getting fresh  
14 eyes today under the current system that we have. I  
15 think we just need to identify where are those areas  
16 that, that within that construct, need to be addressed,  
17 where maybe there isn't the level of skepticism that we  
18 need to have.

19           The other issue has to do with the issue of pay  
20 model. And I do think that you do need to take a look  
21 at -- the firms need to take a look at, is there any one  
22 client or a series of clients that individually, you

1 know, for the firm, for an office, for a partner, is  
2 significant to the level you would certainly, from an  
3 independent standpoint, question whether or not someone  
4 could be objective if, you know -- an extreme example,  
5 you have one audit firm that has one audit client that  
6 represents a hundred percent of their fees, there would  
7 certainly be an issue there.

8 I think that what you find, and certainly I can  
9 speak for my own firm, is that any one client represents  
10 such a small fraction of one percent of certainly the  
11 firm's revenue's, or even an office's percent of  
12 revenues, that, you know, it just doesn't -- it  
13 intuitively does not make sense why a firm would risk it  
14 all, from a litigation, regulatory risk, a reputation  
15 risk, to make -- to be inclined to make decisions that  
16 would put it all on the table for such a small percentage  
17 of the -- of the revenues of the firm.

18 So again, I think that looking at the underlying  
19 causes of deficiencies, of the magnitude of those  
20 deficiencies that the inspectors are finding, and the  
21 cause of audit failures, is really the focus. And, you  
22 know, that's my thoughts.

1           MEMBER FERGUSON:  And one of the things that's  
2 been mentioned by panels today, including, I believe on  
3 yours, although everything is sort of beginning to run  
4 together for me now, but was that it would be helpful,  
5 in an alternative to rotation, it would be helpful if  
6 audit committees had a better understanding of sort of  
7 the PCAOB inspection process and how it works and what  
8 it means.

9           And one of the ways -- you know, because we do  
10 have a lot of knowledge about audit firms, and it's very  
11 detailed knowledge -- one of the things is that, you  
12 know, part of our inspection reports are not public.

13           As people who are inspected by the PCAOB, would  
14 you be willing to, and what do you think about sharing  
15 the non-public portion of your PCAOB inspection reports  
16 with, with your audit clients as their evaluating  
17 auditor?  Because you can do that.  We can't share it,  
18 but you can.  What do you think about that?

19           MR. FOLLETT:  Well, I guess maybe I'll start.  I  
20 think that, you know, certainly my firm would be open to  
21 that.  And we have the dialogues with audit committees  
22 of what we're seeing, whether it's inspection questions

1 that are raised by the inspectors during their work at  
2 our firm, or trends that we're seeing. You know, when  
3 we started seeing the trends with the level two, level  
4 three issues that were coming out within the inspections,  
5 is that having that level of dialogue with audit  
6 committees, proactively letting them know where we're  
7 seeing areas of risk, how we're modifying our audit  
8 accordingly to address those matters, you know, is  
9 important.

10 I would suggest that -- I don't want to get  
11 myself in trouble -- but I think it would be beneficial  
12 as to the inspection process, because as you know there's  
13 sometimes a very significant time lag between the  
14 inspection and the posting of the report, is that maybe  
15 there's an interim step where the inspectors can come  
16 back with, you know, early indications of areas to focus  
17 on, or things that they're seeing in terms of best  
18 practices at the other firms, or early indications from  
19 the findings without having to wait; which, you know,  
20 many times is more than a year from the inspection until  
21 the posting of the report. So the firms can more quickly  
22 react, have those communications with audit committees

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1 and address risk, you know, further in advance than they  
2 can today.

3 MR. GARD: I think actually our firm would be  
4 very happy to share that information. We actually do  
5 discuss that with our clients. We've had the luxury of  
6 having -- we've been through three inspections as well,  
7 and our results have been very good. We do a lot of  
8 private companies as well, and certainly people are  
9 always asking about our peer review results and any  
10 comments and things like that. And that's something that  
11 we routinely share with prospects or clients and so  
12 forth. I think it's important information for them to  
13 know the quality of the firm that they're dealing with.

14 MEMBER FERGUSON: What about sharing also to the  
15 extent that you had a finding, or a part two finding,  
16 sharing your experience in the remediation process and  
17 keeping your clients up to date in terms of that, how's  
18 the remediation going, what are you doing in terms of  
19 remediation, what about that?

20 MR. GARD: Well, I think that would be important.  
21 That would probably be the second step. If you had a  
22 finding, I logically would want to say, here's what we're

1 doing about it, and here's why we believe we've addressed  
2 that issue, here's the things that we put in place to  
3 address it, and how it will be prevented in the future  
4 and so forth.

5 So again, just, I think, open dialogue about that  
6 information, any findings that might be there and steps  
7 being taken, is part of a very positive, healthy  
8 relationship between the client and the auditor.

9 MR. FOLLETT: Well, I would add that once you  
10 start to raise inspection findings, you're almost forced  
11 to then discuss the remediation effort the firm is  
12 taking, you know, and how you reacted to that by its  
13 nature.

14 MR. VASQUEZ: Our firm's been through three PCAOB  
15 inspections as well, and I would echo everybody else's  
16 comments. Also, as chair of the audit committee, I would  
17 definitely want to know what is going on when there is  
18 a remediation.

19 MR. REGAN: Speaking as an audit committee member  
20 or chair, I would like to be informed and have that be  
21 as transparent a process as possible, and I would like  
22 the communication to start as early as possible. I mean,

1 waiting until a year after is something that I would  
2 really like to avoid. I'd like to be aware of the issues  
3 soon as possible. And I would like to understand the  
4 remediation that is, that is going on. I think it's a  
5 very important communication.

6 MEMBER HANSON: Your firms, you've described,  
7 have significant practices in companies that are not  
8 subject to our oversight, non-public companies and public  
9 sector clients. One of the challenges that I would like  
10 you to just tell me if you find it a challenge and how  
11 you're dealing with it.

12 On the plane here yesterday, I was dutifully  
13 reading my Journal of Accountancy and I think you're all  
14 members of the AICPA, and I am too, and the Journal of  
15 Accountancy generally is full of really insightful  
16 articles about ways for CPAs to provide more services to  
17 their clients. It's really about client service from the  
18 perspective of serving the needs of management. And  
19 we've had a lot of discussion here today about serving  
20 the needs of the investors. And Steve Harris is real  
21 good about asking who the client is, and we've had a  
22 discussion about that, that in public company audit, the

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1 auditor's client is really the investors.

2           How do you balance that messaging that your  
3 professionals are often presented with that the  
4 profession is about growing services and selling services  
5 to clients, and the client is defined as management  
6 versus what we're finding challenges with, is resetting  
7 that so that auditors and public companies really think  
8 first about the needs of the investor, not about the  
9 person sitting across the table from them, that they're  
10 debating a particular accounting issue?

11           And you don't all need to respond to that, but  
12 I'll just pick on Tom and Dave for reactions.

13           MR. GARD: Okay. It is a challenge. Within our  
14 firm we probably do about 80 percent of our audit work  
15 is for privately-held companies versus about 20 percent  
16 publicly traded. I would say, I guess, first of all, we  
17 started -- our audit process is very similar. Our risk  
18 assessment and everything, really we address the risks  
19 in the same manner. But there's always a keen awareness,  
20 well, who is, who is the client, who is the reader of the  
21 financials. And it might not be the client, it might be  
22 a financial institution, is the main reader of those

1 financials for a bank loan or whatever. But who, who is  
2 the ultimate reader of those financials, and what's  
3 important to them.

4 That helps us dictate some of our materiality  
5 considerations in different ways that we look at  
6 different things, whether it's a per share calculation,  
7 whether it's measure of equity, whether it's a variety  
8 of different things, much so that is a very, very  
9 important step in our risk assessment.

10 But I think having said that, still, and I guess  
11 it -- while it's not universally true, most of the people  
12 that work on our publicly-traded clients primarily work  
13 in publicly-traded clients, mostly because of their  
14 knowledge about the different regulations of the SEC and  
15 the different forms and filings and so forth. Although  
16 it's not universally true, they still do some private  
17 work. But I think that helps. Since they're primarily  
18 centered in that market, they're typically, as they're  
19 going through the risk assessment, thinking about its  
20 investor and its per share information is important in  
21 a variety of different aspects in that respect.

22 Ultimately, the goal is the same: getting the

1 right answer. Applying the appropriate test work in the  
2 various areas to make sure that you've minimized audit  
3 risk and gotten to the right answer. But we have  
4 planning meetings, interactive planning meetings on every  
5 engagement with the audit partner manager, the entire  
6 team to do brainstorming, obviously, and a variety of  
7 different techniques and thought processes. And one of  
8 those is very, very definitely centered on who's the  
9 ultimate reader here, who's the client, who's the reader,  
10 let's design our procedures in an appropriate manner.

11 MR. FOLLETT: Well, I guess my comments would  
12 echo Tom's. You know, it's interesting when you have a  
13 client base like ours, where you're going to, you know,  
14 have to audit the Port Authority, to benefit plans,  
15 there's a number of, you know, things that we are  
16 involved with that, they're not a listed public company,  
17 but they're in the public interest.

18 And so from a tone at the top, whether it comes  
19 to, you know, our approach to the audit, assessment of  
20 risk, who are the users of the financial statements, and,  
21 you know, who's investing in this company, I mean, it  
22 could even be a private equity firm or a hedge fund of

1 that nature, you know, we do start with the same, the  
2 same starting point. But akin to Tom, for those of us  
3 who have chosen in our careers to, to be a public company  
4 auditor, you know, there is obviously the heightened  
5 level of -- everything with independence rules, and, you  
6 know, we don't, we don't delve into gray areas.

7 I mean, there's certainly the prohibited services  
8 that, that have been outlined, but you'd be pleased,  
9 there's many times we get into conversations about a  
10 particular service or something that's being requested,  
11 and we say, you know, let's just not go there, because  
12 it's just, we don't even want to even get close to that  
13 line. So, you know, there's differences with what I  
14 guess on some level once you start getting down to, you  
15 know, a particular service or the needs of the client,  
16 and certainly some of the smaller companies we deal with,  
17 the private ones are less sophisticated, and we can use  
18 our services in different ways. But there's a line. But  
19 I would say the tone at the top is really the key on, on  
20 everything that we do from an assurance perspective.

21 MR. GURBUTT: Thanks. I guess I have a question  
22 that's specifically related to a remark that Mr. Follett

1 made in his opening remarks, but I'd also be interested  
2 in the views of the rest of the panel.

3           You said in your statement that there would be a  
4 disproportionate burden on middle markets and smaller  
5 public companies as a result of mandatory rotation. And  
6 I guess I just wanted to understand that a little bit  
7 more. And I think my immediate question would be: Why  
8 is it that smaller companies change their auditors more  
9 frequently than larger companies, if that's the case?

10           MR. FOLLETT: Well, I think the comment's  
11 alluding to the fact that -- well, and I do understand  
12 -- and some of the previous panelists do have  
13 limitations, given the industry and the size and  
14 complexity of their international business, they have  
15 certain limitations on the ability to rotate. But in  
16 terms of the cost, the teams involved, sometimes there's  
17 geographic location, there's a number of other factors  
18 that affect the smaller to middle-size, mid-market type  
19 companies that also have an implication.

20           And again, where some of the larger ones aren't  
21 likely to have a transaction, I mean, I could foresee a  
22 situation. I mean, I'm often in conversations with these

1 companies about, you know, are they going to do a private  
2 transaction? Are they going to do an acquisition? Are  
3 they going to be acquired by another company? Well, you  
4 could see situations where they're coming up to the  
5 mandatory period and being forced to change due to  
6 regulation when they are in the midst of doing something  
7 that could, you know, materially change their company.  
8 And you see more of those types of transactions that, you  
9 know, that have huge impacts on the companies, I think,  
10 in the space that we operate in.

11 MR. VASQUEZ: I think it's easier for small- and  
12 mid-market companies to change, because if you're unhappy  
13 with a partner, it's a lot easier to change if you're  
14 smaller and the firm's smaller.

15 Cost, I've noticed, always seems to be a factor.  
16 It seems like all the smaller companies I've sat on, when  
17 we change auditors, rarely does the cost go up. And the  
18 costs have a way of creeping up just slowly but surely  
19 the longer you're there. It's just like salaries of  
20 individuals that work for companies for a long time; one  
21 day you look up and you say, gee, how did this happen?  
22 And so I think that's part of the reason as well.

1           MR. REGAN: I think at some point, in terms of a  
2 company's size, particularly -- not merely its total  
3 assets or sales, but how many countries is it in and its  
4 geographic dispersion, they may be asking themselves: are  
5 we too big to rotate? And I think that's -- that may be  
6 a practical and important question, but some of those  
7 companies may need to rotate. And they may be forced --  
8 they may never rotate unless forced to.

9           CHAIRMAN DOTY: Brian Croteau.

10          MR. CROTEAU: Just quickly, and it may be  
11 somewhat rhetorical, and it may be a question for David,  
12 picking up on a loose point. And I'm asking you because  
13 you said it most recently, but I've heard it from other  
14 firms, and so I thought I would raise it.

15          The point about more timely inspection reports is  
16 a good one. I know it's a point that the PCAOB has  
17 focused on, as well as thinking about other ways to get  
18 broadly more information about inspections out sooner.  
19 But at the same time, don't firms have an opportunity,  
20 relative to inspection comment forms and sort of at the  
21 end of inspection field work, and results of internal  
22 inspections, to really make use of that information much

1 sooner than the time when an inspection report is issued?

2 MR. FOLLETT: Yes, absolutely. I mean, we do  
3 have the dialogue during the inspection period. But you  
4 understand when you have the time lag, you know, it's  
5 better to have more information, I guess, sooner. And  
6 so I think, even if it wasn't the issuance of the report  
7 sooner, but just to even have the opportunity for a more  
8 robust exit interview process than I think we're  
9 currently afforded under the inspection regime, I think  
10 is just, you know, an option for you.

11 CHAIRMAN DOTY: Other Board questions? Marty?

12 MR. BAUMANN: Just one more question. In  
13 discussion a number of times today, should audit  
14 committee members get copies of part two, should you  
15 discuss part two with them? I'm just interested in your  
16 view.

17 Do you think the audit committee members have a  
18 -- would get value out of part two in the sense that --  
19 would they understand it, have context, maybe they'll --  
20 does part two indicate a certain type of deficiency in  
21 your firm? Do they have the ability to put that into  
22 context as to: how important is that in your firm? How

1 is it in relation to other firms? So would that, in  
2 fact, be useful?

3 MR. GARD: Well, I think some of the comments  
4 made earlier, that the more transparent, probably the  
5 better. And I think discussing the comment, we would be  
6 able to supply the context. We would have to fully  
7 explain what was the origin of that finding, that  
8 comment? Does it have a bigger root cause? What's the  
9 remediation? -- and so forth.

10 So, yes, I don't see any real issue as far as us  
11 being able to -- I think it would be incumbent upon us  
12 to provide context to help in the understanding of where  
13 that comment came from.

14 MR. FOLLETT: And I would add that I do think  
15 that something that has been raised by other panelists,  
16 you know, something to really consider, and that is  
17 getting audit committee members that have prior audit  
18 experience. The CFOs are wonderful, and ex-CEOs. But  
19 there's nothing better for me than to have an audit  
20 committee member who's a former auditor. So when we're  
21 discussing areas of risk, fraud risk factors, things that  
22 are changing, I mean, it's certainly very helpful to do

1 that, and I think that's something that we can certainly  
2 encourage.

3           And I have encouraged the boards that I've worked  
4 with to consider that when they have vacancies, as an  
5 alternative. And I think that's something that we have  
6 an opportunity, and that would facilitate a more robust  
7 dialogue about inspection findings. And even beyond  
8 that, just areas of emerging risk.

9           MR. VASQUEZ: I might add, it also helps when  
10 you're trying to negotiate fees.

11           CHAIRMAN DOTY: This may be an appropriate place  
12 to leave it. You represent a segment -- a section of the  
13 audit profession that we are very interested, keenly  
14 interested in hearing from, understanding and knowing  
15 more about. We don't have the chance often to see you  
16 in Washington. So one thing that this trip has  
17 accomplished is it's given us the chance to sit down and  
18 have this discussion with you.

19           It's, I think, extremely significant that Dave  
20 Follett's citing to what Sarbanes-Oxley has done by way  
21 of improving audit quality focuses on the internal  
22 control of financial reporting, the ICFR certification

1 by management, and the report by the auditors. We will  
2 be interested in seeing what the JOBS Act does to that.

3 Your views here on what the JOBS Act has done or  
4 will do to audit quality and to the benefits of Sarbanes-  
5 Oxley, as we go through the process, are going to be very  
6 interesting and very important to us. So you've made a  
7 difference today. It's been a great privilege and a  
8 pleasure to hear from you. And we hope to do more of  
9 that in the future. Thank you.

10 With that, I think we can adjourn the meeting.

11 (Whereupon, the above-entitled matter went off  
12 the record at 6:36 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: PCAOB Rulemaking Docket matter  
No. 37

Before: James R. Doty, Chairman

Date: 06-28-12

Place: San Francisco, CA

was duly recorded and accurately transcribed under  
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